May 28, 2007

"Bezeq" The Israel Telecommunication Corp. Limited

Quarterly Report for the period ending 31.3.2007

Update of Chapter A (Description of Company Operations) of the Periodic Report for 2006

Directors' Report on the State of the Company's Affairs for the period ended March 31, 2007

Condensed Interim Consolidated Financial Statements as at March 31, 2007

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

Update of Chapter A (Description of Company Operations) of the Periodic Report for 2006

Update Of Chapter A (Description Of Company Operations)[1] Of The Periodic Report For 2006 ("The Periodic Report") Of “Bezeq” – The Israel Telecommunications Corp. Ltd. (Hereinafter: “The Company”)

In this report, which contains an update of the chapter regarding the description of the Group’s business from the periodic report for 2006, the Group has included forward-looking information, as defined in the Securities Law 5728-1968 (hereinafter: the “Securities Law”) with respect to both itself and the market. Such information includes forecasts, targets, appraisals and assessments which apply to future events or matters the realization of which is not certain and is not under the Group’s control. Forward-looking information in this report will usually be identified specifically, or by employing statements such as “the Company expects”, “the Company assesses”, “it is the Company’s intention”, and similar statements.

Forward-looking information is not a proven fact and is based only on the Group’s subjective assessment, based, inter alia, on a general analysis of the information available at the time of drafting of this report, including public announcements, studies and surveys, and they contain no undertakings as to the correctness or completeness of the information contained therein, and the Group does not independently check the correctness thereof.

In addition, the realization and/or otherwise of the forward-looking information will be affected by factors that cannot be assessed in advance, and which are not within the control of the Group, including the risk factors that are characteristic of its operations as set out in this report, and developments in the general environment, and external factors and the regulation that affects the Group’s operations, as set out in this report.

1. Description of General Development of Group Operations

Section 1.1 – Group Activity and Description of its Business Development

Section 1.1.5 – Mergers and acquisitions

With respect to the merger of the Company and DBS (sub-section A) – on May 15, 2007, the Company filed an appeal against the decision of the Antitrust Commissioner in which the Commissioner objected to the Company’s merger with DBS.

With respect to the agreement for the purchase of the operations of Tadiran Telecom – Communications Services in Israel (Limited Partnership) (the “**Partnership**”) by the subsidiary BezeqCall Communications Ltd. (which has, in the meantime, merged into the subsidiary Bezeq International Ltd.) – in April 2007, the agreement was rescinded in light of the decision of the Antitrust Authority not to allow the transaction, and following notice by the Partnership of a decision to rescind the agreement.

2. Fixed-Line Domestic Communications –

“Bezeq” – The Israel Telecommunications Corp. Limited (“the Company”)

Section 2.1 – General information on areas of operation

On June 1, 2007, the Communications (Telecommunications and Broadcasts) (Payments for Telecommunications Services) Regulations, 5767-2007 and the Communications (Telecommunications and Broadcasts) (Calculation and Linkage of Payments for Telecommunications Services) (Amendment) Regulations, 5767-2007 are expected to come into force. Under the draft regulations that the Company has received, and based on the draft tariff update set out in the Communications (Telecommunications and Broadcasts) (Calculation and Linkage of Payments for Telecommunications Services) Regulations, 5763-2003, reduction of the Company’s supervised tariffs as of June 1, 2007, is expected to be at an average rate of approximately 3.13%. This reduction is

[1] The update is pursuant to Article 39A of the Securities Regulations (Periodic and Immediate Reports), 5730-1970, and includes material changes or innovations that have occurred in the corporation in any matter which must be described in the Periodic Report. The update relates to the section numbers used in Chapter A (Description of Company Operations) in the Company's Periodic Report for 2005.

based on a reduction of approximately 0.1% in the consumer price index less the average rationalization coefficient at a rate of approximately 3.038%. Likewise, the Communications (Telecommunications and Broadcasts) (Payments for Interconnect) (Amendment) Regulations, 5767-2007 are due to come into force on the same date, prescribing that the reduction of interconnect tariffs as of June 1, 2007 is expected to be at a rate of approximately 4.01%. The aforesaid tariff update is expected to have a substantial adverse effect on the Company's revenues from services the tariffs for which are under supervision as aforesaid. In addition, the draft regulations include a new arrangement for providing a discount in monthly fixed fees for subscribers entitled to a pension under the Assurance of Income Law, 5741-1980. If this arrangement is approved, it will come into force under the draft regulations on September 2, 2007 in lieu of the reduced usage fee arrangement, and therefore, it is not expected to have a substantial effect on the Company's revenues.

Section 2.1.9 – structure of competition in the areas of operation and changes thereto

Competition in this sector is also dependent upon the recommendations formulated by the Grunau Commission regarding the communications industry in Israel, and on the way in which those recommendations are adopted and applied.

Section 2.2 – Products and Services

Section 2.2.3 – internet access services

The number of the Company's ADSL subscribers, as at March 31, 2007, is approximately 911,000 subscribers (compared with approximately 891,000 subscribers at the end of 2006).

Section 2.2.5 D – IP-Centrex

The Company has submitted a service portfolio to the Ministry of Communications.

Section 2.5 – marketing, distribution and service

Section 2.5.1 – the Company operates 17 points of sale and service (BezeqStores) around the country.

Section 2.6 – Competition

With respect to the Commission for Formulation of Recommendations regarding Policy and Rules of Competition in the Field of Communications in Israel (the "**Grunau Commission**"), the Company's initial position as expressed in a document submitted to the Commission is as follows:

The Commission is to create a clear regulatory horizon for the entire communications market, and for the Company in particular, so as to enable the Company to provide better and more efficient services, including upgrading the Company's infrastructure by investing in an advanced communications network (the New Generation Network – NGN) which is a precondition for innovative communications services such as IPTV (a service for provision of digital television services for subscribers over internet infrastructure). In the absence of such a horizon, the Company cannot continue investing the sums involved.

The Company also requests that the Commission give the Company a real possibility for dealing with competition by way of: absolute tariff flexibility; absolute freedom in marketing service packages; absolute cancellation of the structural and corporate separation duties, amendment of the Company's license to permit the Company to provide IPTV services.

Likewise, as with many other countries around the world, the Company expects to be given a regulatory safety net in which it was have exclusivity of use of the NGN network and of provision of services on such network for 5 years from the date on which the network becomes available.

The Company further explains that the "normative revenue" test currently used by the Ministry of Communications as a basis for prescribing the date on which the market is to be opened to competition is an inappropriate test. The Company wishes to convert the existing formula for calculating loss of market share by the Company so as to prescribe a time barrier, based on the earlier of January 1, 2008 and a drop below 85% market share, according to the Ministry of Communication's method. Since if this is not done, then the Company's commercial rivals will in fact have the power to determine when, if at all, true competition will commence in the communications market. Likewise, with respect to competition under a model enabling unbundling (the significance of which is to force the Company to sell infrastructure components to competitors), the Company clarifies that the Grunau Commission shall be required to adopt the recommendations of the previous committee which dealt with rules of competition (the Kroll Committee), to the effect that competition in the communications market must be based on independent infrastructure.

On May 27, 2007, the Company presented its position to the Commission, and is expected to continue presenting its position at the next session that is set down.

The Commission's recommendations, which are supposed to relate to matters that are of the greatest substance to the communications market and to the Company, might bring about changes in the rules of competition employed to date, and the Company is unable to estimate the trends or influences that these may have.

Section 2.6.1 – telephony

With respect to the petition filed by the Company to the High Court of Justice regarding breach of the duty of structural separation by HOT – on April 1, 2007, the Company received a ruling of the Court, following the consent of the parties, that the Ministry of Communications would make a decision within 6 months regarding structural separation of HOT. After receipt of the Ministry's decision, the parties will submit an updated notice in that regard to the Court, following which, a decision will be made as to continued handling of the petition.

On May 2, 2007, the Company contacted the Ministry of Communications, requesting that it be informed as to the full exercise of the Ministry of Communications' instruction to HOT (based on the Ministry's notice to the High Court of Justice) to appoint separate chief executive officers to HOT Telecom and HOT Cable Communications Systems, without any the one being administratively subordinate to the other, and to make the entire administrative level of HOT Telecom subordinate to the chief executive officer to be appointed to that corporation, no later than May 1, 2007. On May 21, 2007, the Director General of the Ministry of Communications responded to the Company that HOT had informed the Ministry that it was intending to act in order to implement the provisions regarding appointment of separate chief executive officers.

Section 2.6.4 – Competition by cellular companies

With respect to the refusal of the Antitrust Commissioner to alter the monopoly declaration pertaining to the Company in the field of fixed-line telephony services, the Company is looking into submitting a new, updated application.

Section 2.6.6A – Numbering and number portability

On May 24, 2007, the Company received a notice from the Director General of the Ministry of Communications, stating that he is considering imposing a financial sanction on the Company under Chapter G1 of the Communications Law, 5742-1982, in respect of violation of the duty to provide number portability commencing 1.9.06, as follows:

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

2. For the period from May 25, 2007 to November 30, 2007 or until the date of remedy of the alleged violation (whichever is earlier) by the Company – NIS 6,450 for each additional day the violation continues.

3. For the period from December 1, 2007 (which is, according to the notice, the reasonable date required by the relevant licensees to remedy the alleged violation) until the date of remedy of the alleged violation – a financial sanction as described in sections 37B(b) and 37C(a) of the Communications Law after Amendment 36. [It is noted that according to the provisions of those sections, the rate of the relevant sanction is 7 times the penalty laid down in section 61(a)(4) of the Penal law (which is NIS 202,000), plus 0.25% of the annual income of the Company, plus a financial sanction of one fiftieth of such sanction for each day on which the violation continues.]

   The subsidiaries Pelephone Communications Ltd. ("Pelephone") and Bezeq International Ltd. ("Bezeq International"), received similar notices. In the Ministry's notice, the Company, Pelephone and Bezeq International were given an opportunity to state their positions to the Director General of the Ministry of Communications by June 24, 2007. As noted in the Company's Periodic Report for 2006, the Company and Pelephone (together with other cellular companies) petitioned the High Court of Justice on this matter, contending, *inter alia*, that it was the Ministry of Communications which had not prepared a number portability plan as required by the provisions of the law. The Company, Pelephone and Bezeq International are studying the implications of the notices, and each of them will respond accordingly.

Apart from that, it should be noted that the Company is preparing itself for the operational and marketing consequences of implementation of the number portability program. Note that at this stage, it is not possible to assess the extent to which the Company's revenues will be harmed.

Section 2.6.7 – the Company's preparations for coping with increasing competition

With respect to sub-section (g) regarding agreements with business customers – on April 11, 2007, following the setting aside of the Company's petition to the High Court of Justice, the Ministry of Communications forfeited the sum of NIS 8 million out of the guarantee deposited by the Company under the provisions of its general license.

Section 2.6.8 – negative factors affecting the Company's competitive status

Competition – the extent to which competition affects the Company depends, as aforesaid, on the recommendations of the Grunau Commission on communications in Israel, and on the manner in which such will be adopted and applied, and the Company is unable to assess what these might be.

With respect to the Company's lack of flexibility with regard to marketing campaigns – on April 26, 2007, an additional sum of NIS 7 million was forfeited out of the above guarantee. This forfeit followed a decision by the High Court of Justice dated April 10, 2007 not to award an interim injunction in a petition filed by the Company, which has not yet been heard, against the Minister of Communications and the Director General of the Ministry of Communications, against forfeiture of the guarantee and the setting aside of the Company's appeal against such, with respect to a campaign under which call minutes were given to subscribers of the Company who purchased terminal equipment (the "Spring Campaign").

Section 2.7 – property, plant & equipment

Section 2.7.1 – fixed-line domestic telecommunications infrastructure (and section 2.6.7(j) and 2.19.2 – network

With respect to sub-section (a) (switches) – during 2007, the Company's Nortel switches are due to be upgraded to a new ISN09 switch. This upgrade is supposed to enable continued use of the Company's switching network, which is based on Nortel's switches, until the end of 2008, subject to the conditions of the agreement with Nortel. Should the Company be required to continue holding the switches beyond the above date, this will entail additional expense.

Section 2.7.4 – real estate

With respect to sub-section (c) – the total number of properties sold by the Company over the years (both before and after the settlement agreement) amounts to approximately 40 properties (in whole or in part) out of the leased properties which were privatized in the agreement for the transfer of assets, such that as at the date of this update to the periodic report, the group of leased properties numbers approximately 180 properties.

With respect to sub-section (d) – during the first quarter of 2007, the Company sold an additional 6 real estate properties, of a total area of approximately 9,200 sqm of land plus approximately 3,400 sqm built-up, at a total sum of approximately 6.92 million dollars.

Likewise, as at the date of this report, sale of the Hillel Station premises has been completed (as set out in the Company's immediate report dated November 15, 2006). The area of the premises is approximately 956 dunams, and the consideration received for sale of it is approximately $ 20.8 million.

Section 2.9 – Human resources

Section 2.9.2 – personnel according to employment framework

During the first quarter of 2007, the number of employees fell from 8,096 as at December 31, 2006 to 7,693 as at March 31, 2007 (a reduction of 403 employees) as a result of retirement of employees from the Company.

Section 2.9.6 – employee remuneration schemes

With respect to the allocation of options to two directors from amongst the employees under the option scheme for all of the employees of the Company, which requires the approval of the general meeting of shareholders of the Company – in light of publication of the interim report of the external examiner as set out in the update to section 2.20 below, and in light of the questions raised, prior to commencement of the discussion, by some of the persons present at the general meeting convened for April 15, 2007 in order to approve the allocation, it was decided that the meeting would not be held. The Company shall report the rest of the steps that it takes with respect to allocation of the options to the two directors elected from amongst the employees.

Section 2.9.7 – Company officers and senior executives

With respect to grants to office-bearers – following the recommendations contained in the report of the external examiner, Dr. Yoram Danziger, dated April 26, 2007 (see update to section 2.20 below), on May 22, 2007, the board of directors of the Company approved grants to office-bearers for 2006 in the total sum of NIS 1,059,566. In addition, the board of directors at the same meeting approved the award of grants to office-bearers for 2005 in the total sum of NIS 210,000. In the opinion of the board of directors, award of these grants does not constitute an extraordinary transaction, as that term is defined in the Companies Law, 5759-1999.

In addition, on May 22, 2007, the board of directors, having received the consent of the Audit Committee in its meetings of May 15, 2007 and May 22, 2007, approved the award of grants to the following office-bearers as follows, which, in the opinion of the board of directors, constituted extraordinary transactions:

Ika Abravanel – Deputy CEO (and as of March 29, 2007 – acting CEO) – NIS 768,000, constituting 80% of the salary in fact paid to him for 2006.

Ron Eilon – Deputy CEO and Chief Financial Officer from October 11, 2005 until August 28, 2006 – NIS 640,000, constituting 80% of the salary in fact paid to him for 2006 for the period of his employment by the Company.

Yuval Rachlevsky – VP Human Resources as of April 1, 2006 – NIS 540,000 constituting 80% of the salary in fact paid to him in 2006.

No discussion was held and no resolutions were passed regarding the grants paid to the former CEO of the Company Mr. Yacov Gelbard, for 2005 and 2006 and his obligation to return the respective grants to Pelephone and to the Company still remains.

Some of the office-bearers will repay the Company the difference (if any) between the grants they received in the past and the grants approved for them as aforesaid. The total repayment is approximately NIS 590,000 (all of the sums set out above are in gross terms – before tax).

In this regard, see also the Company's immediate report dated May 22, 2007.

Section 2.13 – Finance

Section 2.13.4 – sums of credit received after December 31, 2006

On May 27, 2007, the subsidiary Bezeq Gold (Holdings) Ltd. ("**Bezeq Gold**") sold 100,000,000 par value Debentures (Series 5) of the Company on the Tel Aviv Stock Exchange. The consideration, in the sum of NIS 111,900,000, was transferred to the Company as repayment of the balance of the loan granted by the Company to Bezeq Gold, for the purpose of purchasing the Debentures (Series 5).

Section 2.13.6 – credit rating

On May 1, 2007, Ma'alot, which rates all of the debenture series of the Company and Pelephone, announced that following recent discoveries and following the examination report submitted by the external examiner (see update to section 2.20 below) regarding subtraction of property plant and equipment at Pelephone, at this stage, no change is expected to be made to the rating of Pelephone's undertakings or the Company's undertakings.

Section 2.13.7 – estimate of raising funds in the coming year (2007) and sources of financing

On May 14, 2007, the board of directors of the Company approved the raising of debt of up to NIS 1,200 million during 2007, for the purpose of the Company's debt turnover.

Section 2.15 – Environmental protection

The draft of the new Non-Ionized Radiation Regulations prescribes payment of commissions for the filing of an application for a permit for a radiation source. If and to the extent that the above regulations are approved, the Company is expected to be required to pay commissions in a sum estimated at NIS 6 million, which is expected to be spread over a number of years.

The Company wrote to the Ministry for the Environment, via the Ministry of Communications, requesting that it amend the method of calculating the safety range limit proposed in the above draft Regulations which, in the Company's view, increases the safety range beyond the current limits, meaning a reduction in the broadcast sites operated by the Company.

Section 2.16 – Limitation and regulation of Company activities

Section 2.16.2 – the Company's general license

With respect to measurement of the Company's market share, and the review dates: On April 22, 2007, a letter was received from the Ministry of Communications stating that the Ministry had commenced the process, however, it was not able to effect a quantitative review at a sufficiently reliable level, because the Company had not yet provided amended data in the format that it requested. When the data is provided, the Ministry will continue its review.

For the Company's position on measurement of the market share in the document that was submitted to the Grunau Commission, see the update to section 2.6 above.

Section 2.16.7 – Antitrust Laws

With respect to the Antitrust Commissioner's investigation of May 2006 – on May 27, 2007 the Company received notice from the Antitrust Authority (the "**Authority**") stating that the Antitrust Commissioner (the "**Commissioner**") is considering a determination, pursuant to her authority under Section 43(a)(5) of the Antitrust Law, 5748-1988 (the "**Law**"), that the Company abused its status, contrary to the provisions of Section 29A of the Law, in view of the findings of an investigation carried out in recent months by the investigations department of the Authority. The notice states that the Commissioner is considering determining that –

1. In the first half of 2006, and in particular in April and May 2006, the Company's employees imposed sanctions concerning delay in the performance of works or not performing works for the connection or expansion of an existing connection of domestic operators to the Company's network.

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

3. The Company failed to act as required in order to prevent or minimize these events and the harm to domestic operators, competition and the public.

4. In this way, the Company abused its status, in contravention of Section 29A of the Law.

The notice also states that before the Commissioner makes her decision, the Company is given the opportunity to state its position to the Commissioner by June 17, 2007.

It is noted that under Section 43(e) of the Law, such a determination by the Commissioner, if and insofar as made, will serve as *prima facie* evidence of the contents of the determination in any legal proceedings.

The Company is studying the notice and intends to exercise its right to a hearing.

Section 2.16.8 – the Telegraph Ordinance

With respect to the disputes with the Ministry of Communications regarding frequency levies and the Ministry's requirement that the Company pay such – the Company is conducting clarification proceedings with the Ministry with respect to such disputes. The principal sum in disputes amounts, as at March 31, 2007 to approximately NIS 46 million.

Section 2.16.9 – proposed legislation regarding termination of contractual relations

On May 14, 2007, another hearing was held in the Economics Committee of the Knesset, but the statute has not yet received the full approval of the Committee.

Section 2.18 – Legal proceedings

For updates on the subject of legal proceedings, see Note 8 to the financial statements of the Company for the period ended March 31, 2007.

Section 2.20 – Event or matter outside the normal course of business

Sub-section (b) – appointment of external examiner

A. On April 12, 2007, the Company published an immediate report setting out the interim report of the external examiner. On the same date, the board of directors of the Company held a discussion of the interim report and appointed a committee of the board of directors which was authorized to examine the immediate steps which the findings of the interim report required be taken. Likewise, the board of directors agreed to the request of the CEO of the Company, on the date, to extend his leave of absence until discussion by the board of directors of the final report of the external examiner, and determined that up until such date, Mr. Yitshak (Ika) Abravanel would continue to act in lieu of the CEO.

B. On April 26, 2007, the Company published an immediate report setting out the final report of the external examiner. As a result of that, on April 30, 2007, the board of directors of the Company held a special meeting on the final report, and decided, *inter alia*:

1. To authorize a joint notice, signed on April 30, 2007 by the Company and Mr. Yacov Gelbard, a copy of which was attached to the Company's immediate report of the same date, to the effect that Mr. Gelbard's office as CEO of the Company would terminate on April 30, 2007.
2. To set up a committee to find a new chief executive officer for the Company, the committee to recommend a candidate or candidates for the position of CEO to the board of directors.
3. Mr. Ika Abravanel will continue acting in lieu of the chief executive officer of the Company (until a resolution to some other effect is passed by the board of directors).
4. The audit committee of the board of directors is to endeavour to find a candidate to act as permanent internal auditor of the Company.
5. To recommend to the audit committee to appoint external director Mr. Eyal Yaniv as chairman of the audit committee.
6. To appoint a secretary for the Company and an external legal counsel to the board of directors, in addition to the Company's General Counsel.
7. To make immediate changes to some of the working procedures of the board of directors and its committees so that minutes of discussions are detailed, the meetings are held in Hebrew (and where necessary, with simultaneous interpretation into English), and so that the board of directors holds a meeting on the last Thursday of every calendar month, at which it shall discuss the ongoing management of the Company, and at which the managers of the Divisions of the Company and by the CEOs of the subsidiaries shall present reviews of operations to members of the board of directors.

In addition, the board of directors received a review from the committee comprised of members of the board of directors which had been set up for the purpose of examining the board's working procedures as a result of the interim report by the external examiner. This review related, *inter alia*, to prescription of a new and more detailed set of work procedures for the board of directors, committees of the board, reporting and control of the subsidiaries (from the point of view of the board of directors) subject to regulatory restrictions, internal audit and management reports to the board of directors. The committee was asked to submit a final report to the board of directors within 30 days of April 30, 2007. (Accordingly, and at the committee's request, on May 28, 2007, the board of directors of the Company authorized postponement of the filing of the final report by thirty days.)

C. Note that on May 1, 2007, an application was received at the offices of the Company pursuant to Article A of Chapter 3 of Part V of the Companies Law, 5759-1999 (derivative claim), sent by a plaintiff claiming to be a public shareholder in the Company. According to the applicant, in his final report the external examiner indicates a long list of failures and deficiencies relating directly to the procedures of the board of directors, the committees of the board and the members of the board of directors and the former CEO of the Company, and the significance of a large portion of the findings of the report is that those directors and other officers of the Company who were involved in passing the various resolutions in the Company prima facie breached their duty of care and/or trust. Therefore, the application requests that the Company take legal steps against the directors and other officers of the Company who were responsible for such. The Company is examining the application and shall respond to it in accordance with the provisions of the Companies Law.

D. It should be further noted that on May 13, 2007, a claim was received at the offices of the Company together with an application to recognize it as a class action, submitted by a plaintiff who claimed to have purchased shares in the Company in 2006. The claim was filed against the Company, two former CEOs of the Company, directors acting at the time relevant to the claim or at present on the Company and against Ap. Sab. Ar. Holdings Ltd, which holds 30% of the shares of the Company. The claim relates to the allegation that the financial statements of the Company for 2004 and 2005 included substantial information that was false and misleading, including with respect to the annual profit, property plant & equipment and shareholders' equity, in light of the Company's notice in an immediate report dated March 26, 2007 regarding a retroactive subtraction of approximately NIS 320 million in property plant & equipment which was not in use by the subsidiary Pelephone Communications Ltd. According to the Plaintiff, he suffered damage as a result of publication of the misleading information, *inter alia* because he had purchased shares at a higher price than that which he would have purchased had the aforesaid information been available on the market on the date on which the plaintiff purchased the shares. The Group which the plaintiff seeks to have the claim apply to is a group of plaintiffs who purchased shares of the Company in the course of trade on the stock exchange during the period between March 5, 2005 (the first day following publication of the report for 2004) and March 26, 2007 (the date of publication of the aforesaid immediate report), and held shares after March 26, 2007. The sum of the personal claim is NIS 194 and the total sum of the claim for the group is NIS 56.5 million.

E. For re-approval of bonuses for 2005 and 2006, see update to section 2.9.7 above.

3. Cellular – Pelephone Communications Ltd. ("Pelephone")

Section 3.1

Section 3.1.5.3

In May 2007, Pelephone received responses to its request for proposals (RFP) to set up a UMTS network (subject to the consent of Pelephone's competent organs), from five potential suppliers.

Section 3.7 – Competition

Section 3.7.2

As part of an examination by the Ministries of Finance and Communications of the question of operation of virtual operators in Israel (MVNO), the Ministry of Communications has hired the services of a consulting firm and has requested that the carriers provide it with information on the cellular sector, for use in this examination. The Ministry of Communications has asked the consulting firm to submit its conclusions by the end of June 2007. After receiving the conclusions, and prior to making a final decision on the matter, the Ministry is expected to hold a hearing for the carriers. Pelephone, with the assistance of a consulting firm hired for this purpose, is getting ready to present its position to the Ministry of Communications, and is preparing a response to the expected hearing.

Section 3.18 – Restriction and supervision of Pelephone's activities

Section 3.18.3.1 A

In April 2007, the Ministry of Communications published its decision regarding amendment of the license on the matter of changing the mechanism used for identifying users of erotic services as being an adult. Under the amendment, removal of the obstruction of access to receipt of erotic services is to be by way of submission of a written application together with a photocopy of an identity card or by physically appearing before a service representative. The amendment, which was supposed to come into force on May 25, 2007, has been delayed in the meantime by virtue of a temporary injunction awarded by the Supreme Court, pending hearing of the application for injunction and petition before a panel of three judgments. This injunction was given under a private petition to the High Court of Justice against this amendment, which was filed during the month of May. The petition includes an application for an interim injunction to suspend entry of the amendment into force. Pelephone intends to join this petition.

On April 17, 2007, the Ministry of Communications published a hearing document to carriers regarding repeal of a clause in the MRT licenses permitting the marketing of plans with alternate billing segments to 12 second billing segments. If the aforesaid amendment of the license comes into force, Pelephone will be allowed to market plans with 12 second billing segments only, and as of January 1, 2009, plans with 1 second billing segments only. Pelephone is currently preparing its response to the hearing.

Section 3.15 – Financing

Section 3.15.6 – credit rating

On May 1, 2007, Ma'alot, which rates all of the Company's debenture series, announced that following recent discoveries and following the examination report submitted by the external examiner (see update to section 2.20 above) regarding subtraction of property plant and equipment at Pelephone, at this stage, no change is expected to be made to the rating of Pelephone's undertakings (see also update to section 2.13.6 above).

Section 3.19 – Legal proceedings

For updates on the subject of legal proceedings, see Note 8 to the financial statements of the Company for the period ended March 31, 2007.

4. International Communications and Internet Services – Bezeq International Ltd. ("Bezeq International")

Section 4.1 – General

Section 4.1.1 – structure and changes to area of operations

In addition to the services set out in this chapter of the periodic report, Bezeq International has, since its full merger with BezeqCall Communications Ltd. ("**BezeqCall**") on February 11, 2007 (the "**date of full merger**"), been providing NEP (network end point) services ("**NEP Services**"), including data communications infrastructure services, passive infrastructure installation services and low voltage systems, sale of exchange systems including IP telephony communications systems, and provision of installation and maintenance services for these systems.

Section 4.1.2 – legislative and statutory restrictions applicable to Bezeq International

4.1.2.5 – Network End Point License

On December 31, 2006, the Ministry of Communications approved transfer of BezeqCall's NEP License to Bezeq International. As of the date of the full merger, Bezeq International has been providing NEP services under this license.

Section 4.2 – Products and Services

Section 4.2.5 – NEP Services

In the NEP Services sector Bezeq International provides: Sale, installation and maintenance of exchange systems, installation and maintenance of data communications infrastructure, installation and maintenance services for passive infrastructure and low voltage systems, placing an emphasis on integrative solutions that are tailored to business and institutional customers on their premises.

Section 4.4 – New products

As of the date of full merger, all of the products and services that BezeqCall sold and supplied at that date were received by Bezeq International. In this regard, see update to section 4.2 above – Products and Services.

Section 4.6 – Competition

Section 4.6.4 – NEP Services

The traditional field of telephone exchanges is characterized by a large number of competitors and by fierce competition, which has given rise to an erosion of prices for services. The most prominent competitors are: Tadiran, Eurocom, Telrad, GlobeCall, Gil International, Tel-Yad.

The data communications and IP telephony field is characterized by the entry of new players – IT companies – into the world of voice. These are companies such as: Binat, Teldor, Netcom, IBM. These companies are substantially different from the traditional NEP companies and are of a higher technological level. There is also a trend of communications companies conglomerating and of entry of new carriers, intending to provide customers with total communications solutions – telephony, transmission, data communications, internet, information security, etc.

Section 4.11 - Suppliers

As of the date of full merger, all of the rights and obligations of BezeqCall under joint venture, marketing and sale agreements to which BezeqCall had been a party, were transferred to Bezeq International, giving it the right to market and supply installation, support and maintenance services for the equipment sold as part of the NEP services; the most significant of these are the agreements with: LG, Nortel, Cisco and Tadiran.

Section 4.13 – Credit Policy

Section 4.13.1 – customer credit

As part of the provision of NEP services, Bezeq International effects sales to its customers by way of payments in many instalments. In this way, Bezeq International gives its customers credit, which they repay in instalments. In order to reduce the exposure which might stem from providing credit for lengthy periods to its customers, Bezeq International checks their financial resilience, sets ceilings for the maximum credit available to customers and registers a charge over the equipment sold, pending full repayment of the credit.

Section 4.14 - Investments

As at March 31, 2007, Bezeq International held 42.45% (33.66% under full dilution) of the share capital of Walla! Communications Ltd.

Section 4.15 – Finance

During the month of January 2007, Bezeq International repaid on-call loans provided to BezeqCall by a number of banks, in the total sum of approximately NIS 20.3 million.

Section 4.16 – Taxation

During the month of February 2007, Bezeq International paid income tax down payments for the 2006 tax year, in the sum of approximately NIS 36.3 million.

Section 4.19 – Legal proceedings

For updates on the subject of legal proceedings, see Note 8 to the financial statements of the Company for the period ended March 31, 2007.

5. Multi-channel television – D.B.S. Satellite Services (1998) Ltd. ("DBS")

Section 5.1 – General information on areas of operation

As at March 31, 2007, DBS had 542,248 subscribers.

Section 5.6.5 – Competition

With respect to section 5.6.5 F – VOD – on May 21, 2007, a bill for the amendment of the Communications Law was approved in first reading to the effect that, *inter alia*, the Minister of Communications was given authority, following consultation with the Council, and in the event that he finds that there is a difficulty in providing VOD services via satellite to a similar extent and in a similar format to those provided by the general licensee for the provision of cable broadcasts, to permit DBS to provide such services not via satellite.

Section 5.12 – Finance

Section 5.12.2 – credit restrictions applicable to the corporation

As at March 31, 2007, DBS was in compliance with the financial conditions under the financing agreement, following relief received from the banks in this regard, after the balance sheet date, the banks having extended the date for DBS to reach an arrangement with the Israel Aviation Industry regarding a debt to the latter, so that such debt and the call for payment of it not be deemed to be a breach by it of the financing agreement, to June 30, 2007.

Section 5.17 – Legal proceedings

For the claim of DBS v. Pace (section 5.17.1 of the Periodic Report): On March 18, 2007, the registrar of the District Court set aside the defendant's application to cancel the permit of service. On April 10, 2007, the defendant appealed that decision to the District Court, and hearing of the appeal was set down for June 11, 2007. The defendant has not yet filed a statement of defense (the final date for filing the statement of defense is July 1, 2007).

With respect to the Al-Jazeera claim (section 5.17.2 of the Periodic Report): Following negotiations, the parties have reached an agreement with respect to continued broadcast of the channel, as part of the Company's transmissions. On May 9, 2007, Al-Jazeera signed a memorandum of understanding which anchored this agreement and set out that an application to strike out the claim would be filed within 7 days of execution of the memorandum of understanding. On May 17, 2007, an application was filed to strike out the claim.

With respect to the class action regarding the Sports Channel: On February 28, 2007, the court's ruling was published stating that the value of the benefit was $ 10,000,000, and costs at a rate of 6% of the sum of the benefit were ruled for counsel for the plaintiffs, and a total sum of NIS 2,514,000 plus VAT, plus remuneration to the plaintiffs in the sum of NIS 400,000 (including VAT). DBS and the cable companies agreed that the division between the parties would be 70-30, and accordingly, on April 26, 2007, DBS's portion (30% of the total sum) was transferred to counsel for the representative plaintiff. On April 16, 2007, the representative plaintiffs filed an appeal to the Supreme Court against the sum ruled as remuneration to the plaintiffs, and an application to increase it. DBS plans to file a counter-appeal regarding appraisal of the value of the benefit (and accordingly, with respect to the fees of counsel for the plaintiffs), and with respect to the remuneration to the plaintiff.

Proceedings regarding deficit demand from the Customs Department: In December 2006, a deficit demand was sent to Eurocom Digital Communications Ltd. ("Eurocom Communications") from the Customs Department, for payment of purchase tax and VAT (including linkage differentials, interest and fines) in the sum total of approximately NIS 10 million, for decoders purchased by DBS from Eurocom Communications, and imported by it for DBS, smart cards belonging to DBS having arrived with such decoders. Eurocom Communications and DBS have mounted objection proceedings against the deficit demand, the dispute dealing with the proper classification of the smart cards for the purposes of purchase tax. DBS has provided the sureties required by the Customs Department for assurance of the taxes in dispute and DBS and Eurocom Communications have agreed that DBS will bear any payments required under the deficit demand, if any. In the opinion of DBS' and Eurocom Communications' legal advisers, there is a reasonable chance of no effective debt in respect of the sum of approximately NIS 5 million out of the deficit demand, which is in respect of VAT, and there is a reasonable chance of subtraction or cancellation of the linkage differentials, interest and fines included in the deficit demand. As at the date of this report, a decision has not yet been made with respect to the objection to the deficit demand.

Arbitration with Halal Communications: A dispute has arisen between the Company and Halal Communications Ltd. ("Halal") regarding the sum of the monthly payment to Halal for the leasing of space segments on the Amos 2 satellite under the agreement between the parties dated May 16, 2000 (the "agreement"), due to the Company's claim that it is entitled to an annual discount on the rental that it owes under the agreement, due to the number of space segments that it leases on Amos 2, whilst Halal claims that it is not entitled to such discount, since two of the segments leased from Halal are segments transferred from Amos 1. The parties negotiated in an attempt to solve the dispute, under which the Company made an ex gratia payment of the sum of $700,000 out of the sum in dispute. Further to the negotiations between the parties and to exchange of correspondence between them, on March 14, 2007, a letter was sent to the Company from counsel for Halal once again setting out Halal's position, it alleging that the Company's conduct constitutes fundamental breach of the agreement, and Halal gave notice that if the debt was not paid forthwith, the Company would be sued before an arbitrator. In a letter of March 28, 2007, counsel for the Company gave notice that the Company dismissed Halal's claims. The Company further gave notice that it was prepared to have the dispute heard by an arbitrator and that in accordance with the provisions of the agreement, it would deposit the balance of the sum in dispute in trust. An initial pre-arbitration session – in order to determine the procedures for hearing Halal's claim regarding the debt, amounting at present to $ 1,575,000, including the sum of $ 700,000 above (which increases by $ 75,000 each month) – has been set down for May 31, 2007.

For additional updates on the subject of legal proceedings, see Note 8 to the financial statements of the Company for the period ended March 31, 2007.

28.5.2007

Date

Bezeq – The Israel Telecommunication Corp. Ltd.

Names and titles of signatories:

Dov Weisglass, Chairman of the Board
Ika Abravanel, Acting CEO

Directors' Report on the State of the Company's Affairs for the period ended March 31, 2007

Chapter B of the Periodic Report

Directors Report on the State of the Company's Affairs
For the three months ending March 31, 2007

We respectfully present the Directors' Report on the state of the affairs of "Bezeq" – The Israel Telecommunication Corp. Limited (hereinafter: the "Company") and the consolidated Group companies (the Company and the consolidated companies hereinafter collectively referred to as the "Group"), for the three-month period ending March 31, 2007 (hereinafter: "the Directors' Report").

The Directors' Report contains a review, in condensed form, of the matters dealt with by the board of directors, and is drafted taking into account the fact that the reader of the Report is also equipped with a copy of the Directors' Report for the year ended December 31, 2006.

The Group operates in four areas which are reported as business segments in the Company's consolidated reports, as follows:

1) **Domestic fixed-line communications.**
2) **Cellular.**
3) **International communications, internet services and NEP.**
4) **Multi-channel television.**

The Company has an additional area of operations which is not substantial to the Group's operations, and which has been included in the financial statements for March 31, 2007 as a business sector, which mainly includes customer call center services.

The financial statements are drafted in accordance with the International Financial Reporting Standards (IFRS). The financial statements for the first quarter of 2006 have been redrafted in accordance with IFRS. The effect of the transition to reporting in accordance with international standards, on the Company's financial situation and on the results of its operations and cash flows are set out in Note 14 to the financial statements. In order to properly reflect the financial situation of the Group under Israeli accepted accounting rules prior to the transition to IFRS, the Financial Statements of the Group were adjusted by way of restatement as set out in Note 14L to the financial statements.

1. Financial Position

A. The Group's assets, as at March 31, 2007, amount to approximately NIS 15.69 billion, compared with approximately NIS 19.35 billion as at March 31, 2006. Of these, approximately NIS 6.33 billion (approximately 40%) are property, plant and equipment, compared with approximately NIS 7.05 billion (approximately 36%) as at March 31, 2006.

Most of the decrease stems from the fixed-line domestic communications segment. There was a decline in total assets in this segment compared with the previous year, in the sum of approximately NIS 3.18 billion, mainly due to the realization of commercially held financial assets and a reduction in cash balances which were mainly used for the distribution of dividends. 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, the segment's assets decreased from approximately NIS 4.58 billion as at March 31, 2006 to the sum of approximately NIS 4.11 billion as at March 31, 2007. The decrease stemmed mainly from realization of commercially held financial assets used in the payment of dividends and in the repayment of loans, and from a decrease in the depreciated cost of 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, internet and NEP services segment, there was an increase in total assets compared with March 31, 2006, mainly due to the merger with BezeqCall which commenced in January 2007.

In the multi-channel television segment, there was a decrease in total assets compared with March 31, 2006, which stemmed mainly from a decrease in the balance of net investments in property, plant and equipment.

B. The shareholders' equity ascribed to the shareholders of the Company as at March 31, 2007 amounted to approximately NIS 4.35 billion, comprising approximately 28% of the total balance sheet, compared with approximately NIS 5.69 billion as at March 31, 2006, which comprised approximately 29% of the total balance sheet. The decrease in shareholders' equity stemmed from a dividend paid in the sum of NIS 2.5 billion. The decrease was partially offset by the Group's net profit and share-based payments to Company employees from its shareholders.

C. The Group's total debt amounted to approximately NIS 7.83 billion as at March 31, 2007, compared with approximately NIS 9.25 billion as at March 31, 2006. The Group's debt to financial institutions and debenture holders as at March 31, 2007 amounted to approximately NIS 7.25 billion, compared with approximately NIS 8.73 billion as at March 31, 2006. The decrease stemmed mainly from payment of liabilities in the cellular segment and in the domestic fixed-line communications segment.

The Company's auditors drew attention to the financial position of DBS, as set out in Note 7A, including the assessment made by management of DBS, based on the budget for 2007 and an alternative business plan, that the chances of arranging the sources of financing required by it in the coming year are good.

D. The Group's cash and other current investment balances as at March 31, 2007 amounted to the sum of approximately NIS 1.88 billion compared with approximately NIS 4.75 billion as at March 31, 2006. The decrease stemmed mainly from the realization of commercially held securities in the cellular segment and in the domestic fixed-line communications segment, which were used in the payment of a dividend in the sum of NIS 3.7 billion, and for payment 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 ascribed to shareholders of the Company for the first quarter of 2007 amounted to approximately NIS 399 million as opposed to net earnings of approximately NIS 314 million for the corresponding period. The increase in net earnings stemmed mainly from an increase in operating profit and a decrease in financing expenses.

The following are details of changes in the results of the various segments, compared with the corresponding quarter:

Segment	**For the three months ending March 31, 2007 NIS millions profit (loss)**	**For the three months ending March 31, 2006 NIS millions profit (loss)**
Fixed-line domestic communications	369	308
Cellular	213	175
International communications, internet services and NEP	51	35
Multi-channel television	24	(2)
Others	-	-

Basic and diluted earnings per share for the first quarter of 2007 amounted to NIS 0.15 per NIS 1.00 par value compared with a profit of NIS 0.12 per share for the corresponding quarter.

B Revenues

The Group’s revenues in the first quarter of 2007 amounted to approximately NIS 3.09 billion compared with approximately NIS 3.01 billion in the corresponding period.

Revenues from fixed-line domestic communications decreased from approximately NIS 1.45 billion in the first quarter of 2006 to approximately NIS 1.44 billion in the reporting period (a decrease of approximately 0.8%). The decrease in the segment’s revenues stemmed from a reduction of tariffs as of July 2006, and from a reduction in call traffic. The decrease in revenues was offset 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 continued opening up of the communications sector to competition and the effects of regulation.

Revenues in the cellular segment increased from the sum of approximately NIS 1.09 billion in the first quarter of 2006 to approximately NIS 1.15 billion in the reporting period. The increase stemmed from an increase in revenues from cellular services, following an increase in content revenues and an increase in the number of customers, which was set off mainly by price erosion. In addition, there was an increase in revenues from the sale of terminal equipment, which stemmed mainly from an increase in the quantity of handsets sold and upgraded in the first quarter of 2007.

Revenues in the international communications, internet and NEP services segment increased from the sum of approximately NIS 317 million in the first quarter of 2006 to approximately NIS 323 million in the reporting period. The increase stemmed from an increase in internet revenues and from inclusion of the revenues of the subsidiary Actcom, alongside a decrease in global operations.

Revenues from the multi-channel television segment increased from the sum of approximately NIS 327 million in the first quarter of 2006 to approximately NIS 354 million in the reporting period, as a result of an increase in the number of subscribers and an increase in average revenue per customer.

C. Depreciation and amortization

The Group's depreciation and amortization expenses decreased from the sum of approximately NIS 460 million in the first quarter of 2006 to the sum of approximately NIS 441 million in the reporting period, mainly as a result of a decrease in depreciation expenses due to the end of depreciation of property, plant & equipment and a decrease in investments in new property in the domestic fixed-line communications segment.

D. Salaries

The Group's salary expenses increased from the sum of approximately NIS 567 million in the first quarter of 2006 to the sum of approximately NIS 575 million in the report period, due mainly to an increase in salary expenses in the cellular segment and in the international communications, internet and NEP services segment.

In the domestic fixed-line communications segment, there was no change compared with the corresponding period, due to a reduction in salary expenses on account of retiring employees, which was set off against salary increases.

E. General and Operating Expenses

The Group's general and operating expenses for the first quarter of 2007 amounted to approximately NIS 1.42 billion compared with approximately NIS 1.46 billion during the corresponding period.

Revenues in the domestic fixed-line communications segment decreased from the sum of approximately NIS 566 million in the first quarter of 2006 to approximately NIS 533 million in the reporting period. The decrease stemmed mainly from a decrease in cellular expenses, services and maintenance by sub-contractors and royalty expenses.

In the cellular segment, general and operating expenses increased from the sum of approximately NIS 650 million in the first quarter of 2006 to the sum of approximately NIS 668 million in the reporting period as a result of an increase in costs of terminal equipment due to an increase in the quantity of handsets sold. This increase was set off in part by a decrease in the costs of spare parts and laboratory repairs. Likewise, there was an increase in advertising expenses, which was partially set off by a decrease in expenses for doubtful debts.

In the international communications, internet and NEP services segment, there was a decrease in general and operating expenses from the sum of NIS 201 million in the first quarter of 2006 to the sum of approximately

NIS 189 million in the report period. The decrease stemmed mainly from a reduction in global operations.

Revenues in the multi-channel television segment decreased from the sum of approximately NIS 226 million in the first quarter of 2006 to approximately NIS 219 million in the reporting period, as a result of a decrease in content expenses and in royalty expenses.

F. Other operating expenses (income), net

The Group's net other operating income amounted to approximately NIS 8 million in the first quarter of 2007, compared with net other operating expenses in the sum of approximately NIS 12 million during the corresponding period. The income in the reporting period was due to a decrease in the provision for contingent liabilities and an increase in capital gains.

G. Operating income

The Group's operating income during the first quarter of 2007 amounted to approximately NIS 657 million, compared with approximately NIS 516 million in the corresponding period, an increase of approximately NIS 141 million. The increase in operating income stems from changes in the results of the segments as described above under the revenue and expense items. These changes brought about an increase in operating income in all of the main segments in which the Group operates and a transition from operating loss to operating profit in the multi-channel television segment.

H. Financing expenses, net

The Group's net financing expenses in the first quarter of 2007 amounted to approximately NIS 58 million compared with approximately NIS 82 million in the corresponding period, a reduction of approximately NIS 24 million.
This decrease arises out of a decrease in financing expenses in the cellular segment, stemming from an erosion of CPI-linked loans and a reduction in the number of loans in the segment, and from a reduction in financing expenses in the domestic fixed-line communications segment. The reduction in expenses in this segment stemmed mainly from a reduction in the provision of loans, and from erosion of CPI-linked and Euro-linked loans. Concurrently, financing revenues from capital market investments also decreased due to the realization of investments compared with the corresponding period.

3. Liquidity and sources of financing

The consolidated cash flows from current operations for the first quarter of 2007 amounted to approximately NIS 853 million, compared with approximately NIS 856 million in the corresponding period, a decrease of approximately NIS 3 million. The decrease in cash flows from current operations is due mainly to revenues and expenses which do not involve cash flows, and changes in asset and liability items which were offset by an increase in net earnings for the period.

Cash flows generated by operating activities are the principal source of financing of the Group's investments, which during the reported period included, *inter alia*, approximately NIS 177 million in the development of communications infrastructure, compared with an investment in the sum of approximately NIS 307 million in the corresponding period. During the reported period, the Group realized investments in net financial assets in the sum of approximately NIS 124 million compared with a net investment in the sum of approximately NIS 53 million during the corresponding period.

During the reporting period, the Group repaid debts and paid interest in the total sum of approximately NIS 258 million, of which, approximately NIS 82 million in debentures, approximately NIS 69 million in loans, approximately NIS 32 million in short-term credit, and approximately NIS 75 million in interest payments. During the corresponding period, the Group paid net debt and interest payments of approximately NIS 353 million. In the report period, cash dividends in the sum of NIS 2,100 million were paid.

The monthly average short-term credit average from banks in the first quarter of 2007 amounted to approximately NIS 112 million. The monthly average of long-term liabilities to financial institutions and debenture holders in the first quarter of 2007 amounted to approximately NIS 7,243 million.

The working capital as at March 31, 2007 was negative, and amounted to approximately NIS 2,547 million, compared with negative operating capital as at March 31, 2006, which amounted to approximately NIS 136 million. The decrease stems from the domestic fixed-line communications segment, as a result of an increase in current debenture maturities, a decrease in cash balances and exercise of commercially held financial assets. The decrease was moderated to some extent by an increase in the working capital of the other principal Group companies.

4. 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. In addition, employees of the Group volunteer for a variety of other communal activities.
During the report period, the Company donated approximately NIS 50,000 to the Council for Children at Risk.
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 approximately NIS 250,000 per year.
The Company’s employees and retirees have set up a charitable association called Halav. The association works together with local councils to locate families in distress, with the aim of providing them with basic food products.

Pelephone has no binding policy regarding donations and its management discusses each case on an individual basis. During the report period, Pelephone donated approximately NIS 8,500 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 125,000.

5. Details Concerning Exposure to and Management of Market Risks

A. Further to the statements made in the Directors' Report for 2006, hedging transactions against the market risks involved in exposure to exchange rate fluctuations substantially reduced this exposure.

B. The report on positions on derivatives for March 31, 2007 is not very substantially different from the report as at December 31, 2006.

C. Analyses of sensitivity to fair value and the affect of the change in market prices on the fair value of the balance-sheet and off-balance-sheet surpluses in respect of which there are strong contracts as at March 31, 2007, are not very substantially different from the report as at December 31, 2006. It should be noted that there was a decrease in dollar liability exposure to suppliers and a reduction in the sensitivity to changes in securities rates due to the realization of investments mainly used for the payment of dividends.

D. The report on linkage bases for March 31, 2007 is not substantially different from the report as at December 31, 2006.

The Group's surplus monetary liabilities over monetary assets denominated in or linked to foreign currency as at March 31, 2007 amounted to approximately NIS 1.69 billion. As a result of forward currency transactions as at March 31, 2007, the net balance of foreign currency liabilities not hedged by such forward transactions amounted to approximately NIS 173 million.

Surplus monetary liabilities over monetary assets linked to the CPI as at March 31, 2007 amounted to approximately NIS 4.47 billion in the Group.

The Group's main segments have hedging policies which reduce CPI exposures caused by tax expenses being calculated on real profit.

6. Disclosure regarding internal auditor in reporting corporation

A. The internal auditor's procedures were updated and approved by the audit committee of the board of directors on January 4, 2005.

B. During the course of 2006, the internal auditor's term of office at the Company terminated and an acting replacement was appointed. During 2007, in the framework of the Company's reorganization and streamlining measures, the unit was reduced by another six audit employees.

C. The audit plan approved for 2007 is for 10,000 work hours (compared with the work plan of 12,000 hours in 2006).

D. In March 2007, the audit committee authorized the acting internal auditor to continue in office. The audit committee is taking the necessary steps to appoint a permanent internal auditor.

E. During the course of 2007, CEO and audit committee discussions were held on three audit reports. A further ten audit reports have not yet been discussed by the Company's management and have therefore not been brought up for discussion.

F. As of March 15, 2007, the external director Eyal Yaniv has been acting as chairman of the audit committee.

G. The Audit Committee of the Board of Directors is currently reviewing the entire subject of allotment of the resources required for internal auditing in the Company.

7. Critical Accounting Estimates

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. The main issues of uncertainty regarding critical estimates and considerations involved in implementing accounting policy are similar to those that were implemented in the annual statements (see Note 4 to the Financial Statements). We are of the opinion that these estimates and assessments are critical because any change in the estimates and presumptions has the potential of substantially affecting the financial statements.

8. Miscellaneous

Event subsequent to the date of the financial statements

On March 29, 2007, the board of directors of the Company resolved to appoint Adv. Dr. Yoram Danziger as external examiner to examine the issues arising out of the immediate report of the Company dated March 20, 2007 regarding approval of an option scheme for employees and executives, the immediate report of the Company dated March 26, 2007 regarding approval of grants to officers and the immediate report of the Company dated March 26, 2007 regarding restatement, in accordance with the provisions of letters from the Securities Authority to the Company dated March 25, 2007 and March 28, 2007. The findings of the examiner, and the resolutions of the board of directors as a result thereof, including approval of the CEO's notice of termination of office as CEO of the Company, are set out in Note 16 to the Financial Statements, and in the Company's immediate reports dated April 12, 2007 and April 26, 2007.

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

Dov Weisglass	**Ika Abravanel**
Chairman of the Board of Directors	**Acting CEO**

Chapter C – Financial Statements

"BEZEQ" THE ISRAEL TELECOMMUNICATION CORP. LIMITED

FINANCIAL STATEMENTS

MARCH 31, 2007

Contents

Somekh Chaikin

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

At your request, we have reviewed the condensed interim consolidated balance sheet of "Bezeq" - The Israel Telecommunication Corp. Limited (hereinafter "Company") as at March 31, 2007, as well as the condensed interim consolidated statement of income, the statement of recognised income and expense and the condensed 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 condensed interim financial statements of subsidiaries, whose assets as at March 31, 2007, constitute approximately 7% of the total assets included in the condensed interim consolidated balance sheet and whose revenues constitute approximately 11% of the total revenues included in the condensed interim consolidated statement of income for the three-month period then ended. Furthermore, reports of other auditors were furnished to us which relate to investments in associates in which the Company's investments amount to approximately NIS 32 million as at March 31, 2007, and the Company’s share in the losses in respect thereof amount to approximately NIS 473 thousand for the three-month period then ended.

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

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

Somekh Chaikin, a partnership registered under the Israeli Partnership Ordinance, is the Israeli member firm of KPMG International, a Swiss cooperative.

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

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

2. Contingent claims made against the Group of which the exposure cannot yet be assessed or calculated, and other contingencies as described in Notes 8B and 8C.
`
3. The financial position of a subsidiary. As mentioned in Note 7A, the continuation of the activity of the subsidiary is contingent on arranging sources of finance required by the subsidiary in the forthcoming year. In the opinion of the management of the subsidiary, based, among others, on the 2007 budget and on the alternative business plan, the prospects of arranging sources of finance required by the subsidiary in the forthcoming year are good.

Additionally, we draw attention to Note 14L to the Group financial statements regarding the adjustment by way of restatement of the financial statements as at March 31, 2006, in order to retroactively reflect the depreciation of property, plant and equipment and the related tax effects thereon, in respect of the presentation of receipts from interconnect to the cellular networks and in respect of a reduction of lease payments of land from the Israel Lands Administration as described in the aforementioned note. These aforementioned corrections were implemented on the data presented in the Note of restatement to IFRSs in order to properly reflect the financial position of the Group in the transition to IFRSs in accordance with generally accepted accounting principles in Israel.

Somekh Chaikin
Certified Public Accountants (Isr.)

May 28, 2007

Condensed Consolidated Interim Balance Sheets as at

	March 31, 2007	March 31, 2006	December 31, 2006
	(Unaudited)	(Unaudited)	(Audited)
	NIS thousands	NIS thousands	NIS thousands
Assets			
Cash and cash equivalents	**1,032,988**	2,290,704	2,631,790
Trade receivables	**2,106,158**	2,074,193	2,111,451
Other receivables	**295,568**	174,513	250,657
Inventory	**252,356**	219,225	204,669
Broadcasting rights	**200,486**	173,601	169,017
Investments and loans, including derivatives	**850,686**	2,461,631	960,561
Current tax assets	**11,944**	13,254	11,105
Total current assets	**4,750,186**	7,407,121	6,339,250
Trade and other receivables	**442,939**	373,016	417,144
Investments and loans, including derivatives	**325,687**	497,964	342,175
Property, plant and equipment	**6,334,974**	7,046,082	6,492,362
Intangible assets	**2,563,374**	2,595,231	2,554,242
Deferred and other expenses	**366,260**	386,177	373,749
Investments in associates accounted by the equity method	**32,089**	22,418	32,122
Deferred tax assets	**870,712**	1,019,882	993,616
Total non-current assets	**10,936,035**	11,940,770	11,205,410
Total assets	**15,686,221**	19,347,891	17,544,660

	March 31, 2007	March 31, 2006	December 31, 2006
	(Unaudited)	(Unaudited)	(Audited)
	NIS thousands	NIS thousands	NIS thousands
Liabilities			
Loans and borrowing	**3,706,678**	3,065,140	3,637,347
Trade payables	**1,467,210**	1,311,106	1,393,568
Other payables, including derivatives	**883,095**	920,664	802,747
Current tax liabilities	**68,096**	15,467	121,704
Deferred income	**35,705**	34,960	57,879
Provisions	**302,487**	280,539	288,851
Employee benefits	**833,945**	715,606	906,203
Proposed dividend	**-**	1,200,000	300,000
Total current liabilities	**7,297,216**	7,543,482	7,508,299
Debentures	**2,939,578**	4,899,855	3,169,441
Obligations to banks	**434,904**	650,857	480,830
Loans from others	**171,675**	110,609	169,182
Loans provided by the minority in a subsidiary	**577,933**	521,320	564,250
Employee benefits	**359,888**	375,447	373,036
Deferred income and others	**74,870**	24,328	37,020
Provisions	**53,570**	53,020	51,857
Total non-current liabilities	**4,612,418**	6,635,436	4,845,616
Total liabilities	**11,909,634**	14,178,918	12,353,915
Shareholders' Equity			
Share capital	**6,132,636**	6,309,133	6,309,133
Share premium	**-**	1,623,423	1,623,423
Reserves	**672,515**	405,606	671,820
Deficit	**(2,450,631)**	(2,647,869)	(2,849,381)
Total equity attributable to shareholders of the Company	**4,354,520**	5,690,293	5,754,995
Minority equity in capital deficit of a consolidated company	**(577,933)**	(521,320)	(564,250)
Total shareholders' equity	**3,776,587**	5,168,973	5,190,745
Total shareholders' equity and liabilities	**15,686,221**	19,347,891	17,544,660

Dov Weissglas	**Ika Abravanel**	**Ran Oz**
Chairman of the Board	Acting CEO	Deputy CEO and CFO

Date of approval of the financial statements: May 28, 2007.

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

Condensed Consolidated Interim Statements of Income

	For the three month period ended March 31		For the year ended December 31
	2007	2006	2006
	(Unaudited)	(Unaudited)	(Audited)
	NIS thousands	NIS thousands	NIS thousands
Revenue	**3,088,679**	3,012,099	12,231,830
Costs and expenses			
Depreciation and amortisation	**441,199**	460,080	1,864,035
Salary	**575,397**	567,214	2,586,437
Operating and general expenses	**1,422,770**	1,456,434	5,966,616
Other operating expenses (income), net	**(7,676)**	12,010	249,540
	2,431,690	2,495,738	10,666,628
Operating income	**656,989**	516,361	1,565,202
Financing costs			
Financing expenses	**162,387**	246,086	694,393
Financing income	**(104,519)**	(164,104)	(356,425)
Net financing expenses	**57,868**	81,982	337,968
Profit after financing expenses	**599,121**	434,379	1,227,234
Equity in profits of investees accounted by the equity method	**473**	1,591	11,184
Profits before income tax	**599,594**	435,970	1,238,418
Income tax	**214,527**	137,908	488,393
Profit for the period	**385,067**	298,062	750,025
Attributable to:			
The shareholders' of the Company	**398,750**	314,102	808,995
Minority in a consolidated company	**(13,683)**	(16,040)	(58,970)
Profit for the period	**385,067**	298,062	750,025
Earnings per share			
Basic and diluted earnings per share (in NIS)	**0.15**	0.12	0.31

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

Condensed Consolidated Interim Statements of Recognised Income and Expense

	For the three month period ended March 31		For the year ended December 31
	2007	2006	2006
	(Unaudited)	(Unaudited)	(Audited)
	NIS thousands	NIS thousands	NIS thousands
Net change in fair value of financial assets classified as available for sale	**972**	2,874	(1,464)
Net change in fair value of financial assets classified as available for sale transferred to profit and loss	**-**	21,851	(5,218)
Actuarial gains from a defined benefit plan (1)	**-**	-	3,427
Taxes in respect of income and expenses attributable directly to equity	**(277)**	(9,056)	2,227
Income and expenses recognised directly to equity	**695**	15,669	(1,028)
Profit for the period	**385,067**	298,062	750,025
Total recognised income and expense for the period	**385,762**	313,731	748,997
Attributable to:			
The shareholders' of the Company	**399,445**	329,771	807,967
Minority in a consolidated company	**(13,683)**	(16,040)	(58,970)
Total recognised income and expense for the period	**385,762**	313,731	748,997

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

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

Condensed Consolidated Interim Statements of Cash Flows

	For the three month period ended March 31		For the year ended December 31
	2007	2006	2006
	(Unaudited)	(Unaudited)	(Audited)
	NIS thousands	NIS thousands	NIS thousands
Cash flows from operating activities			
Net earnings for the period	**385,067**	298,062	750,025
Adjustments:			
Depreciation	**376,109**	413,912	1,591,054
Amortisation of intangible assets	**59,762**	40,145	247,557
Amortisation of deferred and other charges	**5,328**	6,023	25,424
Loss (Gain) from decrease in holdings in associates	**318**	(523)	(595)
Net financing costs	**11,857**	61,191	440,429
Equity in earnings of associates accounted by the equity method	**(473)**	(1,591)	(11,184)
Net capital gain principally due to disposal of property	**(16,843)**	(10,565)	(159,017)
Share-based payment transactions	**-**	-	286,506
Income tax expenses	**214,527**	137,908	488,393
Change in inventory	**(47,663)**	10,215	23,014
Change in trade receivables	**(12,959)**	38,249	109,100
Change in other receivables	**(52,256)**	(32,579)	(107,854)
Change in trade payables	**55,475**	50,633	(56,778)
Change in suppliers	**32,653**	(159,510)	(79,046)
Change in provisions	**15,349**	21,389	27,327
Change in broadcasting rights	**(31,469)**	(19,101)	(14,517)
Change in employee benefits	**(84,906)**	(23,023)	168,758
Change in deferred and other income	**37,850**	(1,183)	11,509
	947,726	829,652	3,740,105
Interest received	**43,068**	94,129	220,078
Dividend received	**-**	-	26,010
Income tax paid	**(137,888)**	(68,058)	(277,573)
Net cash from operating activities	**852,906**	855,723	3,708,620
Cash flows from investing activities			
Investment in intangible assets	**(49,499)**	(23,840)	(209,733)
Proceeds from sale of property, plant and equipment	**19,311**	13,383	47,804
Proceeds from realisation of deferred expenses	**4,213**	272	-
Current investments, net	**115,816**	(47,426)	1,491,439
Purchase of property, plant and equipment	**(177,493)**	(307,170)	(953,226)
Investment in deferred expenses and others	**(825)**	(2,041)	-
Proceeds from sale of investments and long-term loans	**7,870**	4,264	62,729
Purchase of investments and long-term loans	**-**	(9,507)	(19,723)*
Purchase of a subsidiary	**(12,468)**	-	-
Net cash from (used for) investment activity	**(93,075)**	(372,065)	419,290

* Reclassified

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

Condensed Consolidated Interim Statements of Cash Flows (Contd.)

	For the three month period ended March 31		For the year ended December 31
	2007	2006	2006
	(Unaudited)	(Unaudited)	(Audited)
	NIS thousands	NIS thousands	NIS thousands
Cash flows from financing activities			
Receipt of loans	**-**	-	50,000
Repayment of debentures	**(81,633)**	(148,968)	(280,350)
Repayment of loans	**(69,017)**	(161,081)	(1,268,656)
Short-term credit, net	**(32,023)**	46,316	43,146
Dividends paid	**(2,099,920)**	-	(1,600,000)
Interest paid	**(75,373)**	(89,335)	(601,752)
Net cash used for financing activities	**(2,357,966)**	(353,068)	(3,657,612)
Net increase (decrease) in cash and cash equivalents	**(1,598,135)**	130,590	470,298
Cash and cash equivalents at January 1	**2,631,790**	2,158,773	2,158,773
Effect of fluctuations in the rate of exchange on cash balances	**(667)**	1,341	2,719
Cash and cash equivalents at the end of the period	**1,032,988**	2,290,704	2,631,790

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

Appendix to Condensed Consolidated Interim Statements of Cash Flows

	For the three month period ended March 31		For the year ended December 31
	2007	2006	2006
	(Unaudited)	(Unaudited)	(Audited)
	NIS thousands	NIS thousands	NIS thousands
Appendix of activities not affecting cash flows			
Purchase of property, plant and equipment, and intangible assets	186,430	140,355	141,518
Sale of property, plant and equipment on credit	161,575	9,563	161,800

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

NOTE 1 – REPORTING ENTITY

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

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

NOTE 2 – BASIS OF PRESENTATION

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

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

NOTE 3 – REPORTING PRINCIPLES AND ACCOUNTING POLICIES

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

A. Initial application of accounting standards

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

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

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

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

NOTE 3 – REPORTING PRINCIPLES AND ACCOUNTING POLICIES (CONTD).

A. Initial application of accounting standards (contd.)

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

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

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

B. New standards during the period not yet adopted

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

NOTE 4 – ESTIMATES

The preparation of interim financial statements requires Management to make judgments and use estimates, assessments and assumptions that affect the application of accounting policies and the reported amounts of assets and liabilities, income and expenses. Actual results may differ from these estimates.

The significant estimations applied in these interim statements do not differ significantly from those applied to the annual financial statements.

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

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

	Consumer Price Index	Rate of exchange of the US dollar	Rate of exchange of the euro
	%	%	%
For the three month period ended on:			
March 31, 2007	**(0.23)**	**(1.66)**	**(0.54)**
March 31, 2006	0.58	1.35	3.95
For the year ended December 31, 2006	(0.10)	(8.21)	2.16

NOTE 6 – PROPERTY, PLANT AND EQUIPMENT

During the reporting period, the Group companies commenced examination of the useful lives of their property, plant and equipment in order to determine whether there are significant circumstances justifying a change in their estimated useful lives.

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

The examination also revealed that there are assets whose useful lives might exceed the present estimate, but at this stage a new estimate cannot be assessed. The companies will continue to examine whether these are significant circumstances which support this assessment, also taking into account a clarification of the Securities Authority that its decision regarding extension of the amortisation period of property, plant and equipment should also be implemented by corporations which report according to IFRS, so long as the Authority does not publish another directive.

NOTE 7 – GROUP ENTITIES

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

Since commencing operations, DBS has accumulated considerable losses. Its losses in 2006 amounted to approximately NIS 320 million and the loss in the three-month period ended March 31, 2007, amounted to approximately NIS 48 million. As a result of these losses, its capital deficit and its working capital deficit as at March 31, 2007, amounted to approximately NIS 2,909 million and NIS 1,552 million, respectively.

The Company's investment in DBS (primarily through shareholders' loans) at the balance sheet date amount to approximately NIS 1,562 million (without interest and linkage). The balance of the current debt of DBS to the Company and its subsidiaries amounts to approximately NIS 134 million, of which approximately NIS 111 million is owed to the Company. The Company has come to an arrangement with DBS for the collection of a debt balance of approximately NIS 50 million in arrears. Under the arrangement, the debt will be paid in 60 equal monthly instalments plus interest at prime + 1.5%. The remainder of the debt to the Company is a current debt balance, for which the terms of payment are the normal credit terms in effect between the Company and its customers.

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

The terms of the loans and the credit facility that DBS received from the banks, the balance of which as at March 31, 2007 is NIS 1,376 million, impose various restrictions on DBS that include, *inter alia*, restrictions on the encumbrance or sale of certain assets, a restriction on receipt of credit from other banks without prior approval, a restriction concerning repayment of shareholders' loans, and a requirement for compliance with financial criteria ("the Conditions").

At the date of approval of the financial statements, DBS is in compliance with the Conditions laid down in the financing agreements (following a relief granted in connection with the financial criteria in respect of the first quarter of 2007), however the management of DBS does not expect that it will be in compliance with the Conditions in 2007 and thereafter. In view of this forecast, the bank loans are stated as part of current liabilities. DBS approached the banks for amendment and adjustment of the maturity dates for full repayment of the bank credit. As at the date of approval of the financial statements, these terms have not yet been agreed. The management of the subsidiary believes, based on past experience and talks with the banks, that the financial criteria are likely to be changed.

During 2005-2006, DBS was granted loans in the total amount of NIS 150 million by institutional entities. As at the date of approval of the financial statements, DBS holds an option for the receipt of an additional loan in the amount of NIS 50 million from one of the institutions. DBS is attempting to increase the option to NIS 100 million.

NOTE 7 – GROUP ENTITIES (CONTD.)

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

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

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

On December 24, 2006, the board of directors of DBS approved the budget for 2007. According to this aforementioned budget, DBS will require additional external financing in 2007. As at the date of approval of the financial statements, DBS is working to obtain additional sources of finance that will enable it to achieve the budget targets for the forthcoming year. If such sources cannot be found, DBS will operate in accordance with an alternative business plan that does not require additional funding beyond that available to it. The Management of DBS estimates, based on the 2007 budget and on the alternative business plan, that the chances of arranging the sources of financing required by DBS in the forthcoming year are good.

B. Bezeqcall International Ltd.

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

NOTE 8 – CONTINGENT LIABILITIES

A. Claims

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

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

In the opinion of the managements of the Group's companies, the additional exposure as at March 31, 2007, due to claims filed against the companies in the Group on various matters and the probability of realisation of which is remote or likely, amounts to approximately NIS 30 billion, of which approximately NIS 3.4 billion relates to claims filed by employees.

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

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

NOTE 8 – CONTINGENT LIABILITIES (CONTD.)

A. Claims (contd.)

(1) Further to Note 17A4 to the financial statements as at December 31, 2006, on April 10, 2007, a ruling granted effect to the procedural arrangement, in which the Company and Bezeq International will be struck out from the claim (after undertaking to transfer any sum transferred to them from the Tax and VAT Department, if transferred, in connection with the claim, as instructed by the court.

(2) Further to Note 17A27 to the financial statements as at December 31, 2006, regarding application for certification of a class action against Pelephone concerning the allegation of the misleading of the defendant's subscribers who reside in Eilat, who were charged VAT for cellular communication service, the plaintiffs announced their intention to withdraw the claim. The parties are in the process of filing to the court an application requesting striking-off of the claim.

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

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

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

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

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

The Company is currently studying the claim and request, and at this stage is unable to asses their probability of success.

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

At this early stage, when DBS has not yet formulated its position and the relevant data for drafting the response have not yet been collated, the likelihood of the Application Certification being allowed and the prospects of the action if it is allowed, cannot be assessed.

C. Other contingencies

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

NOTE 8 – CONTINGENT LIABILITIES (CONTD.)

C. Other contingencies (contd.)

(1) In May 2007, a letter arrived at the Company's offices, pursuant to Section 194 of the Companies Law, that was sent by a plaintiff who claims to be a holder of the Company's publicly owned shares.

According to the letter, following the findings of the external examiner appointed by the Company to examine the manner in which various decisions are made and as well as management of the Company, that point to a multitude of shortcomings and failures related directly to the work of the Board of Directors, its committees, its members and the former CEO of the Company, the Company is requested to take legal action against the Board of Directors and the Company's other officers who were responsible therefor.

The Company is assessing the allegations made in the letter, and will respond in accordance with the Companies Law.

(2) Further to Note 17C2 to the Group's annual 2006 financial statements regarding a letter concerning commissions paid to DBS and the debts of DBS to the Company, the Company intends to recommend to the Board of Directors that it reject the aforementioned letter (after having obtained the consent of the writer to an extension for preparing its reply).

(3) Further to Note 17C1 to the Group's annual 2006 financial statements, the Antitrust Commissioner announced on May 27, 2007, that it is considering exercising its authority under Section 43(A)(5) of the Antitrust Law, 5748-1988, to determine that the Company abused its status, contrary to the provisions of Section 29A of that Law, in view of the findings of an investigation carried out recently by the investigations department of the Antitrust Authority.

The Commissioner is considering determining that –

a. In the first half of 2006, and in particular in April and May 2006, the Company's employees imposed sanctions concerning delaying the performance of works or not performing works for the connection of domestic operators (Cellcom, Globecall and Golden Lines) to the Company's network.

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

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

d. In this way, the Company abused its status, in contravention of Section 29A of the Law.

Under Section 43(e) of the Antitrust Law, the Commissioner's determination, if and insofar as made, shall serve as *prima facie* evidence in any legal proceeding.

The Company was given until June 17, 2007 to state its position to the Commissioner. The Company is studying the notice and intends to exercise its right to a hearing.

It is noted that in May 2006, a claim was filed against the Company and against the cable company, with an application for certification as a class action, concerning a fault in the telephone line in the HOT network on May 17, 2006. On this matter, see Note17A(12) to the financial statements of the Company at December 31, 2006.

(4) Further to Note 17C7 to the Group's annual 2006 financial statements concerning number portability, on May 24, 2007, the Company received a notice from the Director General of the Ministry of Communications, stating that he is considering imposing a financial sanction on the Company in respect of alleged violation of the duty to provide number portability commencing September 1, 2006, as follows:

NOTE 8 – CONTINGENT LIABILITIES (CONTD.)

C. Other contingencies (contd.)

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

2. For the period from May 25, 2007 to November 30, 2007 or until the date of remedy of the alleged violation (whichever is earlier) by the Company – NIS 6,450 for each additional day the violation continues.

3. For the period from December 1, 2007 (which allows, according to the notice, the reasonable time required by the relevant licensees to remedy the alleged violation) until the date of remedy of the alleged violation – a financial sanction as described in sections 37B(b) and 37C(a) of the Communications Law after Amendment 36. (It is noted that according to the provisions of those sections, the rate of the relevant sanction is 7 times the penalty laid down in section 61(a)(4) of the Penal Law (which is NIS 202,000), plus 0.25% of the annual income of the Company, plus a financial sanction of one fiftieth of such sanction for each day on which the violation continues.)

The subsidiaries Pelephone Communications Ltd. and Bezeq International Ltd. received similar notices. In the Ministry's notice, Pelephone and Bezeq International were given an opportunity to state their positions to the Director General of the Ministry of Communications by June 24, 2007. As noted in the financial statements as at December 31, 2006, the Company and Pelephone (together with other cellular companies) petitioned the High Court of Justice on this matter, contending, *inter alia*, that it was the Ministry of Communications which had not prepared a number portability plan as required by the provisions of the law. The Company, Pelephone and Bezeq International are studying the implications of the notices, and each of them will respond accordingly.

NOTE 9 – TRANSACTIONS WITH INTERESTED PARTIES AND RELATED PARTIES

A. Transactions with interested parties and related parties

	For the three month period ended March 31		For the year ended December 31
	2007	2006	2006
	(Unaudited)	(Unaudited)	(Audited)
	NIS thousands	NIS thousands	NIS thousands
Sales of products and services			
Telephony services –			
The State of Israel	**82,285**	82,968	368,487
Others	**-**	706	3,267
Expenses –			
State of Israel –			
Royalties	**48,364**	63,194	180,941
Frequencies	**2,854**	4,777	29,342
Others (mainly purchase of satellite segments)	**31,493**	35,188	124,256
Balances with related parties – Loans and long-term debts of interested parties			
Loans and debts – index-linked, with no maturity date and bearing no interest	**868**	875	872

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

B. Further to Note 29D to the Company's financial statements as at December 31, 2006, concerning the cancellation of discount arrangements included in the agreement between the Company and the Ministry of Defence dated May 8, 2005, the Company informed the Ministry of Communications and the Ministry of Defence on April 22, 2007, of its decision to comply with this demand. It should be noted that the Company received a copy of the letter sent by the Ministry of Defence to the Ministry of Communications, which contained a request that the instruction regarding cancellation of the discount arrangements determined in the agreement between the parties be frozen, until the convening of a work meeting between the Ministry of Defence and the Ministry of Communications that will discuss the subject. As of the date of publication of this report, the Company has yet to receive a different instruction from the Ministry of Communications. It should be noted that in the Company's opinion, it was entitled to enter into the agreement in accordance with its general license. In addition, according the Antitrust Authority's notice dated August 2006, the agreement does not contravene the provisions of the Antitrust Law, and the Authority saw no justification, at that time, to insist on cancellation of the agreement. The Company notified the Ministry of Communications of the Antitrust Authority's position, already, in August 2006. It is further noted, that according to the agreement between the Company and the Ministry of Defence, according to which, should one of the parties be unable to fulfil its undertakings provided for in the agreement due to a legal directive or resolution of a competent authority, the same shall not constitute breach, and the parties shall negotiate another agreement, the terms of which shall reflect, to the extent possible, the wishes of the parties in accordance with the agreement. The Company has requested urgent meetings and negotiations with the Ministry of Defence, but the request has not yet been granted.

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

NOTE 10 – REVENUE

	For the three month period ended March 31		For the year ended December 31
	2007	2006	2006
	(Unaudited)	(Unaudited)	(Audited)
	NIS thousands	NIS thousands	NIS thousands
Fixed-line domestic communications	**1,258,168**	1,273,608	5,086,022
Cellular telephone	**881,659**	844,210	3,493,541
Multi-channel television	**349,917**	309,913	1,284,337
Sale of equipment to subscribers, installations and miscellaneous	**313,603**	295,754	1,170,771
International communications and internet services	**235,125**	228,798	963,942
	3,038,472	2,952,283	11,998,613
Other revenues	**50,207**	59,816	233,217
	3,088,679	3,012,099	12,231,830

NOTE 11 – OPERATING AND GENERAL EXPENSES

	For the three month period ended March 31		For the year ended December 31
	2007	2006	2006
	(Unaudited)	(Unaudited)	(Audited)
	NIS thousands	NIS thousands	NIS thousands
General expenses	**256,706**	278,412	1,169,107
Cellular telephone expenses	**452,108**	459,942	1,854,347
Materials and spare parts	**219,949**	197,292	922,449
Consumption satellite services content	**104,046**	108,442	441,268
Services and maintenance by sub-contractors	**101,909**	111,194	428,424
Building maintenance	**81,903**	84,257	347,849
International communication expenses	**98,567**	96,406	383,496
Motor vehicle maintenance expenses	**45,831**	44,968	190,079
Royalties to the Government of Israel	**48,364**	63,194	179,589
Collection fees	**13,387**	12,327	50,008
	1,422,770	1,456,434	5,966,616

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

Income statement

	For the three month period ended March 31		For the year ended December 31
	2007	2006	2006
	(Unaudited)	(Unaudited)	(Audited)
	NIS thousands	NIS thousands	NIS thousands
Revenue	**1,442,342**	1,454,516	5,798,996
Costs and expenses			
Depreciation and amortisation	**237,415**	257,676	1,026,469
Salary	**309,779**	310,887	1,557,000*
General and operating expenses	**532,905**	566,298	2,233,167*
Other expenses (income), net	**(6,939)**	11,903	228,893
	1,073,160	1,146,764	5,045,529
Operating income for the period	**369,182**	307,752	753,467

* Reclassified

NOTE 13 –SEGMENT REPORTING

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

For the three-month period ended March 31, 2007 (unaudited)

	Domestic fixed–line communications	Cellular telephone	International communications, internet and NEP services	Multi-channel television	Others	Adjustments	Consolidated
	NIS thousands	NIS thousands	NIS thousands	NIS thousands	NIS thousands	NIS thousands	NIS thousands
Revenue							
Revenues from external sources	**1,362,116**	**1,067,806**	**305,769**	**349,917**	**3,071**	**-**	**3,088,679**
Inter-segment revenues	**80,226**	**79,627**	**16,873**	**3,669**	**11,413**	**(191,808)**	**-**
Total revenue	**1,442,342**	**1,147,433**	**322,642**	**353,586**	**14,484**	**(191,808)**	**3,088,679**
Segment results	**369,182**	**213,119**	**50,825**	**24,001**	**(138)**	**-**	**656,989**

For the three-month period ended March 31, 2006 (unaudited)

	Domestic fixed–line communications	Cellular telephone	International communications, internet and NEP services	Multi-channel television	Others	Adjustments	Consolidated
	NIS thousands	NIS thousands	NIS thousands	NIS thousands	NIS thousands	NIS thousands	NIS thousands
Revenue							
Revenues from external sources	1,386,562	1,002,346	296,593	321,949	4,649	-	3,012,099
Inter-segment revenues	67,954	86,078	20,473	5,049	9,017	(188,571)	-
Total revenue	1,454,516	1,088,424	317,066	326,998	13,666	(188,571)	3,012,099
Segment results	307,752	174,764	35,578	(1,645)	(88)	-	516,361

NOTE 13 –SEGMENT REPORTING (Contd.)

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

* Reclassified.

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

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

Explanations of the significant effects of the transition from Israeli GAAP to IFRS on the Group's financial position and on its results of operation as of March 31, 2006 and for the three-month period then ended, are provided below. For the full explanations in respect to the transition from Israeli GAAP to IFRS on the transition date and in respect to the reserve balance as at January 1, 2006, see Note 33 to the Group's financial statements for the year 2006.

Significant adjustments to the balance sheet line items

		Israeli GAAP	Effect of the transition to IFRS March 31, 2006	IFRS
	Note	NIS thousands	NIS thousands	NIS thousands
Property, plant and equipment	a-f, k, l	9,439,069*	(2,392,987)	7,046,082
Intangible assets	d, g	1,699,546	895,685	2,595,231
Deferred tax assets	a-c, g, h, l	578,560*	441,322	1,019,882
Equity capital	a - l	6,965,018*	(1,796,045)	5,168,973

Significant adjustments to the income statement line items

		Israeli GAAP	Effect of the transition to IFRS March 31, 2006	IFRS
	Note	NIS thousands	NIS thousands	NIS thousands
Revenue		3,020,255*	8,156	3,012,099
Costs and expenses	a - l	2,610,674*	(114,936)	2,495,738
Net earnings for the year (attributable to shareholders of the Company)	a - l	232,244*	81,858	314,102
Earnings per share				
Basic and diluted earnings per share (in NIS)		0.09*	0.03	0.12

* Restated – see section (l) below.

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

Notes to the material adjustments

a. As of the transaction date, the Group chose to state some of the property, plant and equipment items (the switching, transmission and power group) at their fair value and to determine this value as deemed cost, in accordance with the relief under IFRS 1. The deemed cost was based on an external expert opinion. As a result, the property, plant and equipment balance decreased by NIS 1,329 million at March 31, 2006, to a fair value of approximately NIS 1,803 at that date, while the deferred tax balances deriving from the differences in the measurement of the property, plant and equipment for tax purposes changed compared with the presentation of property, plant and equipment for accounting purposes, by approximately NIS 380 million as at March 31, 2006. The reserve balances were reduced on that date by the net amounts. The depreciation expenses for the three-month period ended on March 31, 2006 decreased by NIS 86 million.

b. On the date of transition to IFRS, in accordance with the directives of IAS 16, the residual value of the property, plant and equipment not included in the calculation of depreciation according to accepted accounting principles in Israel was measured. The revaluation was based on an opinion of an external appraiser. The effect was to increase the property, plant and equipment balances by approximately NIS 43 million and to reduce the depreciation expense for the three month period ended on December 31, 2006 by approximately NIS 12 million. Another effect was to change the deferred tax balances derived from the differences in the measurement of the property, plant and equipment for tax purposes as compared with the presentation of property, plant and equipment fin the financial statements. The reserve balances were reduced by the same net amounts as at the above dates.

c. Under IAS 37, the Group is required to recognise liabilities to bear the costs of site decommissioning and clearing. Under IFRS 1, the Group selected a relief that allowed it to capitalise the expected costs of decommissioning and clearing sites at the transition date at historical capitalization rates.
As a result, the property, plant and equipment balances as at March 31, 2006 increased by NIS 17 million, and the reserve balance decreased by approximately and NIS 12 million (net of tax) as at the same date.

d. Under IFRS, computer software and capitalised software development costs that do not constitute an integral part of the hardware attributed to them, are treated as intangible assets. Accordingly, with the transition to IFRS, the carrying balances at March 31, 2006, of approximately NIS 495 million, relating to computer software and to capitalised software development costs, were reclassified from the property, plant and equipment item to the intangible assets item.

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

   The effect of the transition to IFRS was to decrease property, plant and equipment by approximately NIS 169 million at March 31, 2006, against an increase in the following items:

   (1) Other accounts receivable (prepaid expenses), of approximately NIS 19 million as at March 31, 2006.

   (2) Other long-term assets (long-term prepaid expenses in respect of a right of use of capacity), of approximately NIS 150 million.

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

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

The difference between the accumulated depreciation under accepted accounting principles in Israel and the accumulated depreciation under IFRS for the three-month period ended on March 31, 2006 amounts to approximately NIS 295 million (decrease in property, plant and equipment), and the effect on the depreciation expenses for the three-month period ended on March 31, 2006 is a decrease of approximately NIS 9 million.

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

Under IAS 38, the Group defers only the incremental direct sales commissions to employees and to external dealers in respect of sales to those subscribers who signed a commitment to remain customers of the Group. These costs are depreciated to profit and loss over the term of the commitment of the subscribers, which is up to 36 installments. The losses in respect of subsidising the telephones is attributed to profit and loss and are not deferred. As a result, the Subscriber Acquisition asset as at March 31, 2006 was reduced by approximately NIS 84 million. The effect on profit and loss for the three month period is an increase of approximately NIS 6 million before tax.

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

Accordingly, with the transition to IFRS, the balance of short-term deferred taxes was reclassified, as at March 31, 2006, in the amount of approximately NIS 200 million, from the accounts receivable and debit balances item under current assets, to the deferred tax item under non-current assets (in this Note, the deferred taxes are stated after the above reclassification).

i. Under IFRS, bank loans to a subsidiary, of approximately NIS 1,284 million, were stated as short-term loans, while under accepted accounting principles in Israel these loans were classified as long-term loans. The classification was changed since the subsidiary failed to meet financial criteria set by the banks for these loans on the balance sheet date.

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

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

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

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

1. Leases of land from Israel Lands Administration classified as operating leases, of approximately NIS 119 million at March 31, 2006, were reclassified from the property, plant and equipment item to the deferred expenses item.
2. Materials and spare parts that were stated in a separate item between the current assets item and the property, plant and equipment item in the amount of NIS 76 million as at March 31, 2006.
3. Other income, net, was classified under other operating income, net.

l. Restatement

The financial statements as at March 31, 2006, were adjusted by way of restatement in order to retroactively reflect the following changes:

(1) Recording of amortisation of lease payments in respect of land from the Israel Lands Administration over the term of the lease and not as amortised since the establishment of the Company (4%). The effect of this amendment is the addition of approximately NIS 105 million to property, plant and equipment, and of approximately NIS 80 million to the balance of shareholders' equity as at March 31, 2006. The amendment does not have a significant effect on the profit for the year.

(2) Presentation of receipts from interconnect to the cellular networks, that were not stated commencing 2000 as part of the Company's income, and correspondingly as an operating expense in the same amount, following examination of the criteria under international standards and in order to present them as accepted in Israel and worldwide. The effect of this amendment is an increase to income and a corresponding increase to operating and general expenses of approximately NIS 201million.

(3) Amendment of the accounting treatment of the depreciation of property, plant and equipment not used by Pelephone, and the resulting tax implications. The effect of this amendment is to depreciate property, plant and equipment by approximately NIS 275 million, and to reduce the balance of shareholders' equity by approximately NIS 200 million March 31, 2006, as well as to reduce depreciation expenses by approximately NIS 10 million and to increase net profit by approximately NIS 10 million for the three month period ended on March 31, 2006.

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

I. Restatement (Contd.)

The table below shows the effect of restatement as aforesaid on the comparison numbers according to accepted accounting principles in Israel at March 31, 2006, before the effects of IFRS.

(1) Effect on the consolidated balance sheet

	As previously reported	Effects of restatement	As reported in these financial statements prior to their adjustment to IFRS
	NIS thousand	NIS thousand	NIS thousand
Property, plant and equipment	9,609,751	(170,682)	9,439,069
Deferred tax assets	526,232	52,328	578,560
Shareholders' equity	7,083,372	(118,354)	6,965,018

(2) Effect on undesignated retained earnings (deficit)

	As at March 31 2006
	NIS thousand
As previously reported	(1,032,194)
Effect of restatement	(118,354)
	(1,150,548)

(3) Effect on net earnings

	For the three-month period ended March 31, 2006
	NIS thousand
Net earnings as reported in the past	225,512
<u>Effect of restatement</u>	
Increase in revenue	201,000
Decrease in depreciation expenses and amortisation	9,159
Increase in operating and general expenses	(201,000)
Increase in income tax	(2,427)
Net earnings as reported in these financial statements in the note on adjustment to IFRS	232,244

NOTE 15 –CONDENSED FINANCIAL STATEMENTS OF PELEPHONE COMMUNICATIONS LTD., D.B.S. SATELLITE SERVICES (1998) LTD., AND BEZEQ INTERNATIONAL LTD.

1. Pelephone Communications Ltd.

A. Balance sheet

	March 31, 2007	March 31, 2006	December 31, 2005
	(Unaudited)	(Unaudited)	(Audited)
	NIS thousands	NIS thousands	NIS thousands
Current assets	**1,660,043**	1,799,432	1,451,006
Non-current assets	**2,445,770**	2,780,635	2,520,473
	4,105,813	4,580,067	3,971,479
Current liabilities	**1,171,077**	1,725,654	1,089,973
Long-term liabilities	**1,283,439**	1,591,588	1,383,859
Total liabilities	**2,454,516**	3,317,242	2,473,832
Shareholders' equity	**1,651,297**	1,262,825	1,497,647
	4,105,813	4,580,067	3,971,479

B. Income statement

	For the three month period ended March 31		For the year ended December 31
	2007	2006	2006
	(Unaudited)	(Unaudited)	(Audited)
	NIS thousands	NIS thousands	NIS thousands
Revenues from services and sales	**1,147,433**	1,088,424	4,477,987
Cost of services and sales	**808,221**	792,801	3,250,303
Gross profit	**339,212**	295,623	1,227,684
Sales and marketing expenses	**102,425**	97,706	417,178
General and administrative expenses	**23,668**	23,154	110,008
	126,093	120,860	527,186
Operating income	**213,119**	174,763	700,498
Financing expenses (income), net	**(7,879)**	2,852	17,687
Earnings before income tax	**220,998**	171,911	682,811
Income tax	**66,914**	45,641	196,910
Net earnings for the period	**154,084**	126,270	485,901

NOTE 15 – CONDENSED FINANCIAL STATEMENTS OF PELEPHONE COMMUNICATIONS LTD., D.B.S. SATELLITE SERVICES (1998) LTD., AND BEZEQ INTERNATIONAL LTD. (CONTD.)

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

A. Balance sheet

	March 31, 2007	March 31, 2006	December 31, 2005
	(Unaudited)	(Unaudited)	(Audited)
	NIS thousands	NIS thousands	NIS thousands
Current assets	**375,965**	355,095	338,662
Non-current assets	**672,244**	744,117	677,732
	1,048,209	1,099,212	1,016,394
Current liabilities	**1,927,752**	1,975,643	1,889,416
Non-current liabilities	**2,029,224**	1,750,050	1,987,634
Total liabilities	**3,956,976**	3,725,693	3,877,050
Capital deficit	**(2,908,767)**	(2,626,481)	(2,860,656)
	1,048,209	1,099,212	1,016,394

B. Income statement

	For the three month period ended March 31		For the year ended December 31
	2007	2006	2006
	(Unaudited)	(Unaudited)	(Audited)
	NIS thousands	NIS thousands	NIS thousands
Revenue	**353,586**	332,046	1,355,735
Cost of income	**269,736**	282,525	1,139,308
Gross profit	**83,850**	49,521	216,427
Sales and marketing expenses	**34,716**	32,490	122,996
General and administrative expenses	**25,133**	22,700	94,313
Operating earnings (loss)	**24,001**	(5,669)	(882)
Financing expenses, net	**72,112**	78,529	318,925
Net loss for the period	**(48,111)**	(84,198)	(319,807)

NOTE 15 – CONDENSED FINANCIAL STATEMENTS OF PELEPHONE COMMUNICATIONS LTD., D.B.S. SATELLITE SERVICES (1998) LTD., AND BEZEQ INTERNATIONAL LTD. (CONTD.)

3. Bezeq International Ltd.*

A. Balance sheet

	March 31, 2007	March 31, 2006	December 31, 2005
	(Unaudited)	(Unaudited)	(Audited)
	NIS thousands	NIS thousands	NIS thousands
Current assets	**410,549**	233,098	332,526
Non-current assets	**422,384**	354,502	340,734
	832,933	587,600	673,260
Current liabilities	**350,364**	240,277	307,724
Long-term liabilities	**50,202**	14,798	15,613
Total liabilities	**400,566**	255,075	323,337
Shareholders' equity	**432,367**	332,525	349,923
	832,933	587,600	673,260

B. Income statement

	For the three month period ended March 31		For the year ended December 31
	2007	2006	2006
	(Unaudited)	(Unaudited)	(Audited)
	NIS thousands	NIS thousands	NIS thousands
Revenue	**322,642**	241,533	1,021,573
Operating expenses	**215,465**	157,579	662,244
Gross profit	**107,177**	83,954	359,329
Sales and marketing expenses	**35,378**	34,566	148,594
General and administrative expenses	**21,711**	16,162	71,806
Other income (expenses), net	**(737)**	206	7,064
Operating income	**50,825**	33,020	131,865
Financing costs, net	**(637)**	(9,404)	(6,965)
Equity in earnings of an associate accounted for by the equity method	**474**	1,624	11,051
Earnings before income tax	**50,662**	25,240	135,951
Income tax	**14,158**	7,596	40,391
Net earnings for the period	**36,504**	17,644	95,560

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

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

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

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

B. In May 2007, the subsidiary Bezeq Zahav (Holdings) Ltd. ("Bezeq Zahav") sold 100,000,000 par value of Debentures (Series 5) of the Company on the Tel Aviv stock exchange, out of the Debentures (Series 5) it purchased from the Company prior to the publication of the Company's prospectus on May 24, 2004 ("the Prospectus"), and which were listed for trading in accordance with the Prospectus. The execution rate of the sale is 111.9 (reflecting a yield to redemption of approximately 3.67%).

The proceeds from the sale, NIS 111,900,000, will be transferred to the Company by Bezeq Zahav in (partial) repayment of the loan granted to Bezeq Zahav by the Company for purchasing the Debentures (Series 5), as provided in the loan agreement between the parties.

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

Subsequently, the Board of Directors of the Company discussed and re-approved the grant of bonuses to officers (excluding the outgoing CEO) in respect of the years 2005 and 2006.

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

	Share capital	Premium on shares	Capital reserve in respect of a transaction between a corporation and a controlling shareholder	Capital reserve in respect of financial assets available for sale	Capital reserve in respect of option warrants for employees	Balance of deficit	Total	Minority rights in capital deficit of a subsidiary	Total equity
	NIS thousands								
	Refers to shareholders of the Company								
Three-month period ended March 31, 2007									
Balance as at January 1, 2007 (audited)	**6,309,133**	**1,623,423**	**384,684**	**630**	**286,506**	**(2,849,381)**	**5,754,995**	**(564,250)**	**5,190,745**
Total earnings (losses) recognised in the period (unaudited)	-	-	-	695	-	398,750	399,445	(13,683)	385,762
Dividends to shareholders of the Company which does not comply with the earnings test (unaudited)	(176,497)	(1,623,423)	-	-	-	-	(1,799,920)	-	(1,799,920)
Balance as at March 31, 2007 (unaudited)	**6,132,636**	**-**	**384,684**	**1,325**	**286,506**	**(2,450,631)**	**4,354,520**	**(577,933)**	**3,776,587**
Three-month period ended March 31, 2006									
Balance as at January 1, 2006 (audited)	6,309,133	1,623,423	384,684	5,253	-	(1,761,971)	6,560,522	(505,280)	6,055,242
Total earnings (losses) recognised for the period (unaudited)	-	-	-	15,669	-	314,102	329,771	(16,040)	313,731
Dividends to shareholders of the Company (unaudited)	-	-	-	-	-	(1,200,000)	(1,200,000)	-	(1,200,000)
Balance as at March 31, 2006 (unaudited)	6,309,133	1,623,423	384,684	20,922	-	(2,647,869)	5,690,293	(521,320)	5,168,973

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

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

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