Chapter B of the Periodic Report
Directors' Report on the State of the Company's Affairs
for the year ended December 31, 2005

We respectfully present the Directors' Report on the state of affairs of "Bezeq" - The Israel Telecommunication Corp. Limited (hereinafter: "the Company") and the consolidated Group companies (the Company and the consolidated companies together are hereinafter referred to as "the Group") for the year ended December 31, 2005 (hereinafter: "the Directors' Report").

The Group operates in four areas which are reported as business segments in the Company's consolidated reports as set forth below:

1) Fixed-line domestic communications

2) Cellular

3) International communications and internet services

4) Multi-channel television

The Company has other areas of activity which are not material to the Group's operations, and these are included in the financial statements as at December 31, 2005 of the Company in the "Other" business segment, consisting mainly of Network End Point services, customer service center services and content services for the business segment.

Below is information detailing the financial statements which were fully consolidated for the first time during the reporting period and were not fully consolidated in the entire prior year.

1. Pelephone Communications Ltd. ("Pelephone") - Full consolidation since August 26, 2004 (until that date, 50% proportional consolidation)
2. D.B.S. Satellite Services (1998) Ltd. ("DBS") - Full consolidation since June 21, 2004

1. Financial Position

A. The Group's assets as at December 31, 2005, amounted to approximately NIS 20.67 billion, compared with NIS 20.17 billion on December 31, 2004. Of these, approximately NIS 9.94 billion (approximately 48%) are fixed assets compared with approximately NIS 10.74 billion (approximately 53%) on December 31, 2004.

   In the fixed-line domestic communications segment there was a decrease in the net book value of fixed assets resulting from the difference between depreciation expenses and the investment made in the reporting period. In contrast, there was also an increase in cash balances and short-term investments compared with the prior year.

   In the cellular segment there was an increase in cash and cash equivalents, short-term investments and trade receivables compared with the prior year. Conversely, there was a decrease in the inventory balance due to streamlining measures taken by Pelephone and a reduction in the deferred tax balances due to utilization of past losses for tax purposes and a decrease in the net book value of fixed assets.

   In the international communications and internet services segment, there was an increase in total assets compared with the prior year, due to an increase in cash balances. In contrast, net investments in fixed assets decreased in this segment compared with the prior year.

   In the multi-channel television segment, there was a rise in broadcasting rights and in the customer credit balance. The increase was for the most part offset by a decrease in net investments in fixed assets.

B. The Group's shareholders' equity as at December 31, 2005, amounted to approximately NIS 7.91 billion, comprising approximately 38% of the total balance sheet, compared with approximately NIS 7.32 billion on December 31, 2004, which comprised approximately 36% of the total balance sheet. The increase in shareholder' equity derives from the Group's net earnings in the reporting period.

Shareholders' equity as at December 31, 2005 and December 31, 2004 was retroactively adjusted by way of a restatement due to the recording of the Company's liability to its retirees (see Note 2 (FF) to the financial statements).

C. Total Group debt to financial institutions and debenture holders as at December 31, 2005, amounted to approximately NIS 8.92 billion, compared with approximately NIS 8.32 billion on December 31, 2004. The increase is primarily attributable to an offering of debentures in the cellular and fixed-line domestic communications segments, which was offset by repayment of long-term loans.

D. Group balances in cash and short-term investments as at December 31, 2005, amounted to approximately NIS 4.56 billion, compared with approximately NIS 2.74 billion on December 31, 2004. The increase is primarily attributable to the cash flow from operating activities in the principal segments in which the Group operates, as well as from an offering of debentures and receipt of loans.

2. Results of Operations

A. Principal results

Net earnings for 2005 amounted to approximately NIS 591 million, compared with net earnings of approximately NIS 621 million in the prior year. The difference in the results is primarily attributable to differences in the period in which Pelephone and DBS were consolidated during the reporting period compared with the prior year, and from changes in the operating income of the Group companies, increase in financing expenses, as well as Other revenues (expenses) in the Company, as outlined below.

Below are details of the changes in the results of the segments compared to the prior year.

Segment	**2005 NIS millions**	**2004 NIS millions**
Fixed-line domestic communications	851	971
Cellular[(1)]	466	379
International communications and internet services	98	118
Multi-channel television [(2)]	(99)	(85)
Others	1	8

Net earnings per share for 2005 amounted to NIS 0.227 per NIS 1 par value, compared with earnings of NIS 0.238 per share in the prior year.

B. Revenues

Group revenues in 2005 amounted to approximately NIS 11.10 billion compared with earnings of approximately NIS 9.27 billion in the prior year. The increase of NIS 1.99 billion is attributable to first-time consolidation implemented in 2004. Eliminating the effects of the first-time consolidation, there was a decrease in the Group's revenues which derived from the fixed-line domestic communications segment.

Revenues from fixed-line domestic communications decreased from approximately NIS 4.96 billion in 2004 to approximately NIS 4.72 billion in 2005 (a decrease of approximately 4.8%). Most of the decrease in the segment's revenues is attributable to tariff reductions in June 2004 and June 2005, a decrease in call and internet dial-up traffic, a decrease in revenues from the sale of equipment to subscribers and a decrease in royalties received from Pelephone. The decrease in revenues was moderated by ongoing growth in the number of customers who subscribe to high-speed internet service (ADSL). The auditors drew attention to the ongoing opening of the communications industry to competition and tariff changes.

Revenues from the cellular telephone segment increased from approximately NIS 2.97 billion to approximately NIS 4.43 billion, mainly as a result of the effect of the first-time full consolidation

(1) First-time full consolidation
(2) First-time consolidation

implemented during 2004. Amendment of the cellular network interconnect regulations and the reduction of interconnect tariffs commencing March 1, 2005 eliminated almost completely the upward trend in the segment's revenues despite the increase in the number of customers. This decrease was offset by the rise in revenues from sales of terminal equipment and from terminal equipment services.

Revenues from the international communications and internet services segment increased from approximately NIS 816 million in 2004 to approximately NIS 817 million in 2005. The slight increase relative to 2004 is attributable to growth in the routing of international call traffic and in internet revenues, which is derived from an increase in the number of high-speed internet customers. The growth was offset by a decrease in revenues from outgoing calls due to the continued decrease in traffic and decline in outgoing call tariffs as a result of greater competition in the current year.

Revenues in the multi-channel television segment increased from approximately NIS 542 million in 2004 to approximately NIS 1,222 million in 2005, mainly due to the consolidation of DBS during the course of 2004. In addition, there has been an increase in revenues in this segment compared with the prior year as a result of an increase in the number of subscribers and an increase in the average revenue per subscriber (ARPU).

C. General and Operating Expenses

The Group's general and operating expenses in 2005 amounted to approximately NIS 7.19 billion, compared with approximately NIS 5.57 billion in the prior year. Approximately NIS 1.5 billion of this increase is attributable to first-time consolidation.

In the fixed-line domestic communications segment, expenses remained virtually unchanged. Most of the decrease is attributable to the decreased general expenses and materials and spare parts expenses which were primarily offset by a rise in salary expenses and vehicle maintenance.

In the cellular segment, general and operating expenses increased from approximately NIS 2,217 million to approximately NIS 3,337 million during the reporting period, due mainly to the first-time full consolidation. In addition, expenses in the segment increased compared with the prior year, mainly due to the increased cost of terminal equipment alongside the increase in revenues from terminal equipment and increased subscriber acquisition costs which derive from winning the tender of the Accountant General at the Ministry of Finance. The increase was offset by a decrease in marketing expenses.

In the international communications and internet services segment there was an increase in general and operating expenses from approximately NIS 573 million to approximately NIS 621 million during the reporting period, mainly due to the increase in expenses for foreign managers, deriving mainly from a significant increase in traffic routed from one foreign operator to another foreign operator along with an increase in revenues from this service and an increase in expenses related to internet customers.

In the multi-channel television segment, general and operating expenses increased from approximately NIS 473 million in the prior year to approximately NIS 994 million in the reporting period, mainly due to the consolidation of DBS during 2004. In addition, expenses increased in the segment, relative to the prior year, due to the increase in content and other operating expenses.

D. Depreciation

The Group's depreciation expenses increased from approximately NIS 2,092 million in 2004 to approximately NIS 2,331 million in the reporting period, as the result of the first-time consolidation in respect of which depreciation expenses increased by approximately NIS 321 million. Eliminating this increase, depreciation expenses decreased as a result of fully depreciated fixed assets and a decrease in investments in new assets in the fixed-line domestic communications segment and the international communications and internet services segment. This decrease is partially offset by an increase in depreciation expenses in the cellular segment.

E. Royalties to the Government of Israel

The Group's royalties expenses amounted to approximately NIS 257 million compared with approximately NIS 221 million in the prior year. The source of the increase is the first-time consolidation referred to above, which was partially offset by a decrease in royalties expenses in the fixed-line domestic communications segment.

F. Operating income

The Group's operating income in 2005 amounted to approximately NIS 1,317 million, compared with approximately NIS 1,392 million in the prior year, a decrease of approximately NIS 75 million. The decrease in operating income is attributable to the changes in the results of the revenues and expenses sections of the segments described above. These changes led to a reduction in the profitability of the Group's main segments of operation, except for the improvement in the results of operations in the multi-channel television segment. The first-time consolidation of Pelephone's financial results increased the Group's operating income; however, this was partially offset by the consolidation of DBS.

G. Financing expenses

The Group's net financing expenses in 2005 amounted to approximately NIS 417 million, compared with approximately NIS 218 million in the prior year. Approximately NIS 133 million of the financing expenses is attributable to the first-time consolidation, as described in the introduction to this report above.

The effect of the changes in foreign currency and shekel rates on the Company's liabilities were partially neutralized by hedging transactions and by investment in financial assets.

The Group's financing expenses were influenced by income from the capital markets as a result of investments in marketable securities and by an increase in expenses due to an increase in the Group's total debt and to changes in exchange rates and the Consumer Price Index.

H. Other income (expenses)

Income amounting to approximately NIS 109 million was recorded in the Group's Other income (expenses) item, compared with income of approximately NIS 80 million in the prior year.
Most of the income in the prior year was a reduction in the provision for claims in respect of salary and pension components. The income recorded in the reporting period is primarily attributable to capital gains of approximately NIS 111 million and a reduction of NIS 83 million in the provision for early retirement (due to transfer to an insurance company). The income was partially offset by amortization of goodwill in respect of companies consolidated for the first time in the financial statements (see Note 8 to the financial statements).

I. Group's equity in losses of affiliates

The Group's equity in losses of affiliates in 2005 amounted to approximately NIS 13 million, compared with losses of approximately NIS 135 million recorded during the prior year. Most of the decrease during the reporting period derives from DBS becoming a consolidated company during 2004, and the results of its operations are presented in the financial statements on a consolidated basis, rather than by the equity method (see Note 8 to the financial statements).

The Company's auditors drew attention to the financial condition of DBS, and that in the opinion of DBS's management, based on its 2006 budget and an alternative business plan, there is a good chance that the sources of financing it will require in the coming year will be arranged.

J. Quarterly data – Consolidated statements (in NIS millions)

	2005	**Q4 2005**	**Q3 2005**	**Q2 2005**	**Q1 2005**
Income from telecommunication services	11,099	2,760	2,839	2,727	2,773
Operating and general expenses	7,194	1,852	1,836	1,742	1,764
Depreciation	2,331	582	588	583	578
Royalties to the government of Israel	257	62	65	65	65

	9,782	2,496	2,489	2,390	2,407
Operating income	1,317	264	350	337	366
Financing expenses, net	(417)	(145)	(107)	(110)	(55)
Earnings after financing expenses	900	119	243	227	311
Other income (expenses), net	109	(21)	(23)	65	88
Earnings before tax	1,009	98	220	292	399
Income tax	429	54	115	127	133
Earnings after income tax	580	44	105	165	266
Share in losses of affiliates	(13)	-	(2)	(8)	(3)
Minority share in earnings of a consolidated company	9	0	-	7	2
Accrued impact of change in accounting method	15	-	-	-	15
Net earnings	591	44	103	164	280

In the fourth quarter there was a decrease in the operating income and net earnings of the Group compared with the first three quarters of the year.

Operating income declined in the fourth quarter compared with the third quarter and the corresponding quarter, particularly because of a seasonal decline in revenues and an increase in general and operating expenses mainly due to a provision for a special benefit to employees for the period during the year (nine months) in which the Company was controlled by the State of Israel, as well as due to an adjustment to the provision for slow moving inventory.

In the fourth quarter there was an increase in financing expenses compared with the first three quarters of the year, primarily in the fixed-line domestic communications segment, mainly due to a rise in the Consumer Price Index, and a decrease in income from the Company's financial investments.

Results of operations during the quarters is influenced by the recording in the Other income (expenses) item.

3. Liquidity and sources of financing

Consolidated cash flows generated by operating activities in 2005 amounted to approximately NIS 2,719 million, compared with approximately NIS 2,851 million in the prior year. With the elimination of an increase of approximately NIS 297 million which is attributable to first-time consolidation, cash flows from operating activities decreased by approximately NIS 429 million. The decrease derived mainly from the fixed-line domestic communications and cellular segments, and was mainly due to changes in the assets and liabilities items and the income and expenses items which do not involve cash flows.

Cash flows generated by operating activities are the principal source of financing of the Group's investments, which during the reporting period included, *inter alia*, approximately NIS 1,694 million in the development of communications infrastructure and approximately NIS 972 million in short-term investments.

During the year, the Group repaid approximately NIS 1,646 million in debts, of which approximately NIS 1,366 million was on account of long-term loans, approximately NIS 267 million of debentures and approximately NIS 13 million of short-term credit.

During the year, the Group raised new debt in a total amount of approximately NIS 2,177 million by an issuance of debentures and receipt of new long-term loans.

The average monthly short-term credit in 2005 was approximately NIS 98 million. The average monthly long-term liabilities in 2005 were approximately NIS 8,729 million.

Working capital as at December 31, 2005 was positive and amounted to approximately NIS 1,991 million, compared with working capital of approximately NIS 287 million on December 31, 2004, an increase of approximately NIS 1,704 million. The increase derives mainly from an improvement in working capital in the fixed-line domestic communications segment, in the amount of approximately NIS 994 million, resulting from a positive cash flow in total current liabilities which led to an increase in cash and short-term investment balances.

In the cellular segment, working capital improved compared with the prior year by approximately NIS 705 million, most of which derived from an increase in cash and short-term investments designated for the gradual repayment of bank loans. In addition, current liabilities decreased mainly due to a decrease in trade payables.

4. Group involvement in the community and donations

During the reporting period, the Group was active in the community through its involvement in social institutions and organizations such as the education system in underprivileged areas and the confrontation line. To mark the twentieth anniversary of its establishment, the Company initiated a campaign of donations to various organizations during a 12-month period commencing on February 20, 2004. The amount of the monthly donation is the higher of 5% of its call revenues on the twentieth day of each month of the campaign or NIS 200,000. During the reporting period, the Company donated a total of approximately NIS 231 thousand, for a total of NIS 2,792 thousand as part of this campaign.

In the Summer for the Community project, which the Company has initiated for two years now, 16-18 year old children of employees worked in medical institutions and community centers during the summer. The cost of the project to the Company was approximately NIS 1 million.

In addition, in 2005 Company employees volunteered in additional and diverse community involvement activities. For example, in the Parents and Children Learn About Computers and the Internet project, which has been in existence for 5 years, Company employees volunteer their time to mentor parents and children from underprivileged backgrounds on selected computer and internet issues. The cost of the project, in addition to the time invested by the volunteers, is approximately NIS 250 thousand annually.

In another project, about 500 employees of the Bezeq Group give workshops on Introduction to Modern Communications to junior high school students in a program that began in November 2005 in cooperation with the Ministry of Education.

Pelephone donated approximately NIS 675 thousand to various non-profit organizations during 2005.

During the reporting period, Bezeq International worked on behalf of underprivileged communities in Petach Tikva, adopted “lone” soldiers, adopted a fighting division and participated in conservation and educational projects. During the reporting period, the Company’s expenses amounted to approximately NIS 500 thousand.

5. Details concerning market risks exposure management

Responsibility for the Company’s market risks

The person responsible for management of the Company's market risks is the Deputy CEO and CFO, Mr. Ron Eilon. For details of his education and experience, see Section 13(C) in Chapter D of the Periodic Report.

Description of market risks and the Company's risk management policy

The Company is exposed to market risks as a result of changes in interest rates, exchange rates, inflation, the prices of raw materials and equipment and the prices of securities.

Interest rate – Since most of the Company's foreign-currency loans bear variable interest at the LIBOR rate plus a margin, the Company is exposed to changes in the LIBOR rate. This is an accounting exposure and can affect the financing expenses recorded by the Company as well as its cash flows. On the other hand, the fact that the interest rate is variable makes the fair value of these loans similar to their book value, thereby neutralizing possible economic exposure.

Company loans and debentures that are linked to the Consumer Price Index generally bear fixed interest and therefore a change in the interest rate will affect the fair value rather than the book value. This same is true of the euro-denominated debentures that the Company issued on an overseas stock exchange.

The Company has investments in marketable bonds that are recorded in its books at their market value. This market value is influenced by changes in the interest rates in the economy.

As of the date of this report, the Company does not hedge against the aforementioned exposures. It is not inconceivable, however, that it will do so under future market circumstances. Furthermore, the

Company takes into account such influences when considering the types of loans it takes and in the management of its investment portfolio.

Exchange rates – Of itself, a change in the shekel exchange rate constitutes economic exposure in that it can affect the Company's future earnings and cash flows, mainly the repayment of currency-linked obligations and payments for the currency-linked purchase of equipment and raw materials.

In order to minimize this exposure, the Board of Directors decided that the Company should partially or fully hedge the accounting exposure deriving from all the balances recorded in the balance sheet. In the event of partial hedging, the unhedged exposure would not exceed an amount equivalent to $150 million, of which not more than the equivalent of $50 million would relate to currencies other than the U.S. dollar. In addition, the Company is able to implement additional hedging transactions from time to time against exposure to expected transactions during one year of operation, this being limited to a total volume not exceeding the equivalent of $100 million – of which not more than the equivalent of $30 million would relate to currencies other than the U.S. dollar. The reduction of exposure during the reporting period was accomplished by means of forward transactions of currencies hedged against shekels or against CPI-linked shekels. The time frame of the forward transactions is equal to or shorter than the time frame of the hedged exposure. We note that inherent in some of the Company's hedging transactions is a CPI-linked shekel interest rate, which increases the Company's exposure to the CPI. With the transition in 2004 to financial reporting and measurement based on nominal shekels, the Company has increased the volume of transactions against the nominal shekel.

The Company recorded no significant costs in making hedging transactions against the exchange rate, since they were made as forward transactions. The financial statements include financing expenses of approximately NIS 130 million from these hedging transactions.

Inflation – The rate of inflation affects the operating income and expenses of the Company during the year.

The Company's tariff updating mechanism as set forth in the Regulations allows tariffs to be updated according to the rise in the CPI (less a fixed efficiency factor) once a year. As a result, the annual rate of inflation and its spread over the year can have a material influence on the erosion of the Company's tariffs and on its revenues. On the other hand, the influence of the rate of inflation on the Company's expenses is reduced, since some of these expenses have direct or indirect linkage mechanisms.

In addition, the Company invests a considerable part of its cash balances in unlinked shekel deposits and mutual funds, and these deposits are exposed to changes in their real yield due to a change in the rate of inflation.

The low rate of inflation prevailing in Israel in recent years has considerably reduced the financial significance of this risk.

The Company has a surplus of liabilities over CPI-linked assets. In 2004 there was a transition of financial reporting and measurement to a nominal shekel basis. This transition increases the above-mentioned exposure, and in positive inflationary periods increases the Company’s financing expenses.

As part of its policy of minimizing exposure, the Company has made hedging transactions against the CPI so as to reduce this risk.

Prices of raw materials and equipment – Cash flows generated by the Company's operations are used partially for investment in equipment. The prices of equipment are affected by the indices to which they are linked, including sectoral price indices, exchange rates and global prices. The Company is not protected against this exposure.

Prices of securities – The Company invests some of its financial balances in securities. The composition and amount of the securities portfolio are determined by the Board of Directors of the Company. With the aim of preventing fluctuations in the portfolio's yield, the Board of Directors set investment principles whereby most of the investment will be in bonds, shekel deposits and interest-bearing foreign currency instruments, while the share component will not exceed 15% of the investment portfolio and will include shares invested in the TASE 100. The types of bonds and their proportional part in the portfolio were determined according to criteria based on linkage, redemption date and separation between government and non-government bonds. Additionally, a monetary ceiling was determined for the various types of investments.

Supervision and implementation of market risk management policy – Until the transfer of control in the Company, financial exposure reports at the Group level were submitted to a sub-committee of the Board of Directors which discussed them from time to time.

Recently, as part of the financial management policy at the Group level, a "Finance Team" was appointed and meets once a month, *inter alia*, to make recommendations on market risk policy and management to the boards of directors of the Company and the subsidiaries. These recommendations and regular updates on exposure to market risks are then discussed by those boards of directors from time to time, as necessary.

<u>Description of the risks and their management in the consolidated companies</u> – The persons responsible for management of the market risks in the principal consolidated companies are the Chief Financial Officers of those companies and at Pelephone – the Treasurer of the company. The consolidated companies make hedging transactions in accordance with the decisions and under the supervision of their boards of directors.

The financial statements include financing expenses of approximately NIS 117 million from hedging transactions made in the reporting period.

<u>Linkage based report</u>

Note 29 to the financial statements includes information on the linkage terms of the monetary balances of the Company and the Group as at December 31, 2005.

<u>Positions in derivatives as at December 31, 2005 (consolidated)</u>

<u>(amounts are in NIS thousands)</u>

Dollar / NIS								
	Nominal Value				**Fair Value - asset (liability)**			
	Up to one year		More than one year		Up to one year		More than one year	
	Long	Short	Long	Short	Long	Short	Long	Short
Forward transactions								
Hedging - recognized for accounting	361,336	-	-	-	45	-	-	
Hedging - not recognized for accounting	128,884	-	-	-	(1,644)	-	-	

Euro / NIS								
	Nominal Value				**Fair Value - asset (liability)**			
	Up to one year		More than one year		Up to one year		More than one year	
	Long	Short	Long	Short	Long	Short	Long	Short
Forward transactions								
Hedging - recognized for accounting	1,557,443	-	-	-	(68,944)	-	-	-

CPI / NIS								
	Nominal Value				**Fair Value - asset (liability)**			
	Up to one year		More than one year		Up to one year		More than one year	
	Long	Short	Long	Short	Long	Short	Long	Short
Forward transactions								
Hedging - recognized for accounting	930,000	-	300,000	-	583	-	(567)	-

6. <u>Utilization of proceeds from securities</u>

An offer for sale and issuance to the public through a prospectus was published on May 24, 2004. The application of proceeds from the offering will be decided by the Company from time to time in accordance with its requirements, including taking into account the necessity of replacing loans by early repayment. As at the date of approval of the financial statements there has been no need to replace such loans (except for a loan of NIS 5 million which was repaid by the Company before its due date).

7. Disclosure concerning internal auditor in a reporting corporation

(1) The Internal auditor of the Company

Name: Daniel Freedman

Date of commencement of office: August 1, 2003 (appointed as substitute until December 2, 2003)

Qualifications: BA in Accounting (Hebrew University); MA in Economics and Statistics (Hebrew University); CIA (Certified Internal Auditor – USA); CISA (Certified Information Systems Auditor) – USA);

Internal auditing experience: 21 years in various internal auditing positions.

Employment basis: Senior employee with personal contract, full-time.

(2) Audit department employees

The internal auditing department has 16 employees, including the internal auditor, who is a full-time employee. Fifteen of the department's auditing employees have academic degrees in the following fields: accounting, law, economics, business administration, statistics, criminology, electrical engineering, political science. Three of the employees, including the internal auditor, have international certifications in internal auditing (CIA and/or CISA).

(3) Considerations in determining the internal audit work program

The guiding principle behind the annual work program for the internal audit is the risk inherent in the Company's processes and operations. In order to assess the risks, the audit prepares a 'control risk survey' of the Company every year. As part of this survey, the audit examines, in cooperation with the Company's senior management, the material exposures and risks in the Company's operations and the control environment existing for the management of these risks. The survey's findings are used to compile the topics for the annual and multi-year work program.

Additional considerations taken into account in the compilation of the work program are:

A. Reasonable coverage of all the Company's areas of business (finance; sales and marketing; personnel and payroll, investments, mergers and acquisitions; safety and security; information technology – IT; economics and logistics; engineering and planning).

B. Preparation of follow-up checks – at the request of the Board's Audit Committee or the recommendation of the Internal Auditor.

C. Preparation of reports to follow up the implementation of decisions made by management and the Audit Committee during the two years preceding the year of account.

In addition to the subjects determined in the annual work program, the audit prepares 'special examinations'. These examinations are not included in the work program, and are prepared at the request of the Chairman of the Board of Directors, Chairman of the Audit Committee or the CEO.

(4) The audit's response to corporations comprising a material holding

In all the corporations representing material holdings of the Company, there are internal auditors (either as employees or outsourced). The audit reports are discussed in the audit committees and/or Boards of Directors of these corporations, on which senior executives of the Company serve. The Company auditor regularly receives the audit reports of the corporations which are fully held by the Company: Bezeq Online Ltd., Bezeq International Ltd. and BezeqCall Communications Ltd., and submits a summary of their material findings to the Chairman of the Board of Directors, the CEO and the Chairman of the Audit Committee.

At the request of the Chairman of the Board of Directors, the internal auditor prepares special audit examinations for the affiliated companies. During the reporting year, the internal auditor conducted three examinations: Two at DBS and one at BezeqCall Communications Ltd. These examinations are not part of the work program of the affiliated companies, but additional to it.

(5) Work standards

The Bezeq internal audit is prepared pursuant to the binding standards of the IIA (Institute of Internal Auditors). In 2004 an external audit investigation of Bezeq's internal audit department was carried out, as required by Standard 1312 of the IIA. The conclusion of this investigation was that the work of the Company's internal audit department is carried out in accordance with accepted professional internal audit standards.

(6) Organizational officer responsible for the internal auditor

According to a resolution of the Company's Board of Directors, the Chairman of the Board is the organizational officer responsible for the internal auditor.

(7) Dates for submission of the audit reports

The internal auditor routinely submits the audit reports during the reporting period to the Chairman of the Board of Directors, the CEO, the Chairman of the Audit Committee and the committee members. During the reporting period, 26 reports were submitted, of which two were follow-up reports resulting from implementation of decisions made by management and the Audit Committee in 2003 and 2004.

(8) Dates on which the Audit Committee convenes

The Board's Audit Committee regularly discusses the audit reports submitted by the internal auditor during the reporting period. Over the course of the year, the Committee held 17 meetings. The following table presents the meeting dates during the reporting period, divided into quarters:

First quarter	Second quarter	Third quarter	Fourth quarter
January 4, 2005	April 14, 2005	July 7, 2005	December 8, 2005
January 20, 2005	April 20, 2005	July 12, 2005	January 1, 2006 This meeting was held instead of the meeting that had been scheduled for December 2005 and was postponed.
February 6, 2005	May 3, 2005	July 21, 2005	
February 17, 2005	May 9, 2005	September 13, 2005	
March 14, 2005	June 28, 2005		
March 22, 2005			

24 audit reports were discussed at these meetings. About half of the reports discussed were published during the reporting period and half at the end of the prior reporting period. In addition to discussions of the audit reports, the committee discussed subjects that it is obligated by law to discuss.

(9) Authority and responsibility of the internal auditor

9.1 The authority and responsibility of the Company's internal auditor are determined in the procedure "The Internal Auditor of the Company". The procedure was revised and approved by the Board's Audit Committee on January 4, 2005.

9.2 Duties of the internal auditor according to the procedure

a. To examine whether the activities of the Company, its officers and senior employees are proper from the perspective of upholding the law and proper business management.

b. To verify that the Company's operations were carried out lawfully, by a qualified person, while adhering to principles of efficiency, thrift and purity of ethics, and to ensure that they contribute to achievement of the goals defined.

c. To indicate deficiencies in the management of the business of the Company.

d. To examine the authenticity and quality of the financial and management information.

e. To inspect the cash management, the Company's liabilities and arrangements to safeguard the Company's assets and their entirety, and their operative efficiency and use.

f. To check whether the Company's decisions, including at the Board and its committee levels, were made in accordance with proper procedures.

g. To inspect the Company's information systems and information security system – in the computer environment and in the computer systems.

h. To examine the correctness of the Company's transactions with its senior employees, with their families or with corporations under their control.

i. To examine the correctness and effectiveness of the Company's procedures for entering into commitments.

j. To investigate complaints made by Company employees and complaints from the public regarding damage to purity of ethics and proper procedures.

k. To recommend that the Audit Committee determine or amend procedures on significant topics.

l. To expose deficiencies, identify the reasons for their existence, and note the causes responsible for them.

m. To make proposals for correcting the deficiencies and preventing their recurrence.

n. To re-audit in order to follow up implementation of the recommendations in the various departments.

9.3 <u>Authorities of the Company's internal auditor in accordance with the procedure</u>

a. The Company's internal auditor may demand and receive any information, explanation and document required at his discretion for the performance of his duty, and every Company employee is obliged to provide any document or information at the Company's internal auditor's first request. Every Company employee requested to provide information to the auditor is required to comply with the request at the time and in the manner determined therefore.

b. The internal auditor is authorized to perform an audit at any time, with a scope that he deems appropriate, in any of the Company's departments.

c. The manager and employees of the audited department will allow the internal auditor and his staff to perform the audit and will assist them with any request.

d. For performance of his duty, the internal auditor shall be granted access to any ordinary or computer databank, to any database and to any automated or non-automated data processing work program in the Company.

e. The internal auditor may enter and inspect any of the Company's assets.

f. The above authorities are also granted to audit department staff and to any person acting on behalf of the internal auditor.

(10) <u>Opinion of the Board of Directors</u>

"Based on Sections 1-9 above, we, the members of the Company's Board of Directors, believe that, based on the reports we received from the internal auditor, the scope of the Company audit performed in 2005, the nature and continuity of the internal auditor’s activities, and the work program are reasonable under the circumstances and they achieve the objectives of the audit."

8. Critical accounting estimates

The preparation of the financial statements according to accepted accounting principles obligates the management of the Company to make estimates and assessments that influence the reported values of assets and liabilities, income and expenses, and disclosure relating to contingent assets and liabilities.

Management bases its estimates and assessments on past experience and on additional factors which it believes are relevant, taking into account the circumstances. The actual results can differ from those assessments on various assumptions and conditions. Management has identified the most critical assessments and estimates that require significant discretion in preparing the consolidated financial statements. Management believes that these assessments and estimates are critical because every change in them and in the assumptions has the potential to materially affect the financial statements.

Estimated useful life of fixed assets

The estimated useful lives of fixed assets serve to determine the depreciation expenses that will be recorded in the reporting period.

The main part of the telecommunications infrastructure is managed in accordance with asset groups. The depreciation rates are based on the average useful life of an asset group and not of each individual asset. The useful life of an asset group is examined periodically and is based on past experience, taking into consideration expected technological changes, Company plans or other changes. If such changes take place earlier than expected or differently from expected, the remaining useful life of such assets may be shortened. This results in an increase in future depreciation expenses. If the changes take place later than expected, the remaining useful life may be extended, and this results in a decrease in the depreciation expense. In light of the importance of the Group's depreciation expenses in respect of the above changes, the effect on the operating results and the financial condition of the Group can be extremely significant. In addition, in accordance with the instructions of Accounting Standard No. 15 of the Accounting Standards Institute, the possibility of decreasing the value of the asset is reviewed when there is an indication of a decrease in the recoverable value of the asset.

Regarding a change in the estimated useful life of a fixed asset and the outcome of the review of a possible decrease in the value of the Group – see Note 9 to the financial statements.

Period of amortization of goodwill

Pursuant to Accounting Standard No. 20 of the Accounting Standards Institute, goodwill will be systematically amortized over its useful life. The amortization period reflects the best estimate of the period in which future economic benefits are expected to derive to the entity from the goodwill. The amortization period shall not exceed 20 years.

The period during which future economic benefits are expected to derive to the Company is estimated by management. Use of other assumptions is likely to result in a different estimate of the period in which economic benefits from the goodwill are expected.

For the amortization period and changes thereto – see Note 2(D) to the financial statements.

Liability for employee severance benefits

Liability for employee severance benefits included in the financial statements is based on numerous assumptions and estimates. Material assumptions and estimates are linked to early retirement plans. This provision is based on actuarial calculations which include many calculation assumptions which can be different in practice. The assumptions relate, *inter alia*, to interest rates for capitalization, mortality tables and wage creep. Some of the severance pay liabilities, such as a provision for redemption of sick leave, a provision severance and a provision employee claims, are also based on assumptions and estimates which are likely to be clarified in the future.

With regard to changes in estimates and the restatement in respect of the cessation of the employer-employee relationship, see Note 16 to the financial statements.

Deferred taxes

Deferred taxes are calculated at the tax rate expected to be in effect on their date of utilization. The tax benefit is included in the financial statements since the Company's business plans anticipate realization of the tax benefit. In the nature of things, actual business results can differ from business plans, and this can affect the future realization of the tax benefit.

See Note 11 (D) and Note 11 (F) to the financial statements.

Contingent liabilities

The Group's companies have pending liabilities in amounts for which the possible maximum exposure is considerable. Among these, class actions of extremely significant amounts are pending against Group companies.

The Company makes regular estimates of the potential liabilities associated with every claim. It is naturally very difficult to determine the outcomes of the claims. The Company uses its best judgment and the assessments of its legal advisers to determine whether it is reasonable for the Company to bear the costs of settling claims and whether they can be reasonably estimated.

Taking into consideration the uncertainty inherent in legal claims, it is possible that all or some of them will be concluded with charges for the Company, in amounts materially different from the provisions included in the financial statements, if any.

For details of contingent liabilities, see Note 19 to the financial statements.

9. Directors with accounting and financial expertise

A. The Company's Board of Directors determined that the minimum number of directors who have accounting and financial expertise, as required by the provisions of the Companies Law, is one (and together with the outside directors – two). The Board of Directors believes that this number will enable it to fulfill the duties imposed upon it by law and by the documents of association, including review of the financial condition of the Company and preparing and approving the financial statements, taking into consideration the volume and complexity of its operations.

B. Serving directors who have the above skills are Yigal Cohen-Orgad (external director) and Menachem Inbar. For information about their relevant education and experience, see Sections 12(g) and 12(h) in Chapter D of the Periodic Report.

10. Miscellaneous

A. Disclosure concerning the remuneration of the external auditor

Below are the fees paid to the auditors of the main companies in the group in respect of auditing services for 2005:

- The Company – Somekh Chaikin – approximately NIS 1,300 thousand.
- Pelephone – Kesselman & Kesselman – approximately NIS 440,000 in fees for auditing services and NIS 65,000 for other services.
- DBS – Kesselman & Kesselman – approximately NIS 500,000 for auditing services and NIS 124,000 for other services.
- Bezeq International – Brightman Almagor & Co. – approximately NIS 370,000, which includes tax services for 2004.

B. Adoption of Ethical Code

On April 20, 2005, the Company's Board of Directors adopted an ethical code for its business practices. The ethical code establishes principles and rules of behavior to direct the actions of senior officers, managers and employees. The Deputy VP of Human Resources was appointed to be the person in the Company responsible for implementation of the provisions of the code of ethics.

C. Peer Review

On April 20, 2005, the Securities Authority published a directive requiring disclosure in the matter of giving consent to a peer review, the purpose of which, according to the directive, is to encourage a process of control of the work of external auditors. The directive raises questions, including legal questions, mainly concerning the confidentiality of the material submitted to the accountants and the harm that a company could suffer as a result of the exposure of such material. Since the legal problems of this kind have not yet been resolved, the Company has not yet made a decision on the matter.

D. Sale of controlling interest

On October 11, 2005, the process of selling the controlling interest and transfer of the State's holdings in the Company to Ap.Sb.Ar Holdings Ltd. was completed (see Note 1F to the financial statements). Upon the closing of the transaction, all the directors representing the State resigned from the Board of Directors, and the appointment of new directors, as approved earlier by the General Meeting of the shareholders, took effect. The external directors who served on the Board prior to closing the transaction will continue to serve on the Board.

E. Chairman of the Board and CEO

Commencing October 11, 2005, Moshe Arkin served as Chairman of the Board of Directors and commencing July 12, 2006 Dov Weissglas serves as Chairman of the Board of Directors. Yacov Gelbard serves as CEO commencing October 11, 2005.

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

Dov Weissglas **Chairman of the Board of Directors**	**Yacov Gelbard** **President & CEO**