"BEZEQ" THE ISRAEL TELECOMMUNICATION CORP. LIMITED

INTERIM CONSOLIDATED FINANCIAL STATEMENTS

SEPTEMBER 30, 2006

Condensed Interim Consolidated Financial Statements as at September 30, 2006 (unaudited)

Contents

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

Dear Sirs,

Re: Review of the Unaudited Condensed Interim Consolidated Financial Statements as at September 30, 2006

At your request, we have reviewed the condensed interim consolidated balance sheet of "Bezeq" - The Israel Telecommunication Corp. Limited (hereinafter "Company") as at September 30, 2006, as well as the condensed interim consolidated statements of operations, the condensed interim statements of changes in shareholders' equity and the condensed interim consolidated statements of cash flows for the nine-month period then ended.

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

Reports of other auditors were furnished to us which relate to the review of the condensed interim financial statements of consolidated subsidiaries, whose assets as at September 30, 2006, constitute approximately 7% of the total assets included in the condensed interim consolidated balance sheet and whose revenues constitute approximately 12% of the total revenues included in the condensed interim consolidated statement of operations for the nine-month period then ended and approximately 11% of the total revenues included in the condensed interim consolidated statement of operations for the three-month period then ended. Furthermore, reports of other auditors were furnished to us which relate to investments in affiliated companies in which the Company's investments amount to approximately NIS 95 million as at September 30, 2006, and the Company’s share in the losses in respect thereof amount to approximately NIS 2,790 thousand and NIS 1,167 thousand for the nine-month and three-month periods then ended.

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

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

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

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

2. A program for early retirement as described in Note 6.

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

4. The financial position of a subsidiary as described in Note 4A, including the opinion of the management of the consolidated company, based on updated forecasts and on the alternative business plan, that the prospects of arranging sources of finance required by the consolidated company in the forthcoming year are good.

Similarly, we draw attention to Note 2D. to the financial statements regarding the adjustment by way of restatement of the financial statements as at September 30, 2005 in order to retroactively reflect the amended treatment of the liability of the Company to its retirees, as described in the abovementioned note.

Somekh Chaikin
Certified Public Accountants (Isr.)

October 31, 2006

Condensed Interim Consolidated Balance Sheets as at

Reported amounts

	September 30 2006	September 30 2005	December 31 2005
	(Unaudited)	(Unaudited)	(Audited)
	NIS thousands	NIS thousands	NIS thousands
Current assets			
Cash and cash equivalents	**1,188,480**	2,090,898	2,158,773
Short-term investments	**2,332,791**	2,067,668	2,398,525
Trade receivables	**2,113,488**	2,139,566	2,113,512
Other receivables and debit balances	**322,355**	305,185	321,507
Inventory	**178,077**	256,685	220,404
	6,135,191	6,860,002	7,212,721
Materials and spare parts	**93,040**	122,269	88,881
Broadcasting rights, net	**177,920**	161,335	154,500
Investments and long-term receivables			
Investments, deposits and debit balances	**684,256**	858,224	766,840
Investments in investee companies	**95,237**	64,795	75,467
	779,493	923,019	842,307
Fixed assets			
Cost	**31,226,773**	34,606,992	30,627,629
Less– accumulated depreciation	**22,269,240**	24,486,246	20,684,981
	8,957,533	10,120,746	9,942,648
Other assets			
Goodwill	**1,693,685**	1,722,820	1,699,546
Deferred charges and other assets	**389,539**	390,807	380,483
Deferred taxes	**311,708**	349,420	344,786
	2,394,932	2,463,047	2,424,815
	18,538,109	20,650,418	20,665,872

	September 30 2006	September 30 2005	December 31 2005
	(Unaudited)	(Unaudited)	(Audited)
	NIS thousands	NIS thousands	NIS thousands
Current liabilities			
Bank credit	**140,685**	124,864	75,191
Current maturities of:			
Long-term bank loans	**364,194**	1,322,361	1,262,583
Debentures	**1,985,313**	553,138	527,167
Trade payables	**1,161,858**	1,259,006	1,400,714
Employee severance benefits	**433,656**	489,066*	577,878
Other current liabilities	**1,394,670**	1,337,273	1,387,955
	5,480,376	5,085,708	5,231,488
Long-term liabilities			
Long-term loans	**1,907,489**	2,176,640	2,151,960
Debentures	**3,226,121**	4,902,956	4,903,056
Employee severance benefits	**384,506**	582,206*	431,427
Deferred taxes	**87,471**	–	–
Other long-term liabilities	**37,718**	33,982	34,081
Loans extended by minority in a subsidiary:			
Loans	**1,139,900**	1,102,949	1,114,498
Less – minority share in deficit of a consolidated company	**(1,139,900)**	(1,102,949)	(1,114,498)
	5,643,305	7,695,784	7,520,524
Contingent liabilities (Note 7)			
Shareholders' equity	**7,414,428**	7,868,926*	7,913,860
	18,538,109	20,650,418	20,665,872

* Restated, see Note 2D

Dov Weissglas	**Yacov Gelbard**	**Shay Ben Yakar**
Chairman of the Board	Chief Executive Officer	Acting CFO

Date of approval of the financial statements: October 31, 2006.

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

Condensed Interim Consolidated Statements of Operations

Reported amounts

	For the nine–month period ended September 30		For the three–month period ended September 30		For the year ended December 31
	2006	2005	2006	2005	2005
	(Unaudited)	(Unaudited)	(Unaudited)	(Unaudited)	(Audited)
	NIS thousands		NIS thousands		NIS thousands
Revenues (Note 9)	**8,526,531**	8,339,217	**2,881,404**	2,838,719	11,098,686
Costs and expenses					
Operating and general expenses (Note 10)	**5,394,748**	5,341,136	**1,830,474**	1,835,484	7,193,468
Depreciation	**1,707,582**	1,749,207	**563,089**	587,890	2,330,711
Royalties to the Government of Israel	**125,741**	195,490	**36,319**	65,319	257,429
	7,228,071	7,285,833	**2,429,882**	2,488,693	9,781,608
Operating income	**1,298,460**	1,053,384	**451,522**	350,026	1,317,078
Financing expenses, net	**256,614**	272,449	**70,376**	107,370	417,309
Earnings after financing expenses	**1,041,846**	780,935	**381,146**	242,656	899,769
Other income (expenses), net (Note 11)	**54,055**	130,654	**23,005**	(22,088)	109,386
Earnings before income tax	**1,095,901**	911,589	**404,151**	220,568	1,009,155
Income tax	**399,042**	375,294	**161,273**	115,471	429,594
Earnings after income tax	**696,859**	536,295	**242,878**	105,097	579,561
Equity in losses of affiliates	**3,735**	(13,107)	**2,112**	(1,940)	(12,645)
Minority share in losses (earnings) of subsidiaries	**(26)**	8,971	**–**	(8)	8,942
Earnings before the cumulative effect of a change in accounting principle	**700,568**	532,159	**244,990**	103,149	575,858
Cumulative effect of a change in accounting principle as at the beginning of the period	**–**	15,000	**–**	–	15,000
Net earnings	**700,568**	547,159	**244,990**	103,149	590,858
Primary and diluted earnings per share (in NIS):					
Earnings before the cumulative effect of a change in accounting principle	**0.269**	0.205	**0.094**	0.039	0.222
Cumulative effect of a change in accounting principle	**–**	0.005	**–**	–	0.005
Net earnings per share	**0.269**	0.210	**0.094**	0.039	0.227

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

Condensed Interim Statements of Changes in Shareholders' Equity

Reported amounts

	Share capital	Capital reserve – share premium	Capital reserve in respect of transactions between the Company and a controlling shareholder	Dividend proposed after the balance sheet date	Retained earnings (deficit)	Total
	NIS thousands					
Nine months ended September 30, 2006						
Balance as at December 31, 2005 (audited)	**6,309,133**	**1,623,423**	**39,010**	**1,200,000**	**(1,257,706)**	**7,913,860**
Net earnings (unaudited)	**–**	**–**	**–**	**–**	**700,568**	**700,568**
Dividend (unaudited)	**–**	**–**	**–**	**(1,200,000)**	**–**	**(1,200,000)**
Dividend proposed for payment (unaudited)	**–**	**–**	**–**	**400,000**	**(400,000)**	**–**
Balance as at September 30, 2006 (unaudited)	**6,309,133**	**1,623,423**	**39,010**	**400,000**	**(957,138)**	**7,414,428**
Nine months ended September 30, 2005						
Balance as at December 31, 2004 (audited)	6,309,133	1,623,423	37,775	–	(648,564)*	7,321,767 *
Net earnings (unaudited)	–	–	–	–	547,159	547,159
Balance as at September 30, 2005 (unaudited)	6,309,133	1,623,423	37,775	–	(101,405)*	7,868,926 *
Three months ended September 30, 2006						
Balance as at July 1, 2006 (unaudited)	**6,309,133**	**1,623,423**	**39,010**	**–**	**(802,128)**	**7,169,438**
Net earnings (unaudited)	**–**	**–**	**–**	**–**	**244,990**	**244,990**
Dividend proposed for payment (unaudited)	**–**	**–**	**–**	**400,000**	**(400,000)**	**–**
Balance as at September 30, 2006 (unaudited)	**6,309,133**	**1,623,423**	**39,010**	**400,000**	**(957,138)**	**7,414,428**
Three months ended September 30, 2005						
Balance as at July 1, 2005 (unaudited)	6,309,133	1,623,423	37,775	–	(204,554)*	7,765,777 *
Net earnings (unaudited)	–	–	–	–	103,149	103,149
Balance as at September 30, 2005 (unaudited)	6,309,133	1,623,423	37,775	–	(101,405)*	7,868,926 *
Year ended December 31, 2005						
Balance as at December 31, 2004 (audited)	6,309,133	1,623,423	37,775	–	(648,564)	7,321,767
Net earnings (audited)	–	–	–	–	590,858	590,858
Payment from the State in respect of privatization of the company (audited)	–	–	1,235	–	–	1,235
Dividend proposed for payment (audited)	–	–	–	1,200,000	(1,200,000)	–
Balance as at December 31, 2005 (audited)	6,309,133	1,623,423	39,010	1,200,000	(1,257,706)	7,913,860

* Restated, see Note 2D

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

Condensed Interim Consolidated Statements of Cash Flows

Reported amounts

	For the nine-month period ended September 30		For the three-month period ended September 30		For the year ended December 31
	2006 (Unaudited)	2005 (Unaudited)	2006 (Unaudited)	2005 (Unaudited)	2005 (Audited)
	NIS thousands		NIS thousands		NIS thousands
Cash flows from operating activities					
Net earnings	**700,568**	547,159	**244,990**	103,149	590,858
Adjustments to reconcile net earnings to net cash flows from operating activities (see A below)	**1,603,114**	1,254,402*	**619,281**	428,611*	2,127,730
Net cash generated by operating activities	**2,303,682**	1,801,561*	**864,271**	531,760*	2,718,588
Cash flows from investing activities					
Investment in fixed assets	**(805,096)**	(1,330,827)	**(273,155)**	(347,247)	(1,694,071)
Proceeds from disposal of fixed assets and sale of operations	**33,696**	144,528	**10,336**	18,988	147,810
Investment in long-term deposits and investments	**(5,125)**	(7,218)	**(276)**	(236)	(10,068)
Redemption of long-term deposits and investments	**58,976**	93,239	**46,092**	84,630	91,431
Decrease (increase) in short-term investments, net	**99,512**	(717,270)	**175,019**	(527,234)	(972,260)
Investment in investee companies	**(15,424)**	(6,474)	**(4,571)**	(728)	(18,836)
Investment in other assets	**(95,513)**	(68,872)	**(54,727)**	(29,430)	(91,893)
Net cash used in investing activities	**(728,974)**	(1,892,894)*	**(101,282)**	(801,257)*	(2,547,887)
Cash flows from financing activities					
Issue of debentures (after deduction of issue expenses)	**–**	1,702,265	**–**	464,029	1,702,265
Repayment of other debentures	**(235,906)**	(182,108)	**(56,850)**	(61,801)	(267,332)
Receipt of long-term loans	**–**	442,000	**–**	24,500	474,521
Repayment of long-term loans	**(1,174,589)**	(1,257,767)	**(783,979)**	(205,321)	(1,365,578)
Receipt (repayment) of short-term bank credit, net	**65,494**	20,734	**9,718**	19,685	(12,911)
Dividend paid	**(1,200,000)**	–	**–**	–	–
Net cash generated by (used in) financing activities	**(2,545,001)**	725,124	**(831,111)**	241,092	530,965
Increase (decrease) in cash and cash equivalents	**(970,293)**	633,791	**(68,122)**	(28,405)	701,666
Balance of cash and cash equivalents at the beginning of the period	**2,158,773**	1,457,107	**1,256,602**	2,119,303	1,457,107
Balance of cash and cash equivalents at the end of the period	**1,188,480**	2,090,898	**1,188,480**	2,090,898	2,158,773

* Reclassified

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

Condensed Interim Consolidated Statements of Cash Flows (Contd.)

Reported amounts

	For the nine-month period ended September 30		For the three-month period ended September 30		For the year ended December 31
	2006 (Unaudited)	2005 (Unaudited)	2006 (Unaudited)	2005 (Unaudited)	2005 (Audited)
	NIS thousands		NIS thousands		NIS thousands
A – Adjustments to reconcile net earnings to net cash flows from operating activities					
Revenue and expenses not involving cash flows:					
Depreciation	**1,707,582**	1,749,207	**563,089**	587,890	2,330,711
Deferred taxes	**115,725**	132,212	**83,485**	58,462	144,035
Company's equity in losses (gains) of affiliated companies	**(3,735)**	13,107	**(2,112)**	1,940	12,645
Minority share in gains (losses) of a subsidiary	**26**	(8,971)	**–**	8	(8,942)
Decrease in employee severance benefits, net	**(191,143)**	(345,298)	**(37,050)**	(230,138)	(407,265)
Gain on disposal of fixed assets	**(35,797)**	(5,346)	**(23,610)**	(2,597)	(5,715)
Gain from sale of operations	**–**	(103,869)	**–**	–	(103,869)
Provision for impairment of the value of investments	**–**	5,868	**–**	1,168	5,868
Erosion (appreciation) and interest on long-term deposits and investments	**1,128**	14,881	**(2)**	1,735	22,170
Erosion (appreciation) of short-term investments, net	**(3,167)**	(62,589)	**(7,473)**	(35,927)	(60,396)
Appreciation (erosion) of long-term liabilities:					
Debentures	**24,724**	(129,083)	**(76,746)**	(10,668)	(69,730)
Long-term loans and other liabilities	**28,382**	152,841	**26,813**	76,783	129,032
Amortization of other assets and deferred expenses	**83,056**	143,361	**42,404**	47,637	196,015
Changes in asset and liability items:					
Decrease (increase) in broadcasting rights	**(23,420)**	(20,839)	**11,076**	(1,721)	(14,004)
Decrease (increase) in trade receivables	**40,717**	(98,673)	**(1,537)**	(84,155)	(63,298)
Decrease (increase) in other receivables and debit balances	**4,599**	39,888	**(8,586)**	63,841	24,600
Decrease (increase) in inventory	**42,741**	43,040	**35,718**	23,937	75,943
Decrease (increase) in materials and spare parts	**(14,526)**	(5,552)*	**6,936**	28,264*	24,952
Increase in trade payables	**(184,131)**	(218,029)	**14,913**	(48,759)	(112,461)
Increase (decrease) in other current liabilities	**6,715**	(28,361)	**(4,188)**	(52,679)	20,733
Increase (decrease) in deferred revenues	**3,638**	(13,393)	**(3,849)**	3,590	(13,294)
	1,603,114	1,254,402*	**619,281**	428,611*	2,127,730
B– Non-cash transactions					
Acquisition of fixed assets, other assets, materials and spare parts on credit	**215,065**	133,125	**215,065**	133,125	124,719
Sale of fixed assets on credit	**43,699**	–	**43,699**	–	17,089

* Reclassified

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

Notes to the Financial Statements as at September 30, 2006

NOTE 1 – GENERAL

A. These interim statements were prepared according to the 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 to 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 subsidiaries as at December 31, 2005 and for the year then ended, and their 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, published on March 1, 2006, 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 fields of competition in cellular telephone markets, international communication services, domestic communication services and multi-channel television services, appear in Note 1 to the Company's annual financial statements as at December 31, 2005. The significant changes that occurred from the date of the annual financial statements to the date of these financial statements are as follows:

(1) Further to Note 1C. to the financial statements as at December 31, 2005, concerning a gradual reduction in the percentage of royalties from 3.5% to 3% – on August 9, 2006, the Knesset Finance Committee approved regulations promulgated by the Minister of Communications with the approval of the Finance Minister, for a reduction in the royalty rate for all the licensees who are required to pay royalties, effective from January 1, 2006, by 0.5% each year until the rate reaches 1% per year in 2010. In addition, the Ministry announced that it would work for amendment of the regulations in a way that would grant the Company retroactive exemption commencing January 2004 from the duty to pay royalties in respect of revenues from services which have been opened to competition.

With the approval of the regulations, the Group's royalty expense was reduced by approximately NIS 29 million in the third quarter, in respect of the nine-month period ended September 30, 2006.

(2) Further to Note 1D. to the financial statements as at December 31, 2005, concerning an appeal filed by the Company in 2001 in the Antitrust Court to change the announcement of the Company's monopoly in the basic telephony service (fixed-line domestic telephony) – following the Company's request that the court expedite the hearing of the appeal, the Company agreed, at the proposal of the court (in view of the time elapsed since it was filed together with an economic opinion), to withdraw the appeal, and it was struck out on August 2, 2006. The Company is preparing to file a new and revised application to the Antitrust Commissioner. In the opinion of the Company, the mobile telephony market is an alternative market for fixed-line telephony, and this fact is reinforced by new and up-to-date data which have accumulated during the period since the appeal was filed in 2001.

(3) Further to Note 1E(1)a. to the financial statements as at December 31, 2005, concerning revision of the Company's tariffs – on July 1, 2006, the Communications Regulations (Telecommunications and broadcasts) (Payment for telecommunication services), 5766-2006 and the Communications Regulations (Telecommunications and broadcasts) (Computation of payments for telecommunication services and their linkage) (Amendment No. 2), 5766-2006, came into effect. According to the regulations and based on the tariff update formula prescribed in the Communications Regulations (Telecommunications and broadcasts) (Computation of payments for telecommunication services and their linkage), 5763-2003, the average reduction of the controlled tariffs of the Company determined according to Section 15(a) of the Communications Law, applicable from July 1, 2006, is an average rate of 0.36% (excluding the reduction of VAT by 1% which took effect on the same date). This reduction is based on a change of approximately 2.4% in the Consumer Price Index, less an average efficiency factor of approximately 2.7%. In addition, the Communications Regulations (Telecommunications and broadcasts) (Payment for interconnect) (Amendment), 5766-2006 were amended, whereby interconnect fees were reduced by approximately 2% (including the 1% VAT reduction), came into effect on the same date.

NOTE 1 – GENERAL (CONTD.)

(4) Further to Note 1E(1)c. to the financial statements as at December 31, 2005, concerning regulations relating to proceedings and conditions for receipt of a special general license for providing fixed-line domestic communications services without a universal obligation – to the best of the Company's knowledge, during the first quarter of 2006 another two licenses were granted to two additional operators. The subsidiary Bezeq International Ltd. filed an application for such a license. Since the Ministry of Communications had not yet responded to the subsidiary's application for a general license, on July 25, 2006, the subsidiary filed an application for extension of the term of the marketing trial license for VOIP services until the date of the Ministry of Communications' decision on the matter of the general license. On August 31, 2006, the Ministry of Communications notified the subsidiary of extension of the term of the marketing trial license to February 28, 2007.

During the first quarter of 2006, Pelephone received the license for marketing trials in VOIP technology which it had applied for. In addition, Pelephone applied for a special general license.

(5) In September 2006, a Government decision was made in the matter of "Increasing competition in telephony – Virtual operators and broadband access operators", whereby the Minister of Communications is required to examine and formulate a policy on the subject of the provision of fixed-line telephony services by means of broadband access over the internet, and to do so by no later than April 1, 2007. In addition, it was decided to impose a duty on the Director General of the Ministry of Communications together with the Supervisor of Budgets at the Ministry of Finance to examine the issue of the activities of virtual mobile telephone operators and to formulate, if necessary, a model of action for encouraging the activities of virtual operators, and to do so by May 1, 2007.

On October 25, 2006, the Ministry of Communications announced a hearing for the relevant communications operators in the matter of VOB policy, in order to complete the policy formulation process in this area. According to the Ministry's press release, the hearing focuses on the structure of the interconnect tariff that will be paid to the VOB licensee for completing a call in the "VOB network" – according to the press release, the Ministry of Communications is considering a number of alternatives: (a) a reciprocity arrangement whereby the interconnect tariff for call completion in a network will be the same as the interconnect payment for call completion in a public telecommunication network of a domestic operator; (b) the interconnect tariff for call completion in a licensee's network will depend on a proportion of the volume of traffic; (c) a combination of those two alternatives.

(6) Further to Note 1E(1)f. to the financial statements as at December 31, 2005, concerning a numbering plan for number portability records – during February and March 2006, further correspondence with the Ministries of Communications and Finance concerned the inability of operators, including the Company, to comply with the timetables set. On August 23, 2006 the Ministers of Communications and Finance announced that application of the numbering plan would not be postponed beyond September 1, 2006. In their notice, the Ministers also said that the Director General of the Ministry of Communications had recommended that if the plan is not implemented by September 1, 2006, "the relevant communication companies would be declared to be in violation of the law, with all the implications of such a declaration". Following this decision, on August 24, 2006, both the Company and Pelephone (together with other cellular operators) filed petitions in the High Court of Justice for grant of an interlocutory injunction against the Government of Israel and the Minister of Communications. The petitioners allege, *inter alia*, that even though they worked hard to implement the plan, investing enormous resources to do so, they are unable to meet the unrealistic timetable prescribed in the law for its implementation. As background to their arguments, the petitioners allege that the Ministry of Communications failed to prepare a numbering plan for number portability or the payment structure that would apply among the entities, as it was required to do under the provisions of the law. The State has filed its preliminary response to the High Court of Justice, in which it applies for dismissal of the petition *in limine*. At this stage, the Company and Pelephone are unable to assess the effects the above might have on them.

NOTE 1 – GENERAL (CONTD.)

(7) Further to Note 1H to the financial statements as at December 31, 2005, concerning the resolution of the Board of Directors of the Company on March 1, 2006, to recommend to the General Meeting of the shareholders of the Company, the distribution of a cash dividend to the shareholders in the amount of NIS 1,200,000,193, which as at the date of the distribution constitutes NIS 0.4606446 per share – the Special General Meeting of the shareholders of the Company which convened on March 23, 2006, approved the distribution of the dividend. The dividend was distributed on April 16, 2006.

On October 30, 2006, the Company distributed to its shareholders an additional cash dividend of NIS 400,000,064, which as at the date of the distribution constitutes NIS 0.1535482 per share

(8) The Ministry of Communications notified the Company on May 9, 2006, of its intention to call in a guarantee of NIS 7 million out of the bank guarantee of $10 million which the Company deposited for securing fulfillment of the terms of its license, due to its position that the Company launched a campaign in a way which deviates from the rules of the regulation applicable to campaigns. The position of the Company is that it does not require the approval of the Ministry for marketing campaigns. The Company intends to exhaust every legal avenue open to it on this matter, and its first step, taken on May 24, 2006, was to appeal the Minister's decision. The appeal has been heard but no decision has yet been made. The financial statements do not include a provision in respect of this matter.

(9) In May 2006 the Company received a letter from the Antitrust Authority concerning complaints by certain communications operators of actions ostensibly being taken by the Company against those operators and a complaint by one of the operators which was received from the Ministry of Communications. According to the operators, the actions constitute abuse of the Company's monopolistic power. The Company was requested to submit to the Authority and the Ministry both data and answers to questions in the letter, and has done so.

(10) On May 23, 2006, investigators from the Antitrust Authority appeared at the Company's offices and presented a search warrant issued by the Magistrate's Court for the Company's offices and permitting them to seize any document or object required for their investigation. According to the warrant, the cause for its grant was suspicion of abuse of monopoly status according to Section 29A of the Antitrust Law together with Section 47(A)(4a) of that law and/or unreasonable refusal to provide a monopoly asset or service according to Section 29 of the Antitrust Law. During the search, which has not yet been completed, the investigators collected various documents, including computerized material, and several employees were requested to accompany the investigators to the Antitrust Authority's offices for questioning. The Company cooperated fully with the Authority's investigators. To the best of the Company's knowledge, the investigation is still in progress, and accordingly, the Company, relying on its external legal adviser who is handling the case on its behalf, is unable, at this stage, to estimate the outcome and implications of the investigation, including the possibility of indictments being filed and/or civil proceedings being instituted against the Company.

(11) Further to Note 1E(2)a. to the financial statements as at December 31, 2005, concerning the decision of the Minister of Communications to oblige the Company to transfer to Cellcom interconnect payments according to actual traffic – a settlement agreement was signed between the Company and Cellcom, under which the Company paid Cellcom the agreed amount. There is no effect on the financial statements of the Company for the reporting period, due to an existing provision recorded in the Company's books.

(12) Further to Note 9F to the financial statements as at December 31, 2005, concerning the Company's satellite communication operations, the Company has terminated its contacts with potential investors and is currently considering further action in this area.

(13) Further to Note 1E(1)d. to the financial statements as at December 31, 2005, on October 16, 2006, the Ministry of Communications announced its intention to extend the temporary order period for nine months. The Company has expressed its objection to the aforementioned.

NOTE 2 – REPORTING PRINCIPLES AND ACCOUNTING POLICY

A. General

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

B. Initial application of accounting standards

(1) Accounting Standard No. 20 (Amended) – Accounting treatment of goodwill and intangible assets in the acquisition of an investee company

Commencing January 1, 2006, the Company has applied Accounting Standard No. 20 (Amended) ("the Standard") of the Israeli Accounting Standards Board ("IASB"). The Standard prescribes the accounting treatment for goodwill and intangible assets upon acquisition of a subsidiary and of an investee company which is not a subsidiary, including a company under joint control.

The principal changes set out in the Standard as compared with the principles applied in the past are: attribution of the surplus cost of the acquisition of investment in an investee company also to identifiable intangible assets of the acquired company; a distinction between intangible assets having a defined useful life and intangible assets of an indefinite useful life; immediate recognition as gain, on the date of acquisition, in the statement of income, of negative goodwill created in the acquisition after deduction of intangible assets and non-financial assets of the investee company; termination of the systematic deduction of positive goodwill and intangible assets with an indefinite useful life; distinction between goodwill of a subsidiary and of an investee company which is not a subsidiary for the matter of impairment. Comparative figures were not restated.

The amounts of amortization of goodwill, the deduction of which was terminated on January 1, 2006, in the nine-month and three-month periods ended September 30, 2005 and in the year 2005, were NIS 69,837,000, NIS 23,278,000 and NIS 93,112,000, respectively (see also Note 11).

(2) Accounting Standard No. 21 – Earnings per share

Commencing January 1, 2006, the Company has applied Accounting Standard No. 21 (Amended) ("the Standard") of the IASB. Pursuant to the Standard, the Company computes the basic earnings per share with regard to profit or loss, as well as the basic earnings per share with regard to profit or loss from ongoing operations, attributed to the ordinary shareholders. The basic earnings per share is calculated by dividing the profit or loss attributed to the ordinary shareholders, by the weighted average of the number of ordinary shares in circulation during the period. For the purpose of calculating diluted earnings per share, the Company adjusted the profit or the loss attributed to the ordinary shareholders, and the weighted average of the number of ordinary shares in circulation, in respect of the effects of all the diluted potential ordinary shares. The Company's equity in the earnings of investee companies was computed according to its equity in the earnings per share of those companies, multiplied by the number of shares the Company holds. The initial application of the Standard did not affect the earnings per share of the Company.

(3) Accounting Standard No. 22 – Financial instruments: disclosure and presentation

Commencing January 1, 2006, the Company has applied Accounting Standard No. 22 ("the Standard") of the IASB. The Standard sets out the rules for stating financial instruments in the financial statements and details the proper disclosure required for them. In addition, the Standard determines the manner of classification of financial instruments as financial liability and as shareholders' equity, the classification of interest, dividends, related losses and gains, and the circumstances in which financial assets and financial liabilities should be set off. The Standard cancels Opinion 53 – Accounting treatment of convertible liabilities, and Opinion 48 –

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

B. INITIAL APPLICATION OF ACCOUNTING STANDARDS (CONTD.)

Accounting treatment of option warrants. The Standard was adopted on a prospective basis. Comparison figures relating to prior periods were not restated.

Following the first-time adoption of the Standard, the Company set off deferred issuance expenses of approximately NIS 9 million from the debenture and loan items.

(4) Accounting Standard No. 24 – Share-based payment

Commencing January 1, 2006, the Company has applied Accounting Standard No. 24 ("the Standard") of the IASB. Pursuant to the provisions of the Standard, the Company will recognize share-based payment transactions in its financial statements including transactions with employees or other parties that must be settled in equity instruments, in cash or by other assets. Share-based payment transactions in which goods or services are received will be reported at their fair value.

Regarding transactions which are settled in capital instruments, the Standard applies to grants made after March 15, 2005 but which had not yet vested by January 1, 2006. In the same manner, the Standard applies to changes which occurred in the terms of the transactions settled in capital instruments which were made after March 15, 2005, even if the grants in respect of which the changes were made were prior to that date. The first-time application of the Standard did not affect the results of operations and the financial condition of the Group.

(5) Accounting Standard No. 25 – Revenues

Commencing January 1, 2006, the Company has applied Accounting Standard No. 25 ("the Standard") of the IASB. The Standard deals with recognition of revenues from three types of transactions: the sale of goods, the provision of services, and the use made by others of the company's interest-yielding assets, royalties and dividends, and it prescribes the accounting treatment required (rules of recognition, measurement and disclosure) for those three types of transaction. The initial application of the Standard did not affect the results of operations and the financial condition of the Group.

As of January 1, 2006, the Company has applied the IASB published Clarification No. 8 – "Reporting income on a gross basis or a net basis" ("the Clarification"). The Clarification is based on the professional publication EITF 99-19 of the Emerging Issues Task Force in the USA. According to the Clarification, an entity operating as an agency or as a broker without bearing the risks and rewards deriving from the transaction, will state its income on a gross or a net basis. Conversely, an entity operating as a principal supplier and bearing the risks and rewards deriving from the transaction, will state its income on a gross basis. The Clarification provides a list of indicators to be considered in order to determine the basis on which income should be reported – gross or net. Since in the past the Company treated the matter of gross or net income in accordance with the provisions of EITF 99-19, the first-time application of the new Clarification had no material effect on the Company.

C. DISCLOSURE OF THE EFFECTS OF NEW ACCOUNTING STANDARDS IN THE PERIOD PRIOR TO THEIR APPLICATION

(1) Accounting Standard No. 29 – Adoption of international financial reporting (IFRS)

In July 2006 the IASB published Accounting Standard No, 29 - Adoption of International Financial Reporting Standards (IFRS) ("the Standard"). The Standard states that entities subject to the Securities Law, 5728-1968 and which are required to report in accordance with the regulations of that law, will prepare their financial statements according to IFRS standards for periods commencing January 1, 2008. The Standard allows earlier adoption, commencing from the financial statements which will be published after July 31, 2006. The IFRS standards will be adopted for the first time together with application of the provisions of IFRS Standard 1 – First-time Adoption of IFRS Standards, for the purpose of the transition. The Company is examining

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

C. DISCLOSURE OF THE EFFECTS OF NEW ACCOUNTING STANDARDS IN THE PERIOD PRIOR TO THEIR APPLICATION (CONTD.)

the effects of the Standard on its financial statements, including the possibility of early application of the IFRS standards.

(2) Accounting Standard No. 26 – Inventory

In August 2006 the IASB published Accounting Standard No. 26 – Inventory ("the Standard"). The Standard provides guidelines for determining the cost of the inventory and its subsequent recognition as an expense, as well as determining the impairment of the value of the inventory to its net realization value. The Standard also provides guidelines for cost formulas to be used for attributing costs to different types of inventory. The Standard will apply to financial statements for periods commencing January 1, 2007, or later. The Company estimates that application of the Standard is not expected to have a significant effect on the results and financial situation of the Company.

(3) Accounting Standard No. 27 – Fixed assets

In August 2006 the IASB published Accounting Standard No. 27 – Fixed assets. ("the Standard"). The Standard sets out rules for the recognition, measurement and disposal of fixed asset items and the disclosure required in respect thereof. The Standard states, *inter alia*, that upon first-time recognition of a fixed asset item, the entity must estimate and include as part of the cost of the item the costs that will be generated by it in respect of a commitment to dismantle and transfer the item and restoration of the place where it is located. Additionally, the Standard determines that a group of similar fixed asset items will be measured at cost less accumulated depreciation, and net of losses from impairment of value, or alternatively, in a revalued amount less accumulated depreciation, where an increase in the value of an asset as a result of revaluation beyond its initial cost, will be charged directly to the shareholders' equity as a revaluation reserve line item. Any part of a fixed asset with a cost which is significant in relation to the total cost of the item, will be depreciated separately, including costs of significant periodic tests. In addition, the Standard states that an entity must review, at least at the end of every fiscal year, the residual value, useful life, and depreciation method used for the asset. The Standard also states that a fixed asset item purchased in exchange for another, non-financial item is essentially a commercial transaction, "will be measured at fair value".

The Standard will apply to financial statements for periods commencing January 1, 2007. An entity which elects to use the revaluation method for measuring fixed assets for the first time on January 1, 2007 will recognize a revaluation reserve on that date in the amount of the difference between the revalued amount of the asset on that date, and its book cost. In addition, an entity which did not include in the past, in the cost of a fixed asset, at the time of first recognition, the preliminary estimate of the costs of liquidation and transfer of the item and restoration of the place where it is located, will –

(a) measure the above liability as at January 1, 2007, in accordance with accepted accounting principles;
(b) calculate the amount which would have been included in the cost of the relevant asset at the time the liability first came into being, by capitalization of the amount of that liability in section (a) above as at the date on which the liability came into being for the first time ("the Capitalized Amount");
(c) calculate the accumulated depreciation on the Capitalized Amount as at January 1, 2007, on the basis of the useful life of the asset on that date.
(d) The difference between the amount to be charged to the asset according to sections (b) and (c) above and the amount of the liability according to section (a) above, will be charged to earnings.

Other than the above, adoption of the Standard will be by way of retroactive application.

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

C. DISCLOSURE OF THE EFFECTS OF NEW ACCOUNTING STANDARDS IN THE PERIOD PRIOR TO THEIR APPLICATION (CONTD.)

The Company is examining the effects of the Standard, but is unable, at this stage, to assess the extent the effect of its application on its financial statements.

D. RESTATEMENT

Further to Note 2FF to the financial statements as at December 31, 2005, the financial statements as at September 30, 2005 and December 31, 2005 were adjusted retroactively by way of restatement in order to reflect the recording of a liability of the Company to its retirees, as shown below:

(1) Effect on the consolidated balance sheet as at September 30, 2005

	As previously reported	Effect of restatement	As reported in these financial statements
	NIS thousands	NIS thousands	NIS thousands
Current liabilities	5,075,708	10,000	5,085,708
Long-term liabilities	7,561,784	134,000	7,695,784
Shareholders' equity	8,012,926	(144,000)	7,868,926

(2) Effect on retained earnings (deficit)

	As at September 30	As at June 30	As at December 31
	2005	2005	2004
As previously reported	42,595	(60,554)	(504,564)
Effect of restatement	(144,000)	(144,000)	(144,000)
As reported in these financial statements	(101,405)	(204,554)	(648,564)

The effect of the amendment on the statement of operations in the reported periods is marginal.

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

The changes that occurred in the consumer price index and in the exchange rates of the US dollar and the euro in the period of account, 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, 2006	**0.78**	**(6.54)**	**0.16**
September 30, 2005	1.89	6.73	(5.94)
For the three-month period ended:			
September 30, 2006	**(0.76)**	**(3.11)**	**(3.34)**
September 30, 2005	1.38	0.52	0.01
For the year ended December 31, 2005	2.39	6.85	(7.33)

Notes to the Financial Statements as at September 30, 2006

NOTE 4 – INVESTMENTS IN INVESTEE COMPANIES

A. D.B.S. SATELLITE SERVICES (1998) LTD. ("DBS")

In January 1999, DBS received a license from the Ministry of Communications for satellite television broadcasts, and commenced provision of services in July 2000. Since starting operations, DBS has accumulated considerable losses. The loss for 2005 amounted to approximately NIS 328 million and the loss for the nine-month period ended September 30, 2006 amounted to approximately NIS 218 million. As a result of these losses, DBS's capital deficit and working capital deficit as at September 30, 2006 amounted to approximately NIS 3,815 million and NIS 580 million respectively.

The Company's investment in DBS (mainly shareholders' loans) as at the balance sheet date is approximately NIS 1,562 million (before interest and linkage). The Company's equity in the accumulated losses of DBS since its investment (excluding deduction of goodwill) is approximately NIS 1,781 million, of which approximately NIS 207 million was recorded in the nine-month period ended September 30, 2006 (DBS's losses for the period, net of the increase in new loans given by minority shareholders). The balance of DBS's current debt to the Company and its consolidated companies amounts to approximately NIS 111 million. This debt has not yet been fully repaid, and recently the Company formulated an arrangement with DBS for its collection.

The terms of the long-term loans which DBS received from banks, the balance of which as at September 30, 2006 is NIS 1,324 million (including current maturities), impose various restrictions on DBS, which include, *inter alia* – restrictions relating to encumbrance or sale of certain assets, restrictions on receipt of credit from other banks without prior approval, a restriction on repayment of shareholders loans, and a demand to comply with financial criteria ("the Conditions"). As at September 30, 2006, DBS is in compliance with the Conditions prescribed in the financing agreements (after a benefit which was granted in connection with the financial criteria in respect of the third quarter of 2006). In view of the projections of the Management of DBS regarding its business results for the coming years, DBS is working with the banks to revise the financial stipulations in the financing agreement. DBS is also negotiating with the banks to settle a dispute relating to insurance obligations prescribed in the financing agreement.

During April and May 2005, the Company and DBS filed petitions in the High Court of Justice for grant of an order *nisi* against the Minister of Communications, declaring that the decisions described above are null and void. The petitions, which were heard on October 11, 2005, raised questions of principle which are far from simple, both factually and legally, which were brought into sharp focus during the hearing. The Court has not yet given its decision.

On March 21, 2006, the Company received a letter from the Minister of Communications, stating that after examining the implications of further injections of funds into DBS for the promotion and consolidation of competition in fixed-line domestic communications, and based on the business plans of DBS for 2006 which were presented to the Minister of Communications, according to which the injections needed in 2006 amount to NIS 55 million, the Minister of Communications is considering placing a limit on injections of funds in 2006 in the following manner:

(1) The Company's part in the total injections into DBS would not exceed 40%.
(2) The part of the other DBS shareholders and of the banks or financing institutions would not exceed 60%.
(3) The Company or an entity acting on its behalf would not provide a guarantee to the shareholders, the banks or institutional financing entities, or any similar commitment, for securing their part in the injections or in credit granted by them to DBS.
(4) Towards the end of 2006, the subject of the injections, insofar as required in future years, would be re-examined.

The Company sent its response to the letter on April 2, 2006, in which it gave notice that it opposes the decision being considered by the Ministry of Communications, which it believes to be *ultra vires*, and is requesting a hearing to explain its position and make its arguments orally before the Minister of Communications. As at the date of publication of these financial statements, the Company had not yet been invited to argue its position before the Minister.

NOTE 4 – INVESTMENTS IN INVESTEE COMPANIES (C0NTD.)

A. D.B.S. SATELLITE SERVICES (1998) LTD. ("DBS") (CONTD.)

As at the date of approval of the financial statements, DBS is working to obtain additional financial resources which will enable it to achieve its targets for the coming year. If those resources cannot be obtained, DBS will operate in accordance with an alternative business plan which does not necessitate additional resources beyond those already existing. The Management of DBS believes, based on up-to-date projections and on the alternative business plan, that the prospects for arranging the financial resources required by DBS in the coming year are good.

On August 2, 2006 the Company and DBS filed merger notices to the Antitrust Commissioner ("the Commissioner"), concerning exercise of options for DBS shares by the Company, which would increase the percentage of the Company's holding in DBS from approximately 49.8% to approximately 58%. The Commissioner's approval for increasing the Company's holding in DBS to more than 50% had already been given (on certain conditions) in the past (on January 2, 2005), but expired one year later, and therefore the companies have submitted a renewed request for approval of the merger. Subsequently, the Antitrust Authority demanded details and data from the Company and DBS, relating to the merger application, which they provided. With the consent of the parties, the date by which the Antitrust Commissioner will give his decision was postponed to November 9, 2006.

B. GOLDNET COMMUNICATION SERVICES, A REGISTERED PARTNERSHIP ("GOLDNET")

On April 30, 2006 an agreement was signed between the Company, Malam Systems Ltd. and Goldnet of the first part, and the subsidiary Bezeq International of the other part, for acquisition of all the operations of Goldnet by Bezeq International, in consideration of NIS 6.8 million, which will be divided between the Company (NIS 5.1 million) and Malam Systems (NIS 1.7 million).

Upon fulfillment of all the suspending terms prescribed in the acquisition agreement, Goldnet will cease to provide services.

C. MERGER OF THE OPERATIONS OF BEZEQCALL COMMUNICATIONS LTD. AND BEZEQ INTERNATIONAL LTD.

At the end of July 2006, the Company began examining a possible merger of the operations of the wholly-owned subsidiary BezeqCall Communications Ltd. (whose business is in network end points) and the wholly-owned subsidiary Bezeq International Ltd. (internet, international calls and integration solutions for businesses). On October 5, 2006 the Antitrust Commissioner gave his approval for the merger. Completion of the merger requires, *inter alia*, the approval of the Ministry of Communications for re-assigning the network end point license of BezeqCall to Bezeq International.

In addition, on October 15, 2006, BezeqCall signed an agreement for the acquisition of all the operations of Tadiran Communication Services Ltd., a limited partnership, in consideration of NIS 93 million subject to certain adjustments depending on the transaction closing date. The transaction is subject to a due diligence process and to receipt of approvals, among them that of the Antitrust Commissioner.

NOTE 5 – LONG-TERM LOANS

Further to Note 13D(1) to the financial statements as at December 31, 2005, following repayment of the balance of a long-term loan in the amount of approximately NIS 460,000, the Company's commitment to restrictions imposed on it in that loan agreement came to an end, including a duty to comply with a ratio of net financial debt to EBITDA, which was not to exceed 3 : 1 for the Group.

NOTE 6 – LIABILITY FOR EMPLOYEE SEVERANCE BENEFITS

EARLY RETIREMENT PLAN

Further to Note 16D to the financial statements as at December 31, 2005 – the negotiations between the Company's Management and the employees' representatives in connection with a change in the organizational structure, retirement / layoff of employees and a new labor agreement, are at an advanced stage of drafting the agreement. The agreement will require the approval of the New General Federation of Workers ("the Histadrut") and the Board of Directors of the Company.

1. On April 27, 2006 the Company received a "Notice of strike action or work to rule" pursuant to the Resolution of Labor Disputes Law, 5717-1957, applicable from May 14, 2006. Following the notice of the parties to the Labor Court, this proceeding was struck out.

2. On October 5, 2006 the Company received a "Notice of strike action or work to rule" pursuant to the Resolution of Labor Disputes Law, 5717-1957, which was delivered by the person who handles the Bezeq portfolio at the Histadrut ("the Notice").

   The Notice is of a strike at the Company commencing on October 20, 2006, which was declared by the Histadrut and approved, according to the Notice, by the National Central Executive f the Histadrut.

   The issues in dispute, according to the Notice, are as follows:

   "a. A unilateral decision concerning the implementation of structural/organizational changes in the area of activity of virtual operators, the meaning of which is a decrease in the activities of the employer in the field of fixed-line telephony.

   b. Even though this decision of the employer has significant implications for the terms of employment, status, rights, pay and occupational security of the workers, since it will necessarily narrow the activities of the employer, it was made, as noted, unilaterally and without negotiating for the execution of a collective agreement with the competent employees' representatives as to the implications for and harm to the workers.

   c. Conduct in bad faith in a way which is unacceptable in labor relations as a whole and in labor relations in public service in particular."

   In its letter to the Histadrut and to the chairman of the employees' representatives immediate after receipt of the Notice, the Company stated that there was no justification for allegations against it in the matters described in the Notice and that it was not a party to the dispute, and demanded that they withdraw the notice and not take any actions and/or apply any sanctions or disruptions which could harm the Company, its workers and its customers. Following an approach by the Company's Management, the employees' representatives announced that it would postpone its sanctions for 90 days, in order to enable talks with the Ministry of Communications during that time. In addition, the Company requested of the Director General of the Ministry of Communications to hold a joint hearing with representatives of the Management and the employees.

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 annual financial statements of the Company as at December 31, 2005, and published on March 1, 2006. No material changes in contingent liabilities have occurred up to the date of signing these financial statements, other than the following:

NOTE 7 – CONTINGENT LIABILITIES (CONTD.)

A. CLAIMS AND CONTINGENT LIABILITIES (CONTD.)

(1) Further to Note 19A(2)(a) to the financial statements as at December 31, 2005, concerning an investigation by the Antitrust Authority regarding *prima facie* suspicion of restrictive agreements in public and private switching (NEP), on October 25, 2006, the Antitrust Tribunal affirmed an agreed order between the Company and its subsidiary BezeqCall Communications Ltd. and the Antitrust Authority. The agreed order includes an undertaking to pay the State Treasury NIS 2 million, without admitting to violation of the Antitrust Law, and the Authority's confirmation that it will refrain from instituting enforcement proceedings, including a determination under section 43 of the Antitrust Law, against Bezeq and BezeqCall Communications Ltd., or any officer of them, present or past, with respect to arrangements made in the field of public switching or private switching (NEP).

(2) Further to Note 19A(4)(b) to the financial statements as at December 31, 2005, concerning different claims relating to recognition of various salary components as pension components and of the notice of a party to the collective dispute ("the Claim") which was filed by the New General Federation of Workers ("the Histadrut") in the name of all the employees of the Company, in which the Histadrut alleged that grossing up payments, the administrative on-call component and clothing allowances ("the Components") which were and are paid to Company employees, are regular pay which form part of the determining salary of every employee, including for the calculation of payments upon retirement, redemption of holidays, grants, acclimatization payments, percentage increments and hourly pay value and that various payments and provisions should be made in respect thereof, including for pension purposes – on April 4, 2006 the decision of the Jerusalem Regional Labor Court dismissed the Claim and all its component parts filed by the Histadrut in the name of all Company employees.

In its decision, the Court allowed, in full, the argument of the Company that the conduct of the parties over so many years indicates unequivocally that the demands of the Histadrut directly contradict the agreements applicable to the relationships between the parties, which are binding in the circumstances, and therefore those demands should be dismissed. The Court further determined that even if the Components are examined on their merits the Claim would be dismissed, since according to case law, all three Components fall within the definition of "extras" and not "pay", and therefore do not grant entitlement to the reliefs claimed by the Histadrut.

Following an application by the Histadrut, the National Labor Court extended the date for appealing its decision.

Further to Note 19A(4)c. to the financial statements as at December 31, 2005, concerning the claim of a group of employees in the matter of including a number of components as part of the determining salary for pension, on August 6, 2006, a decision was given dismissing the claim and all its parts, and the court ruled that the salary increments are not fictitious extras but genuine and conditional increments and therefore are not part of the basic salary for the computation of the pension or of severance pay, vacation pay, sick pay, retirement grant and acclimatization grant. The decision is subject to a right of appeal by the plaintiffs, and has been appealed.

The financial statements contain a provision of NIS 50 million in respect of the administrative on-call component and in respect of the Components claim. The Company has examined the significance and implications of the decision described above, and has concluded that the conditions do not yet exist for allowing the cancellation or reduction of the provision or part of it.

(3) Further to Note 19A(9) to the financial statements as at December 31, 2005, concerning a claim filed by a competing international communications operator against the Company and against Bezeq International in the amount of NIS 57 million, for a number of causes relating, *inter alia*, to postponement of implementation of the customer allocation proceeding, a mediation proceeding was commenced between the parties and is now in progress. The Company, relying on its legal advisers, believes that the chances of the claim being dismissed are greater than the chances of it being allowed. The management of Bezeq International believes, considering that its part in the

NOTE 7 – CONTINGENT LIABILITIES (CONTD.)

A. CLAIMS AND CONTINGENT LIABILITIES (CONTD.)

amount of the claim is approximately NIS 29 million and the estimation of its legal advisers that there is a reasonable but not definite chance that Bezeq International will be ordered to pay some part of that amount, that Bezeq International will not sustain material loss beyond the amounts included in the financial statements.

(4) Further to Note 19A(11) to the financial statements as at December 31, 2005, concerning a claim and application for certification as a class action, in the matter of restitution of a commission which the plaintiff alleges was collected unlawfully, for calls in Israel from a public telephone operated by means of a BezeqCard – on April 16, 2006, the applicant filed an application to amend the application for certification as a class action pursuant to the new Class Action Law, 5766-2006. The Company opposed the application. The Court has not yet given its decision. In the opinion of the legal advisers who are handling the claim on behalf of the Company, against a background of developments and the possibility that the court will allow the applicants to amend their claim following amendment of the Telecommunications Regulations, the chances that the claim will prevail cannot be assessed at this stage.

(5) Further to Note 19A(13) to the financial statements as at December 31, 2005, concerning a claim and an application for its certification as a class action, in the matter of deception relating to telephone calls to numbers starting with the digits 1-800 and 1-700, which leads consumers to believe that these are free calls even when made from a cellular telephone – on September 5, 2006, a decision was given on the basis of an agreement reached by the parties, whereby the application and the claim were struck out and the Company paid the expenses (NIS 27,500) incurred by the plaintiffs.

(6) Further to Note 19A(14) to the financial statements as at December 31, 2005, concerning the dismissal of a class action filed against the Company in May 2003, alleging that the Company abuses its monopolistic power and collects enormous sums of money from internet users in that it refuses to install splitters on high-speed (ADSL) lines – on March 27, 2006, the plaintiff filed an appeal in the Supreme Court, in which he petitions for the decision of the District Court dismissing his claim, to be cancelled. The Company filed an application for the appeal to be struck out due to its late filing. Based on the opinion of its external legal advisers, the Company believes that the chances of the appeal being allowed are lower than the chances of its dismissal, and accordingly, no provision has been included in the financial statements in respect of this claim.

(7) Further to Note 19A(16) to the financial statements as at December 31, 2005, concerning an action for declaratory relief filed in the Regional Labor Court by the Organization of Bezeq Retirees and six Company retirees against the Makefet Fund, the State of Israel and the Company, alleging breach of agreements for binding arrangements which were made at the time when the employees transferred from the civil service to the Company – in the decision on the application for dismissal *in limine* which was filed by the Company, the court decided not to strike out the Organization as a plaintiff and effectively put an end to the claim against Makefet. Regarding the claim against the Company and the State, the court directed that an amended statement of claim be filed, which has been done, and the Company is now required to respond with a statement of defense.

(8) Further to Note 19A(17) to the financial statements as at December 31, 2005, concerning various claims against the Company and/or against the Makefet Fund filed by employees who retired from the Company on a disability pension due to their medical condition and who had learned, against the background of the pension reform, of a 50% reduction in their pension, and following the report in the same Note on most of those claims (except one) being struck out following amendment of the Supervision of Insurance Law – the last claim in this matter and the allegations of the Company against the Makefet Fund were allowed, and it was ruled that the Makefet Fund must continue to pay the plaintiff a disability pension without charging the Company.

NOTE 7 – CONTINGENT LIABILITIES (CONTD.)

A. CLAIMS AND CONTINGENT LIABILITIES (CONTD.)

(9) Further to Note 19A(20) to the financial statements as at December 31, 2005, concerning the dispute between the Company and the Ministry of Communications relating to the payment of royalties in respect of revenues for interconnection from cellular subscribers to Company subscribers, the Company reached an agreement with the Ministry for ending past disputes concerning royalties up to and including 2002, except for two negligible revenue components. As part of this agreement, the Company paid the sum of approximately NIS 17 million to the Ministry of Communications. In the past, the Company's financial statements included a provision for royalties which, in view of the agreement with the Ministry of Communications, is unnecessary. Accordingly, the royalty expenses to the Government of Israel were reduced in the quarter by approximately NIS 36 million, and financing expenses in respect of the royalties were reduced by approximate NIS 31 million. The financial statements still contain a provision for possible disputes commencing from 2003, which the Company's Management believes to be appropriate.

(10) On April 6, 2006, the Company received a claim together with an application for certification as a class action, which was filed by a private (and inactive) company which is a subscriber of the Company. According to its allegations, the claim concerns the plaintiff being subscribed for the "Free From 7" track and being debited according to that track tariff, without having ordered the service. According to the plaintiff, it has cause of claim in the circumstances of the matter, under the Consumer Protection Law, 5741-1981, the Contracts Law (General part), 5733-1973, and the Unjust Enrichment Law, 5739-1979. The amount of the personal claim is assessed by the plaintiff at NIS 239.18.

The plaintiff has applied for the claim to be certified as a class action in the name of all the subscribers who were debited unlawfully in debit tracks and for certain services of the Company which are listed in the claim. The plaintiff estimates that the financial loss of the members of the group included in the class action could reach millions of shekels per year. The Company filed an application for the claim to be struck *in limine*, and the date for the Company's response to the claim has been postponed until a decision is made on its application (which has not yet been given). Relying on its legal advisers, the Company is unable, at this stage, to estimate the prospects of the claim.

(11) On May 15, 2006, the Company received a claim with an application for certification as a class action, which was filed in the Jerusalem District Court pursuant to Section 5 of the Class Action Law, 5766-2006. The statement of claim alleges that the Company collected from the plaintiff arrearage interest on amounts of Value Added Tax which the plaintiff should have paid to the Company and which are not part of the services provided by the Company. The amount of the plaintiff's personal claim is NIS 0.33. The plaintiff does not make any assessment of the amount of the class action. The Company filed its response to the application and subsequently, in view of the remarks and suggestion of the court, the parties reached an agreement on the basis of which the court struck out the claim and dismissed the application to certify it as a class action, without an order to pay costs.

(12) On May 25, 2006, a claim was filed in the Tel Aviv District Court together with an application for certification as a class action under the Consumer Protection Law and the Class Action Law, alleging deception in advertising in the matter of a charge for calls from a Bezeq line to a cellular line. According to the plaintiff, the Company deceived the public in its advertisements, which stated that the price of a call from a Bezeq line to a cellular line would be "approximately 44 agorot per minute", whereas the exact price per call minute was 44.57 agorot, nor did it disclose that the charge for interconnect was made according to segments of 12 seconds, which means that the actual average charge was 49 agorot per minute. The plaintiff estimates the amount of the claim at approximately NIS 68.5 million (the amount of the personal claim is NIS 11). The Company is unable, at this stage, based on the lawyer who is handling the claim on his behalf, to estimate the chances of the application for approval.

(13) Various municipalities and local councils have submitted demands to the Company for retroactive payment of municipal taxes in respect of an increase in the areas of buildings and changes in classification for municipal tax purposes. These claims amount to approximately NIS 60 million. The financial statements include a provision which the Company's Management, relying on the legal advisers who are handing the claims for it, considers appropriate.

NOTE 7 – CONTINGENT LIABILITIES (CONTD.)

A. CLAIMS AND CONTINGENT LIABILITIES (CONTD.)

(14) On May 18, 2006, a claim was filed in the Tel Aviv District Court together with an application for certification as a class action against the cable companies and against the Company. According to the plaintiff, on May 17, 2006, a fault occurred in his telephone line in the HOT network and it is possible that Company employees (who were imposing sanctions at that time) played some part in the malfunction. The plaintiff alleges that as a result of the malfunction, he incurred economic damages, harm to his goodwill and distress. The amount of the claim is estimated by the plaintiff at approximately NIS 100 million (the amount of the personal claim is assessed at about NIS 1,000). On July 16, 2006, the Company filed an application for dismissal *in limine* of the application for certification, arguing that the claim cannot be filed as a class action since it is not among the types of claims defined in the Class Action Law and there are no provisions in any other law under which the claim can be filed. Accordingly, the date for filing the Company's response to the application for certification was postponed until a decision is given on the application for dismissal. In addition, the cable companies filed an application to strike out the claim *in limine*, alleging that they are not liable for the malfunction, and the plaintiff requested an extension for filing his response to that application until completion of the cable companies' investigation of the matter. No decisions have been given as yet on the applications. Relying on its legal advisers, the Company is unable, at this stage, to assess the chances of the application for approval.

(15) Further to Note 19A(34) to the financial statements as at December 31, 2005. concerning notice of the filing of an application to add Pelephone to an appeal proceeding filed by the owners of rights in land adjoining a cellular communication site operated by Pelephone together with others in Ramat Gan, Pelephone's objection to joining the proceeding as a whole was allowed. Pelephone believes, relying on its legal advisers at this stage of the proceeding that it is at no risk of exposure.

(16) A number of proceedings were recently submitted to Pelephone, in which local committees were requested to add Pelephone as a party to various appeals filed in appeals committees against the dismissal of claims of impairment of value under Section 197 of the Planning and Construction Law, in respect of the erection of communications installations. Pelephone is studying each application on its merits and making its decisions accordingly. Relying on its legal advisers, Pelephone believes that, a this stage, it is not at risk of material exposure in respect of these proceedings.

(17) A number of legal proceedings are in progress against Pelephone (whether in administrative petitions, appeals or civil actions), which were filed against the licensing and/or erection of communications sites. Pelephone, the respondent in these proceedings, opposes the reliefs applied for, and believes, relying on its legal advisers that it is not at risk of material exposure from these proceedings.

(18) On July 12, 2006, a claim was filed against Pelephone in the District Court, together with an application for certification as a class action, in the amount of approximately NIS 251 million. The claim relates to the interpretation of the agreement with Pelephone signed by the plaintiff, concerning the reimbursement of payments he was charged by Cellcom when he switched from Cellcom to Pelephone. According to the plaintiff, Pelephone should have paid NIS 3,000 in respect of those payments, even though he did not comply with the terms of the agreement. At this stage, Pelephone is unable to asses the chances or the implications of the action.

(19) On August 10, 2006, a claim was filed in the District Court against Pelephone, Cellcom, and Partner, together with application for certification as a class action for a total of approximately NIS 100 million. The action relates to the time of disconnection of calls made from a cellular network to the Company's network, and alleges that in such a call, where the Company customer initiates its termination, a surplus charge is applied until the actual disconnection of the call. At this stage, Pelephone is unable to assess the prospects and implications of the action.

NOTE 7 – CONTINGENT LIABILITIES (CONTD.)

A. CLAIMS AND CONTINGENT LIABILITIES (CONTD.)

(20) Further to Note 19A(25) to the financial statements as at December 31, 2005, concerning a claim filed against Bezeq International by a supplier of a system in the amount of approximately NIS 18.5 million, for enforcement of an agreement for the delivery and installation of a customer care and billing system – following a mediation proceeding between the parties a settlement was reached for the mutual clearance of the claims in the case, against payment of a non-material sum by Bezeq International to the plaintiff. On June 19, 2006, the court validated the settlement agreement and instructed that the court fees paid by the parties be returned to them in full.

(21) On June 14, 2006, an application was filed in the Tel Aviv District Court for the certification of a claim as a class action against DBS and against the cable companies in connection with the broadcasting of advertisements during World Cup games. According to the applicants, the broadcasting of advertisements which they allege were integrated into the first three days of broadcasts on the World Cup channel as part of the games and the World Cup studio, was against the law, contrary to the contract between DBS and its customers and contrary to the terms laid down in the decision of the Council to approve the broadcasting of the 2006 World Cup games. The Applicants estimated the amount of the claim at NIS 530 for each subscriber who purchased the World Cup package, and in total – approximately NIS 106 million for all the members of the group (based on 200,000 World Cup subscribers from the cable companies and DBS together). The Applicants wish to sue DBS on the basis of the Class Action Law, 5766-2006 for cause of deception, violation of a legislated duty, unjust enrichment and breach of a contractual undertaking, in respect of three damages categories: impairment of the value of the World Cup package, harm to autonomy, and causing distress. On September 26, 2006, the Company and the cable companies filed their responses to the Application for Certification. DBS argues that the Application for Certification should be dismissed since the action does not meet the criteria required for its certification as a class action. DBS, relying on its legal advisers, is unable to assess the chances of the claim at this preliminary stage.

(22) Further to 19A(46) to the financial statements as at December 31, 2005, on October 26, 2006, DBS signed a compromise agreement with the plaintiffs whereby DBS undertakes to broadcast various sports broadcasts on Channel 5 for one complete season of the relevant sectors of the sporting industry during the years 2006-2007 and other sectors of the sporting industry during the years 2007-2008. The agreement determined that the parties will apply to the court in order to grant the compromise agreement the validity of a court judgment. Following execution of a settlement agreement, and prior to its submission to the Court for authorization, it became apparent that some of the rights ascribed to some of the broadcast content that was supposed to be transferred between the channels might not be in the possession of the sports channels on the relevant dates. Submission of the agreement to the Court for authorization has been delayed pending clarification of the status of these rights, and counsel for the plaintiffs is negotiating directly with the CEO of the Sports Channel, to find a fair solution to the situation that has arisen.

(23) For the provisions of their services, the Company and the subsidiary Pelephone operate installations which emit electromagnetic radiation. The operation of such installations is subject to the Non-ionizing Radiation Law, 5766-2006, most of whose provisions will come into force on January 1, 2007 ("the Radiation Law"), and the Pharmacists Regulations (Radioactive elements and their products), 5740-1980, which regulate the erection and operation of installations and their supervision, including a requirement for permits for that purpose. Erection and operation permits are granted by the Supervisor of Radiation at the Ministry for Protection of the Environment, where operating permits require the presentation of a permit under the Planning and Construction Law. The Company and Pelephone are at an advanced stage of preparation and adaptation of their installations for operation in accordance with the provisions. The Company is acting to obtain building permits, to the extent required, for its broadcasting installations, as well as working with the Ministry of the Interior and the Ministry for Protection of the Environment on expediting the implementation of National Outline Plan 36B ("NOP 36B"), which deals with building permits for large broadcasting installations. On July 19, 2006, the Company sent a letter

NOTE 7 – CONTINGENT LIABILITIES (CONTD.)

A. CLAIMS AND CONTINGENT LIABILITIES (CONTD.)

to the Ministry for Protection of the Environment, requesting that the Radiation Law be amended so that the application of its provisions concerning the presentation of a permit under the Planning and Construction Law be postponed for three years from the date on which NOP 36B takes effect. The subject of electromagnetic radiation and its effects has not yet been thoroughly investigated in Israel or elsewhere. The Company and Pelephone are using their best efforts to meet the requirements of the Radiation Law, including concerning the permits required.

Nevertheless, the Company and Pelephone are unable to assess whether all the permits will be received within the time prescribed in the Radiation Law, and what the aforementioned implications might be.

B. FORWARD TRANSACTIONS

Future Currency Transactions – Accounting Hedging Transactions

Consolidated

	Currency purchased	Currency payable	Final repayment date	Amounts receivable	Amounts payable
				NIS millions	
Forward contracts at predetermined exchange rate					
(excluding premium/discount)	Dollar	NIS	February 2007	102	102
	Euro	NIS	August 2007	1,544	1,620
	CPI-linked NIS	NIS	December 2010	1,117	1,146

Future Currency Transactions – Contracts not for Accounting Hedging Purposes

	Purchased currency	Currency payable	Last repayment date	Scope of commitment
				NIS millions
Forward contracts at predetermined exchange rate				
(excluding premium/discount)	Dollar	Shekel	June 2007	320
	Index	Shekel	December 2007	250

NOTE 8 – TRANSACTIONS WITH INTERESTED PARTIES AND RELATED PARTIES

A. Further to Note 27C to the financial statements as at December 31, 2005, on March 23, 2006 the general meeting of the shareholders of the Company approved the Company entering into an agreement with a company which will be owned and controlled by the shareholders of Ap.Sab.Ar. Holdings Ltd. and will provide the Company with regular management and consultation services, including by means of serving directors and directors who will serve from time to time in the Company and/or in its subsidiaries, for US $1.2 million per year. The term of the agreement is from October 11, 2005 the date of closing the purchase of 30% of the shares of the Company by Ap.Sab.Ar.) to December 31, 2008, unless one of the parties gives the other three months' notice of its wish to terminate it.

B. BENEFITS FOR DIRECTORS AND CEO

(1) On May 15, 2006 the Audit Committee and the Board of Directors approved the terms of employment of the Chairman of the Board, and on June 21, 2006 the terms were approved by the general meeting. Below are the details of the terms of his employment:

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

B. BENEFITS FOR DIRECTORS AND CEO (CONTD.)

a. The Chairman will be employed at an 80% position under a personal employment agreement, at a monthly salary of NIS 150,000 and standard social benefits (managers' insurance, supplementary study fund, company car, driver, expense account, telephone, etc.).

b. In addition to his regular monthly salary, a once yearly payment (with no accompanying conditions of any kind) in the amount of one million two hundred thousand shekels (linked to the Consumer Price Index.

c. The commitment will be for an undefined period, where each party has the right to bring the commitment to an end by giving three months' notice.

d. Insofar as the Company has an employee stock options plan, the Chairman will be included in it in accordance with the criteria of that plan.

(2) On August 14, 2006 the Board of Directors of the Company approved the sale of a real estate asset of the Company to the CEO of the Company (through a company in his control), for $630,000 plus VAT. The consideration was set according to the valuation of an external appraiser and after no higher offer was received from other bidders.

C. Further to Note 27B to the financial statements of the Company as at December 31, 2005, concerning the new commercial agreement signed between the Company and the Ministry of Defense on behalf of the State of Israel for the provision of communication services by the Company – on August 23, 2006, the Company received a letter from the Antitrust Authority to the legal counsel of the Ministry of Defense and Israel Defense Forces, in which the Authority announced that the agreement does not contradict the provisions of the Antitrust Law, 5748-1988, and that the Authority sees no justification, at the present time, for insisting on cancellation of the agreement. The Company forwarded a copy of the letter to the Ministry of Communications for its information. Accordingly, the agreement came into force and the parties are acting in accordance with its provisions. The financial statements include revenues in accordance with the new agreement.

Notes to the Financial Statements as at September 30, 2006

NOTE 9 – REVENUES FROM COMMUNICATION SERVICES

	For the nine-month period ended September 30		For the three-month period ended September 30		For the year ended December 31
	2006 (Unaudited)	2005 (Unaudited)	2006 (Unaudited)	2005 (Unaudited)	2005 (Audited)
	NIS thousands		NIS thousands		NIS thousands
Revenues from communication services –					
Traffic	**1,013,690**	1,083,535	**341,182**	367,075	1,436,615
Fixed fees	**1,964,785**	1,914,818	**664,478**	647,254	2,559,559
	2,978,475	2,998,353	**1,005,660**	1,014,329	3,996,174
Cellular telephone	**2,856,301**	2,740,753	**985,535**	916,766	3,643,795
International communications and internet services	**712,532**	571,918	**238,060**	191,163	775,532
Multi-channel television	**957,355**	895,586	**322,072**	319,450	1,171,318
Installation and sale of equipment to subscribers and miscellaneous	**861,917**	940,043	**297,678**	330,887	1,246,947
	8,366,580	8,146,653	**2,849,005**	2,772,595	10,833,766
Other revenues	**159,951**	192,564	**32,399**	66,124	264,920
	8,526,531	8,339,217	**2,881,404**	2,838,719	11,098,686

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
	2006 (Unaudited)	2005 (Unaudited)	2006 (Unaudited)	2005 (Unaudited)	2005 (Audited)
	NIS thousands		NIS thousands		NIS thousands
Salaries and incidental expenses –					
Operations	**1,360,193**	1,325,596	**449,828**	450,121	1,794,458
General and administrative	**529,444**	500,269	**180,126**	173,572	684,290
Total salaries and related expenses	**1,889,637**	1,825,865	**629,954**	623,693	2,478,748
General expenses	**872,250**	927,518	**301,886**	313,775	1,209,169
Materials and spare parts	**611,913**	743,914	**197,854**	244,759	1,016,735
Consumption of satellite service content	**333,900**	309,533	**117,743**	107,282	419,309
Cellular telephone expenses	**780,049**	733,253	**267,113**	255,611	991,066
Building maintenance	**259,005**	264,132	**91,487**	94,327	366,630
Services and maintenance by sub-contractors	**326,215**	329,483	**111,221**	118,846	422,416
International communication expenses	**299,604**	199,839	**103,898**	69,718	277,210
Vehicle maintenance expenses	**142,888**	131,481	**50,927**	50,317	181,385
Collection fees	**36,190**	37,597	**10,917**	12,842	49,196
	5,551,651	5,502,615	**1,883,000**	1,891,170	7,411,864
Less – salaries charged to investment in fixed assets	**156,903**	161,479	**52,526**	55,686	218,396
	5,394,748	5,341,136	**1,830,474**	1,835,484	7,193,468

Notes to the Financial Statements as at September 30, 2006

NOTE 11 – OTHER INCOME (EXPENSES), NET

	For the nine-month period ended September 30		For the three-month period ended September 30		For the year ended December 31
	2006 (Unaudited)	2005 (Unaudited)	2006 (Unaudited)	2005 (Unaudited)	2005 (Audited)
	NIS thousands		NIS thousands		NIS thousands
Provision for employee severance benefits upon early retirement	**–**	83,000	**–**	–	83,000
Disposal of assets and impairment of value of fixed assets	**–**	–	**–**	–	(830)
Provision for impairment and other liabilities in respect of the value of investments in other companies	**(7,147)**	(5,868)	**–**	(1,168)	(5,868)
Compensation in respect of a settlement agreement	**–**	14,483	**–**	–	14,483
Amortization of goodwill	**–**	(69,837)	**–**	(23,278)	(93,112)
Capital gain from sale of operation	**–**	103,869	**–**	–	103,869
Dividend (1)	**26,010**	–	**–**	–	–
Capital gains, net	**35,797**	5,346	**23,610**	2,579	5,715
Others	**(605)**	(339)	**(605)**	(221)	2,129
	54,055	130,654	**23,005**	(22,088)	109,386

(1) On May 14, 2006 the Company received the notice of Eurofund 2000 Partnership, a venture capital fund which invests mainly in start-ups in communications, software, internet, semiconductors and homeland security ("the Fund"), of a distribution, following the sale of the Fund's holdings (approximately 18%) in an optical network equipment company for approximately US $42 million (the Fund had invested $2 million in the company). As a result of the distribution, the Company recorded a gain from the dividend of approximately NIS 26 million.

Notes to the Financial Statements as at September 30, 2006

NOTE 12 – 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
	2006 (Unaudited)	2005 (Unaudited)	2006 (Unaudited)	2005 (Unaudited)	2005 (Audited)
	NIS thousands		NIS thousands		NIS thousands
Revenues (Note 12B)	**3,509,098**	3,566,204	**1,177,398**	1,211,014	4,723,734
Costs and expenses					
Operating and general expenses (Note 12C)	**1,744,496**	1,733,455	**575,900**	604,220	2,346,451
Depreciation	**958,561**	1,047,889	**315,356**	347,411	1,390,435
Royalties to the Government of Israel*	**40,993**	104,021	**15,828**	33,915	135,575
	2,744,050	2,885,365	**907,084**	985,546	3,872,461
Operating income	**765,048**	680,839	**270,314**	225,468	851,273
Financing income (expenses), net	**(28,866)**	(28,448)	**(3,642)**	2,575	(80,897)
Earnings after financing expenses	**736,182**	652,391	**266,672**	228,043	770,376
Other income, net	**64,772**	200,855	**24,179**	1,455	201,012
Earnings before income tax	**800,954**	853,246	**290,851**	229,498	971,388
Income tax	**250,294**	298,087	**97,840**	99,399	332,118
Earnings after income tax	**550,660**	555,159	**193,011**	130,099	639,270
Company's equity in earnings (losses) of investee companies	**149,908**	(23,000)	**51,979**	(26,950)	(63,412)
Earnings before the cumulative effect of change in accounting principle	**700,568**	532,159	**244,990**	103,149	575,858
Cumulative effect of change in accounting principle as at the beginning of the year	**-**	15,000	**-**	-	15,000
Net earnings	**700,568**	547,159	**244,990**	103,149	590,858

* See Note 7A(9).

Notes to the Financial Statements as at September 30, 2006

NOTE 12 – CONDENSED INTERIM FINANCIAL STATEMENTS OF THE COMPANY (CONTD.)

B. 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
	2006 (Unaudited)	2005 (Unaudited)	2006 (Unaudited)	2005 (Unaudited)	2005 (Audited)
	NIS thousands		NIS thousands		NIS thousands
Fixed-line domestic communications-					
Traffic	**1,030,610**	1,121,254	**346,205**	377,184	1,460,076
Fixed fees	**1,833,966**	1,797,867	**619,879**	607,442	2,404,970
Total revenues from fixed-line communications	**2,864,576**	2,919,121	**966,084**	984,626	3,865,046
Cellular telephone	**280,205**	280,050	**94,301**	94,584	370,706
International communications	**87,352**	82,476	**29,177**	28,498	109,207
Installation and sale of equipment to subscribers and miscellaneous	**139,217**	120,205	**44,367**	45,931	167,904
	3,371,350	3,401,852	**1,133,929**	1,153,639	4,512,863
Other income	**137,748**	164,352	**43,469**	57,375	210,871
	3,509,098	3,566,204	**1,177,398**	1,211,014	4,723,734

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
	2006 (Unaudited)	2005 (Unaudited)	2006 (Unaudited)	2005 (Unaudited)	2005 (Audited)
	NIS thousands		NIS thousands		NIS thousands
Salaries and related expenses –					
Operations	**863,636**	834,499	**282,295**	282,128	1,140,482
General and administrative	**237,169**	207,445	**76,960**	70,672	288,804
Total salaries and incidental expenses	**1,100,805**	1,041,944	**359,255**	352,800	1,429,286
General expenses	**193,814**	232,556	**63,441**	78,522	298,767
Materials and spare parts	**57,734**	60,812	**15,455**	22,437	97,294
Building maintenance	**233,446**	236,342	**82,172**	83,254	320,700
Services and maintenance by sub-contractors	**143,568**	157,623	**49,384**	54,636	195,820
International communications expenses	**19,199**	22,478	**5,890**	12,603	30,033
Vehicle maintenance expenses	**103,552**	94,378	**36,664**	36,971	128,961
Collection fees	**27,300**	27,868	**8,569**	9,630	36,735
	1,879,418	1,874,001	**620,830**	650,853	2,537,596
Less – salaries charged to investments in fixed assets	**134,922**	140,546	**44,930**	46,633	191,145
	1,744,496	1,733,455	**575,900**	604,220	2,346,451

Notes to the Financial Statements as at September 30, 2006

NOTE 13 – BUSINESS SEGMENTS

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

	For the nine-month period ended September 30, 2006 (unaudited)						
	Domestic fixed-line communications	**Cellular telephone**	**International communications and Internet services**	**Multi-channel television**	**Others**	**Adjustments**	**Consolidated**
	NIS thousands						
Revenues							
Revenues from external sources	**3,295,732**	**3,317,991**	**745,582**	**996,758**	**170,468**	**–**	**8,526,531**
Inter-segment revenues	**213,366**	**12,023**	**15,903**	**12,645**	**73,293**	**(327,230)**	**–**
Total revenues	**3,509,098**	**3,330,014**	**761,485**	**1,009,403**	**243,761**	**(327,230)**	**8,526,531**
Segment results*	**765,048**	**457,710**	**102,121**	**(35,642)**	**9,223**	**–**	**1,298,460**

	For the nine-month period ended September 30, 2005 (unaudited)						
	Domestic fixed-line communications	**Cellular telephone**	**International communications and Internet services**	**Multi-channel television**	**Others**	**Adjustments**	**Consolidated**
	NIS thousands						
Revenues							
Revenues from external sources	3,365,414	3,343,524	587,946	881,003	161,330	–	8,339,217
Inter-segment revenues	200,790	10,797	16,186	14,583	89,564	(331,920)	–
Total revenues	3,566,204	3,354,321	604,132	895,586	250,894	(331,920)	8,339,217
Segment results*	680,839	384,045	68,922	(78,763)	(1,659)	–	1,053,384

* Segment results do not include Other income (expenses), net, as stated in Note 11.

Notes to the Financial Statements as at September 30, 2006

NOTE 13 – BUSINESS SEGMENTS (CONTD.)

	For the three-month period ended September 30, 2006 (unaudited)						
	Domestic fixed-line communications	Cellular telephone	International communications and Internet services	Multi-channel television	Others	Adjustments	Consolidated
	NIS thousands						
Revenues							
Revenues from external sources	**1,105,131**	**1,139,846**	**253,763**	**336,120**	**46,544**	**–**	**2,881,404**
Inter-segment revenues	**72,267**	**4,472**	**5,974**	**3,660**	**25,618**	**(111,991)**	**–**
Total revenues	**1,177,398**	**1,144,318**	**259,737**	**339,780**	**72,162**	**(111,991)**	**2,881,404**
Segment results*	**270,314**	**163,472**	**33,072**	**(18,609)**	**3,273**	**–**	**451,522**

	For the three-month period ended September 30, 2005 (unaudited)						
	Domestic fixed-line communications	Cellular telephone	International communicatio ns and Internet services	Multi-channel television	Others	Adjustments	Consolidated
	NIS thousands						
Revenues							
Revenues from external sources	1,144,535	1,139,297	195,157	304,867	54,863	–	2,838,719
Inter-segment revenues	66,479	3,232	6,432	5,786	28,747	(110,676)	–
Total revenues	1,211,014	1,142,529	201,589	310,653	83,610	(110,676)	2,838,719
Segment results*	225,468	129,725	26,038	(28,970)	(2,235)	–	350,026

	For the year ended December 31, 2005 (unaudited)						
	Domestic fixed-line communications	Cellular telephone	International communicatio ns and Internet services	Multi-channel television	Others	Adjustments	Consolidated
	NIS thousands						
Revenues							
Revenues from external sources	4,457,189	4,413,421	795,176	1,200,865	232,035	–	11,098,686
Inter-segment revenues	266,545	14,854	21,488	20,997	104,511	(428,395)	–
Total revenues	4,723,734	4,428,275	816,664	1,221,862	336,546	(428,395)	11,098,686
Segment results*	851,273	466,165	97,978	(99,535)	1,197	–	1,317,078

* Segment results do not include Other income (expenses), net, as stated in Note 11.

Notes to the Financial Statements as at September 30, 2006

NOTE 14 – CONDENSED FINANCIAL STATEMENTS OF PELEPHONE COMMUNICATIONS LTD., DBS SATELLITE SERVICES (1998) LTD, AND BEZEQ INTERNATIONAL LTD.

1. PELEPHONE COMMUNICATIONS LTD.

A. Balance sheets

	September 30 2006	September 30 2005	December 31 2005
	(Unaudited)	(Unaudited)	(Audited)
	NIS thousands	NIS thousands	NIS thousands
Current assets	**1,506,905**	1,882,739	1,881,982
Long-term trade receivables	**319,916**	339,872	338,281
Investment in shares and in an investee partnership	**4,923**	3,216	3,565
Deferred taxes	**–**	33,322	19,799
Fixed assets, net	**2,752,163**	3,029,525	3,009,219
Other assets, net	**360,052**	336,925	337,787
	4,943,959	5,625,599	5,590,633
Current liabilities	**1,226,841**	1,571,287	1,558,012
Long-term liabilities	**1,491,105**	1,721,223	1,666,193
Shareholders' equity	**2,226,013**	2,333,089	2,366,428
	4,943,959	5,625,599	5,590,633

NOTE 14 – CONDENSED FINANCIAL STATEMENTS OF PELEPHONE COMMUNICATIONS LTD., DBS SATELLITE SERVICES (1998) LTD, AND BEZEQ INTERNATIONAL LTD. (CONTD.)

1. PELEPHONE COMMUNICATIONS LTD. (CONTD.)

B. 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
	2006 (Unaudited)	2005 (Unaudited)	2006 (Unaudited)	2005 (Unaudited)	2005 (Audited)
	NIS thousands		NIS thousands		NIS thousands
Revenues from Pelephone services and sales	**3,330,016**	3,354,322	**1,144,321**	1,142,530	4,428,277
Cost of Pelephone services and sales	**2,480,310**	2,557,693	**844,745**	871,563	3,415,885
Gross profit	**849,706**	796,629	**299,576**	270,967	1,012,392
Sales and marketing expenses	**309,300**	330,155	**108,249**	114,983	432,808
General and administrative expenses	**73,879**	76,232	**27,855**	26,264	107,218
	383,179	406,387	**136,104**	141,247	540,026
Operating income	**466,527**	390,242	**163,472**	129,720	472,366
Financing expenses, net	**54,349**	82,277	**12,496**	42,829	115,264
Other expenses (income), net	**4,921**	(497)	**2,736**	(390)	(1,136)
Earnings before income tax	**407,257**	308,462	**148,240**	87,281	358,238
Income tax	**117,672**	96,855	**51,188**	23,860	113,333
Earnings after income tax	**289,585**	211,607	**97,052**	63,421	244,905
Company's equity in losses of company and investee partnership, net	**-**	(8,548)	**-**	(2,140)	(8,507)
Net earnings	**289,585**	203,059	**97,052**	61,281	236,398

Notes to the Financial Statements as at September 30, 2006

NOTE 14 – CONDENSED FINANCIAL STATEMENTS OF PELEPHONE COMMUNICATIONS LTD., DBS SATELLITE SERVICES (1998) LTD, AND BEZEQ INTERNATIONAL LTD. (CONTD.)

2. DBS Satellite Services (1998) Ltd.

A. Balance sheets

	September 30 2006	September 30 2005	December 31 2005
	(Unaudited)	(Unaudited)	(Audited)
	NIS thousands	NIS thousands	NIS thousands
Current assets	**165,576**	142,114	154,567
Broadcasting rights, net	**177,925**	161,339	154,500
Fixed assets, net	**965,203**	1,071,672	1,047,994
	1,308,704	1,375,125	1,357,061
Current liabilities	**746,085**	617,877	613,379
Long-term liabilities	**1,377,839**	1,376,272	1,419,257
Loans from shareholders	**3,000,000**	2,850,274	2,893,024
Capital deficit	**(3,815,220)**	(3,469,298)	(3,568,599)
	1,308,704	1,375,125	1,357,061

B. 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
	2006	2005	2006	2005	2005
	(Unaudited)	(Unaudited)	(Unaudited)	(Unaudited)	(Audited)
	NIS thousands		NIS thousands		NIS thousands
Revenues from DBS services	**1,009,396**	895,585	**339,774**	310,652	1,221,863
DBS operating expenses	**873,936**	799,940	**298,283**	276,143	1,089,835
Gross profit	**135,460**	95,645	**41,491**	34,509	132,028
Sales and marketing expenses	**89,442**	107,282	**30,340**	40,575	140,665
General and administrative expenses	**71,863**	57,640	**26,334**	19,650	77,055
	161,305	164,922	**56,674**	60,225	217,720
Operating loss	**25,845**	69,277	**15,183**	25,716	85,692
Financing expenses, net	**191,026**	174,064	**61,928**	73,263	241,335
Other expenses, net	**904**	568	**702**	480	830
Net loss	**217,775**	243,909	**77,813**	99,459	327,857

Notes to the Financial Statements as at September 30, 2006

NOTE 14 – CONDENSED FINANCIAL STATEMENTS OF PELEPHONE COMMUNICATIONS LTD., DBS SATELLITE SERVICES (1998) LTD, AND BEZEQ INTERNATIONAL LTD. (CONTD.)

3. BEZEQ INTERNATIONAL LTD.

A. Balance sheets

	September 30 2006	September 30 2005	December 31 2005
	(Unaudited)	(Unaudited)	(Audited)
	NIS thousands	NIS thousands	NIS thousands
Current assets	**306,947**	320,208	366,078
Long-term investments and debit balances	**41,098**	28,619	28,702
Fixed assets	**313,071**	317,273	305,826
Other assets	**21,086**	23,930	23,625
	682,202	690,030	724,231
Current liabilities	**328,690**	218,317	401,126
Long-term liabilities	**25,693**	186,269	14,835
Shareholders' equity	**327,819**	285,444	308,270
	682,202	690,030	724,231

Notes to the Financial Statements as at September 30, 2006

NOTE 14 – CONDENSED FINANCIAL STATEMENTS OF PELEPHONE COMMUNICATIONS LTD., DBS SATELLITE SERVICES (1998) LTD, AND BEZEQ INTERNATIONAL LTD. (CONTD.)

3. BEZEQ INTERNATIONAL LTD. (CONTD.)

B. 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
	2006 (Unaudited)	2005 (Unaudited)	2006 (Unaudited)	2005 (Unaudited)	2005 (Audited)
	NIS thousands		NIS thousands		NIS thousands
Revenues from international telecommunication services	**761,485**	604,132	**259,736**	201,589	816,664
Operating expenses	**498,674**	394,064	**171,846**	127,592	530,806
Gross profit	**262,811**	210,068	**87,890**	73,997	285,858
Marketing expenses	**109,868**	98,351	**38,006**	35,899	135,736
General and administrative expenses	**50,822**	42,795	**16,811**	12,060	57,561
Operating income	**102,121**	68,922	**33,073**	26,038	92,561
Financing income (expenses), net	**1,985**	(3,388)	**1,462**	175	(3,361)
Earnings after financing, net	**104,106**	65,534	**34,535**	26,213	89,200
Other income (expenses), net	**2,031**	63	**2,226**	17	1,377
Earnings before income tax	**106,137**	65,597	**36,761**	26,230	90,577
Tax benefit (Income tax)	**(33,342)**	17,678	**(11,491)**	7,700	15,226
Earnings after income tax	**72,795**	83,275	**25,270**	33,930	105,803
Company's equity in earnings of an affiliated company	**6,902**	2,940	**2,889**	1,643	4,583
Net earnings	**79,697**	86,215	**28,159**	35,573	110,386