# "BEZEQ" THE ISRAEL TELECOMMUNICATION CORP. LIMITED

## INTERIM CONSOLIDATED FINANCIAL STATEMENTS

## SEPTEMBER 30, 2002

**Interim Consolidated Financial Statements as at September 30, 2002 (unaudited)**

## Contents

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

Dear Sirs,

**Re: Review of the Unaudited Interim Consolidated Financial Statements for the Nine Month and Three Month Periods Ended September 30, 2002**

At your request we have reviewed the interim consolidated balance sheet of "Bezeq" - The Israel Telecommunication Corp. Limited and its subsidiaries as at September 30, 2002, as well as the interim consolidated statement of operations, the interim statement of changes in shareholders' equity and the interim consolidated statement of cash flows for the nine month and the three month periods then ended.

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

Reports of other auditors were furnished to us which relate to the review of the interim financial statements of subsidiaries, whose assets as at September 30, 2002, constitute approximately 18.7% of the total assets included in the interim consolidated balance sheet and whose revenues constitute approximately 34.2% and 35% of the total revenues included in the interim consolidated statement of operations for the nine months and the three months, respectively, then ended. Furthermore, the data contained in the interim consolidated financial statements, which relate to the net asset value of the Company's investments in affiliated companies and its equity in their results, is based on interim financial statements which were reviewed by other auditors.

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

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

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

4. The financial position of an affiliated company, the need for additional financing which is significantly higher than the financing needs defined in the financing agreement between the

affiliated company and certain banking corporations and agreements in principle reached as at the date of these financial statements between the affiliated company, its shareholders and the banking corporations. As described in Note 4A the continuation of the activities of the affiliated company is dependent upon the execution of the agreements in principle reached with the banking corporations regarding increasing the credit facilities and upon additional loans to be received from the shareholders. The assessment of the affiliated company's management as to the likelihood of resolution of the required financing is included in the aforementioned note. As stated in the aforementioned note, the grant of additional loans by the Company are subject, among others, to the approval of the Ministerial Committee for Privatization. The Company is taking action to obtain the Committee's approval to increase its exposure.

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

November 26, 2002

**Interim Consolidated Balance Sheet**

In adjusted shekels of September 2002

| | September 30 2002 (Unaudited) | September 30 2001 (Unaudited) | December 31 2001 (Audited) |
|---|---|---|---|
| | NIS thousands | NIS thousands | NIS thousands |
| **Current assets** | | | |
| Cash and cash equivalents | **1,105,090** | 1,178,836 | 1,394,056 |
| Short-term investments | **831,600** | 295,193 | 471,448 |
| Trade receivables | **1,787,388** | 1,483,361 | 1,805,118 |
| Other receivables and debit balances | **416,768** | 568,563* | 310,104* |
| Inventory | **181,331** | 141,994 | 124,141 |
| | **4,322,177** | 3,667,947 | 4,104,867 |
| **Materials and spare parts** | **161,287** | 211,299 | 162,414 |
| **Investments and long-term receivables** | **1,567,269** | 1,767,826 | 1,798,399 |
| Investments, deposits and debit balances | **434,672** | 428,963 | 493,287 |
| Investments in investee companies | | | |
| | **2,001,941** | 2,196,789 | 2,291,686 |
| **Fixed assets** | | | |
| Cost | **30,996,506** | 32,228,294 | 30,134,089 |
| Less – accumulated depreciation | **20,846,753** | 20,857,039 | 19,180,838 |
| | **10,149,753** | 11,371,255 | 10,953,251 |
| **Other assets** | | | |
| Deferred charges and other assets | **286,208** | 389,811 | 364,187 |
| Deferred taxes | **455,374** | 340,463* | 479,242* |
| | **741,582** | 730,274 | 843,429 |
| | **17,376,740** | 18,177,564 | 18,355,647 |

| | September 30 2002 (Unaudited) | September 30 2001 (Unaudited) | December 31 2001 (Audited) |
|---|---|---|---|
| | NIS thousands | NIS thousands | NIS thousands |
| **Current liabilities** | | | |
| Bank credit | **405,614** | 545,818 | 453,166 |
| Current maturities of: | | | |
| Long-term bank loans | **600,623** | 481,854 | 595,845 |
| Other debentures | **204,291** | 199,185 | 199,769 |
| Trade payables | **929,622** | 890,488 | 1,089,872 |
| Employee severance benefits | **238,798** | 308,823 | 281,322 |
| Other current liabilities | **1,111,325** | 992,515* | 1,235,817 |
| | **3,490,273** | 3,418,683 | 3,855,791 |
| **Long-term liabilities** | | | |
| Long-term loans | **2,368,450** | 2,838,419 | 2,689,597 |
| Other debentures | **2,745,137** | 2,735,822 | 2,700,666 |
| Employee severance benefits | **1,186,383** | 1,390,089* | 1,365,074 |
| Deferred revenues | **49,159** | 66,303 | 62,090 |
| | **6,349,129** | 7,030,633 | 6,817,427 |
| **Contingent liabilities** | | | |
| **Shareholders' equity** | **7,537,338** | 7,728,248 | 7,682,429 |
| | **17,376,740** | 18,177,564 | 18,355,647 |

| | | |
|---|---|---|
| Avi Barak<br>Member of the Board and Chairman of the Finance Committee | Ilan Biran<br>Chief Executive Officer | Oren Lieder<br>Chief Financial Officer |

* Reclassified

Date of approval of the financial statements: November 26, 2002

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

## Interim Consolidated Statement of Operations

In adjusted shekels of September 2002

| | For the nine month period ended September 30 | | For the three month ended period September 30 | | For the year ended December 31 |
|---|---|---|---|---|---|
| | 2002 (Unaudited) | 2001 (Unaudited) | 2002 (Unaudited) | 2001 (Unaudited) | 2001 (Audited) |
| | NIS thousands | | NIS thousands | | NIS thousands |
| **Revenues from telecommunications services (Note 8)** | **6,236,830** | 6,548,066 | **2,096,521** | 2,168,939 | 8,721,515 |
| **Costs and expenses** | | | | | |
| Operating and general expenses (Note 9) | **3,470,500** | 3,568,207 | **1,177,444** | 1,185,154 | 4,779,747 |
| Depreciation (see also Note 5) | **1,749,828** | 2,072,335 | **585,210** | 682,656 | 2,777,987 |
| Royalties to the Government of Israel | **190,665** | 213,797 | **57,206** | 64,925 | 289,283 |
| | **5,410,993** | 5,854,339 | **1,819,860** | 1,932,735 | 7,847,017 |
| Operating income | **825,837** | 693,727 | **276,661** | 236,204 | 874,498 |
| **Financing expenses, net** | **(154,910)** | (105,640) | **(82,530)** | (50,392) | (154,144) |
| Earnings after financing expenses, net | **670,927** | 588,087 | **194,131** | 185,812 | 720,354 |
| **Other expenses, net (Note 4C)** | **(392,962)** | (960) | **(398,602)** | (25,868) | (107,578) |
| Earnings (loss) before income tax | **277,965** | 587,127 | **(204,471)** | 159,944 | 612,776 |
| **Income tax** | **(181,765)** | (266,136) | **(24,819)** | (84,438) | (246,706) |
| Earnings (loss) after income tax | **96,200** | 320,991 | **(229,290)** | 75,506 | 366,070 |
| **Equity in losses of affiliates** | **(243,604)** | (150,783) | **(116,288)** | (69,233) | (243,138) |
| **Minority share in losses of a consolidated company** | **2,313** | 5,197 | **754** | 1,552 | 6,654 |
| Net earnings (losses) | **(145,091)** | 175,405 | **(344,824)** | 7,825 | 129,586 |
| **Primary and diluted earnings (loss) per NIS 1 par value of common shares (in NIS)** | **(0.060)** | 0.073* | **(0.143)** | 0.003 | 0.054 |

* Restated as a result of a clerical error.

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

## Interim Statement of Changes in Shareholders' Equity

In adjusted shekels of September 2002

| | Share capital | Capital reserve for distribution of bonus shares | Capital reserve – share premium | Capital reserve in respect of transactions between the Company and a controlling shareholder | Retained earnings | Total |
|---|---|---|---|---|---|---|
| | NIS thousands | | | | | |
| **Nine months ended September 30, 2002** | | | | | | |
| Balance as at December 31, 2001 (audited) | **6,262,767** | **–** | **960,587** | **38,678** | **420,397** | **7,682,429** |
| Net loss (unaudited) | **–** | **–** | **–** | **–** | **(145,091)** | **(145,091)** |
| Balance as at September 30, 2002 (unaudited) | **6,262,767** | **–** | **960,587** | **38,678** | **275,306** | **7,537,338** |
| **Three months ended September 30, 2002** | | | | | | |
| Balance as at July 1, 2002 (unaudited) | **6,262,767** | **–** | **960,587** | **38,678** | **620,130** | **7,882,162** |
| Net loss (unaudited) | **–** | **–** | **–** | **–** | **(344,824)** | **(344,824)** |
| Balance as at September 30, 2002 (unaudited) | **6,262,767** | **–** | **960,587** | **38,678** | **275,306** | **7,537,338** |
| **Nine months ended September 30, 2001** | | | | | | |
| Balance as at December 31, 2000 (audited) | 4,499,900 | 1,734,310 | 893,122 | 38,678 | 312,930 | 7,478,940 |
| Net earnings (unaudited) | – | – | – | – | 175,405 | 175,405 |
| Conversion of convertible debentures (unaudited) (1) | 6,438 | – | 67,465 | – | – | 73,903 |
| Distribution of bonus shares (unaudited) | 1,756,429 | (1,734,310) | – | – | (22,119) | – |
| Balance as at September 30, 2001 (unaudited) | 6,262,767 | – | 960,587 | 38,678 | 466,216 | 7,728,248 |
| **Three months ended September 30, 2001** | | | | | | |
| Balance as at July 1, 2001 (unaudited) | 6,262,767 | – | 960,587 | 38,678 | 458,391 | 7,720,423 |
| Net earnings (unaudited) | – | – | – | – | 7,825 | 7,825 |
| Balance as at September30, 2001 (unaudited) | 6,262,767 | – | 960,587 | 38,678 | 466,216 | 7,728,248 |
| **Year ended December 31, 2001** | | | | | | |
| Balance as at December 31, 2000 (audited) | 4,499,900 | 1,734,310 | 893,122 | 38,678 | 312,930 | 7,478,940 |
| Net earnings (audited) | – | – | – | – | 129,586 | 129,586 |
| Conversion of convertible debentures (audited) (1) | 6,438 | – | 67,465 | – | – | 73,903 |
| Distribution of bonus shares (audited) | 1,756,429 | (1,734,310) | – | – | (22,119) | – |
| Balance as at December 31, 2001 (audited) | 6,262,767 | – | 960,587 | 38,678 | 420,397 | 7,682,429 |

(1) 59,754,681 par value convertible debentures were converted into 5,904,612 ordinary shares with a par value of NIS 1 each.

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

**Interim Consolidated Statement of Cash Flows**

In adjusted shekels of September 2002

| | For the nine month period ended September 30 | | For the three month period ended September 30 | | For the year ended December 31 |
|---|---|---|---|---|---|
| | 2002 (Unaudited) | 2001 (Unaudited) | 2002 (Unaudited) | 2001 (Unaudited) | 2001 (Audited) |
| | NIS thousands | | NIS thousands | | NIS thousands |
| **Cash flows provided by operating activities** | | | | | |
| Net earnings (loss) | **(145,091)** | 175,405 | **(344,824)** | 7,825 | 129,586 |
| Adjustments to reconcile net earnings (loss) to net cash flows provided by operating activities (see A below) | **2,041,506** | 2,354,259 | **889,560** | 896,617 | 3,311,280 |
| Net cash provided by operating activities | **1,896,415** | 2,529,664 | **544,736** | 904,442 | 3,440,866 |
| **Cash flows used in investing activities** | | | | | |
| Investment in fixed assets | **(925,405)** | (1,099,610) | **(372,009)** | (331,963) | (1,352,276) |
| Proceeds from disposal of fixed assets | **13,839** | 53,393 | **5,395** | 8,792 | 87,727 |
| Proceeds from disposal of investment in affiliated company | **112,130** | 31,803 | **–** | 31,803 | 31,802 |
| Investment in long-term deposits and investments | **(182,467)** | (1,166,389) | **(63,941)** | (54,891) | (1,179,588) |
| Proceeds from long-term deposits and investments | **153,703** | 15,445 | **25,884** | 4,193 | 39,132 |
| Increase in short-term investments, net | **(427,772)** | (83,942) | **(429,342)** | (6,441) | (256,556) |
| Decrease (increase) in materials and spare parts | **(19,366)** | (22,726) | **(20,513)** | (53,210) | 52,316 |
| Investment in investee companies | **(304,576)** | (404,295) | **(79,522)** | (128,945) | (560,408) |
| Investment in other assets | **(100,782)** | (171,251) | **(13,828)** | (56,953) | (209,549) |
| Net cash used in investing activities | **(1,680,696)** | (2,847,572) | **(947,876)** | (587,615) | (3,347,400) |
| **Cash flows used in financing activities** | | | | | |
| Issue of other debentures (net of issue expenses) | **109,546** | 546,231 | **–** | – | 546,231 |
| Repayment of other debentures | **(205,081)** | (219,806) | **(25,966)** | (76,200) | (242,105) |
| Receipt of long-term loans | **197,657** | 730,082 | **1,848** | 564,090 | 785,418 |
| Repayment of long-term loans | **(559,255)** | (971,097) | **(313,602)** | (760,672) | (1,107,635) |
| Receipt (repayment) of short-term bank credit, net | **(47,552)** | (251,782) | **176,126** | (192,200) | (344,435) |
| Net cash used in financing activities | **(504,685)** | (166,372) | **(161,594)** | (464,982) | (362,526) |
| **Decrease in cash and cash equivalents** | **(288,966)** | (484,280) | **(564,734)** | (148,155) | (269,060) |
| **Balance of cash and cash equivalents at the beginning of the period** | **1,394,056** | 1,663,116 | **1,669,824** | 1,326,991 | 1,663,116 |
| **Balance of cash and cash equivalents at the end of the period** | **1,105,090** | 1,178,836 | **1,105,090** | 1,178,836 | 1,394,056 |

The notes to the financial statements are integral part thereof.

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

In adjusted shekels of September 2002

| | For the nine month period ended September 30 | | For the three month period ended September 30 | | For the year ended December 31 |
|---|---|---|---|---|---|
| | 2002 (Unaudited) | 2001 (Unaudited) | 2002 (Unaudited) | 2001 (Unaudited) | 2001 (Audited) |
| | NIS thousands | | NIS thousands | | NIS thousands |
| **A – Adjustments to reconcile net earnings (loss) to net cash flows provided by operating activities** | | | | | |
| Revenues and expenses not involving cash flows: | | | | | |
| Depreciation (See also Note 5) | **1,749,828** | 2,072,335 | **585,210** | 682,656 | 2,777,987 |
| Provision for impairment of fixed assets | **–** | 22,708 | **–** | 22,708 | 109,156 |
| Provision for impairment of long-term investments | **400,500** | – | **400,500** | – | – |
| Deferred taxes | **47,154** | 23,238 | **(4,052)** | 33,239 | (125,096) |
| Company's equity in losses of affiliated companies, net | **243,604** | 150,783 | **116,288** | 69,233 | 243,138 |
| Minority share in losses of a consolidated company | **(2,313)** | (5,197) | **(754)** | (1,552) | (6,654) |
| Decrease in employee severance benefits, net | **(221,216)** | (39,431)* | **(119,524)** | (37,285) | (91,947) |
| Gain (loss) on disposal of fixed assets | **(7,326)** | (29,332) | **(1,820)** | 3,624 | (9,313) |
| Loss on disposal of investment in affiliated company | **–** | 3,723 | **–** | – | 3,723 |
| Appreciation and interest on long-term deposits and investments | **(204,747)** | (152,151) | **(26,880)** | (133,300) | (212,145) |
| Erosion (appreciation) of short-term investments, net | **67,621** | (6,878) | **5,005** | (2,669) | (10,519) |
| Appreciation of long-term liabilities: | | | | | |
| Other debentures | **144,528** | 29,994 | **17,191** | 132,506 | 17,722 |
| Long-term loans | **20,988** | 92,678 | **32,548** | 56,556 | 137,375 |
| Amortization of deferred expenses and other adjustments | **181,396** | 197,800 | **59,784** | 82,490 | 262,693 |
| Changes in current assets and liabilities : | | | | | |
| Decrease (increase) in trade receivables | **25,420** | 12,873 | **(17,561)** | (42,018) | (431,559) |
| Decrease (increase) in receivables and debit balances | **(24,031)** | 51,668 | **4,469** | (98,421) | 340,996 |
| Decrease (increase) in inventory | **(58,027)** | 6,375 | **13,461** | 28,516 | 23,775 |
| Increase (decrease) in trade payables | **(176,632)** | (36,148) | **(116,765)** | 123,292 | 85,528 |
| Increase (decrease) in other current liabilities | **(132,310)** | (31,350)* | **(53,169)** | (18,801) | 210,062 |
| Decrease in deferred revenues | **(12,931)** | (9,429) | **(4,371)** | (4,157) | (13,642) |
| | **2,041,506** | 2,354,259 | **889,560** | 896,617 | 3,311,280 |
| **B – Non–cash transactions** | | | | | |
| Acquisition of fixed assets, other assets, materials and spare parts on credit | **156,870** | 106,515 | **156,870** | 106,515 | 175,216 |
| Sale of fixed assets on credit | **5,936** | 15,642 | **5,936** | 15,642 | – |

* Reclassified

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

**Notes to the Interim Consolidated Financial Statements as at September 30, 2002 (Unaudited)**

## NOTE 1 – GENERAL

**A.** The interim statements were prepared according to generally accepted accounting principles, applicable to the preparation of financial statements for interim financial statements. These statements should be read in conjunction with the Company's annual financial statements and accompanying notes as at December 31, 2001 and for the year then ended.

**B.** In the notes to the interim financial statements, the Company presents only the significant changes in its business and legal environment that occurred from the date of the latest annual financial statements until the date of these interim financial statements. The full and detailed description, including significant changes and developments which occurred in recent years, particularly in the field of cellular telephone services, international communication services, domestic communication services, the opening of these markets to competition and decisions of the Ministerial Committee for Privatization to reduce the State's holdings in the Company, appear in Note 1 to the Company's annual financial statements as at December 31, 2001. The significant changes that occurred from the date of those annual financial statements to the date of these financial statements, are as follows:

1. Effective as of January 1, 2002, payment of the access fees to the Company by the international telecommunications operators was cancelled in accordance with the licenses of the operators which stated that payment of the access fees would be cancelled at the end of 2001.
   As a result of cancellation of payment of the aforementioned access fees, commencing January 1, 2002, the Company's revenues from international telecommunications exclude access fees. The access fees included in the Group's revenues from international communications were approximately NIS 94 million in the nine month period ended September 30, 2001, approximately NIS 32 million in the three month period then ended, and approximately NIS 124 million in the year ended December 31, 2001 (in the Company's revenues – approximately NIS 140 million, NIS 48 million and NIS 186 million, respectively).

2. On March 18, 2002 the Company received a draft amendment to its general license. The draft incorporates new requirements and restrictions on the Company (some of which are reflected in the Telecommunications Law and/or the Telecommunications Order and/or in other laws, and some are new requirements/restrictions), as well as a broadening of existing requirements and restrictions on various matters. The Company submitted its comments and objections to the Ministry of Communications and a number of hearings on the matter took place.

3. On May 14, 2002, the Company's tariffs were changed. As part of the change, tariffs for various services were revised, *inter alia*, the call tariffs, installation fees and other services. The change in the call tariffs included an adjustment of peak and off–peak times and uniformity of the tariff for local calls and domestic long–distance calls at all hours of the day.

4. On August 8, 2002, the committee for formulating rules and policies for opening domestic fixed-line communications to competition submitted its recommendations to the Minister of Communications. The recommendations set out the proposed policy, the principles for opening domestic fixed-line communications to competition and recommendations for the removal of barriers to the entry of new operators. The Company submitted its comments to the Minister of Communications on the committee's recommendations, wherein it expressed, *inter alia*, its position that adoption of the committee's recommendations concerning structural separation, universal service, splitting of transmission services, data communication and infrastructure and an immediate permit for the selective provision of those services and in addition, comments on the supervision of the Company's tariffs, would have a severely adverse effect on the Company, consumers and the economy. The Minister of Communications adopted the committee's recommendations, with certain changes, the main ones being postponement of the date of grant of the permit for access services to Internet providers to a date when a permit will be granted for services to the general public and permitted the requirement of corporate separation on a domestic operator. The Company petitioned the High Court of Justice against the decision of the Minister of Communications, insofar as it relates to the separation of data communications and transmission from telephony (which is impractical, in the Company's opinion) and for immediate grant of a permit for the selective

## NOTE 1 – GENERAL (CONTD.)

provision of data and transmission services without a universal obligation, in which it contends, *inter alia*, that the decision of the Minister is unreasonable and in making it, he had exceeded his authority.

## NOTE 2 – ACCOUNTING POLICY

1. The significant accounting policies employed in preparation of these financial statements are the same as those employed in the preparation of the latest annual financial statements, except for the following:

2. In 2001 the Israeli Institute for Accounting Standardization published Accounting Standard No. 12 – Termination of the Adjustment of Financial Statements. Under this Standard, the adjustment of financial statements for the effects of changes in the general purchasing power of the Israeli currency will end on January 1, 2003. On November 10, 2002, a decision of the Professional Committee of the Institute for Accounting Standardization postponed application of the Standard to January 1, 2004 and accordingly the adjustment of the financial statements will end as of January 1, 2004.. Through December 31, 2003, the Company will continue to prepare adjusted financial statements in accordance with Opinion 36 of the Institute of Certified Public Accountants in Israel (ICPAI). The application of this Standard is liable to have a materially adverse effect on the reported business results of the Company. The extent of that effect depends on the rate of inflation, on the composition of assets and the financing structure of the Company. In addition, the application of Standard No. 13 – The Effect of Changes in Foreign Currency Exchange Rates, was postponed to January 1, 2004.

3. In August 2002 the Israeli Institute for Accounting Standardization published Accounting Standard No. 14 – Financial Reporting for Interim Periods. The Standard determines the minimum content of financial reports for interim periods, including the disclosure required in the notes and in addition details the accounting principles with respect to recognition and measurement to be applied in financial reports for interim periods. This Standard will apply to financial statements for periods starting on January 1, 2003, or thereafter. The Standard does not require the restatement of comparative information for interim periods prior to the starting date; however, if financial statements include comparative information for interim periods prior to the starting date, which is not presented in accordance with the provisions of the Standard then the notes to the financial statements must include a description of the main differences between the principles detailed in the Standard and the principles under which the comparative information was prepared. In the Company's opinion, the effects of this new standard on the results of its operations, its financial condition and its cash flows is not expected to be significant.

## NOTE 3 – FINANCIAL STATEMENTS IN ADJUSTED VALUES

The financial statements were prepared on the basis of historical cost adjusted for changes in the general purchasing power of the Israeli currency. The changes that occurred in the Consumer Price index ("CPI") and foreign currency exchange rates are as follows:

| | Consumer price index | Exchange rate US dollar | Exchange rate of the euro |
|---|---|---|---|
| | % | % | % |
| In the nine month period ending: | | | |
| September 30, 2002 | 6.988 | 10.303 | 22.830 |
| September 30, 2001 | 1.996 | 7.770 | 6.011 |
| In the three month period ended: | | | |
| September 30, 2002 | 0.648 | 2.139 | 1.388 |
| September 30, 2001 | 0.888 | 4.562 | 13.060 |
| In the year ended December 31, 2001 | 1.397 | 9.279 | 3.845 |

**Notes to the Interim Consolidated Financial Statements as at September 30, 2002 (Unaudited)**

## NOTE 4 – INVESTMENTS IN INVESTEE COMPANIES

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

1. Further to Note 8(F) to the financial statements as at December 31, 2001, at the beginning of May 2002 additional shares in DBS were issued to the Company, thereby increasing the Company's holding in DBS to approximately 45%. As a result of the increase in the percentage of its holding in DBS a surplus cost in the amount of approximately NIS 269 million was generated to the Company which will be amortized over a period of 10 years.

   The Company's investment in DBS at balance sheet date amounts to approximately NIS 1,044 million. The Company's share in the accumulated losses of DBS is approximately NIS 679 million, of which approximately NIS 205 million was recorded in the nine month period ended September 30, 2002, and approximately NIS 100 million was recorded in the three month period then ended. In addition, the balance of the current debt of DBS to the Company and its consolidated companies amounts to approximately NIS 47 million.

2. DBS expects considerable losses and negative cash flows from its operating activities during its initial years of operation. The loss arising in the year 2001 amounted to approximately NIS 898 million and the loss in the nine month period ended September 30, 2002, amounted to approximately NIS 533 million. The negative cash flows from operating activities during 2001 amounted to approximately NIS 613 million and during the nine month period ended September 30, 2002, approximately NIS 6 million. As a result of these losses the deficit in working capital as at September 30, 2002 amounted to approximately NIS 1,615 million.

3. On May 23, 2001, a financing agreement ("the Financing Agreement") was signed between DBS and certain banks ("the Banks"), stipulating, *inter alia*, undertakings by DBS to meet certain contingent conditions and to achieve cumulative milestones and financial conditions ("the Conditions"). As at the date of approval of these financial statements some of the aforementioned Conditions had not been met.

4. In addition, an economic study carried out by the Banks determined that, in order to finance the operations of DBS, additional financing would be required which considerably exceeds the financing requirements defined in the Financing Agreement.

5. The Company provided a perpetual guarantee in favor of the banks with respect to payment of the debts of DBS. The guarantee is up to a maximum equal to the percentage of the Company's holding in DBS multiplied by the value of DBS as derived from disposal of the mortgaged shares of the remaining shareholders. If the Company joins the remaining shareholders in their disposal of the mortgaged shares, the amount of the guarantee will not exceed the amount received by the Company from the sale of its shares in DBS. The letter of guarantee includes numerous limitations on the Company relating to the disposal of its shares in DBS and lists events of default that, should they occur, will allow the banks to foreclose on the guarantee.

6. At the beginning of May 2002, DBS and the Banks signed an addendum to the Financing Agreement. On the same date, DBS signed a debenture in favor of the banks, and some of the shareholders pledged their rights in the shareholders' loans that they have extended or will extend to the company with a first ranking fixed charge. Concurrently, the Company undertook that in the event of realization of the securities provided by the shareholders, it will not be entitled to sue for or to receive from DBS any payment in connection with the shareholders' loans.

   The agreements reached with the Banks require that DBS, with the consent of its shareholders and to the satisfaction of the Banks, takes action to find a solution for obtaining the additional financing required for its operations and that it should present a business plan showing that it will be able to meet its undertakings towards the Banks. If no such solution is found by June 30, 2002, the Banks will be entitled to take the necessary steps, at their absolute discretion, for collecting all the amounts payable to them and to act in accordance with their rights under the Financing Agreement in the event of default.

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

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

As at the date of approval of these financial statements, DBS, its shareholders and the Banks had formulated an agreement in principle concerning an increase in the credit together with additional investments of the shareholders in an amount which is not less than a sum equal to 150% of the amount to be provided by the Banks. The aforementioned agreement was approved in principle by the parties – see paragraph 7 below. The above mentioned Financing Agreement has not yet been signed, and is subject, *inter alia*, to the preparation of documents and individual agreements. During the period from October 1, 2002 to the date of approval of these financial statements the Banks injected into DBS approximately six million dollars on the basis of the agreement in principle,. In addition, discussions were held between the parties regarding a continuing financing plan. Following these discussions, the continuing financing plan was approved in principle by the authorized entities of a bank. In accordance with an agreement with the other Banks, discussions will be held at a later stage, regarding their approval of the continuing financing plan. As at the date of approval of these financial statements and prior to completion of signing the Financing Agreement with the Banks, the shareholders are continuing to make further credit available to the affiliate, beyond the requirements in the agreement in principle that was reached with the Banks, as aforesaid.

7. The grant of loans by the Company to DBS is subject, *inter alia*, to the approval of the Ministerial Committee for Privatization ("the Committee"). The Committee had given its approval for the Company to increase its exposure up to the total of the percentage of its holding in DBS multiplied by 480 million dollars. The Company is taking action to obtain the Committee's approval to increase its exposure.

8. The continuation of the activities of DBS is contingent upon implementation of the agreement in principle which was formulated by the Banks for an increase in the credit facility, as described above, and upon receipt of additional loans from the shareholders, including approval of the Committee as mentioned in Section 7 above.

   The Management of DBS believes that there are good chances that discussions between DBS, the shareholders and the Banks will lead to implementation of the agreement in principle formulated with the Banks and the shareholders, including the formulation of a continuing financing plan as mentioned above and the arrangement of the financial resources required by DBS in the coming year.

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

Bezeq International Ltd. ("Bezeq International") invested in Walla, an Israeli company whose shares are listed on the Tel Aviv Stock Exchange and which provides Internet services and operates Internet portals.

On March 14, 2002, Walla issued a prospectus for a rights issue. Bezeq International invested approximately NIS 11,238,000 in exercise of the rights and a further NIS 3,308,000 in the acquisition of additional rights from the public and the exercise thereof. Subsequent to exercise of the aforementioned rights, the acquisition from the public, and an additional acquisition of shares from Walla's shareholders during the second quarter, Bezeq International's holding in Walla increased from 24.83% to 36.74%.

Under the investment agreement between Bezeq International and Walla, Bezeq International undertook to invest an additional $3 million, through itself or through a strategic investor. During 2002, Bezeq International extended loans amounting to approximately NIS 11,237,000 to Walla, of which NIS 1,770,000 was subsequent to the balance sheet date. The loans are linked to the CPI and are interest-free. Repayment of the loans will be on a date shortly after the date on which Bezeq International invests in Walla's share capital. During the second quarter Bezeq International recorded reduction in the amount of NIS 7,384,000 in the value of its investment in Walla. The balance of its investment in Walla reflects the fair economic value of Walla to Bezeq International, based on the valuation of Walla which was prepared as part of the merger with IOL.

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

### C. Pelephone Communications Ltd. ("Pelephone")

1. Following various indications of a decrease in the value of the subsidiary Pelephone Communications Ltd. ("Pelephone"), in which 50% of the shares are held by the Company and 50% are held by Pelephone Holdings L.L.C. of Shamrock Holdings of California, Inc ("Shamrock"), the Company commissioned a revised valuation of Pelephone. According to the revised valuation, the current value of Pelephone is estimated at between $1 billion and $1.2 billion.

   As explained in the Company's financial statements for the year ended December 31, 2001, the consideration in respect of the purchase of Shamrock's share in Pelephone was financed in part by a $240 million loan extended by the Company to Shamrock, for which the Company received debentures which are convertible over a period of four years (from February 27, 2001) for 80% of the shares of Shamrock (and since Shamrock holds 50% of the shares in Pelephone, conversion of the debentures is equivalent to acquisition of 40% of Pelephone's shares). These debentures, plus interest and exchange rate differences, are presented in the Company's balance sheet under the item Long-term investments, deposits and debit balances.

   Part of the financing for acquisition of the Pelephone shares by Shamrock and additional investments which Shamrock made in Pelephone after the acquisition, was by means of bank loans, the balance of which on September 30, 2002 was approximately $ 375 million (including interest), against which shares of Shamrock and Shamrock's shares in Pelephone were pledged under a first ranking lien in favor of the bank. This lien has prior claim over a lien that was given to the Company against the aforementioned debentures, the balance of which on September 30, 2002, was approximately $ 254 million (including interest).

   In view of the revised valuation, the value of Shamrock's holding in Pelephone is approximately $550 million (based on the mid-range of the valuation). Since the amount of the bank financing is secured under a first ranking lien, the balance available for repayment of the debentures is limited to approximately $ 175 million. Accordingly, there is doubt as to the collection of approximately $80 million of the balance of the debentures (in shekels – approximately NIS 390 million).

   Based on the revised valuation, a provision in the amount of NIS 354 million (after deduction of a tax saving of NIS 36 million) was made in respect of a decrease in value of the Company's holding in the debentures.

2. During the reporting period, the Company and Shamrock Holdings of California, Inc. each invested approximately NIS 148 million as an investment against the share premium of shares of Pelephone which were issued in the past.

3. On October 29, 2002, Pelephone signed an agreement with Suny.Com Ltd. ("Suny"), for the purchase of all of Suny's shares in GoNext Ltd. (49% of the share capital) at a consideration of their par value; and for the assignment to Pelephone of all Suny's rights in all the loans extended by it and/or on its behalf to GoNext Ltd.,in the amount of NIS 42.2 million, which will be transferred to Suny by Pelephone on the date of closing the transaction.

## NOTE 5 – FIXED ASSETS

In October 2001, pursuant to the Company's policy of periodically reviewing the useful lives of its assets, a committee was appointed to examine whether there was a need to revise the useful lives of the assets and make recommendations to Management. The review included only fixed assets of the Company and was based on the balance of its fixed assets as at December 31, 2001. On May 28, 2002, the Board of Directors of the Company resolved to adopt Management's recommendations that were based on the report of the committee.

## NOTE 5 – FIXED ASSETS (CONTD.)

According to the recommendations of the committee, which were based, *inter alia*, on technological changes, changes in the investment plans of the Company (including providing broadband Internet service in ADSL technology on the existing copper infrastructure), and based on customary practices among the world's communications companies, the remainder of the useful lives of certain investments in the Company's copper cable network was extended, effective from January 1, 2002, while conversely, the useful lives of certain switching systems was shortened.

The aforementioned changes reduced the depreciation charge of the Company during the nine month period ended September 30, 2002 by approximately NIS 195 million and in the three month period then ended by approximately NIS 65 million and increased the Company's net earnings in the same periods by approximately NIS 125 million and NIS 42 million, respectively. In addition, earnings per share in the nine month period ending September 30, 2002, increased by approximately NIS 0.052 per NIS 1 par value and in the three month period then ended, earnings per share increased by approximately NIS 0.017 per NIS 1 par value.

Had the new depreciation rates been applied in 2001, the depreciation charges in that year would have been reduced by approximately NIS 229 million (and for the nine month period ended September 30, 2001, by approximately NIS 172 million and for the three month period then ended by approximately NIS 57 million), and the balance of the fixed assets would have increased by the same amounts.

In addition, net earnings in 2001 would have increased by approximately NIS 147 million (during the nine month period ended September 30, 2001, by approximately NIS 110 million and during the three month period then ended by approximately NIS 37 million). Earnings per share would have increased by NIS 0.061 (in the nine month period ended September 30, 2001, by approximately NIS 0.045 and in the three month period then ended by approximately NIS 0.015) per NIS 1 par value.

## NOTE 6 – LIABILITY FOR EMPLOYEE SEVERANCE BENEFITS

### 1. Early retirement plan

In September 2000, the Company reached an agreement with workers' representatives to extend the 1997 collective agreement for early retirement. Under the agreement 1,770 additional employees would take early retirement from April 1, 2001, through December 31, 2006 (with an option to extend the final retirement date for certain employees through December 31, 2008).

The agreement also stated that the Company would be able to terminate the employment of employees in a compensation track, in excess of the aforementioned quota. In the opinion of the Company's Management, the possibility of additional employees retiring under the aforementioned track is low and accordingly no provision was made in the financial statements. Under this plan, approximately 290 employees had taken early retirement by September 30, 2002.

**2.** The pension fund through which the early retirement plan is implemented ("the Fund") was directed by the Capital Markets Division of the Ministry of Finance to fulfill an undertaking it made in connection with changing the retirement tracks of approximately 600 Company retirees, provided that the Company pay the Fund NIS 50 million. After the Fund undertook that no extra cost would be imposed on the Company, the Company notified the Fund that it should continue to implement the agreement which enabled transfer from one retirement track to another at no additional cost to the Company. As a result, the Fund no longer allowed Company retirees to switch from one retirement track to another and even stopped implementation of the agreement, in whole or in part, in relation to retirement benefits paid in respect of April 2002. In the opinion of the Company's Management, based on consultations with its legal advisers, it is unlikely that the Company will be charged any costs in connection with implementation of the agreement and therefore it will insist on its implementation with no further payment to the Fund. Accordingly, no provision was made in the financial statements in respect of the above.

## NOTE 7 - CONTINGENT LIABILITIES

### A. Claims

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 20A to the Company's financial statements for the year ended December 31, 2001. There were no significant changes in respect of contingent liabilities through the date of the signing of these financial statements, except for the following:

1. Further to Note 20A(7) to the financial statements as at December 31, 2001 in the matter of a claim of a group of employees who were employed as temporary employees at the Ministry of Communications and were transferred to the Company when it commenced operations, the plaintiffs have withdrawn their consent to narrow the claim. The Labor Court may now rule whether it will approve the withdrawal of consent.

2. Further to Note 20A(11) to the financial statements as at December 31, 2001 in the matter of a class action in which the plaintiffs allege that the Company unlawfully collected money from its customers for certain services which it provides, on October 22, 2002, the Supreme Court decided to convert to an appeal the application for permission to appeal which was filed against the decision of the District Court to dismiss the application for approval of the claim as a class action.

3. Further to Note 20A(18) to the financial statements as at December 31, 2001 in the matter of a claim and an application to approve the claim as a class action, which were submitted to an affiliate, in which it is alleged that the affiliate is misleading consumers in its advertisements in connection with an offer to the consumer for the purchase certain channels only, as well as with regard to the number of channels offered, on March 18, 2002 the parties signed a compromise agreement under which an application will be filed in court to strike the claim and the application for approval of the claim as a class action. In exchange, the affiliate will compensate the plaintiff with an immaterial amount.

4. Further to Note 20A(22) to the financial statements as at December 31, 2001 in the matter of providing a blocking service for all land-line subscribers of the Company against outgoing calls to cellular phone area codes as an automatic default, on November 6, 2002 the case was heard and following the recommendation of the court, the petitioners withdrew their petition, which was stricken.

5. Further to Note 20A(25) to the financial statements as at December 31, 2001 in the matter of a class action against Pelephone Communications Ltd. ("Pelephone") concerning the plaintiff's allegation that Pelephone collected surplus amounts from its subscribers for reciprocal connection fees, in contravention of the applicable regulations and/or its license, the parties reached a compromise arrangement which took effect on May 2, 2002, in which the District Court partially approved the claim as a class action while validating the compromise agreement as a judgment. The amount of the settlement deriving from the agreement is approximately NIS 6.6 million. The financial statements include a provision that the management of Pelephone believes to be appropriate.

6. Further to Note 20A(26) to the financial statements as at December 31, 2001 in the matter of a claim filed in the Ramallah District Court by the General Public Palestinian Communications Co. Ltd. against Pelephone and another company, as at the date of signing these financial statements, the processing of service of this claim was terminated by the Attorney General and it is no longer counted among the claims pending against Pelephone.

7. On May 21, 2002 a statement of claim together with an application for its recognition as a class action were received at the Company's offices. The claim and application were filed in the Tel Aviv District Court against all the cellular companies in Israel, among them Pelephone (a proportionally consolidated company) and against the Company as a formal defendant.

**NOTE 7 - CONTINGENT LIABILITIES (CONTD.)**

**A. Claims (contd.)**

The plaintiffs, who contend that they are subscribers of the Company and of one of the defendant cellular companies, allege in their claim that the defendant cellular companies collected and collect, unlawfully, payments for what are ostensibly cellular calls but which in fact are fixed-line calls in every respect. The reference is to calls initiated by Company subscribers to commercial entities that provide entertainment and information services and which made an agreement with the cellular companies. Even though these calls do not "consume airtime", the cellular companies collected payment for them, in contravention of their licenses and of the law.

The amount of the class action against the cellular companies is estimated at about NIS 600 million. The Company has submitted its response to the application for recognition of the claim as a class action. It should be noted that the Company approached the Ministry of Communications on this matter, requesting its intervention. The Company, relying on its legal advisers, is unable to estimate at this stage the chances and implications of the claim, and accordingly, no provision was made in the financial statements in respect of this claim.

8. Further to Note 20A(31) to the financial statements as at December 31, 2001 in the matter of a report from the Ministry of Communications received at Bezeq International Ltd., a consolidated company, which calls into doubt the reliability of one of the main files which was transferred to the Ministry of Communications during the customer allocation process, at a meeting on June 26, 2002 the Company withdrew its petition upon the recommendation of the court. The customer allocation process with the supplementary questionnaire commenced on July 1, 2002, after postponements, is scheduled for completion at the end of February 2003. The management of the consolidated company and its legal advisers are unable to estimate, at this stage, the outcome of the above proceeding and its effect on the financial position and the results of operations of the consolidated company.

9. On July 28, 2002, a claim together with an application for its recognition as a class action, which were filed in the Tel Aviv District Court against the Company, was received at the Company offices. The plaintiffs, who contend that they are Company subscribers or use its services, allege in their claim that the Company unlawfully collects interest in arrears, as defined in a directive from the Accountant General concerning interest rates, in respect of arrears in payment for services provided by other communications service providers, which are included in the invoice issued by the Company to its subscribers. According to the plaintiffs, the Company may collect such interest only in respect of arrears in payment for the telecommunication services provided by the Company itself. The plaintiffs further allege that the Company refrains from transferring the full amount of interest in arrears that it collects to the other communications providers. The plaintiffs are requesting restitution of the interest in arrears that the Company is alleged to have collected unlawfully. If approved as a class action, the total amount of the claim is estimated by the plaintiffs to be in the tens of millions of shekels. The Company, based on consultations with its legal advisers, is unable, at this stage, to estimate the outcome of the action and no provision in respect thereof is included in the financial statements.

10. On June 23, 2002, the Company received at its offices a statement of claim that was filed in the Jerusalem District Court against the Company by the Development Authority, the Jewish National Fund and the State of Israel (Israel Lands Administration, the Ministry of Communications and the Ministry of Finance) (jointly referred to as "the State").

    The claim sues for declaratory relief whereby the interpretation of the "Asset Transfer Agreement" which was signed between the State and the Company in connection with the transfer of real estate ("the Real Estate") to the Company prior to the commencement of its operations in 1984, and the "Umbrella Contract" which was signed in 1993 in connection with some of those assets, requires, inter alia, the following conclusions:

    a. The State is the sole and exclusive owner of the Real Estate and the Company has no rights in the ownership of the Real Estate and is not entitled to act as if it were the owner.

## NOTE 7 - CONTINGENT LIABILITIES (CONTD.)

### A. Claims (contd.)

b. At most, the Company has a right to use the Real Estate, such right being limited by conditions and objectives that are defined in the aforementioned agreements, and failing compliance with those conditions and objectives, the Real Estate should be restored to the State immediately and unconditionally.

c. The State has the right to immediately deny the Company the use of the Real Estate leased to it in the bi-annual contracts referred to in the Asset Transfer Agreement, even where the Company is using the Real Estate for the purpose for which it was transferred, as long as the State believes that there is another preferable use for the Real Estate, and as long as alternative real estate is made available to the Company for continuation of the provision of services by the defendant as defined in the agreements and insofar as the defendant can prove that such real estate is needed.

d. The Company is required to immediately return to the State certain assets in the Rishpon region (480 dunams), in the Sakia region (1,300 dunams) and parts of parcels in the Givat Mordechai neighborhood and in Ramat Beit Hakerem in Jerusalem.

It is noted that this claim was filed following a broad dispute that arose in recent years between the Company and the State concerning real estate that was transferred from the State to the Company prior to the start of operations in 1984 and is known as "the Real Estate Dispute". See Note 9B to the financials statements as at December 31, 2001.

The Company's position in this dispute is described in general in Note 9B to the financial statements as at December 31, 2001, and in the opinion of its legal advisers, the Company has worthy arguments to substantiate its position. The Company filed a statement of defense in which it alleges, *inter alia*, that the claim or part of it should be stricken *in limine* or clarified and amended and that in any case the claim should also be dismissed on its merits. The Company, relying on its legal advisers, is unable, at this stage, to estimate the chances of the claim and its overall implications.

It should be noted that concurrently with the above legal proceeding, the Company is negotiating with representatives of the State and of Israel Lands Administration in relation to the Real Estate Dispute. Although these negotiations are far advanced, no format has yet been agreed upon for the final agreement. Under the principles of the agreement being formulated, which has been approved by the Board of Directors of the Company, several properties defined as "Renewable Lease Properties" out of the Real Estate in the Company's possession will be returned to the State and the rest of the properties will remain in the Company's possession on capitalized lease terms. In addition, the State will lift the restrictions it alleges are applicable to the use and exploitation of the Real Estate that was transferred to the Company with the status of capitalized lease.

To the best of the Company's knowledge, the Economic-Social Cabinet of the Government approved the principles of the arrangement being formulated.

11. Further to Note 20A(1) to the financial statements as at December 31, 2001, in the matter of the claim and application for recognition as a class action by way of a motion in the District Court, the plaintiff alleges that the Company is misleading the public in that the prices of direct-dial international calls are calculated and collected on the basis of meter pulses rather than on the basis of call time units as promised in its advertisements, on September 29, 2002, the Supreme Court allowed the plaintiff's application for an additional hearing and ruled that the additional hearing would be held before a panel of seven judges. On October 17, 2002, the Supreme Court allowed the application of the Israeli Consumer Council to be added as a party to the additional hearing. If the decision on the appeal of the Company and Bezeq International is reversed in the additional hearing, the main hearing will be resumed in the District Court.

**NOTE 7 - CONTINGENT LIABILITIES (CONTD.)**

**A. Claims (contd.)**

12. Further to Note 20A(34) to the annual financial statements in the matter of "Notice of a party to a collective dispute" which was filed by the New General Federation of Workers ("the Applicant") in the name of Company employees, the Applicant alleges that payment for grossing up of tax, the on-call duty benefit components and the clothing allowance which were and are paid to Company employees, are normal wages constituting part of the employee's regular pay, and that various payments and provisions should be made in respect thereof, including for pension purposes. On October 20, 2002, the Attorney General gave notice that he would be joining the claim. Furthermore, the Attorney General filed his position on the matter, stating that all parts of the application should be dismissed.

13. Further to Note 20A(28) to the annual financial statements in the matter of individual claims of employees and former employees concerning the inclusion of various wage components which could have a lateral effect, it should be noted that a ruling in another case has created a precedent which has adversely affected the Company's position regarding a particular wage component. Nevertheless, in consultation with its legal advisers, the Company is unable at this stage, to estimate the outcome of the proceeding. Accordingly, no provision was made in the financial statements in respect of this claim.

14. In September 2002 an application was filed in the Tel Aviv District Court for approval of a class action against Pelephone Communications Ltd. (“Pelephone”). The plaintiff alleges that Pelephone collected overpayment from users who make calls at peak hours from cellular telephones to Bezeq subscribers and that it does so unlawfully and in contravention of the Telecommunications Regulations (Payments for reciprocal connection), 5760-2000. This collection allegedly commenced at the beginning of 2001 and is coordinated with the other cellular companies. According to the plaintiff, even though the collection is ostensibly for Bezeq, Pelephone does not transfer the full payment to Bezeq and retains part of it for itself. Pelephone has not yet filed its response to the petition, but its management estimates, based on the opinion of its legal advisers and on an external legal opinion, that the claim has little chance of success , as a judgment exists on this matter as a result of a compromise agreement which was validated as a judgment, in which the claim was approved as a class action and restitution was made to the plaintiff and Pelephone customers in respect of overpayment, *inter alia* for the same charges in respect of which the present claim was filed. Pelephone's lawyers contacted the plaintiff and referred him to that *judgment*. The plaintiff admitted that he had been unaware of the compromise agreement but has not yet given notice of what he intends to do regarding the claim he filed.

15. In September 2002 an application was filed in the Tel Aviv District Court for approval of a class action against Pelephone Communications Ltd. (“Pelephone”) in a total amount of NIS 20 million. The applicant, through his lawyers, alleges that Pelephone compels its customers to subscribe to the "GoNext" service and connects them without their prior consent and without giving them a clear explanation of the nature of the service. Pelephone and its legal advisers are studying the claim documents and are unable, at this stage, to estimate the outcome of the action.

16. Further to Note 20A(10) to the annual financial statements, on November 14, 2002 an application was filed for permission to appeal the decision of the Tel Aviv District Court dated October 1, 2002, to dismiss the applicants' application to approve their claim against Pelephone as a class action.

    The claim was based on the applicants' allegation that throughout the years in which Pelephone was a monopoly in the cellular market, it exploited its monopoly status and collected exorbitant prices for all its services. Therefore, the applicants sought to order Pelephone to make restitution to its customers of the excess profits it collected and which allegedly amount to the amount of the claim. The outcome of the application for leave to appeal cannot be estimated at this stage.

17. On November 11, 2002, a petition was filed in the High Court of Justice by Ganei Tikva Local Council against the Minister of Communications, the Company and Golden Channels. The petition is for transfer of the cable network in the jurisdiction of the Council which the Company

## NOTE 7 - CONTINGENT LIABILITIES (CONTD.)

### A. Claims (contd.)

maintains for Golden Channels to an underground infrastructure (instead of above-ground). The petitioners are requesting that the High Court of Justice direct the Minister of Communications to instruct the Company and Golden Channels to make the transfer immediately and at their own expense since the network in its condition today constitutes a safety hazard. The Company and the cable companies are embroiled in a long-standing dispute on the question of who should bear the costs of transferring the infrastructure, deriving from conflicting interpretations of the contract between the parties. The Company is studying the petition and is unable, based on consultations with its legal advisers, to estimate at this stage the outcome and the implications of the petition. No provision has been made in the financial statements in respect of this action.

### B. Forward Exchange Contracts

#### 1. Hedging Contracts (Forward)

| | Currency purchased | Currency payable | Final repayment date | Amounts receivable | Amounts payable |
|---|---|---|---|---|---|
| | | | | NIS millions | |
| **Contracts at predetermined interest rates** | | | | | |
| | Dollars | CPI-linked NIS | April 2004 | **636** | **648** |
| | Euro | CPI-linked NIS | February 2005 | **1,049** | **927** |
| **Contracts at predetermined exchange rate** (excluding premium/discount) | | | | | |
| | Dollars | NIS | December 2002 | **97** | **98** |
| | Euro | NIS | August 2003 | **394** | **352** |
| | CPI-linked NIS | NIS | June 2003 | **547** | **520** |
| **Call options purchased** | Dollars | NIS | March 2003 | **39** | **40** |

#### 2. Contracts not for hedging purposes

| | Currency purchased | Currency payable | Final repayment date | Amounts receivable | Amounts payable |
|---|---|---|---|---|---|
| | | | | NIS millions | |
| **Forward exchange contracts –** | Dollars | NIS | June 2003 | **(0.5)** | **58** |
| **Put options** | NIS | Dollars | December 2002 | **-** | **731** |
| **Call options** | NIS | Dollars | December 2002 | **(19)** | **731** |

## NOTE 8 – 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 |
|---|---|---|---|---|---|
| | 2002 (Unaudited) | 2001 (Unaudited) | 2002 (Unaudited) | 2001 (Unaudited) | 2001 (Audited) |
| | NIS thousands | | NIS thousands | | NIS thousands |
| **Revenues from communication services –** | | | | | |
| Domestic fixed-line communications | **1,747,745** | 1,937,718 | **587,951** | 647,913 | 2,567,965 |
| Cellular telephone | **1,651,860** | 1,663,402 | **570,540** | 558,331 | 2,216,617 |
| Fixed fees | **1,593,105** | 1,662,370 | **531,763** | 550,765 | 2,218,891 |
| International communications and internet services (1) | **511,314** | 625,685 | **171,813** | 212,903 | 839,238 |
| Installation and sale of equipment to subscribers | **411,378** | 343,729 | **140,457** | 108,469 | 455,275 |
| Other | **87,059** | 104,153 | **21,853** | 34,755 | 127,490 |
| | **6,002,461** | 6,337,057 | **2,024,377** | 2,113,136 | 8,425,476 |
| Other revenues | **234,369** | 211,009 | **72,144** | 55,803 | 296,039 |
| | **6,236,830** | 6,548,066 | **2,096,521** | 2,168,939 | 8,721,515 |

(1) See Note 1B(1).

## NOTE 9 – 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 |
|---|---|---|---|---|---|
| | 2002 (Unaudited) | 2001 (Unaudited) | 2002 (Unaudited) | 2001 (Unaudited) | 2001 (Audited) |
| | NIS thousands | | NIS thousands | | NIS thousands |
| Salaries and related expenses | **1,510,337** | 1,535,984 | **489,690** | 511,587 | 2,051,868 |
| General expenses | **552,785** | 563,483 | **188,627** | 201,969 | 784,337 |
| Materials and spare parts | **445,369** | 392,178 | **153,661** | 130,662 | 544,001 |
| Cellular telephone expenses | **358,088** | 362,892 | **127,494** | 116,552 | 467,213 |
| Building maintenance | **279,653** | 312,271 | **91,913** | 102,346 | 408,314 |
| Services and maintenance by subcontractors | **216,559** | 250,862 | **69,143** | 76,443 | 346,003 |
| International communications expenses | **117,332** | 168,857 | **52,737** | 52,307 | 213,859 |
| Vehicle maintenance expenses | **74,825** | 64,704 | **25,923** | 22,047 | 89,119 |
| Collection fees | **24,963** | 29,778 | **7,719** | 9,412 | 39,204 |
| | **3,579,911** | 3,681,009 | **1,206,907** | 1,223,325 | 4,943,918 |
| Less – salaries charged to investment in fixed assets | **109,411** | 112,802 | **29,463** | 38,171 | 164,171 |
| | **3,470,500** | 3,568,207 | **1,177,444** | 1,185,154 | 4,779,747 |

## NOTE 10 – TRANSACTIONS WITH INTERESTED AND RELATED PARTIES

Further to Note 28B to the financial statements as at December 31, 2001, the Company reached an agreement with the Ministry of Defense in the name of the State of Israel for the provision of telecommunication services by the Company to the IDF.

The main points of the agreement are as follows:

1. The Company will provide the IDF with telecommunications services at a special inclusive discount of approximately 28% in relation to services that the Company provided to the IDF prior to signing the agreement and of 14% relating to services which did not exist or which the Company did not provide to the IDF prior to signing the agreement. Based on the volume of services that the Company provided to the IDF prior to the effective date of the agreement, the discount in respect of the services under the agreement does not differ significantly from the discount that was given pursuant to the memorandum of understanding under which the parties acted prior to signing the agreement.

2. The Ministry of Defense undertakes to purchase services from the Company for which the consideration will be not less than approximately NIS 81.2 million (excluding VAT) for each year of the contract and to order from the Company cabling and development works of communications infrastructures within IDF bases which are used for providing the Company's services, for which the consideration will be not less than 80% of the overall monetary value of the orders of the Ministry of Defense for such infrastructures in each year of the contract.

3. The agreement ends and exhausts all the disputes between the parties up to April 1, 2001, including the disputes that were brought before a special professional commission ("the Gabai Commission") but excluding a dispute concerning a discount of 18% which the Ministry of Defense deducted from payments collected by the Company for other communications providers.

4. At the end of the term of the agreement, ownership of the infrastructures within the IDF base shall remain that of the Ministry of Defense while ownership of infrastructures outside IDF bases shall remain that of the Company.

5. The term of the contract commences on the date of signing the agreement, July 21, 2002, through March 31, 2005 (under the terms of the agreement, retroactive accounting will be effective as of April 1, 2001, and as a result of the aforementioned the Company expects to receive a rebate in a non-material amount).

## NOTE 11 – 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 |
|---|---|---|---|---|---|
| | 2002 (Unaudited) | 2001 (Unaudited) | 2002 (Unaudited) | 2001 (Unaudited) | 2001 (Audited) |
| | NIS thousands | | NIS thousands | | NIS thousands |
| **Revenues from telecommunication services (Note 11B)** | **4,259,470** | 4,760,020 | **1,405,109** | 1,561,686 | 6,306,581 |
| **Costs and expenses** | | | | | |
| Operating and general expenses (Note 11C) | **1,846,065** | 2,029,664 | **603,664** | 657,761 | 2,693,259 |
| Depreciation (See also Note 5) | **1,455,396** | 1,715,387 | **487,791** | 566,132 | 2,301,356 |
| Royalties to the Government of Israel | **134,644** | 153,866 | **39,582** | 51,028 | 202,545 |
| | **3,436,105** | 3,898,917 | **1,131,037** | 1,274,921 | 5,197,160 |
| Operating income | **823,365** | 861,103 | **274,072** | 286,765 | 1,109,421 |
| **Financing expenses, net** | **(131,790)** | (50,856) | **(55,651)** | (32,186) | (77,839) |
| Earnings after financing expenses | **691,575** | 810,247 | **218,421** | 254,579 | 1,031,582 |
| **Other expenses, net (Note 4C)** | **(393,193)** | (5,205) | **(398,473)** | (25,817) | (2,675) |
| Earnings (loss) before income tax | **298,382** | 805,042 | **(180,052)** | 228,762 | 1,028,907 |
| **Income tax** | **(208,786)** | (286,156) | **(39,424)** | (84,883) | (370,989) |
| Earnings (loss) after income tax | **89,596** | 518,886 | **(219,476)** | 143,879 | 657,918 |
| **Company's equity in losses of investee companies** | **(234,687)** | (343,481) | **(125,348)** | (136,054) | (528,332) |
| Net earnings (loss) | **(145,091)** | 175,405 | **(344,824)** | 7,825 | 129,586 |

## Notes to the Interim Consolidated Financial Statements as at September 30, 2002 (Unaudited)

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

### B. REVENUES FROM TELECOMMUNICATIONS SERVICES

| | For the nine month period ended September 30 | | For the three month period ended September 30 | | For the year ended December 31 |
|---|---|---|---|---|---|
| | 2002 (Unaudited) | 2001 (Unaudited) | 2002 (Unaudited) | 2001 (Unaudited) | 2001 (Audited) |
| | NIS thousands | | NIS thousands | | NIS thousands |
| **Revenues from communications services** | | | | | |
| Domestic fixed-line communications | **1,766,916** | 1,956,828 | **594,374** | 655,208 | 2,597,245 |
| Cellular telephone | **478,839** | 548,552 | **161,785** | 176,168 | 714,912 |
| Fixed fees | **1,498,362** | 1,574,394 | **488,089** | 517,282 | 2,099,687 |
| International communications (1) | **112,967** | 262,028 | **38,875** | 87,175 | 350,464 |
| Installation and sale of equipment to subscribers | **121,035** | 117,954 | **39,655** | 41,525 | 149,555 |
| Other | **91,450** | 104,289 | **22,749** | 34,955 | 134,837 |
| | **4,069,569** | 4,564,045 | **1,345,527** | 1,512,313 | 6,046,700 |
| Other revenues | **189,901** | 195,975 | **59,582** | 49,373 | 259,881 |
| | **4,259,470** | 4,760,020 | **1,405,109** | 1,561,686 | 6,306,581 |

(a) See Note 1B(1).

### 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 |
|---|---|---|---|---|---|
| | 2002 (Unaudited) | 2001 (Unaudited) | 2002 (Unaudited) | 2001 (Unaudited) | 2001 (Audited) |
| | NIS thousands | | NIS thousands | | NIS thousands |
| Salaries and related expenses | **1,168,343** | 1,218,502 | **376,540** | 411,077 | 1,623,823 |
| General expenses | **216,668** | 203,987 | **68,094** | 71,197 | 304,342 |
| Materials and spare parts | **38,190** | 53,973 | **14,310** | 15,577 | 67,408 |
| Cellular telephone expenses | **22,635** | 91,164 | **4,919** | 15,732 | 92,469 |
| Building maintenance | **243,578** | 271,502 | **81,120** | 86,564 | 357,405 |
| Services and maintenance by subcontractors | **173,136** | 212,455 | **57,398** | 65,685 | 288,613 |
| International communications expenses | **4,316** | 7,686 | **1,099** | 2,303 | 10,370 |
| Vehicle maintenance expenses | **62,483** | 53,608 | **20,703** | 18,391 | 74,150 |
| Collection fees | **26,127** | 29,589 | **8,944** | 9,406 | 38,850 |
| | **1,955,476** | 2,142,466 | **633,127** | 695,932 | 2,857,430 |
| Less – salaries charged to investments in fixed assets | **109,411** | 112,802 | **29,463** | 38,171 | 164,171 |
| | **1,846,065** | 2,029,664 | **603,664** | 657,761 | 2,693,259 |

## Notes to the Interim Consolidated Financial Statements as at September 30, 2002 (Unaudited)

### NOTE 12 – CONDENSED FINANCIAL STATEMENTS OF BEZEQ INTERNATIONAL LTD. AND PELEPHONE COMMUNICATIONS LTD.

**1. BEZEQ INTERNATIONAL LTD.**

**A. Balance sheet**

| | September 30 2002 | September 30 2001 | December 31 2001 |
|---|---|---|---|
| | (Unaudited) | (Unaudited) | (Audited) |
| | NIS thousands | NIS thousands | NIS thousands |
| Current assets | **184,122** | 224,203 | 175,172 |
| Investments | **20,065** | 12,060 | 9,155 |
| Fixed assets | **426,961** | 398,286 | 434,057 |
| Other assets | **9,991** | 19,480 | 16,626 |
| | **641,139** | 654,029 | 635,010 |
| Current liabilities | **326,140** | 361,730 | 346,698 |
| Long-term liabilities | **173,719** | 206,136 | 206,854 |
| Quasi capital receipt | **–** | 171,939 | 171,939 |
| Shareholders' equity (deficit) | **141,280** | (85,776) | (90,481) |
| | **641,139** | 654,029 | 635,010 |

**Notes to the Interim Consolidated Financial Statements as at September 30, 2002 (Unaudited)**

## NOTE 12 – CONDENSED FINANCIAL STATEMENTS OF BEZEQ INTERNATIONAL LTD. AND PELEPHONE COMMUNICATIONS LTD. (CONTD.)

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

### B. Statement of Operations

| | For the nine month period ended September 30 | | For the three month period ended September 30 | | For the year ended December 31 |
|---|---|---|---|---|---|
| | 2002 (Unaudited) | 2001 (Unaudited) | 2002 (Unaudited) | 2001 (Unaudited) | 2001 (Audited) |
| | NIS thousands | | NIS thousands | | NIS thousands |
| **Revenues from international telecommunications services** | **519,797** | 533,124 | **173,338** | 183,926 | 715,558 |
| **Operating expenses** | **301,449** | 402,495* | **110,382** | 129,869* | 528,820 |
| Gross profit | **218,348** | 130,629 | **62,956** | 54,057 | 186,738 |
| **Marketing expenses** | **108,322** | 97,145 | **38,474** | 34,646 | 130,363 |
| **General and administrative expenses:** | | | | | |
| **In respect of the reporting period** | **50,405** | 78,495* | **17,668** | 26,083* | 99,310 |
| **In respect of cost differences in communication services in previous periods** | **(7,576)** | – | **(14,329)** | – | – |
| | **151,151** | 175,640 | **41,813** | 60,729 | 229,673 |
| Operating income (loss) | **67,197** | (45,011) | **21,143** | (6,672) | (42,935) |
| **Financing income (expenses), net** | **7,238** | (11,118) | **(3,022)** | (4,501) | (11,607) |
| Earnings (loss) after financing, net | **74,435** | (56,129) | **18,121** | (11,173) | (54,542) |
| **Other income (expenses), net** | **13** | 4,420 | **5** | (216) | 4,262 |
| Earnings (loss) before income tax | **74,448** | (51,709) | **18,126** | (11,389) | (50,280) |
| **Income tax** | **(1,051)** | – | **(409)** | – | (3,229) |
| Earnings (loss) after income tax | **73,397** | (51,709) | **17,717** | (11,389) | (53,509) |
| **Company's equity in losses of an affiliated company** | **(13,575)** | (25,627) | **(2,060)** | (3,591) | (28,532) |
| Net earnings (loss) | **59,822** | (77,336) | **15,657** | (14,980) | (82,041) |

* Reclassified

## NOTE 12 – CONDENSED FINANCIAL STATEMENTS OF BEZEQ INTERNATIONAL LTD. AND PELEPHONE COMMUNICATIONS LTD. (CONTD.)

### 2. PELEPHONE COMMUNICATIONS LTD.

### A. Balance sheet

| | September 30 2002 | September 30 2001 | December 31 2001 |
|---|---|---|---|
| | (Unaudited) | (Unaudited) | (Audited) |
| | NIS thousands | NIS thousands | NIS thousands |
| Current assets | **1,348,889** | 1,084,088* | 1,106,663* |
| Long-term trade receivables, net | **164,406** | 95,729 | 100,526 |
| Deferred income tax | **319,457** | 47,890* | 261,605* |
| Fixed assets, net | **2,753,074** | 2,970,951 | 2,699,256 |
| Other assets | **493,283** | 683,979 | 636,231 |
| | **5,079,109** | 4,882,637 | 4,804,281 |
| Current liabilities | **1,943,298** | 1,815,515 | 1,971,053 |
| Provision for losses of investee company | **4,051** | 204 | 3,985 |
| Long-term liabilities | **1,191,671** | 1,205,184* | 1,067,405 |
| Minority rights | **11,842** | 12,881 | 12,841 |
| Shareholders' equity | **1,928,247** | 1,848,853 | 1,748,997 |
| | **5,079,109** | 4,882,637 | 4,804,281 |

* Reclassified

## NOTE 12 – CONDENSED FINANCIAL STATEMENTS OF BEZEQ INTERNATIONAL LTD. AND PELEPHONE COMMUNICATIONS LTD. (CONTD.)

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

### B. Statement of Operations

| | For the nine month period ended September 30 | | For the three month period ended September 30 | | For the year ended December 31 |
|---|---|---|---|---|---|
| | 2002 (Unaudited) | 2001 (Unaudited) | 2002 (Unaudited) | 2001 (Unaudited) | 2001 (Audited) |
| | NIS thousands | | NIS thousands | | NIS thousands |
| **Revenues from cellular services, sales and services** | **3,015,583** | 2,834,582 | **1,037,478** | 936,616 | 3,818,747 |
| **Cost of cellular services, sales and services** | **2,582,303** | 2,500,092 | **886,209** | 845,352 | 3,399,307 |
| Gross profit | **433,280** | 334,490 | **151,269** | 91,264 | 419,440 |
| **Sales and marketing expenses** | **393,808** | 383,214 | **134,903** | 124,222 | 543,381 |
| **General and administrative expenses** | **164,864** | 174,956 | **54,026** | 54,650 | 236,988 |
| | **558,672** | 558,170 | **188,929** | 178,872 | 780,369 |
| Operating loss | **(125,392)** | (223,680) | **(37,660)** | (87,608) | (360,929) |
| **Financing expenses, net** | **54,355** | 85,214 | **46,861** | 25,960 | 131,801 |
| **Other income (expenses), net** | **892** | 2,080 | **79** | 363 | (217,946) |
| Loss before income tax | **(178,855)** | (306,814) | **(84,442)** | (113,205) | (710,676) |
| **Tax benefit** | **57,851** | 30,254 | **30,170** | 1,532 | 243,971 |
| Loss after income tax | **(121,004)** | (276,560) | **(54,272)** | (111,673) | (466,705) |
| **Minority equity in losses of a consolidated company** | **4,627** | 10,394 | **1,508** | 3,104 | 13,309 |
| **Company's equity in losses of an affiliate** | **(332)** | (4,167) | **(351)** | (530) | (8,193) |
| Net loss | **(116,709)** | (270,333) | **(53,115)** | (109,099) | (461,589) |