"BEZEQ" THE ISRAEL TELECOMMUNICATION CORP. LIMITED

INTERIM CONSOLIDATED FINANCIAL STATEMENTS

SEPTEMBER 30, 2004

Condensed Interim Consolidated Financial Statements as at September 30, 2004 (unaudited)

Contents

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

Dear Sirs,

Re: Review of the Unaudited Interim Consolidated Financial Statements as at September 30, 2004

At your request, we have reviewed the interim consolidated balance sheet of "Bezeq" - The Israel Telecommunication Corp. Limited and its consolidated subsidiaries as at September 30, 2004, as well as the interim consolidated statement of operations, the interim statement of changes in shareholders' equity and the interim consolidated statement of cash flows for the nine-month and three-month periods then ended.

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

Reports of other auditors were furnished to us which relate to the review of the interim financial statements of consolidated subsidiaries, whose assets as at September 30, 2004, constitute approximately 35.9% of the total assets included in the interim consolidated balance sheet and whose revenues constitute approximately 44.8% of the total revenues included in the interim consolidated statement of operations for the nine-months then ended and approximately 42% of the total revenues included in the interim consolidated statement of operations for the three months then ended. Furthermore, reports of other auditors were furnished to us which relate to investments in affiliated companies at the same date in which the Company's investments amount to approximately NIS 61,967 thousand as at September 30, 2004, and the Company’s share in the losses in respect thereof amount to approximately NIS 130,695 thousand and NIS 1,365 thousand for the nine-month and three-month periods ending on the same date.

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

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

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

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

2. The intention of the Ministry of Communications to implement an amendment to the Ministry of Communications Regulations in respect of a consolidated company, such that there will be a reduction to the interconnect tariffs for the cellular network, as described in Note 1.C(6).

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

4. Contingent claims made against the Company and against investee companies, as described in Note 7A.

5. The financial position of a consolidated company as described in Note 4B. The continuation of the activities of the consolidated is dependent upon receipt of additional loans from shareholders within the framework of the financing agreements including loans from the Company in accordance with the work plan of the consolidated subsidiary.

Somekh Chaikin
Certified Public Accountants (Isr.)

November 4, 2004

Condensed Interim Consolidated Balance Sheets as at September 30, 2004 (Unaudited)

	September 30 2004 (Unaudited)	September 30 2003 (Unaudited)	December 31 2003 (Audited)
	Reported amounts*	Adjusted for the effects of inflation in shekels of December 2003	
	NIS thousands	NIS thousands	NIS thousands
Current assets			
Cash and cash equivalents	**1,313,837**	887,196	1,954,350
Short-term investments	**1,254,967**	1,370,553	1,340,341
Trade receivables	**2,147,714**	1,712,552	1,667,623
Other receivables and debit balances	**418,610**	461,241	415,372
Inventory	**254,353**	101,649	83,995
	5,389,481	4,533,191	5,461,681
Materials and spare parts	**139,704**	147,939	151,911
Broadcasting rights			
Cost	**207,605**	–	–
Less – rights utilized	**79,195**	–	–
	128,410	–	–
Investments and long-term receivables			
Investments, deposits and debit balances	**876,076**	638,429	765,971
Investments in investee companies	**61,967**	287,054	240,667
	938,043	925,483	1,006,638
Fixed assets			
Cost	**35,607,803**	30,279,526	28,385,188
Less - accumulated depreciation	**24,888,542**	21,137,760	19,686,070
	10,719,261	9,141,766	8,699,118
Other assets			
Goodwill	**1,834,529**	11,623	6,553
Deferred charges and other assets	**393,956**	219,788	202,124
Deferred taxes	**450,447**	454,950	560,739
	2,678,932	686,361	769,416
	19,993,831	15,434,740	16,088,764

	September 30 2004 (Unaudited)	September 30 2003 (Unaudited)	December 31 2003 (Audited)
	Reported amounts*	Adjusted for the effects of inflation in shekels of December 2003	
	NIS thousands	NIS thousands	NIS thousands
Current liabilities			
Bank credit	**1,321,527**	188,490	144,714
Current maturities of:			
Long-term bank loans	**1,407,591**	647,284	685,883
Debentures	**230,513**	596,870	598,153
Trade payables	**1,597,310**	994,642	1,130,716
Employee severance benefits	**696,644**	138,167	602,520
Other current liabilities	**1,449,414**	1,427,627	1,188,200
	6,702,999	3,993,080	4,350,186
Long-term liabilities			
Long-term loans	**1,633,409**	1,881,636	1,754,293
Debentures	**3,663,469**	2,244,031	2,324,582
Employee severance benefits, net	**607,058**	777,014	770,909
Other liabilities	**37,093**	31,551	43,764
Loans provided by the minority in a consolidated company:			
Loans	**1,051,620**	–	–
Less – minority share in deficit of a consolidated company	**(1,051,620)**	–	–
	5,941,029	4,934,232	4,893,548
Minority rights	**(12,012)**	37	88
Contingent liabilities (Note 7)			
Shareholders' equity	**7,361,815**	6,507,391	6,844,942

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

Date of approval of the financial statements: November 4, 2004

	19,993,831	15,434,740	16,088,764

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

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

Condensed Interim Consolidated Statements of Operations

	For the nine-month period ended September 30		For the three-month period ended September 30		For the year ended December 31
	2004 (Unaudited)	2003 (Unaudited)	2004 (Unaudited)	2003 (Unaudited)	2003 (Audited)
	Reported amounts*	Adjusted for the effects of inflation in shekels of December 2003	Reported amounts*	Adjusted for the effects of inflation in shekels of December 2003	Adjusted for the effects of inflation in shekels of December 2003
	NIS thousands		NIS thousands		NIS thousands
Revenues from telecommunications services (Note 9)	**6,494,244**	6,013,718	**2,473,463**	2,079,136	7,981,268
Costs and expenses					
Operating and general expenses (Note 10)	**3,734,934**	3,358,944	**1,510,954**	1,158,391	4,485,300
Depreciation	**1,495,079**	1,635,317**	**556,290**	552,819**	2,160,011
Royalties to the Government of Israel	**155,835**	183,285	**59,774**	62,028	242,608
	5,385,848	5,177,546	**2,127,018**	1,773,238	6,887,919
Operating income	**1,108,396**	836,172	**346,445**	305,898	1,093,349
Financing expenses, net	**136,625**	130,069	**67,878**	46,144	157,522
Earnings after financing expenses	**971,771**	706,103	**278,567**	259,754	935,827
Other expenses (income), net (Note 11)	**(108,939)**	266,446**	**(131,940)**	257,456**	983,178
Earnings (loss) before income tax	**1,080,710**	439,657	**410,507**	2,298	(47,351)
Income tax (Note 12)	**433,098**	174,624	**166,320**	9,617	48,013
Earnings (loss) after income tax	**647,612**	265,033	**244,187**	(7,319)	(95,364)
Equity in losses of affiliates	**130,695**	263,813**	**1,365**	77,803**	343,334
Minority share in earnings (losses) of a consolidated company	**44**	(581)	**172**	(348)	(862)
Net earnings (loss)	**516,873**	1,801	**242,650**	(84,774)	(437,836)
Primary and diluted earnings (loss) per NIS 1 par value of ordinary shares (in NIS)	**0.198**	0.001	**0.093**	(0.035)	(0.179)

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

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

Condensed Interim Statements of Changes in Shareholders' Equity

	Share capital	Capital reserve for premium on shares	Capital reserve in respect of transactions between the Company and a controlling shareholder	Dividend proposed after the balance sheet date	Retained earnings (deficit)	Total
	Reported amounts*					
	NIS thousands					
Nine months ended September 30, 2004						
Balance as at January 1, 2004 (audited)	**6,309,133**	**1,623,423**	**37,775**	**–**	**(1,125,389)**	**6,844,942**
Net earnings for the period (unaudited)	**–**	**–**	**–**	**–**	**516,873**	**516,873**
Balance as at September 30, 2004 (unaudited)	**6,309,133**	**1,623,423**	**37,775**	**–**	**(608,516)**	**7,361,815**

	Share capital	Capital reserve for premium on shares	Capital reserve in respect of transactions between the Company and a controlling shareholder	Dividend proposed after the balance sheet date	Retained earnings (deficit)	Total
	Adjusted for the effects of inflation in shekels of December 2003					
	NIS thousands					
Nine months ended September 30, 2003						
Balance as at January 1, 2003 (audited)	6,116,378	938,134	37,775	186,416	(688,623)	6,590,080
Net earnings for the period (unaudited)	–	–	–	–	1,801	1,801
Dividend paid (unaudited)	–	–	–	(186,416)	1,070	(185,346)
Issue of shares (unaudited)	23,248	77,608	–		–	100,856
Balance as at September 30, 2003 (unaudited)	6,139,626	1,015,742	37,775	–	(685,752)	6,507,391

	Share capital	Capital reserve for premium on shares	Capital reserve in respect of transactions between the Company and a controlling shareholder	Dividend proposed after the balance sheet date	Retained earnings (deficit)	Total
	Reported amounts*					
	NIS thousands					
Three months ended September 30, 2004						
Balance as at July 1, 2004 (unaudited)	**6,309,133**	**1,623,423**	**37,775**	**–**	**(851,166)**	**7,119,165**
Net earnings for the period (unaudited)			**–**	**–**	**242,650**	**242,650**
Balance as at September 30, 2004 (unaudited)	**6,309,133**	**1,623,423**	**37,775**	**–**	**(608,516)**	**7,361,815**

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

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

Condensed Interim Statement of Changes in Shareholders' Equity (Contd.)

	Share capital	Capital reserve for premium on shares	Capital reserve in respect of transactions between the Company and a controlling shareholder	Dividend proposed after the balance sheet date	Retained earnings (deficit)	Total
	Adjusted for the effects of inflation in shekels of December 2003					
	NIS thousands					
Three months ended September 30, 2003						
Balance as at July 1, 2003 (unaudited)	6,116,378	938,134	37,775	–	(600,978)	6,491,309
Net loss for the period (unaudited)	–	–	–	–	(84,774)	(84,774)
Issue of shares (unaudited)	23,248	77,608	–	–	-	100,856
Balance as at September 30, 2003 (unaudited)	6,139,626	1,015,742	37,775	–	(685,752)	6,507,391
Year ended December 31, 2003						
Balance as at January 1, 2003 (audited)	6,116,378	938,134	37,775	186,416	(688,623)	6,590,080
Net loss (audited)	–	–	–	–	(437,836)	(437,836)
Dividend paid (audited)	–	–	–	(186,416)	1,070	(185,346)
Issue of shares (audited)	192,755	685,289	–	–	–	878,044
Balance as at December 31, 2003 (audited)	6,309,133	1,623,423	37,775	–	(1,125,389)	6,844,942

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

Condensed Interim Consolidated Statements of Cash Flows

	For the nine-month period ended September 30		For the three-month period ended September 30		For the year ended December 31
	2004 (Unaudited)	2003 (Unaudited)	2004 (Unaudited)	2003 (Unaudited)	2003 (Audited)
	Reported amounts*	Adjusted for the effects of inflation in shekels of December 2003	Reported amounts*	Adjusted for the effects of inflation in shekels of December 2003	Adjusted for the effects of inflation in shekels of December 2003
	NIS thousands		NIS thousands		NIS thousands
Cash flows from operating activities					
Net earnings (loss)	**516,873**	1,801	**242,650**	(84,774)	(437,836)
Adjustments to reconcile net earnings (loss) to net cash flows from operating activities (see A below)	**1,509,844**	1,975,613	**315,641**	636,057	3,129,841
Net cash derived from operating activities	**2,026,717**	1,977,414	**558,291**	551,283	2,692,005
Cash flows for investing activities					
Investment in fixed assets	**(997,465)**	(1,162,029)	**(319,762)**	(441,065)	(1,413,803)
Proceeds from disposal of fixed assets	**73,629**	60,867	**30,966**	52,654	86,492
Investment in long-term deposits and investments	**(29,085)**	(16,361)	**(995)**	(11,395)	(159,564)
Proceeds from long-term deposits and investments	**36,313**	35,651	**391**	8,996	77,216
Decrease (increase) in short-term investments, net	**143,390**	(169,050)	**(38,802)**	(48,958)	(107,137)
Decrease (increase) in materials and spare parts	**(40,066)**	(21,497)	**6,335**	8,611	(260)
Investment in investee companies	**(108,594)**	(157,589)	**(465)**	(42,324)	(190,037)
Companies consolidated for the first time (see C below)	**(246,935)**	-	**(246,935)**	-	-
Investment in other assets	**(107,300)**	(43,077)	**(36,876)**	(10,237)	(51,124)
Net cash used in investing activities	**(1,276,113)**	(1,473,085)	**(606,143)**	(483,718)	(1,758,217)
Cash flows from financing activities					
Issue of debentures (after deduction of issue expenses)	**1,426,215**	-	**105,921**	-	-
Repayment of other debentures	**(573,467)**	(179,303)	**(29,186)**	(27,080)	(207,623)
Receipt of long-term loans	**189,500**	416,682	**50,000**	216,131	493,191
Repayment of long-term loans	**(2,312,951)**	(413,396)	**(1,941,725)**	(128,383)	(557,302)
Repayment of short-term bank credit, net	**(120,414)**	(330,361)	**(23,254)**	(272,502)	(374,137)
Proceeds from issue of shares	**-**	100,856	**-**	100,856	878,044
Dividend paid	**-**	(185,346)	**-**	-	(185,346)
Net cash (used in) derived from financing activities	**(1,391,117)**	(590,868)	**(1,838,244)**	(110,978)	46,827
Increase (decrease) in cash and cash equivalents	**(640,513)**	(86,539)	**(1,886,096)**	(43,413)	980,615
Balance of cash and cash equivalents at the beginning of the period	**1,954,350**	973,735	**3,199,933**	930,609	973,735
Balance of cash and cash equivalents at the end of the period	**1,313,837**	887,196	**1,313,837**	887,196	1,954,350

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

The notes to the financial statements are integral part thereof.

Condensed Interim Consolidated Statements of Cash Flows (contd.)

	For the nine-month period ended September 30		For the three-month period ended September 30		For the year ended December 31
	2004 (Unaudited)	2003 (Unaudited)	2004 (Unaudited)	2003 (Unaudited)	2003 (Audited)
	Reported amounts*	Adjusted for the effects of inflation in shekels of December 2003	Reported amounts*	Adjusted for the effects of inflation in shekels of December 2003	Adjusted for the effects of inflation in shekels of December 2003
	NIS thousands		NIS thousands		NIS thousands
A – Adjustments to reconcile net earnings (loss) to net cash flows provided by operating activities					
Income and expenses not involving cash flows:					
Depreciation	**1,495,079**	1,635,317**	**556,290**	552,819**	2,160,011
Disposal of assets and impairment of fixed assets	**–**	35,412**	**–**	35,412**	327,295
Deferred taxes	**40,273**	8,138	**38,469**	(24,251)	(137,670)
Company's equity in losses of affiliated companies	**130,695**	263,813**	**1,365**	77,803**	343,334
Minority share in losses (earnings) of a consolidated company	**44**	(581)	**172**	(348)	(862)
Increase (decrease) in employee severance benefits, net	**(79,202)**	(411,761)	**(19,418)**	(351,779)	46,488
Loss (gain) on disposal of fixed assets	**(7,143)**	8,540	**(7,539)**	4,688	(1,634)
Provision for impairment of investments	**–**	26,207**	**–**	21,327**	14,603
Erosion (appreciation) and interest on long-term deposits and investments	**(12,238)**	55,146	**7,420**	(69,137)	25,160
Appreciation of short-term investments, net	**(5,530)**	(43,680)	**(15,675)**	(21,488)	(75,381)
Appreciation (erosion) of long-term liabilities:					
Debentures	**18,499**	96,978	**16,760**	96,698	207,133
Long-term loans and other liabilities	**5,028**	(62,469)	**(39,897)**	56,258	(77,647)
Amortization of other assets and deferred expenses	**76,102**	96,248	**32,184**	19,101	138,438
Changes in asset and liability items:					
Increase in broadcasting rights	**(5,430)**	–	**(5,430)**	–	–
Decrease (increase) in trade receivables	**40,031**	(8,396)	**37,431**	(15,564)	29,835
Decrease (increase) in receivables and debit balances	**121,551**	57,667	**39,422**	(52,882)	129,706
Decrease (increase) in inventory	**(58,593)**	60,918	**4,159**	13,653	78,083
Increase (decrease) in trade payables	**(204,542)**	(97,737)	**(88,679)**	135,618	(123,852)
Increase (decrease) in other current liabilities	**(29,992)**	268,099	**(241,689)**	161,931	63,054
Increase (decrease) in deferred revenues	**(14,788)**	(12,246)	**296**	(3,802)	(16,253)
	1,509,844	1,975,613	**315,641**	636,057	3,129,841
B - Non-cash transactions					
Acquisition of fixed assets, other assets, materials and spare parts on credit	**119,488**	170,527	**119,488**	170,527	313,119
Sale of fixed assets on credit	**1,993**	–	**1,993**	–	–

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

** Reclassified

The notes to the financial statements are integral part thereof.

Condensed Interim Consolidated Statements of Cash Flows (contd.)

	For the nine-month period ended September 30		For the three-month period ended September 30		For the year ended December 31
	2004 (Unaudited)	2003 (Unaudited)	2004 (Unaudited)	2003 (Unaudited)	2003 (Audited)
	Reported amounts*	Adjusted for the effects of inflation in shekels of December 2003	Reported amounts*	Adjusted for the effects of inflation in shekels of December 2003	Adjusted for the effects of inflation in shekels of December 2003
	NIS thousands		NIS thousands		NIS thousands
C – Companies consolidated for the first time (Note 2H)					
Working capital (excluding cash and cash equivalents)	**2,057,632**	–	**171,938**	–	–
Fixed assets	**(2,967,819)**	–	**(1,763,768)**	–	–
Long-term liabilities	**2,322,740**	–	**2,391,877**	–	–
Minority loans to a consolidated company	**1,048,637**	–	**-**	–	–
Less – minority share in deficit	**(1,048,637)**	–	**-**	–	–
Minority rights	**(16,549)**	–	**-**	–	–
Investment in an affiliated company	**178,339**	–	**(2,215)**	–	–
Goodwill	**(1,821,278)**	–	**(1,044,767)**	–	–
	(246,935)	–	**(246,935)**	–	–

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

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

Notes to the Financial Statements as at September 30, 2004

NOTE 1 – GENERAL

A. These interim statements were prepared according to generally accepted accounting principles, applicable to the preparation of financial statements for interim periods pursuant to Accounting Standard 14 of the Israeli Accounting Standards Board (hereinafter – the IASB) and the provisions of Section 4 of the Securities Regulations (Periodic and Immediate Reports) 5730-1970.

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

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

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

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

(2) Further to Note 1B to the financial statements as at December 31, 2003, concerning changes in and the updating of the Company's tariffs, call completion tariffs on the Bezeq network for calls originating on a cellular network and international interconnect tariffs were lowered on June 1, 2004, by an average rate of 8.2%. In addition, in accordance with a formula prescribed in the Regulations and starting on the same date, the Company's controlled tariffs were reduced by an average of approximately 4.3%. This rate includes an average reduction of approximately 5% in interconnect tariffs paid to the Company, which were reduced as of August 1, 2004.

(3) Further to Note 1E(1) to the financial statements as at December 31, 2003, concerning the Company's appeal to the District Court against the decision of the Minister of Communications regarding interconnect payments between the Company and the cellular companies, on August 17, 2004, the Company received the ruling of the Court which stated that it had no jurisdiction to hear the appeal and that therefore the appeal was to be struck out.. On October 13, 2004, the Company requested that the Minister of Communications re-examine his decision of July 2003, on interconnect fees between the Company and the cellular companies, in the light of the position of the Ministry of Communications on interconnect fees and the economic findings presented by the Ministry of Communications in support of that position (see paragraph (6) below).

Notes to the Financial Statements as at September 30, 2004

NOTE 1 – GENERAL (CONTD.)

(4) Further to Note 1E(2) to the financial statements as at December 31, 2003, concerning the expansion of competition in the international communications market, the Telecommunications Regulations (Telecommunications and Broadcasts) (Processes and Conditions for Receipt of a General License for the Provision of International Telecommunications Services) 5764-2004 were published on March 30, 2004, and took effect on April 22, 2004. Most of the claims of Bezeq International were accepted and the Regulations provide that a license will not be granted to a corporation in which an interested party is an international operator, nor to a corporation in which a party with considerable influence in it (as defined in the Regulations) is a cellular operator, nor will a license be granted to a corporation that is a domestic carrier or a cellular operator or a significant operator in the international transmission service operations sector (as defined in the Regulations) and a limitation was imposed on an applicant for a license which provides that at least twenty-six percent of all means of control in such applicant must be held by a citizen and resident of Israel. The Regulations also provide that in other situations of cross-ownership, a license will only be granted to a corporation if the Minister is convinced that grant of the license will promote competition in the field of telecommunications, in the communications operations sector or is in the public interest. The Minister of Communications may also stipulate restrictions and conditions in the license concerning the relationship between the licensee and companies with an interest which are a domestic carrier, a cellular operator or a significant operator as aforesaid, including regarding filling positions and appointing officers, information transfer, the existence of separate companies or separate accounting systems for operations and, in addition, concerning technological or commercial restrictions in setting up an international telecommunications system, in providing services, in implementing interconnect connections and in granting use of the licensee's telecommunications installations.

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

Pursuant to this, the Ministry of Communications granted general licenses for the provision of international telecommunications services to a number of additional operating companies, one of which commenced operations during August 2004.

In the opinion of Bezeq International, the increase in competition will cause a further reduction in international call tariffs, although, unlike when competition started in 1997, the extent of international traffic will not significantly increase as a result since call tariffs today do not deter the public from using the service. In addition, Bezeq International believes that the aforementioned increase in competition is likely to have an adverse effect on the results of its operations and financial position, but Bezeq International cannot, at this stage, estimate the extent of that effect.

(5) On July 5, 2004, regulations were published relating to processes and conditions for the receipt of a specific general license for the provision of domestic fixed-line communications services with no universal service obligation. These Regulations prescribe the method for filing an application to receive such a license, and the treatment of such application, as well as the conditions and limitations for grant of a domestic operator license. Under the Regulations, the licensee is to be the owner and operator of the telecommunications network under which the services are to be provided to its subscribers, but at the same time, the licensee will be entitled to use the infrastructure of others, provided that it is the owner and operator of the switch via which the services are provided to its subscribers.

In the meantime, a number of companies have applied for a license for a "marketing trial for consideration" for the provision of domestic fixed-line telecommunication services in accordance with the policy document which was published by the Ministry of Communications that permits the aforementioned trial under certain conditions. Bezeq International is one of the applicants. As of the date of these financial statements the Company has received notice from the Ministry of Communications that one operator has received a license for the aforementioned marketing trial. The Company presented to the Ministry of Communications its reservations regarding the

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granting of a license for the above marketing trial.

(6) Pursuant to a notice from the Minister of Communications to Pelephone on July 28, 2004 (which was also sent to the Company on August 8, 2004), following economic research performed as part of a review of interconnect tariffs to a cellular network, the Ministry of Communications intends to amend the Telecommunications Regulations (Telecommunications and Broadcasts) (Payments for Interconnection), 5760-2000 ("the Regulations") so as to reduce the interconnect tariffs to a cellular network in respect of call completion, the transmission of SMS messages and computation of the call duration charge.

The main amendments under consideration are as follows:

a. Reduction of payments received from a domestic operator or a cellular operator for the completion of one traffic minute on a cellular network from NIS 0.45 per traffic minute to a maximum tariff of NIS 0.27 starting on January 1, 2005, and to a maximum tariff of NIS 0.151 commencing January 1, 2006.
b. Reduction of payments received from an international licensee for completion of a traffic minute on a cellular network from NIS 0.25 to a maximum tariff of NIS 0.151, commencing January 1, 2006.
c. Reduction of payments received from another cellular operator for the transfer of an SMS message in a cellular network from NIS 0.285 per traffic minute to a maximum tariff of NIS 0.058 commencing January 1, 2005, and to a maximum tariff of NIS 0.011 commencing January 1, 2006.
d. For counting the traffic minutes for computation of the payment for call completion to a cellular network, billing will be according to segments of one second rather than 12 seconds as is today. Likewise, call completion tariffs and SMS tariffs will be updated each year from January 1, 2007, in accordance with the rate of change in the CPI, and with respect to call completion – using a reduction coefficient of 1%.

The notice to Pelephone and the Company was given as part of a hearing process regarding amendment of the Regulations, and Pelephone and the Company were invited to submit their responses to the Minister's notice. During August 2004 a discussion was held between representatives of Pelephone and the Ministry of Communications, in which Pelephone presented its position on the proposed amendments. The position of the Ministry has not yet been received. In Pelephone's opinion, if and to the extent that the amendments being considered are accepted and implemented, they are likely to cause considerable harm to its revenues, and as a result, it's financial results will be materially adversely affected.

(7) The Company contracts with business customers for defined periods with the aim of encouraging increased use of its services by providing assistance in financing communications equipment or annual financial bonuses in the form of discounts which the Company believes it is entitled to give. Pursuant to a notice from the Ministry of Communications, following an investigation it carried out, the position of the Ministry of Communications is that these contracts contravene the provisions of the law and the Company's general license and therefore it intends to order the Company to rescind the contracts and if these are not rescinded within the time set out, to order forfeiture of a guarantee in the sum of NIS 10 million and to prohibit the Company from entering into new contracts. The Company has submitted its position to the Ministry of Communications in writing, stating that its operations in this respect are in accordance with the provisions of the law and its general license. The Company also questioned the Ministry of Communications' authority to order rescission of agreements that had already been signed and its authority to forfeit the guarantee in these circumstances. The Company submitted an appeal to the Minister of Communications against the decision of his Ministry. On October 11, 2004, the appeal was heard by the Minister, and in a letter dated October 31, 2004, and received on November 4, 2004, the Minister notified the Company of his decision that there was no justification for changing the decision of his Ministry and that in order to allow the Company sufficient time to ready itself for rescission of the arrangements, the date for doing so was being postponed to December 31, 2004, and that if the arrangements were not rescinded, the amount of the forfeited guarantee was being reduced to NIS 8 million. The Company intends to appeal to the courts against the

Notes to the Financial Statements as at September 30, 2004

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Minister's decision. In its estimation, if it is prohibited from entering into contracts of this kind, the Company will be denied a means of providing itself with important and fundamental marketing tools in its field of operations.

(8) Pursuant to agreement reached between the Company and Pelephone, commencing September 2004 Pelephone ceased making certain payments to the Company. Up to that date, Pelephone paid the Company 3% of a defined list of revenues from cellular services.

D. On August 1, 2004, a temporary provision took effect which provided that interconnect fees would not be paid for calls between the Company's network and a domestic operator's network for the earlier of a period of two years or until a gap of up to 1.05 billion traffic minutes is generated between the Company's network and that of the domestic operator (other than a special domestic operator and the Company). Pursuant to a letter which the Company received from the Ministry of Communications, the Company will receive compensation for non-payment of these interconnect fees up to the sum of approximately NIS 40 million by way of amendment of the Royalty Regulations.

The Company expressed its objection to this arrangement because in its opinion, the arrangement harms it and its property, there is no similar precedent to it anywhere in the world and it could generate distortions, market failure and abuse. Therefore, on July 29, 2004, the Company filed a petition in the High Court of Justice against the aforesaid temporary provision, claiming *ultra vires*, discrimination and harm to the Company's property. The Company also claimed that whilst the arrangement regarding non-payment of the interconnect fee is supposed to take effect on August 1, 2004, there is no corresponding arrangement in force for the compensation promised to the Company. Following the filing of the petition, a letter was received from the Minister of Communications and the Minister of Finance sent on August 4, 2004, enclosing a draft amendment to the Royalties Regulations and clarifying that they intend to act to amend the Royalties Regulations in such a way as to guarantee the aforesaid compensation to the Company and that in the event that the amendment of the Royalties Regulations does not come into force, they will act to suspend the temporary provision until such amendment is effected. On September 22, 2004, the Knesset Finance Committee approved the aforementioned amendment to the Royalties Regulations. In addition, the State and the cable companies have submitted their responses to the petition, and its hearing is scheduled for February 23, 2005.

E. (1) The offer for sale and the offering to the public under the Company's prospectus published on May 24, 2004, contained the following securities:

An offer for sale to the public, by the State of Israel, of approximately 156,000,000 ordinary shares of NIS 1 par value each of the Company (representing approximately 5.99% of the issued share capital of the Company).

An offering by the Company of 1,200,000,000 debentures (Series 4) of NIS 1 par value each, payable in four equal annual installments. Of these debentures, approximately 400,000,000 debentures of NIS 1 par value each were issued on the eve of the prospectus to Bezeq Gold (Holdings) Ltd., which is a wholly owned and controlled subsidiary of the Company.

In addition, on May 20, 2004, the Company issued a series of 600,000,000 debentures (Series 5) of NIS 1 par value each, out of which it issued 50,000,000 debentures to institutional investors and the remainder to Bezeq Gold (Holdings) Ltd. The interest rate prescribed for these debentures is 5.3% per annum. These debentures were listed for trading under the aforesaid prospectus.

The results of the offer of sale to the public by the State of Israel were the sale of 70,671,100 shares (approximately 2.71% of the issued share capital of the Company), at a price of NIS 4.921 per share. The debentures (Series 4) offered by the Company were sold in full. The interest rate set for the debentures is 4.8% per annum.

(2) Just prior to the issue, the State (the Government Companies Authority) and employee

NOTE 1 – GENERAL (CONTD.)

representatives of the Company reached an arrangement regarding compensation to Company employees for the offer to the public under the prospectus, and for the private sale of the State's shares in the Company (future sale of controlling interest). The arrangement includes conditions for providing the compensation, including noting those employees who are entitled to compensation, the term of the arrangement, the number of shares, the price at which the shares are to be offered to the employees, the rate of the discount, preconditions, etc.

NOTE 2 – REPORTING POLICIES AND ACCOUNTING PRINCIPLES

A. General

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

B. Definitions

In these financial statements –

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

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

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

Nominal financial reporting – financial reporting based on reported values.

C. Termination of adjustment of financial statements

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

D. Financial statements in reported values

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

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

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

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

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

D. Financial statements in reported values (Contd.)

(5) Balance Sheets:

a. Non-monetary items are stated at reported values.

b. Monetary items are stated in the balance sheet at historical nominal values as at the balance sheet date.

Statements of Operations:

a. Revenues and expenses deriving from non-monetary items or from provisions included in the balance sheet are derived from the difference between the reported value opening balance and the reported value closing balance.

b. The remaining items of the Statement of Operations are stated in nominal values.

E. Broadcasting rights

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

F. Initial Application of Accounting Standards

Accounting Standard No. 20, period of amortization of goodwill

The Company is applying Accounting Standard No. 20 concerning the period of amortization of goodwill (hereinafter – the Standard). The Standard states that goodwill is to be methodically amortized over its useful life using the straight-line method. The amortization period should reflect the best estimate of the period in which future economic benefits can be expected to be derived from the goodwill. The amortization period is not to exceed 20 years from the date of first recognition. The Standard applies to financial statements whose periods commence on January 1, 2004 or thereafter. The change in the amortization period of the balances of goodwill as at January 1, 2004 is treated as a prospective change of estimate (“from now on”). Such balances of goodwill were amortized by the straight-line method during the balance of the period remaining for completion of the amortization period determined. As a result of application of the Standard in the reported period, the period of amortization of goodwill created by the acquisition of DBS Satellite Services (1998) and Pelephone was set at 20 years. The effect of the above changes on the financial statements of the Group is an increase of approximately NIS 4 million in net earnings for the three-month period ended September 30, 2004.

G. Disclosure of effect on new Accounting Standards in the period preceding their application

In July 2004, the IASB published Accounting Standard No. 19 – “Income Taxes”. The Standard prescribes that deferred tax liabilities are to be recognized for all temporary taxable differences, with a small number of exceptions. Similarly, deferred tax assets for all deductible temporary differences, losses for tax purposes and unutilized tax benefits are to be recognized where it is anticipated that there will be taxable income against which these may be utilized, with a small number of exceptions. The new standard is to apply to financial statements for the periods commencing January 1, 2005. The Standard provides that it is to be adopted by way of cumulative effect of the change in the accounting method. In the Company’s estimation, the effect of the Standard on the results of its operations, financial position and cash flows is not expected to be material.

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

H. Companies consolidated for the first time

(1) **D.B.S. Satellite Services (1998) Ltd.**

(a) A number of gradual, substantial changes have taken place over recent years in the Company's investment in D.B.S. Satellite Services (1998) Ltd. (hereinafter – DBS), principal among them being the percentage of holding, changes in undertakings to invest in and finance of DBS, and changes in actual investments. These developments have gradually made the Company the dominant interested party in DBS until, upon implementing the resolution of the Board of Directors to inject NIS 440 million on the conditions set out in the resolution, the Company became, for the first time, the sole shareholder financing DBS's operations. The Company therefore gave notice of its intention to consolidate DBS's financial statements from that date.

On July 1, 2004, the Board of Directors of the Company resolved to approve that management act to exercise the warrants and on July 19, 2004, the Company applied for regulatory consents, including the approval of the Antitrust Commissioner, to increase its holdings in DBS to more than 50% (hereinafter – Merger) (see Note 4B). Due to initial comments of the Antitrust Authority prior to submission of notice of the Merger and which indicated a possible difficulty in approving the Merger due to the structure of the communications market, the Company applied to the Securities Authority, requesting its position on the possibility of postponing the date of full consolidation of DBS until it became completely certain that the regulatory approvals could be obtained for the increase in the Company's holdings in DBS to more than 50%. The plenum of the Securities Authority discussed the Company's request on August 17, 2004 and notified the Company that it must commence consolidation of the financial statements of DBS in the Company's financial statements as at June 30, 2004. On June 21, 2004 the Company began to inject funds on account of the aforementioned NIS 440 million, and from that date the financial statements of DBS have been consolidated with those of the Company, i.e. from that date the Company has been recording in its financial statements the full financial results of DBS.

(b) Below are the DBS data as included in the consolidated financial statements as a result of the increase in the percentage of the Company's holdings:

	On the date of acquiring control	As at September 30, 2004
	NIS thousand	NIS thousand
Balance Sheet		
Working capital (excluding cash and cash equivalents)	(1,795,696)	(1,771,345)
Fixed assets and broadcasting rights, net	1,204,051	1,225,629
Long-term liabilities	(20,862)	(8,410)
Minority loans to a consolidated company	(1,048,637)	(1,051,620)
Less – minority share in deficit	1,048,637	1,051,620
Minority rights	16,549	12,012
Goodwill	776,511	766,425
Statement of Operations		
Revenue turnover		268,680
Net loss		(71,867)
Group share in loss		(71,867)

(c) The sum of goodwill generated following consolidation of DBS's financial statements for the first time amounts to approximately NIS 452,000.

(2) **Pelephone Communications Ltd.**

(a) On August 26, 2004 the transaction of exercise of the option to purchase the remaining 50% of the shares of Pelephone from Shamrock was finally closed (increase of the Company's

Notes to the Financial Statements as at September 30, 2004

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

H. Newly consolidated companies (contd.)

(2) **Pelephone Communications Ltd. (Contd.)**

holding from 50% to 100%) so that all the shares of Pelephone are now owned by the Company, either directly or through holdings in Pelephone Holdings (see Note 4A).

(b) Below are the Company data included in the consolidated financial statements as a result of the increase in the percentage of holdings:

	On the date of acquiring control	As at September 30, 2004
	NIS thousand	NIS thousand
Balance Sheet		
Working capital (excluding cash and cash equivalents)	**(171,938)**	**(129,927)**
Cash	**25,465**	**25,465**
Fixed assets, net	**1,527,962**	**1,507,147**
Long-term liabilities	**(2,391,877)**	**(605,301)**
Other assets	**235,806**	**235,806**
Goodwill	**1,044,767**	**1,039,758**
Investment in an affiliated company	**2,215**	**2,215**
Statement of Operations		
Revenue turnover		**213,447**
Net earnings		**34,537**
Group share in earnings		**34,537**

(c) The sum of goodwill generated following consolidation of Pelephone's financial statements for the first time amounts to approximately NIS 1,045,000.

NOTE 3 – RATES OF CHANGES IN THE CONSUMER PRICE INDEX AND FOREIGN CURRENCY EXCHANGE RATES

The changes that occurred in the Consumer Price Index ("CPI") and in the US Dollar and Euro exchange rates are as follows:

	Consumer price index	Exchange rate of the US dollar	Exchange rate of the Euro
	%	%	%
For the nine-month period ended:			
September 30, 2004	**1.207**	**2.352**	**(0.152)**
September 30, 2003	(1.481)	(6.249)	4.336
For the three-month period ended:			
September 30, 2004	**(0.198)**	**(0.334)**	**1.079**
September 30, 2003	(0.992)	2.992	5.228
For the year ended December 31, 2003	(1.848)	(7.557)	11.350

NOTE 4 – INVESTMENTS IN INVESTEE COMPANIES

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

Further to Note 8D(3) to the financial statements as at December 31, 2003, concerning the decision of the Board of Directors of the Company dated February 26, 2004, to exercise the option to acquire the remaining 50% of the shares in Pelephone from the Shamrock Group, an agreement was signed with the Shamrock Group on August 12, 2004, amending the option agreement so that the Company would exercise the option in consideration of an exercise price of US $60 million (approximately NIS 270 million). It was also agreed with the Shamrock Group that the Company and a corporation from the Shamrock Group that holds the Pelephone shares being purchased ("Pelephone Holdings") would support a proposal to distribute a dividend to the shareholders of Pelephone immediately prior to closing the transaction for exercise of the option, in a total sum of approximately US $8.3 (about NIS 38 million).

On August 26, 2004, after receipt of approvals from the Ministerial Committee on Privatization, the Ministry of Communications and the Antitrust Commissioner for the Merger of Bezeq Pelephone Holdings and Pelephone, the transaction for exercise of the option was finally closed. It is noted that the approval of the Antitrust Commissioner was made contingent on a number of conditions which in the opinion of the Company prevent and thwart any possibility of business or commercial cooperation between the Company and Pelephone. It is further noted that on October 10, 2004, the Company was served with an appeal filed in the Antitrust Court by the company “Cellcom”, petitioning for revocation of the Merger approval. According to Cellcom, the Antitrust Commissioner erred in deciding to approve the Merger and the Company should therefore be ordered to sell the recently-purchased Pelephone shares or alternatively, to make the Merger contingent upon additional conditions. In the opinion of the legal advisers of the Company, the chances that the petition will be allowed in a way that will lead to revocation of the transaction are smaller than the chances that the petition will be dismissed and it is difficult to estimate the chances as to whether the court will make the Merger contingent upon additional conditions. However, they do believe that the conditions of the Merger laid down by the Antitrust Commissioner are harsh for the Company and for Pelephone.

On completion of the transaction, the Company holds all the participation units in Pelephone Holdings and as a result, all the shares of Pelephone are wholly owned by the Company, either directly or through its holding in Pelephone Holdings.

In addition to payment of US $60 million to Shamrock with the closing of the transaction for exercise of the option as aforesaid and conversion of the convertible debenture (of a par value of $240 million, recorded in the financial statements at zero value), the Company extended a loan to Pelephone Holdings in the amount of NIS 1,766 million (US $394 million), which it will use for actual clearance of the balance of the bank loans it took for financing part of the cost of purchasing the Pelephone shares. As a result of closing the transaction as aforesaid, the Company recorded NIS 1,045 million of goodwill in the purchase. The goodwill will be amortized over a period of 20 years, which is the expected period of economic benefit.

B. DBS Satellite Services (1998) Ltd. ("DBS")

In January 1999, DBS received a license from the Ministry of Communications for satellite television broadcasts, and commenced provision of services in July 2000. Since the start of its operations, DBS has accumulated considerable losses and negative cash flows. The loss for the year 2003 amounted to approximately NIS 555 million and the loss for the nine-month period ended September 30, 2004 amounted to approximately NIS 277 million. As a result of these losses, the deficit in shareholders’ equity and the working capital deficit as at September 30, 2004, amounted to approximately NIS 3,106 million and NIS 1,763 million respectively. The working capital deficit includes credit from banking corporations in the amount of NIS 1,312 million.

The Company’s investment in DBS (primarily shareholders’ loans) as at the balance sheet date amounts to approximately NIS 1,399 million (nominal). The Company’s share in the accumulated losses of DBS amounts to approximately NIS 1,259 million, of which approximately NIS 208 million was recorded in the year of account. The balance of the current debt of DBS to the Company and its consolidated companies amounts to approximately NIS 64 million.

NOTE 4 – INVESTMENTS IN INVESTEE COMPANIES (CONTD.)

B. DBS Satellite Services (1998) Ltd. ("DBS") (Contd.)

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

On December 30, 2002, DBS, the shareholders and the Banks signed an agreement to increase the credit facility provided by the Banks (hereinafter – the Interim Facility), to be implemented concurrently with additional investments by the shareholders in the sum of no less than 150% of the sum to be provided by the Banks.

On August 6, 2003, an agreement amending the Financing Agreement (hereinafter – "the Amending Agreement") was executed by the Banks and by DBS. Under the Amending Agreement, the Banks will provide DBS with additional sums to those provided under the Financing Agreement and the Interim Facility, subject to DBS's meeting the conditions and milestones set out in the Amending Agreement, including implementation of additional investments by shareholders in amounts of no less than 150% of the amounts to be provided by the Banks. The Amending Agreement came into force in December 2003. Pursuant to the Amending Agreement, DBS converted short-term credit to a total amount of NIS 1,225 million for long-term loans in February 2004.

Following the approval of additional investments by the Company in DBS (see below), negotiations were completed in July 2004 between DBS and the Banks, following which a further amendment to the Amending Agreement was signed, in which it was agreed to amend the conditions that DBS was required to fulfill.

As at the date of approval of the financial statements, DBS is in fulfillment of the amended conditions prescribed. However, due to the position of the Minister of Communications as set out below, the full amounts that the banks were scheduled to make available to DBS for the third quarter of 2004 have not yet been transferred. The Company made up the amounts for the third quarter on November 3, 2004. In view of the above, the long-term loans were recorded in the financial statements of DBS were classified under its current liabilities.

The Company has signed a perpetual guarantee in favor of the Banks for the payment of DBS's debts. The guarantee is up to a maximum amount equal to the percentage of the Company's holdings in DBS multiplied by the value of DBS as derived from disposal of the pledged shares of the remaining shareholders. If the Company joins the sale in the framework of disposing of the pledged shares of remaining shareholders, the amount of the guarantee will not exceed the proceeds that the Company will receive from the disposal of its shares in DBS. The deed of guarantee includes numerous restrictions on the Company with respect to disposing the shares it holds, and details of circumstances of breaches which, if committed, will enable the Banks to call in the guarantee. The Company also undertook to put its shares up for sale in the event of sale of the pledged shares by the Banks, and agreed that in the event of exercise of the guarantees given by the other shareholders, the Company will waive repayment of the Shareholders' Loan given to DBS, and that its guarantee will apply also, *mutatis mutandis*, to the options and the right to receive them.

The shareholders of DBS, with the exception of one of them, provided undertakings to the Banks not to object to the sale or other exercise of their shares in DBS, which were charged or guaranteed (by the Company) in such a way as to enable the Banks to effect the sale and exercise without interference (friendly liquidation).

Under an agreement between DBS and its shareholders dated December 30, 2002, it was decided that the loans extended by the shareholders to DBS starting on July 10, 2002 (hereinafter – the New Shareholders' Loans) would have priority over the shareholders' loans to DBS which were made earlier (hereinafter – the Old Shareholders' Loans). Under the agreement, the New Shareholders' Loans will be entitled to repayment in full by DBS before any distribution of dividends by DBS and/or repayment of the

NOTE 4 – INVESTMENTS IN INVESTEE COMPANIES (CONTD.)

B. DBS Satellite Services (1998) Ltd. ("DBS") (Contd.)

Old Shareholders' Loans to DBS by shareholders, this being subject to DBS's cash flow and liabilities under agreements with the Banks (including the priority of repayment of the bank financing).

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

Based on a resolution of the Board of Directors of the Company, continued investment in DBS will be effected by way of preferred New Shareholders' Loans, and the Company is to receive warrants for shares in accordance with the existing agreements between DBS and its shareholders. Similarly, the Board of Directors approved the immediate bringing forward of the balance of the investment under the current financing agreement (in the amount of NIS 55 million, provided in full during April-May 2004), against receipt of such option warrants. Accordingly, on July 19, 2004, the Company received additional warrants which, if exercised, will bring the Company's holdings in DBS to 54.75%. Under the present financing agreement for DBS and the Company's investments in DBS, the Company will be entitled, in return for anticipated investments therein, to additional shares which will bring its holdings to approximately 60% and/or option warrants for shares which, if exercised, will bring its holdings to the same percentage (all presuming that another shareholder meets its full obligations under the present financing agreement, and if not, the Company will be entitled to shares bringing its holdings to approximately 61%; the Management of the Company estimates that the additional shareholder will meet its obligations). The additional shareholder has, at this stage, provided approximately $ 3.3 million on account of the aforesaid undertaking.

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

In view of the requirements of DBS, the difficulty in obtaining additional bank financing and the non-participation of the other shareholders in financing DBS beyond the present Financing Agreement, the Board of Directors of the Company adopted a resolution on March 30, 2004, which was later amended, to approve an additional investment (beyond the present Financing Agreement) of approximately NIS 440 million by the end of 2005, which would be made gradually, according to the requirements of DBS and the Work Plan. The investment of NIS 440 million will take into account development of regulatory conditions in the communications market that are to the satisfaction of the Company and subsequent to implementation of the Banks' commitment under the present Financing Agreement. In this regard, from time to time, developments will be examined by the Board of Directors of the Company. Similarly, the resolution provided that its implementation is subject to receipt of the required consents and pursuant to the remarks of the Attorney General. Commencing June 21, 2004, the Company began providing sums on account of the NIS 440 million investment. As a result, the Company was granted an additional option warrant, which, if exercised, will increase the Company's

NOTE 4 – INVESTMENTS IN INVESTEE COMPANIES (CONTD.)

B. DBS Satellite Services (1998) Ltd. ("DBS") (Contd.)

holdings in DBS to 56.38%. When the Company started providing these funds as aforesaid, the financial statements of DBS became consolidated with those of the Company (see Note 2H).

At a meeting held on July 1, 2004, the Board of Directors of the Company resolved to approve action by the Management of the Company which would exercise the warrants for shares in DBS. On July 19, 2004, the Company applied for the regulatory approvals required for exercising the warrants (consent of the Ministerial Committee on Privatization, the Minister of Communications and the Antitrust Commissioner). The initial comments made by the Antitrust Authority prior to submission of the notice of merger indicated a possible difficulty in approving the merger, due to the structure of the communications market. Following submission of the notice of the Merger and upon request, the Company and DBS transferred large quantities of material to the Antitrust Commissioner. As at the date of the financial statements, no decision had been received from the Commissioner.

In the Company's opinion, relying on its legal advisers, continued investment by the Company in DBS does not, in and of itself, require the approval of the authorities provided that the Company has not exercised the options allotted to it. The Government Companies Authority notified the Company that the Deputy Attorney General has confirmed that upon the Company becoming a mixed company, it will no longer require the consent of the Ministerial Committee on Privatization in order to increase the Company's exposure in DBS. Exercise of the warrants does require the approval of the authorities. Likewise, under the articles of association of DBS, DBS will allot shares or convertible securities after the Banks making loans to DBS confirm that such securities are secured in their favor.

On August 31, 2004, the Minister of Communications notified the Company that after a preliminary examination of the Company's request to exercise the options it holds for shares in DBS, he believes that the process raises significant concern of damage to competition in the field of communications and in light of that concern he is considering instructing the Company to refrain from further injection of funds to DBS. In his aforementioned letter, the Minister also informed the Company that he does not approve its request that it exercise the options and that the Company is required, meantime, until formulation of his decision, not to implement the additional injection of funds (in the amount of NIS 440 million) of which the Company gave notice in its request and of which part had already been transferred to DBS.

As part of a process of consolidation and out of a desire to find a pragmatic solution in mutual understanding, the Company agreed to cooperate with the Minister of Communications and reach an arrangement on the matter of the funding, without prejudice to its legal position on the matter of the authority of the Minister of Communications concerning the injection of funds already made, at the time. Under this arrangement, the Company and DBS submitted to the Ministry of Communications the documents and information they requested. As at the date of these financial statements, the Company has transferred to DBS NIS 173 million out of the aforementioned additional investment.

On October 28, 2004, the Board of Directors of the Company was presented with an external legal opinion stating that the Minister of Communications does not have authority to prevent the Company from injecting funds into DBS .Nevertheless, and without derogating from that legal opinion, the Board of Directors resolved to authorize the Management of the Company to continue talks with the Ministry of Communications on the continued injection of funds into DBS at the same time as the Ministry carries out its examination. On October 31, 2004, the Ministry of Communications notified the Company that "during November 2004, injection of funds in the amount of NIS 50 million into DBS is approved".

DBS's continued operations are conditional upon the continued receipt of shareholders' loans under the financing agreements, including loans from the Company pursuant to DBS's Work Plan.

Management of DBS and the Company believe that the chances of arranging the financial funding required by DBS in the coming year are good.

NOTE 4 – INVESTMENTS IN INVESTEE COMPANIES (CONTD.)

C. Walla! Communications Ltd.

In February 2004 Walla! Communications Ltd. (hereinafter – Walla) published a prospectus for an offering of warrants to its existing shareholders by way of rights. Bezeq International made a prior commitment to exercise options (Series 3) in a total amount equal to the balance of the shareholders' loans that it had provided to Walla as at September 30, 2003 (approximately NIS 14 million). Bezeq International's commitment is subject to the provisions of Section 328 of the Companies Law, i.e., Bezeq International will not exercise warrants in such a way that after exercise it will hold more than 45% of the issued share capital of Walla, except in compliance with the provisions of the law.

In March 2004, Bezeq International purchased 7,073,980 warrants (Series 3) (36.74% of all of the options offered) for a consideration of NIS 1,414,000, which was set off against the aforementioned shareholders' loans. During the period of account, Bezeq International exercised 3,766,940 warrants (Series 3) in consideration of NIS 6,780,000, which was offset against the balance of the shareholders' loans as set out above. Following exercise of the aforementioned warrants, the percentage of Bezeq International's holding in Walla increased from 36.74% on December 31, 2003, to 44.99% as at the date of these interim financial statements (at full dilution, as at September 30, 2004 – 34.59%).

NOTE 5 – FIXED ASSETS

A. Depreciation Policy

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

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

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

2. DBS depreciates its digital satellite decoders (hereinafter – the Decoders) using the straight -line method, based on the estimated duration of their use. With the accumulation of experience and data during the course of DBS's operations, DBS decided to examine the useful life of the Decoders in June 2004. As part of this examination, DBS received an engineering opinion which relates to the useful life of the Decoders. Pursuant to the above opinion, which takes into account, *inter alia*, exposure to technological changes, the useful life of a Decoder is no less than 6 years. Based on the engineering opinion, the depreciation rate for Decoders changed in April 2004 from 25% to 17%.

NOTE 5 – FIXED ASSETS (CONTD.)

A. Depreciation Policy (contd.)

3. The following table shows the effects of the above on the Company's financial statements:

	Data before modification of estimate	Effect of modification of estimate	Data presented in the financial statements (after modification of estimate)
	Reported amounts*		
	NIS thousands		
For the nine months ended September 30, 2004 (unaudited)			
Depreciation expenses	1,582,829	(87,750)	1,495,079
Earnings before income tax	992,960	87,750	1,080,710
Net earnings	459,335	57,538	516,873
Earnings per share	0.176	0.022	0.198
For the three months ended September 30, 2004 (unaudited)			
Depreciation expenses	588,540	(32,250)	556,290
Earnings before income tax	378,257	32,250	410,507
Net earnings	221,687	20,963	242,650
Earnings per share	0.085	0.008	0.093

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

B. Further to Note 9F to the financial statements as at December 31, 2003, concerning the resolution of the Board of Directors of the Company to close the Inmarsat station, and the notice of the Ministry of Communications to the Company that it is not authorized to decide on the closure of the station, the Company (with the knowledge of the Ministry of Communications) contacted representatives of the Ministry of Defense and the Israel Defense Forces ("IDF") in an attempt to reach an arrangement for termination of the service. IDF representatives stated unequivocally that the Inmarsat service is an essential service that the IDF cannot forego. In light of this, the Company is now examining a number of possible actions, including sale of the service (with the consent of the Ministry of Defense, the IDF and the Ministry of Communications), introduction of a strategic partner, or continued provision of the service whilst significantly reducing its costs.

NOTE 6 – LIABILITY FOR EMPLOYEE SEVERANCE BENEFITS

A. Early retirement plan

In September 2000, the Company reached an agreement with workers' representatives to extend the 1997 collective agreement on early retirement (the "Retirement Agreement"). Under the Retirement Agreement, 1,770 additional employees, of whom up to 300 are not transferred employees, were to take early retirement between April 1, 2001 and December 31, 2006 (with the option of extending the final date of retirement for certain employees to December 31, 2008). Similarly, in accordance with the provisions of the agreement, the Company may terminate the employment of employees on the severance pay track in excess of the aforementioned quota. According to the agreement between the Company and workers' representatives, the funds raised by the Company (in 2003) will be used to finance the costs of retirement of employees under the agreement. Therefore, it was agreed that the funds raised would be held, managed and invested by the Company as part of its total monetary balances, and that shortly before the Government ceases to hold control of the Company, the Company shall transfer the retirement funds to an external body which would hold the money for the purpose of

NOTE 6 – LIABILITY FOR EMPLOYEE SEVERANCE BENEFITS (CONTD.)

A. Early retirement plan (Contd.)

employee retirement arrangements. Under this plan, 1,127 employees had retired by September 30, 2004. The fund raising was completed in 2003.

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

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

On March 18, 2004, an amendment to the Retirement Agreement was signed between the Company (after being approved by the Board of Directors of the Company), the New General Workers' Trade Union and the workers' representation under which certain amendments to the present Retirement Agreement were agreed upon with the aim of clarifying the uncertainties arising out of the amendment of the Supervision of Insurance Business Law. Amongst other things, it was agreed that by September 30, 2004, 400 employees would retire, and it was also agreed that the retirement conditions of all transferred employees who take a pension under the Retirement Agreement as of September 2000, will remain in force despite the amendments to the Pension Law and the Company shall bear any additional costs that might be required. It was agreed, that in the event that an alternative pension fund to the Makefet Fund is found, in which the status and rights afforded to the retirees under the retirement agreement and the current agreement are retained, then the Company shall be entitled to contract with such a fund with the consent of the employees' representatives and the receipt of all necessary permits as required by law. As of the date of these financial statements, the Company has begun searching for a replacement for the Makefet Fund in coordination with the employees' representatives. In addition, the parties agreed that they would enter into negotiations in order to regulate the retirement of the remaining transferred employees by 2011 on the one hand, and the demands of Management for organizational and other changes on the other hand. A provision will be recorded in the financial statements if and when the negotiations result in an agreement. As at the balance sheet date, the negotiations had not yet started.

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

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

B. Makefet Fund

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

NOTE 7 – CONTINGENT LIABILITIES

A. CLAIMS AND CONTINGENT LIABILITIES

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

(1) a. Further to Note 19A(1) to the financial statements as at December 31, 2003, regarding an investigation conducted by the Antitrust Authority ("the Authority") concerning suspected cartels in public switching between 1993 - 1997, to which the Company might have been a party. News items have appeared recently in the media from which it transpires that the Authority has reached agreed arrangements with some of the other suspects in the affair, whereby indictments will not be filed against those suspects and they (some or all of them) will pay the Authority a total of NIS 8 million. Furthermore, the Authority recently informed the Company that it (the Authority) is considering the issuance of a ruling against it under Section 43 of the Antitrust Law and that the Company is invited to state its claims on the matter. The Company is attempting to arrange a hearing with the Antitrust Commissioner in connection with the intention to issue the ruling.

In the opinion of the Company's legal advisers, there are reasonable grounds for believing that an indictment will not be filed against the Company in the public switching affair. However, they are unable to estimate whether the Authority will eventually decide to issue a ruling under Section 43 of the Law.

Further to the above Note on the matter of demands made by shareholders in November 2000 and November 2001 that the Company institute legal proceedings against suppliers Telrad and Tadiran, on November 2, 2004 another similar demand was received from a Company shareholder, who believes that the Company should file an action in respect of losses caused to her by the suppliers. The Company is looking into the matter and has not yet replied to the demand.

b. On September 21, 2004, a claim and application for approval as a class action was filed against the Company and several other defendants and against the State of Israel – Ministry of Communications as a formal defendant. The claim was filed by the prosecutor under the Antitrust Law, 5748-1988 and under Article 29 of the Civil Procedures Regulations, 5744-1984. According to the prosecutor, the defendants unlawfully created cartels that divided up the market and prices of communications exchanges in Israel, where the Company was a partner in those agreements as a customer of Telrad and Tadiran. It is alleged that these arrangements gave rise to unnecessary expenditure by the Company which resulted in an unjustified rise in the Company's tariffs in a cumulative amount of NIS 1,700 million. In view of the early stage of the proceeding, the legal advisers of the Company are unable to estimate the exposure deriving to the Company in connection with the claim, but they believe that the Company has a meritorious defense against it. If a ruling is issued by the Authority as aforesaid in sub-section a. stating that the Company was a party to a public switching cartel, and as long as that ruling remains in place, it will constitute *prima facie* evidence of the existence of a cartel. However, if a ruling is issued the Company will be able, in an appeal before the Antitrust Tribunal, to oppose the Stipulation. In the opinion of the Company's legal advisers, the Company will have good arguments in such an appeal.

Notes to the Financial Statements as at September 30, 2004

NOTE 7 – CONTINGENT LIABILITIES (CONTD.)

A. CLAIMS AND CONTINGENT LIABILITIES (CONTD.)

(2) Further to Note 19A(3) to the financial statements as at December 31, 2003, regarding a claim filed against the Company alleging that the process for selecting the equipment to be purchased by the Company was unlawfully managed, in violation of tender laws and the rules of good administration, with negligence and while exploiting the Company's status as a monopoly or monopsony, it was decided, with the consent of the parties, to refer the dispute to an arbitrator, who is to rule on the amount of compensation to be paid by the Company to the plaintiff, with a floor and ceiling mechanism in amounts that are not material. The proceeding is at the stage of exchanging written summations between the parties.

(3) Further to Note 19A(4) to the financial statements as at December 31, 2003, regarding a declaratory suit filed by 2,423 pensioners of the Company, in a request for recognition of certain wage components as part of their determining wage of their pensions, a suit which could have material financial implications as explained in that Note and which, under certain assumptions, could reach NIS 1.258 billion. On June 24, 2004, the Regional Court handed down a ruling to strike the suit *in limine*. The Court held that the group of plaintiffs was not homogeneous, each having different data relevant to his suit, that it would not be possible to manage the suit as if it were a class action, that the suit is for monetary relief that was not quantified as required by the law, and that the suit failed to contain all of the facts required in order to quantify it.

The Court further held that the pensioners' organization did not come within the bounds of the definition of a workers' organization as set out in Section 3 of the Collective Agreements Law, that this was not a claim under a collective dispute and that the consent of the organization was not sufficient for the filing of a suit on behalf of all the 2,423 plaintiffs. It should be noted that the Court stated in this ruling that "it is correct that the suit should be struck out and counsel for the plaintiffs shall be allowed to file a new suit on behalf of any person who signs a power of attorney, and in which the correct relief is formulated or is properly quantified, without harming the defendant's right to defend itself". On October 10, 2004, that decision was appealed. In the opinion of the legal advisers of the Company, the outcome of the proceeding cannot be assessed at this stage. In view of the weighty arguments available to the Company and the circumstances of the suit, the Company decided not to record a provision in the financial statements in respect of this claim.

(4) Further to Note 19A(7) to the financial statements as at December 31, 2003, concerning an action accompanied by an application for approval of the action as a class action, filed against the Company, Bezeq International and the other international communications operators, alleging unlawful collection of 17% VAT for some collect calls received by Company subscribers in Israel and originating abroad, the Company believes, relying on its legal advisers, that in the circumstances of the matter to date, and noting, *inter alia*, the Company's status (similar to that of the other defendant communications companies) as formal respondents, and noting the statements made by counsel for the plaintiffs to the effect that the claim is not for independent relief against the communications companies (including the Company), it would appear that the Company is not subject to financial exposure in connection with this claim (and if there is any exposure, it will be minor). On April 18, 2004, the Supreme Court ruled to stay the proceedings in this case until after a ruling is issued by the Supreme Court in another case (to which the Company is not a party).

(5) Further to Note 19A(9) to the financial statements as at December 31, 2003, regarding a letter of demand on behalf of the committee of Moshav Porat in the Sharon Region, containing claims regarding direct and indirect damages caused and which are still being caused, according to members of the Moshav, as a result of the erection of the Hillel Station near the Moshav and the station's broadcasts, and regarding a claim filed with the District Court at Tel Aviv against the Company, the Broadcasting Authority and the State of Israel by various plaintiffs from Moshav Porat, including the estates of deceased persons, on June 13, 2004, an additional claim was filed in the Tel Aviv District Court by 25 plaintiffs from Moshav Porat and Moshav Ein Vered, including 11 heirs to the estates of deceased persons, against the Company, the Broadcasting Authority, and the State of Israel, for compensation for bodily harm (18 of the plaintiffs are suing the Company, the Broadcasting Authority and the State, and 7 additional plaintiffs are suing the Broadcasting Authority and the State of Israel only).

NOTE 7 – CONTINGENT LIABILITIES (CONTD.)

A. CLAIMS AND CONTINGENT LIABILITIES (CONTD.)

The additional claim contains an alleged breach of statutory duties and acts and/or failures by the defendants jointly and/or severally, as alleged in the statement of claim, in respect of operation of the Hillel broadcasting station located near the plaintiffs' homes, and it was further alleged that the plaintiffs suffered bodily harm as a result of prohibited radiation derived from the broadcasting station, which in some cases caused the death of some of the plaintiffs.

The amount of the compensation sued for under the additional claim is not estimated (however the claim is within the jurisdiction of the District Court, meaning that it is more than NIS 2.5 million), and the compensation is based on items of monetary and non-monetary damage, described for each plaintiff, as well as penal damages. The claim also states that the plaintiffs will petition to split remedies so as to reserve the right to sue for other monetary damages that do not fall within the bounds of the bodily harm that they allegedly suffered, and that such damages relate to harm to crops, loss of value of land, fleeing of potential investors, etc. According to the plaintiffs, these damages amount to "millions of shekels", but their amount has not yet been formulated. The Company filed its Statement of Defense on October 31, 2004.

At present, the Company's legal advisers are not yet in a position to estimate the chances of the Company's defense against the suit. Nevertheless, since the claim is similar in substance to the previous claim referred to above, the Company's legal advisers anticipate (subject to the aforesaid) that the chances that this suit will be dismissed are greater than the chances that it will be allowed, and therefore no provision has been recorded in the financial statements.

(6) Further to Note 19A(12) to the financial statements as at December 31, 2003, regarding a claim accompanied by an application for approval of the claim as a class action against the Company in the matter of restitution of a commission which the claimants allege was collected unlawfully in respect of calls in Israel from a public telephone operated by means of a Bezeqcard, on February 23, 2004, the Telecommunications Regulations (Payments for the Telecommunications Services Listed in the Addendum to the Law) (Amendment to Regulations 5759-1999, 5760-2000, 5761-2001) 5764-2004 were enacted, containing amendments to the Telecommunications Regulations (Payments for the Telecommunications Services Listed in the Addendum to the Law) for the years 1999-2001. In the Company's opinion, following this amendment, there is no longer any basis for the claim and for the application for recognition as a class action.

(7) Further to Note 19A(13) to the financial statements as at December 31, 2003, regarding claims dealing mainly with recognition of different wage components as pension components, including the notice of a party to a collective dispute filed by the New General Trade Union on behalf of employees of the Company, in which financial implications of such suit as described in that Note being material and likely to reach approximately NIS 1.357 billion under certain assumptions. In the opinion of the Company's legal advisers it is not possible, at this stage, to estimate the chances of success of this suit with respect to certain components. Given the heavy arguments available to the Company and the circumstances of the suit, the Company decided not to make an additional provision in its financial statements over and above the provision already made based on management estimations prior to the issuing of a ruling by the National Labor Court in another case to which the Company is not a party.

On October 13, 2004, the National Labor Court gave a ruling in the appeal for dismissal of a claim filed by a former employee of the Company, which is mainly a claim for the inclusion of on-call pay and a jubilee bonus in the determining salary for making various payments, including pension.

The National Court ruled that the source of the right to on-call pay is contractual and that the parties to the agreement may set the terms for grant of the right, its scope and its boundaries, and therefore the stipulation laid down in the Company procedure, whereby the payment for on-call pay is not part of the salary in any shape or form insofar as rights derived from the agreement are concerned, should be fully validated. Nevertheless, the ruling does determine that on-call pay

Notes to the Financial Statements as at September 30, 2004

NOTE 7 – CONTINGENT LIABILITIES (CONTD.)

A. CLAIMS AND CONTINGENT LIABILITIES (CONTD.)

should be included in the determining salary for the matter of computing rights by virtue of law (the Hours of Work and Rest Law and the Annual Vacation Law).

The external legal advisers of the Company are of the opinion that this ruling puts an end to the allegation that the on-call pay should be seen as a wage component in all respects. Accordingly, and based also on the resolution of the Board of Directors of the Company from October 28, 2004, the Company reduced the provision in the financial statements in respect of these claims by about NIS 145 million.

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

(9) Further to Note 19A(16) to the financial statements as at December 31, 2003, concerning the "derivative claim" filed by a Company shareholder against 20 directors and certain senior managers who served the Company during October-November 2000 and against the Company, the plaintiff was granted an extension for filing the application until April 1, 2004, but failed to file the application by that date. On May 17, 2004, the plaintiff filed an application to strike out the claim *in limine* without an order as to the costs, and the claim was struck out.

(10) Further to Note 19A(18) to the financial statements as at December 31, 2003, concerning a claim accompanied by an application to recognize the claim as a class action, in the matter of alleged overcharging for calls from Company subscribers to cellular network subscribers of Cellcom and Pelephone during part of 1996, the application for approval of the claim as a class action was dismissed by consent on February 17, 2004, and accordingly, the statement of claim that accompanied it was also struck out.

(11) Further to Note 19A(20) to the financial statements as at December 31, 2003, concerning a renewed statement of claim filed against Bezeq International and against the State of Israel and an application for recognition of the claim as a class action claim, alleging that the tariffs for international telecommunications services during the period from May 10, 1996, through July 8, 1997, were overpriced and unreasonable, in abuse of Bezeq International's status as a monopoly, based on the reduction of prices when the international call market was opened to competition. In February 2004, at the application of the State and Bezeq International, the District Court stayed execution of the ruling regarding approval of the claim as a class action. On January 23, 2004, the State filed an application in the Supreme Court for permission to appeal the ruling recognizing the claim as a class action, and on March 7, 2004, Bezeq International also filed an application for permission to appeal the ruling.

The hearing of the class action in both applications for permission to appeal was consolidated into one case which is currently at the summations stage.

Bezeq International's legal counsel estimate that should the claim eventually be approved as a class action by the Supreme Court also, and should it be allowed, the amount of the action is liable to reach hundreds of millions of shekels. However, they believe that Bezeq International has credible arguments against the decision of the District Court and therefore no provision has been included in the financial statements of Bezeq International in respect of this claim.

(12) Further to Note 19A(23) to the financial statements as at December 31, 2003, concerning a claim filed by the State of Israel against Pelephone in respect of royalties allegedly payable to the State for the period from January 1994 through February 1996, mediation proceedings commenced in 2002, during which an outside inspector was appointed to examine the revenue components on which royalties must be paid for the period cited in the claim, which would affect the amount of the original claim. The results of the examination were submitted in September 2004, and found that the maximum amount of royalties on Pelephone's revenues from January 1, 1994 to

Notes to the Financial Statements as at September 30, 2004

NOTE 7 – CONTINGENT LIABILITIES (CONTD.)

A. CLAIMS AND CONTINGENT LIABILITIES (CONTD.)

February 7, 1996 is only approximately NIS 118 million, of which approximately NIS 23 million is for the period from January to October 1994.

In the opinion of the Pelephone's management, in reliance on the opinion of its external legal advisers who are dealing with the claim, Pelephone has a substantial defense against the claim. Pelephone's financial statements include a provision which in the estimation of Pelephone's management is proper and sufficient should Pelephone be required to pay any amount under the suit / mediation proceedings.

Regarding the commitment made by the Company to Pelephone, the Company estimates that the risk that it will be charged with payment is low, and therefore no provision has been made in the financial statements.

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

It became known at the beginning of the year that the Ramallah Court may have issued a decision in this claim. According to the State of Emergency Order (Judea, Samaria and Gaza Strip – Jurisdiction for Offenses and Legal aid) (Areas of the Palestinian Authority, Legal Aid in Civil Matters), 5759-1999, enforcement of decisions issued by a court of the Palestinian Authority may only be executed if they receive the approval of the Commissioner for Legal Aid at the Ministry of Justice. Pelephone believes that such a ruling, if made, was made without jurisdiction, contrary to public order and to the provisions of the Interim Agreement and the Extension of the Term of State of Emergency Regulations Law (Judea, Samaria and the Gaza Strip, Jurisdiction for Offenses and Legal Aid), 5727-1967. Should an attempt be made to submit this ruling for the approval of the Commissioner or to enforce it in any way, the Company shall act to prevent such approval and/or enforcement of the judgment and/or proceedings for execution of judgment or to cancel it for the reasons set out above, which formed the basis of the Commissioner's decision to prevent service of the claim on the Company in the first place, and due to the fact that the very holding of hearing a claim in the Ramallah Court without the process having been served in accordance with the Order and the Agreement, constitute a breach of the Agreement and harm to the sovereignty of the State of Israel, and that any ruling handed down in such a claim has no force.

(14) Further to Note 19A(28) to the financial statements as at December 31, 2003, concerning a claim and an application to approve the claim as a class action, filed with the District Court at Tel Aviv against Pelephone, alleging that since June 2003, the plaintiffs suffer from a high percentage of dropped calls and blocked calls, over and above the threshold set out in Pelephone's license. In June 2004, at the recommendation of the Court, the plaintiffs withdrew their claim and the application for its approval as a class action.

(15) Further to Note 19A(32) to the financial statements as at December 31, 2003, regarding the claim of 66 Company pensioners (who were later joined by others, bringing the total to 264 pensioners) who retired under the retirement agreement of November 1997, for specific performance of the agreement dated April 2001, which was supposed to enable employees to change the track that they had chosen. A statement of defense has been filed on behalf of the Company and statements of defense have been filed on behalf of the Makefet Fund and the State. The case is still in its early stages.

(16) On May 17, 2004, a petition filed on May 13, 2004, by the municipalities and local planning and building committees of Herzliya and Ramat Hasharon against the State of Israel, the National

Notes to the Financial Statements as at September 30, 2004

NOTE 7 – CONTINGENT LIABILITIES (CONTD.)

A. CLAIMS AND CONTINGENT LIABILITIES (CONTD.)

Council for Planning and Building, the Minister of Health, the Ministry of the Interior, the Head of the Noise and Radiation Prevention Department at the Ministry of the Environment, the Attorney-General, the Future Generations Commission and Pelephone, Cellcom, Partner and MIRS, was served at the offices of Pelephone. The petition seeks relief in matters relating, *inter alia*, to the setting of radiation and safety standards for cellular sites, to supervision and to enforcement.

On July 5, 2004, a hearing was held in respect of the petition, in which the High Court of Justice ruled to stay the hearing of the petition to a later date, and to rule on continuation of the proceedings in light of a supplementary notice to be submitted by the State Attorney's office within three to four months. The notice shall relate to the Government's position on legislation regarding non-ionizing radiation. The date for the further hearing in this petition has yet to be set. At this stage, Pelephone is unable to estimate the chances of success of the petition or its implications.

(17) A group of approximately 130 employees filed a claim with the Regional Labor Court in June 1997 via the General Trade Union, applying for declaratory relief regarding the pension rights of the employees in the group, who are transferred employees from the Ministry of Communications, who serve as field managers and are employed under personal contracts. According to the plaintiffs, they are entitled to identical pension conditions to those of the rest of the Company's employees, who are employed under a collective agreement. In September 1997, the Attorney General gave notice that he would appear in the proceedings. In May 1998, the Company submitted an actuarial opinion to the Regional Labor Court which stated that the cost of the plaintiffs' demand amount to approximately NIS 155 million. In November 1999, a ruling was handed down dismissing the large part of the causes of action in the claim. An appeal was filed against this ruling with the National Labor Court, which was dismissed in full. On May 23, 2004, the plaintiffs filed a petition to the High Court of Justice, to cancel the ruling of the National Labor Court. On June 23, 2004, the Company filed a preliminary response to the petition via its legal counsel, seeking to have the petition dismissed *in limine*. A ruling on these pleadings has yet to be handed down. The Company's legal advisers believe that there is a good chance that the High Court of Justice will not even hold a hearing on the petition, but rather, will strike it out *in limine*. Accordingly, no provision has been made in the financial statements regarding this petition.

(18) At the beginning of July 2004, a claim for declarative relief was filed in the Regional Labor Court by the Bezeq Pensioners' Organization and six of its pensioners, against the Makefet Fund, the State of Israel and the Company, alleging that the defendants were in breach of agreements for binding arrangements which were agreed upon when the employees were transferred to the Company from the public service. According to the plaintiffs, the standard bylaws under the Pension Fund Recovery Law should not be applied to them, or alternatively, the defendants or any of them must compensate the plaintiffs for application of the standard bylaws to them. According to the Company's legal advisers, there are heavy preliminary claims in favor of dismissal of the claim, and with respect to the claim itself, there is only a minor chance that any financial obligation will be imposed on the Company. Accordingly, no provision has been included in the financial statements for this claim.

(19) In September 2004 a claim was filed in the Regional Labor Court against Makefet Fund by an employee who was transferred from the Ministry of Communications to the Company upon its establishment, and who retired on a "full and permanent" disability pension set by Makefet Fund because of his medical condition. Against the background of the pension reform, the plaintiff was called in July 2004, for another medical examination, following which he was notified that his pension would be reduced, initially, to only 50% of its current rate. On September 28, 2004, the plaintiff filed a claim against Makefet Fund, demanding that the repeat examination and its results be cancelled, and that Makefet Fund be ordered to continue paying his disability pension. On October 17, 2004, the plaintiff petitioned the Court for temporary relief. The application was against Makafet Fund and also against the Company, with the petitioner declaring that he intends to seek the addition of the Company as a defendant. The plaintiff is petitioning in this application to require Makefet Fund to pay him a full disability pension until the decision in the main case, and alternatively, to require the Company to pay him the difference between the full disability

Notes to the Financial Statements as at September 30, 2004

NOTE 7 – CONTINGENT LIABILITIES (CONTD.)

A. CLAIMS AND CONTINGENT LIABILITIES (CONTD.)

pension and the pension that will be paid by Makefet Fund. Two other transferred employees filed a similar claim. Concurrently, an application was filed by the Company and one of its pensioners to require Makefet Fund to continue paying that pensioner a full disability pension. If suits are also filed against the Company itself on this matter, then the Company believes, relying on its legal advisers, that the chances of the Company being found liable are slight and therefore no provision has been made in the financial statements.

(20) On October 19, 2004, a claim accompanied by an application for its approval as a class action was served on the Company's offices. The Statement of Claim alleges that the Company adds VAT to the arrearage interest it collects from its subscribers in respect of payment arrears, thereby creating over-collection in contravention of the law, since the Company is allowed to collect interest charged by the Accountant General of the Ministry of Finance, which already incorporates the VAT component. The cause of claim is, *inter alia*, by virtue of the Antitrust Law, 5748-1988 and the Consumer Protection Law, 5741-1981. The amount of the claim against the Company is estimated by the plaintiffs at about NIS 87 million (and if it is decided that the cause of claim is only under the Consumer Protection Law, 5741-1981 then the plaintiffs estimate the amount of the claim at about NIS 56 million). The Company, relying on its legal advisers, is unable to estimate the chances of the outcome of the claim at this stage, and therefore, no provision has been made in the financial statements.

B. COMMITMENTS

Further to Note 19B(6) to the financial statements as at December 31, 2003, regarding Pelephone winning a tender for frequencies, Pelephone was granted a right to future allocation of those frequencies, for which, upon exercise, Pelephone will complete payment of the reduced amount, plus the frequency fees in respect of the relevant period, all plus linkage differentials and interest as is customary. During the months of March to August 2004, Pelephone paid the balance of the license fee, which was approximately NIS 99 million.

On May 4, 2004, Pelephone received a letter from the Director General of the Ministry of Communications and the Commissioner for Budgets at the Ministry of Finance, informing it that according to an amended calculation made by the Ministries of Finance and Communications, the sum that Pelephone would be required to pay upon allocation of the frequencies in the future would be NIS 51 million rather than the NIS 33 million agreed upon in March 2004. Pelephone has not yet presented its position on this to the Ministries. Pelephone is unable to estimate when the third generation frequencies will come into use, however it estimates that it will need them in the future and therefore it is reserving the option of buying them back.

C. SECURITIES AND CHARGES

The Company undertook towards two groups of foreign banks which provided it with loans in the amount of NIS 760 million (presented under long-term loans), financial covenants under which the Company is to maintain a ratio of 35% between its tangible shareholders' equity and its tangible assets (as at the balance sheet date the Company had fallen below this ratio). In order to reduce the Company's possible exposure to the possibility of failure to meet the above financial conditions, the Company came to an agreement with one group of banks to reduce the ratio to 15%, and with the other group of banks to cancel the ratio altogether.

NOTE 7 – CONTINGENT LIABILITIES (CONTD.)

D. FUTURE CONTRACTS (CONSOLIDATED)

1. Futures Currency Transactions – Hedging Contracts

	Currency purchased	Currency payable	Final repayment date	Amounts receivable	Amounts payable
				NIS millions	
Currency exchange contracts at predetermined interest rates -	Dollars	CPI-linked NIS	February 2005	94	104
	Euro	CPI-linked NIS	September 2005	326	298
Forward contracts at predetermined exchange rates -	Dollars	NIS	December 2005	1,094	1,123
(excluding premium/discount)	Euro	NIS	December 2005	1,195	1,226
	CPI-linked NIS	NIS	January 2006	642	644

2. Futures Currency Transactions – Contracts not for Hedging Purposes

	Currency purchased	Currency payable	Final repayment date	Fair value	Total transactions
				NIS millions	
Call options acquired	Dollar	NIS	September 2005	0.4	105

NOTE 8 – TRANSACTIONS WITH INTERESTED PARTIES AND RELATED PARTIES

A. Further to Note 27A to the financial statements as at December 31, 2003 regarding a claim filed by the Company against the Ministry of Defense for payment of amounts in connection with a dispute regarding a discount of 18% which the Ministry of Defense deducted from payments collected by the Company for other communications providers, on March 16, 2004, the State filed a statement of defense. On May 17, 2004, the Company filed a statement of response. As proposed by the court, the parties agreed to refer the case to mediation proceedings, but those proceedings have not yet commenced. According to the Company, in reliance on its legal counsel, it is not possible to assess the chances of success of the Company's claim. No revenue was recorded in the financial statements regarding this claim.

B. Further to Note 27D to the financial statements as at December 31, 2003 regarding the officers' insurance policy held by the Company, on August 5, 2004 the Board of Directors of the Company, and its audit committee approved an extension of the insurance policy for a period of 12 months until July 31, 2005. The insurance ceiling is $150 million per event and in total for the entire period of the policy (12 months) plus 20% for legal expenses. The extension was approved by the general meeting of shareholders.

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

Notes to the Financial Statements as at September 30, 2004

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

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

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

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

a. The claim of a shareholder who held 15% or more of the share capital of the Company. The total extent of the indemnity will not exceed $150 million plus $30 million for legal expenses.

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

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

Notes to the Financial Statements as at September 30, 2004

NOTE 9 – REVENUES FROM TELECOMMUNICATION SERVICES

	For the nine-month period ended September 30		For the three-month period ended September 30		For the year ended December 31
	2004 (Unaudited)	2003 (Unaudited)	2004 (Unaudited)	2003 (Unaudited)	2003 (Audited)
	Reported amounts*	Adjusted for the effects of inflation in shekels of December 2003	Reported amounts*	Adjusted for the effects of inflation in shekels of December 2003	Adjusted for the effects of inflation in shekels of December 2003
	NIS thousands		NIS thousands		NIS thousands
Revenues from communication services -					
Domestic fixed-line communications	**1,200,897**	1,575,712	**367,569**	516,134	1,990,649
Fixed fees	**1,847,505**	1,685,201	**619,020**	588,309	2,289,868
Cellular telephone	**1,758,393**	1,502,046	**707,500**	521,212	1,989,970
International communications and Internet services	**584,336**	508,464	**205,284**	176,709	683,037
Multi-channel television	**257,578**	–	**257,578**	–	–
Installation and sale of equipment	**531,138**	426,666	**204,659**	162,856	590,866
Other	**68,821**	48,688	**29,743**	12,577	74,851
	6,248,668	5,746,777	**2,391,353**	1,977,797	7,619,241
Other revenues	**245,576**	266,941	**82,110**	101,339	362,027
	6,494,244	6,013,718	**2,473,463**	2,079,136	7,981,268

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

Notes to the Financial Statements as at September 30, 2004

NOTE 10 – OPERATING AND GENERAL EXPENSES

	For the nine-month period ended September 30		For the three-month period ended September 30		For the year ended December 31
	2004	2003	2004	2003	2003
	(Unaudited)	(Unaudited)	(Unaudited)	(Unaudited)	(Audited)
	Reported amounts*	Adjusted for the effects of inflation in shekels of December 2003	Reported amounts*	Adjusted for the effects of inflation in shekels of December 2003	Adjusted for the effects of inflation in shekels of December 2003
	NIS thousands		NIS thousands		NIS thousands
Salaries and related expenses-					
Operations	**1,115,433**	1,132,816**	**397,952**	401,713**	1,648,415**
General and administrative	**394,062**	351,950**	**149,748**	103,624**	304,463**
General expenses	**638,313**	555,197	**269,353**	217,148	733,412
Materials and spare parts	**426,992**	431,327	**155,548**	152,195	597,676
Consumption of satellite services content	**94,476**	–	**94,476**	–	–
Cellular telephone expenses	**429,348**	349,062	**177,923**	122,017	480,536
Building maintenance	**248,530**	261,234	**95,354**	93,424	352,405
Services and maintenance by subcontractors	**243,973**	204,919	**107,698**	62,676	250,220
International communications expenses	**168,714**	104,355	**65,223**	27,780	159,478
Vehicle maintenance expenses	**97,673**	90,684	**36,925**	30,750	118,050
Collection fees	**29,396**	25,981	**10,485**	5,304	36,160
	3,886,910	3,507,525	**1,560,685**	1,216,631	4,680,815
Less – salaries charged to investment in fixed assets	**151,976**	148,581	**49,731**	58,240	195,515
	3,734,934	3,358,944	**1,510,954**	1,158,391	4,485,300

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

** Reclassified

Notes to the Financial Statements as at September 30, 2004

NOTE 11 – OTHER EXPENSES (REVENUES), NET

	For the nine-month period ended September 30		For the three-month period ended September 30		For the year ended December 31
	2004	2003	2004	2003	2003
	(Unaudited)	(Unaudited)	(Unaudited)	(Unaudited)	(Audited)
	Reported amounts*	Adjusted for the effects of inflation in shekels of December 2003	Reported amounts*	Adjusted for the effects of inflation in shekels of December 2003	Adjusted for the effects of inflation in shekels of December 2003
	NIS thousands		NIS thousands		NIS thousands
Provision for severance pay on early retirement (1)	**30,000**	–	–	–	419,016
Disposal of assets and impairment of fixed assets	**–**	35,412*	–	35,412*	327,295
Provision for impairment of investments in other companies	**–**	26,207*	–	21,327*	42,908
Provisions for severance pay (2)	**(145,000)**	195,000	**(145,000)**	195,000	195,000
Net capital losses (gains)	**(7,143)**	8,540	**(7,539)**	4,688	(1,634)
Amortization of goodwill	**16,554**	727	**16,190**	315	1,032
Others	**(3,350)**	560	**4,409**	714	(439)
	(108,939)	266,446*	**(131,940)**	257,456*	983,178

* Reclassified
(1) See Note 6A
(2) See Note 7A(7)

NOTE 12 – TAXES ON INCOME

On June 29, 2004, the Knesset passed the Income Tax Ordinance Law (Amendment) (No. 140 and temporary provision), 5764-2004 (hereinafter – "the Amendment"). The Amendment provides a gradual reduction in the corporate tax rate from 36% to 30%, in the following manner:

During the 2004 tax year the tax rate will be 35%, in 2005 it will be 34%, in 2006 it will be 32%, and from 2007 onwards it will be 30%.

Current taxes and deferred tax balances as at September 30, 2004 are calculated in accordance with the new tax rates set out in the Amendment. The effect of the change on the consolidated financial statements for the beginning of 2004 is an increase in tax expenses on revenue in the statement of operations and a reduction in deferred taxes in the balance sheets in the sum of NIS 78 million.

NOTE 13 – CONDENSED INTERIM FINANCIAL STATEMENTS OF THE COMPANY

A. Statements of Operations

	For the nine-month period ended September 30		For the three-month period ended September 30		For the year ended December 31
	2004	2003	2004	2003	2003
	(Unaudited)	(Unaudited)	(Unaudited)	(Unaudited)	(Audited)
	Reported amounts*	Adjusted for the effects of inflation in shekels of December 2003	Reported amounts*	Adjusted for the effects of inflation in shekels of December 2003	Adjusted for the effects of inflation in shekels of December 2003
	NIS thousands		NIS thousands		NIS thousands
Revenues from telecommunication services (Note 13B)	**3,750,806**	3,990,560	**1,228,658**	1,342,924	5,230,561
Costs and expenses					
Operating and general expenses (Note 13C)	**1,728,223**	1,789,287	**588,374**	618,848	2,366,547
Depreciation	**1,130,465**	1,340,418	**374,119**	443,731	1,776,279
Royalties to the Government of Israel	**109,849**	137,511	**35,276**	46,780	181,116
	2,968,537	3,267,216	**997,769**	1,109,359	4,323,942
Operating income	**782,269**	723,344	**230,889**	233,565	906,619
Financing expenses, net	**64,791**	50,490	**33,557**	19,327	62,372
Earnings after financing expenses	**717,478**	672,854	**197,332**	214,238	844,247
Other (income) expenses, net	**(120,061)**	254,009**	**(148,418)**	249,711**	846,948
Earnings (loss) before income tax	**837,539**	418,845	**345,750**	(35,473)	(2,701)
Income tax	**354,034**	174,570	**125,163**	8,969	33,513
Earnings (loss) after income tax	**483,505**	244,275	**220,587**	(44,442)	(36,214)
Company's equity in losses (earnings) of investee companies	**(33,368)**	242,474**	**(22,063)**	40,332**	401,622
Net earnings (loss)	**516,873**	1,801	**242,650**	(84,774)	(437,836)

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

Notes to the Financial Statements as at September 30, 2004

NOTE 13 – CONDENSED INTERIM FINANCIAL STATEMENTS OF THE COMPANY (CONTD.)

B. REVENUES FROM TELECOMMUNICATIONS SERVICES

	For the nine-month period ended September 30		For the three-month period ended September 30		For the year ended December 31
	2004	2003	2004	2003	2003
	(Unaudited)	(Unaudited)	(Unaudited)	(Unaudited)	(Audited)
	Reported amounts*	Adjusted for the effects of inflation in shekels of December 2003	Reported amounts*	Adjusted for the effects of inflation in shekels of December 2003	Adjusted for the effects of inflation in shekels of December 2003
	NIS thousands		NIS thousands		NIS thousands
Domestic fixed-line communications	**1,211,001**	1,586,160	**371,514**	519,560	2,006,567
Fixed fees	**1,757,423**	1,606,394	**589,885**	560,176	2,184,650
Cellular telephone	**325,175**	354,689	**105,907**	107,205	428,149
International communications	**97,727**	99,257	**31,712**	32,629	134,212
Installation and sale of equipment	**126,581**	107,739	**41,720**	41,277	144,338
Other	**75,951**	51,857	**31,616**	13,717	80,105
	3,593,858	3,806,096	**1,172,354**	1,274,564	4,978,021
Other revenues	**156,948**	184,464	**56,304**	68,360	252,540
	3,750,806	3,990,560	**1,228,658**	1,342,924	5,230,561

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

Notes to the Financial Statements as at September 30, 2004

NOTE 13 – CONDENSED INTERIM FINANCIAL STATEMENTS OF THE COMPANY (CONTD.)

C. Operating and general expenses

	For the nine-month period ended September 30		For the three-month period ended September 30		For the year ended December 31
	2004 (Unaudited)	2003 (Unaudited)	2004 (Unaudited)	2003 (Unaudited)	2003 (Audited)
	Reported amounts*	Adjusted for the effects of inflation in shekels of December 2003	Reported amounts*	Adjusted for the effects of inflation in shekels of December 2003	Adjusted for the effects of inflation in shekels of December 2003
	NIS thousands		NIS thousands		NIS thousands
Salaries and related expenses –					
Operations	**837,315**	917,043**	**274,407**	319,288**	1,206,623**
General and administrative	**206,264**	198,083**	**70,309**	48,644**	241,206**
General expenses	**247,186**	248,530	**89,693**	106,867	342,492
Materials and spare parts	**84,944**	68,532	**22,149**	29,341	93,601
Building maintenance	**224,612**	239,550	**84,220**	84,897	322,099
Services and maintenance by subcontractors	**158,666**	157,462	**55,875**	51,094	207,843
International communications expenses	**16,692**	6,107	**7,352**	1,711	10,685
Vehicle maintenance expenses	**77,510**	76,932	**25,784**	26,085	101,597
Collection fees	**27,010**	25,630	**8,316**	9,161	35,916
	1,880,199	1,937,869	**638,105**	677,088	2,562,062
Less - salaries charged to investments in fixed assets	**151,976**	148,582	**49,731**	58,240	195,515
	1,728,223	1,789,287	**588,374**	618,848	2,366,547

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

Notes to the Financial Statements as at September 30, 2004

NOTE 14 – SEGMENTS OF BUSINESS OPERATIONS

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

	For the nine-month period ended September 30, 2004						
	Domestic fixed-line communications	Cellular telephone	International communications and Internet services	Multi-channel television	Others	Adjustments	Consolidated
	Adjusted for the effects of inflation in shekels of December 2003						
	NIS thousands						
Revenues							
Revenues from externals	**3,593,126**	**1,859,073**	**601,214**	**260,608**	**180,223**		**6,494,244**
Inter-segment revenues	**157,680**	**5,189**	**12,991**	**8,092**	**52,651**	**(236,603)**	**–**
Total revenues	**3,750,806**	**1,864,262**	**614,205**	**268,700**	**232,874**	**(236,603)**	**6,494,244**
Segment results	**782,269**	**257,489**	**93,308**	**(32,711)**	**8,041**	**–**	**1,108,396**

	For the nine-month period ended September 30, 2003						
	Domestic fixed-line communications	Cellular telephone	International communications and Internet services	Multi-channel television	Others	Adjustments	Consolidated
	Adjusted for the effects of inflation in shekels of December 2003						
	NIS thousands						
Revenues							
Revenues from externals	3,826,272	1,491,659	512,818	–	182,969	–	6,013,718
Inter-segment revenues	164,289	5,908	7,891	–	26,487	(204,575)	–
Total revenues	3,990,561	1,497,567	520,709	–	209,456	(204,575)	6,013,718
Segment results	723,343	49,473	**45,911	–	16,958	487	836,172

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

Notes to the Financial Statements as at September 30, 2004

NOTE 14 – SEGMENTS OF BUSINESS OPERATIONS (CONTD.)

	For the three-month period ended September 30, 2004						
	Domestic fixed-line communications	Cellular telephone	International communications and Internet services	Multi-channel television	Others	Adjustments	Consolidated
	Adjusted for the effects of inflation in shekels of December 2003						
	NIS thousands						
Revenues							
Revenues from externals	**1,172,430**	**784,287**	**204,576**	**260,608**	**51,562**	**–**	**2,473,463**
Inter-segment revenues	**56,228**	**2,063**	**8,586**	**8,092**	**29,811**	**(104,780)**	
Total revenues	**1,228,658**	**786,350**	**213,162**	**268,700**	**81,373**	**(104,780)**	**2,473,463**
Segment results	**230,889**	**117,482**	**26,749**	**(32,711)**	**4,036**	**–**	**346,445**

	For the three-month period ended September 30, 2003						
	Domestic fixed-line communications	Cellular telephone	International communications and Internet services	Multi-channel television	Others	Adjustments	Consolidated
	Adjusted for the effects of inflation in shekels of December 2003						
	NIS thousands						
Revenues							
Revenues from externals	1,284,423	547,039	180,350	–	67,324	–	2,079,136
Inter-segment revenues	58,502	969	3,244	–	8,679	(71,394)	–
Total revenues	1,342,925	548,008	183,594	–	76,003	(71,394)	2,079,136
Segment results	233,563	55,996	**(2,817)	–	18,995	161	305,898

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

NOTE 14 – SEGMENTS OF BUSINESS OPERATIONS (CONTD.)

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

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

Notes to the Financial Statements as at September 30, 2004

NOTE 15 – CONDENSED INTERIM FINANCIAL STATEMENTS OF PARTIALLY CONSOLIDATED COMPANY AND CONSOLIDATED COMPANIES

1. PELEPHONE COMMUNICATIONS LTD.

A. Balance sheet

	September 30 2004	September 30 2003	December 31 2003
	(Unaudited)	(Unaudited)	(Audited)
	Reported amounts*	Adjusted for the effects of inflation in shekels of December 2003	
	NIS thousands	NIS thousands	NIS thousands
Current assets	**1,324,025**	1,249,218	1,264,002
Long-term trade receivables	**258,066**	185,432	199,136
Investment in investee companies	**4,429**	1,783	2,253
Deferred income tax	**111,786**	334,017	238,367
Fixed assets, net	**3,014,294**	2,925,466	2,977,528
Other assets, net	**359,826**	369,501	339,506
	5,072,426	5,065,417	5,020,792
Current liabilities	**1,800,390**	1,815,286	1,761,626
Provision for losses of investee company	**-**	5,108	5,372
Long-term liabilities	**1,210,602**	1,422,815	1,386,774
Shareholders' equity	**2,061,434**	1,822,208	1,867,020
	5,072,426	5,065,417	5,020,792

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

Notes to the Financial Statements as at September 30, 2004

NOTE 15 – CONDENSED INTERIM FINANCIAL STATEMENTS OF PARTIALLY CONSOLIDATED COMPANY AND CONSOLIDATED COMPANIES (CONTD.)

1. PELEPHONE COMMUNICATIONS LTD. (Contd.)

B. Statement of Operations

	For the nine-month period ended September 30		For the three-month period ended September 30		For the year ended December 31
	2004 (Unaudited)	2003 (Unaudited)	2004 (Unaudited)	2003 (Unaudited)	2003 (Audited)
	Reported amounts*	Adjusted for the effects of inflation in shekels of December 2003	Reported amounts*	Adjusted for the effects of inflation in shekels of December 2003	Adjusted for the effects of inflation in shekels of December 2003
	NIS thousands		NIS thousands		NIS thousands
Revenues from Pelephone services, sales and services	**3,301,627**	2,995,133	**1,145,804**	1,096,013	4,054,749
Cost of cellular services, sales and services	**2,398,009**	2,437,174	**834,334**	823,850	3,238,098
Gross profit	**903,618**	557,959	**311,470**	272,163	816,651
Sales and marketing expenses	**354,363**	349,124	**117,997**	122,040	470,935
General and administrative expenses	**111,277**	111,979	**34,110**	38,849	152,447
	465,640	461,103	**152,107**	160,889	623,382
Operating profit	**437,978**	96,856	**159,363**	111,274	193,269
Financing expenses, net	**82,389**	118,627	**19,445**	47,038	143,786
Other expenses (income), net	**(3,084)**	(1,052)	**(212)**	(450)	167
Earnings (loss) before income tax	**358,673**	(20,719)	**140,130**	64,686	49,316
Income tax (tax benefit)	**120,194**	(4,488)	**46,394**	(1,496)	18,289
Earnings (loss) after income tax	**238,479**	(16,231)	**93,736**	66,182	31,027
Company's equity in losses of an affiliate	**6,383**	3,784	**3,101**	2,867	6,224
Net earnings (loss)	**232,096**	(20,015)	**90,635**	63,315	24,803

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

Notes to the Financial Statements as at September 30, 2004

NOTE 15 – CONDENSED INTERIM FINANCIAL STATEMENTS OF PARTIALLY CONSOLIDATED COMPANY AND CONSOLIDATED COMPANIES (CONTD.)

2. DBS SATELLITE SERVICES (1998) LTD.

A. Balance sheet

	September 30 2004	September 30 2003	December 31 2003
	(Unaudited)	(Unaudited)	(Audited)
	Reported amounts*	Adjusted for the effects of inflation in shekels of December 2003	
	NIS thousands	NIS thousands	NIS thousands
Current assets	**123,300**	107,416	107,188
Broadcasting rights, net	**128,410**	142,626	128,334
Fixed assets, net	**1,097,219**	1,179,346	1,124,158
	1,348,929	1,429,388	1,359,680
Current liabilities	**1,886,458**	1,778,603	1,862,403
Long-term liabilities	**16,596**	86,738	31,858
Loans from shareholders	**2,552,036**	2,229,493	2,271,283
Equity deficit	**(3,106,161)**	(2,665,446)	(2,805,864)
	1,348,929	1,429,388	1,359,680

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

Notes to the Financial Statements as at September 30, 2004

NOTE 15 – CONDENSED INTERIM FINANCIAL STATEMENTS OF PARTIALLY CONSOLIDATED COMPANY AND CONSOLIDATED COMPANIES (CONTD.)

2. DBS SATELLITE SERVICES (1998) LTD. (Contd.)

B. Statement of Operations

	For the nine-month period ended September 30		For the three-month period ended September 30		For the year ended December 31
	2004 (Unaudited)	2003 (Unaudited)	2004 (Unaudited)	2003 (Unaudited)	2003 (Audited)
	Reported amounts*	Adjusted for the effects of inflation in shekels of December 2003	Reported amounts*	Adjusted for the effects of inflation in shekels of December 2003	Adjusted for the effects of inflation in shekels of December 2003
	NIS thousands		NIS thousands		NIS thousands
Revenues from DBS services	**754,550**	614,830	**268,680**	216,506	842,374
DBS operating expenses	**746,934**	748,603	**248,081**	249,156	1,012,159
Gross profit (loss)	**7,616**	(133,773)	**20,599**	(32,650)	(169,785)
Sales and marketing expenses	**95,007**	79,123	**34,234**	27,951	109,859
General and administrative expenses	**53,150**	61,682	**17,092**	20,984	84,691
	148,157	140,805	**51,326**	48,935	194,550
Operating loss	**(140,541)**	(274,578)	**(30,727)**	(81,585)	(364,335)
Financing expenses, net	**134,556**	135,830	**40,252**	50,308	179,608
Other expenses, net	**2,258**	4,399	**888**	48	11,201
Net loss	**(277,355)**	(414,807)	**(71,867)**	(131,941)	(555,144)

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

NOTE 15 – CONDENSED INTERIM FINANCIAL STATEMENTS OF PARTIALLY CONSOLIDATED COMPANY AND CONSOLIDATED COMPANIES (CONTD.)

3. BEZEQ INTERNATIONAL LTD.

A. Balance sheet

	September 30 2004	September 30 2003	December 31 2003
	(Unaudited)	(Unaudited)	(Audited)
	Reported amounts*	Adjusted for the effects of inflation in shekels of December 2003	
	NIS thousands	NIS thousands	NIS thousands
Current assets	**202,580**	146,947	149,765
Investments	**25,086**	12,708	12,704
Fixed assets	**352,919**	482,479	375,703
Other assets	**19,848**	3,296	2,695
	600,433	645,430	540,867
Current liabilities	**242,258**	290,549	276,061
Long-term liabilities	**182,524**	171,708	180,881
Shareholders' equity	**175,651**	183,173	83,925
	600,433	645,430	540,867

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

Notes to the Financial Statements as at September 30, 2004

NOTE 15 – CONDENSED INTERIM FINANCIAL STATEMENTS OF PARTIALLY CONSOLIDATED COMPANY AND CONSOLIDATED COMPANIES (CONTD.)

3. **BEZEQ INTERNATIONAL LTD. (Contd.)**

B. Statement of Operations

	For the nine-month period ended September 30		For the three-month period ended September 30		For the year ended December 31
	2004 (Unaudited)	2003 (Unaudited)	2004 (Unaudited)	2003 (Unaudited)	2003 (Audited)
	Reported amounts*	Adjusted for the effects of inflation in shekels of December 2003	Reported amounts*	Adjusted for the effects of inflation in shekels of December 2003	Adjusted for the effects of inflation in shekels of December 2003
	NIS thousands		NIS thousands		NIS thousands
Revenues from international telecommunications services	**614,205**	520,709	**213,162**	183,583	703,336
Operating expenses	**379,907**	314,386	**134,598**	117,063	431,066
Gross profit	**234,298**	206,323	**78,564**	66,520	272,270
Marketing, general and administrative expenses	**140,990**	143,414	**50,915**	52,342	188,299
Operating income	**93,308**	62,909	**27,649**	14,178	83,971
Financing expenses, net	**4,516**	19,510	**829**	2,204	21,830
Earnings after financing, net	**88,792**	43,399	**26,820**	11,974	62,141
Other expenses (income), net	**(5,138)**	11,893	**(555)**	7,060	128,580
Earnings (loss) before income tax	**93,930**	31,506	**27,375**	4,914	(66,439)
Income tax	**500**	2,186	**46**	1,284	3,489
Earnings (loss) after income tax	**93,430**	29,320	**27,329**	3,630	(69,928)
Company's equity in losses (earnings) of an affiliated company	**(1,141)**	619	**(303)**	(83)	619
Net earnings (loss)	**94,571**	28,701	**27,632**	3,713	(70,547)

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