March 3, 2005

Chapter B of the Periodic Report

Directors' Report on the State of the Company's Affairs for the year ended December 31, 2004

We respectfully present the Directors' Report on the state of affairs of "Bezeq" - The Israel Telecommunications Corporation 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, 2004 (hereinafter: "the Directors' Report").

The Group is the principal provider of communications services in Israel and it operates and provides a broad range of telecommunications services. 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** – service provided by the Company.

2) **Cellular** – service provided by Pelephone Communications Ltd. (hereinafter: "Pelephone").

3) **International communications and internet services** – service provided by Bezeq International Ltd. (hereinafter: “Bezeq International”).

4) **Multi-channel television** - D.B.S. Satellite Services (1998) Ltd. (hereinafter: "DBS")

The Company has other areas of business which are not material to the Group’s operations which are included in the Company's Financial Statements for December 31, 2004 as an “Other” business segment, and they include mainly network end point services, customer call center services and content services for the business sector.

Below is a table detailing the reports which were fully consolidated for the first time in the years ended December 31, 2004 and 2003.

	2004	**2003**
Pelephone Communications Ltd.	Full consolidation from August 26, 2004	50% proportional consolidation
D.B.S. Satellite Services (1998) Ltd.	Full consolidation from June 21, 2004	-

1. Financial Position

A. The Group's assets as at December 31, 2004 amounted to approximately NIS 20.17 billion, compared with NIS 16.09 billion on December 31, 2003. Of these, approximately NIS 10.74 billion (approximately 53%) are fixed assets, compared with approximately NIS 8.70 billion (54%) on December 31, 2003. NIS 3.38 billion of the increase in total assets originates from the first-time consolidation.

In the fixed-line domestic communications segment there was a decrease in the net book value of the fixed assets resulting from the difference between the depreciation expense and the investment made during the Report Period There was also a decrease in cash balances and short-term investments compared with the prior year.

In the cellular segment there were additional investments in sites and an investment in 3G infrastructure, as well as an increase in inventory which contributed to the increase in total assets.

B. The Group's shareholders' equity as at December 31, 2004, amounted to approximately NIS 7.47 billion, comprising approximately 37% of the total balance sheet, compared with approximately NIS 6.84 billion on December 31, 2003, comprising approximately 43% of the total balance sheet. The increase in shareholder' equity derived from the Group’s net earnings arising during the Report Period.

C. Total Group debt to financial institutions and debenture holders as at December 31, 2004, amounted to approximately NIS 8.32 billion, compared with approximately NIS 5.51 billion on December 31, 2003. Approximately NIS 2.42 billion of the increase derives from the first-time consolidation and the remainder derives from the receipt of loans and an issuance of bonds to the public and institutional investors by the Company and Pelephone.

D. Group balances in cash and short-term investments as at December 31, 2004, amounted to approximately NIS 2.74 billion compared with approximately NIS 3.29 billion on December 31, 2003. The decrease derives mainly from exercise of the option to purchase the second half of the shares in Pelephone. The decrease was offset by the cash flow from current operations in the main segments of the Group's business and also from an issuance of bonds and receipt of loans.

2. Results of Operations

A. Principal results

Net earnings for 2004 amounted to approximately NIS 621 million, compared with a net loss of approximately NIS 438 million in the corresponding period in the prior year. The difference in the results derives mainly from the Other income (expenses) item, where an expense of approximately NIS 983 million (before tax) was recorded in the corresponding period mainly in connection with early retirement costs and a provision for claims for salary components in pensions. In addition, in the prior period, deductions were recorded in respect of impairment in assets and expenses connected with changes in the estimated useful life of assets. The source of the increase in earnings is also an increase in the Group's operating income.

Below are details of the changes in the results of the segments as compared with the previous year.

Segment	**2004 NIS millions**	**2003 NIS millions**
Fixed-line domestic communications	971	907
Cellular[1]	379	96
International communications and internet services	118	90
Multi-channel television [2]	(85)	-
Others	8	-

Earnings per share for the year 2004 amounted to NIS 0.238 per NIS 1 par value, compared with a loss of NIS 0.179 per share in the corresponding period in the prior year.

B. Revenues

Group revenues in 2004 amounted to approximately NIS 9.27 billion, compared with approximately NIS 7.98 billion in the corresponding period in the prior year. An increase of approximately NIS 1.26 billion derives from the first-time consolidations.

Revenues from the fixed-line domestic communications segment decreased from approximately NIS 5.23 billion in 2003 to approximately NIS 4.96 billion in 2004 (a decrease of approximately 5%). Most of the reduction in the segment's revenues derives from tariff reductions in September 2003 and June 2004 and a decrease in call and internet dial-up traffic. In contrast, the segment's revenues from fixed fees increased as a result of the continued rising trend in subscribers from the high speed internet service (ADSL) and the

[1]First-time full consolidation
.[2] First-time consolidation

increase of fixed fee tariffs per line commencing in September 2003. In addition, revenues in the segment rose due to an increase in installations and sales of equipment. The auditors drew attention to the ongoing opening of the telecommunications industry to competition and changes in tariffs in their opinion letter to the shareholders.

Revenues from the cellular telephone segment increased from approximately NIS 2.03 billion to approximately NIS 2.97 billion, mainly as a result of the effect of the first-time full consolidation implemented in the Report Period. In addition, the segment's revenues increased as a result of the increase in the number of subscribers and the increase in revenues from the sales of handsets to customers. For the future effect on revenues of the segment resulting from the amendment to the cellular network interconnect regulations, see Note 1 F (2) to the Financial Statements.

Revenues from the international communications and internet services segment increased from approximately NIS 703 million in 2003 to approximately NIS 816 million in 2004 (an increase of approximately 16%). The segment's revenues increased mainly as a result of the increase in internet revenues which derived from the growth in the number of high speed internet customers, the sale of internet access service capacity, growth in international call routing traffic and in data services. The growth was slowed by a decrease in call and internet tariffs.

Revenues of approximately NIS 542 million from the multi-channel television segment have been included for the first time in the financial statements. There has been an increase in revenues in this segment compared with the corresponding period on account of the increase in the number of subscribers and the average revenue per subscriber.

C. General and Operating Expenses

The Group's general and operating expenses in 2004 amounted to approximately NIS 5.57 billion, compared with approximately NIS 4.49 billion in the corresponding period in the prior year. Approximately NIS 991 million derives from first-time consolidation.

In the fixed-line domestic communications segment expenses decreased by approximately 1%. Most of the decrease is attributable to the decrease in salary expenses in the segment due to the retirement of employees under the early retirement plan. The decrease was partially offset by a rise in expenses of materials and satellite communications.

In the cellular segment the increase in expenses arises from the first-time consolidation. Expenses in the segment did not increase compared to the prior year, despite the growth in operations.

In the international communications and internet services segment there was an increase in operating expenses due to the growth in operations and as a result of a change in estimates relating to depreciation and doubtful debts in 2003.

Operating and general expenses from the multi-channel television segment amounting to approximately NIS 473 million have been included for the first time in the financial statements.

D. Depreciation

The Group's depreciation expense decreased from approximately NIS 2.16 billion in 2003 to approximately NIS 2.09 billion in 2004. The decrease is due to the cessation of the depreciation charge on fixed assets and a decrease in investments in new assets in the fixed-line domestic communications segment. Furthermore, an additional decrease was recorded due to the change in the estimated useful lives of assets in this segment. A decrease in depreciation in the cellular segment also contributed to the overall decrease. The Group's depreciation expense increased by approximately NIS 227 million as a result of the first-time consolidation,

E. Royalties to the Government of Israel

The Group's royalties expense in 2004 amounted to approximately NIS 221 million as compared to approximately NIS 243 million in the corresponding period in the prior year. The source of the decrease is the reduction in the percentage of royalties payable on the Group's revenues, from 4% to 3.5%, effective January 1, 2004. The decrease was partially offset by additional royalties of approximately NIS 28 million, the source of which is the first-time consolidations referred to in Section A above.

F. Operating income

The Group's operating income in 2004 amounted to approximately NIS 1,392 million, compared with approximately NIS 1,093 million in the corresponding period in the prior year, an increase of approximately NIS 299 million. The increase in operating income derives from the changes in the results of the segments described above in the revenues and expenses items. These changes led to a rise in the profitability of all the Group's segments of operation. The operating income of the Group was partially offset by the first-time consolidation of DBS, as described in Section A above.

G. Financing expenses

The Group's net financing expenses in 2004 amounted to approximately NIS 218 million, compared with approximately NIS 158 million in the corresponding period in prior year. Commencing in 2004, financing expenses included in the financial statements reflect the nominal financing expenses rather than the inflation-adjusted financing expenses recorded in the past, due to the transition to financial reporting based on nominal financial data. Therefore, there is no basis for comparison of the results. Approximately NIS 66 million of the financing expenses are attributable to the first-time consolidations, as described in Section A above.

The financing expenses in the period were affected mainly by changes in the CPI and the exchange rates of the dollar and the euro. The effect of the changes in the foreign currency and shekel rates was largely eliminated by hedging transactions and by financing income from financial instruments. The financing expenses in the fixed-line domestic communications segment rose mainly due to a decrease in revenues from investments and deposits. In the international communications and internet services segment, and the cellular segment financing expenses decreased. In the cellular segment this decrease was due, *inter alia*, to the decrease in the total debts.

H. Tax expenses

The Group's tax expense in 2004 amounted to approximately NIS 497 million, compared with approximately NIS 48 million in the corresponding period in the prior year. Following the amendments to the Income Tax Law coming into effect including, *inter alia*, the gradual reduction in corporate tax rates from 36% to 30%, the Group reduced its tax asset and set it at the rate expected to apply when that asset is utilized. As a result, an additional tax expense of approximately NIS 84 million was recorded.

I. Other Income (Expenses)

Income amounting to approximately NIS 80 million was recorded in 2004 in the Group's Other Income (Expenses) item, compared with an expense of approximately NIS 983 million in the corresponding period in the prior year.

Most of the expense in the corresponding period was an increase in the provision for early retirement. Furthermore, a reduction in Company assets and investments and in Bezeq International and a provision in connection with certain employee claims were also recorded. The income recorded in the Report Period derived from a reduction of the provision for employee claims recorded by the Company in the corresponding period. This income was partially offset by an additional increase in the provision for early retirement. (For details, see Note 24 to the financial statements). The Company's auditors have drawn attention to the Company's retirement plans and to the claims filed against it.

J. Group's equity in losses of affiliates

The Group's equity in losses of affiliates decreased compared with the corresponding period of the prior year, from approximately NIS 343 million in 2003 to approximately NIS 135 million in the Report Period. Most of the decrease derived from the decrease in the Company's equity in the losses of DBS in the first half of the year. With the full consolidation of DBS close to the end of the first half, the results of its operations are presented in the financial statements on a consolidated basis, rather than on the equity basis (see Note 8 to the financial statements).

The Company's auditors have drawn attention to the financial condition of DBS and to the fact that its continued operation is contingent upon further receipt of loans from the shareholders including loans from the Company in accordance with the DBS's work plan.

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

	Year 2004	Q4 2004	Q3 2004	Q2 2004	Q1 2004
Revenue from telecommunications services	9,269.8	2,775.5	2,473.5	2,011.6	2,009.2
General and operating expenses	5,565.1	1,830.1	1,511.0	1,133.2	1,090.8
Depreciation	2,092.5	597.4	556.3	467.0	471.8
Royalties to the Government of Israel	220.7	64.9	59.8	48.7	47.4
	7,878.3	2,492.4	2,127.0	1,648.9	1,610.0
Operating income	1,391.5	283.1	346.5	362.7	399.2
Financing expenses, net	217.5	80.9	67.9	38.0	30.7
Earnings after financing expenses	1,174.0	202.2	278.6	324.7	368.5
Other income (expenses), net	79.7	(29.2)	131.9	7.5	(30.5)
Earnings before tax	1,253.7	173.0	410.5	332.2	338.0
Income tax	497.5	64.4	166.3	161.5	105.3
Earnings after income tax	756.2	108.6	244.2	170.7	232.7
Equity in losses of affiliates	(134.8)	(4.1)	(1.4)	(64.4)	(64.9)
Minority share in earnings (losses) of a consolidated company	0.6	0.6	0.1	-	(0.1)
Net earnings	620.8	103.9	242.7	106.3	167.9

The quarterly financial results were affected mainly by the first-time consolidations which commenced in the third quarter and by the recording of one-time other income (expenses) in the various quarters. The results of the second quarter were affected mainly by a change in the tax rates (see Section H above). In the fourth quarter there was a decrease in operating income in the Group's principal segments as compared with the third quarter. The reason for the decrease is partly a seasonal decline in income and partly a rise in operating expenses.

3. Liquidity and sources of financing

Consolidated cash flows generated by operating activities in 2004 amounted to approximately NIS 2,850 million, compared with approximately NIS 2,692 million in the corresponding period in the prior year. The increase in consolidated cash flows from operating activities was due to first-time consolidation and to an increase in the operating cash flows of the international communications and internet services segment.

Cash flows generated by operating activities are the principal source of financing of the Group's investments, which during the Report Period included, *inter alia*, approximately NIS 1,651 million in the development of telecommunications infrastructure and approximately NIS 390 million investment in investee companies. During the year, the Group repaid approximately NIS 3,263 million in debts, of which approximately NIS 2,605 million was in respect of long-term loans, approximately NIS 601 million in respect of debentures and approximately NIS 57 million in respect of short-term credit.

The Group raised new debt in a total amount of approximately NIS 1,843 million by an issuance of debentures (of which NIS 850 million par value was by a stock exchange issuance) and receipt of new long-term loans.

The average monthly short-term credit during the period was approximately NIS 52 million. The average monthly long-term liabilities for the period was approximately NIS 6,565 million.

Working capital as at December 31, 2004, amounted to approximately NIS 287 million, compared with working capital of approximately NIS 1,111 million on December 31, 2003. The decrease derives mainly from the first-time consolidation described in Section A above, and from a decrease in the Company's working capital deriving mainly from a decrease in cash and short-term investments.

4. Group involvement in the community and donations

Since becoming a “mixed company”, the Company is no longer forbidden to make donations, as was the case when it was a government company.

During the Report Period the Group was active in the community through its involvement in social institutions and organizations such as the education system in distressed areas and the confrontation line. To mark the twentieth anniversary of its establishment, the Company initiated a campaign of donations to various organizations during 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. The twelve month campaign commenced on February 20, 2004. During the Report Period the Company donated a total of approximately NIS 2.562 million through this campaign.

The Company initiated and invested approximately NIS 846,000 in the "Summer for the Community" project in which 16-18-year old children of employees worked in medical institutions and community centers.

Pelephone donated NIS 500,000 during the Report Period , as well as the use of part of its infrastructure, for the "Good Day" project of the "Israeli Spirit" society.

5. Details concerning market risks exposure management

The Company and the consolidated companies each manage their market risks individually and not from a consolidated perspective. The financial statements contain financing expenses of approximately NIS 16.1 million from hedging transactions made during the Report Period. Following is a description of the risks and their management by the Company:

Responsibility for the Company’s market risks

The person responsible for management of the Company's market risks is the Chief Financial Officer, 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 –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 of 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 ("CPI") usually 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.
The Company has investments in marketable bonds defined as a "permanent investment", and therefore their presentation is not affected by market value or by changes in the interest rate 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 be 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 Report Period was accomplished by means of forward transactions of currencies hedged against shekels or against CPI-linked shekels. The time frame of the forward contracts 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 bears no significant costs in making hedging transactions against the exchange rate, since they were made as forward transactions. The financial statements include financing income of approximately NIS 3.8 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. Commencing 2004 there is a transition of financial reporting and measurement to a nominal shekel basis. This transition increases the abovementioned 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 sectorial price indices, exchange rates and global prices. The Company is not hedged against this exposure.

Prices of securities – The Company invests some of its cash 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 execution of market risk management policy

Following the amendment to the Securities Regulations (Periodic and immediate reports) with respect to the subject of exposure to market risks and its management, a sub-committee of the Finance Committee of the Company's Board of Directors was established, with a mandate to discuss the market risk management policy of the Company and make recommendations to the Finance Committee and the Board of Directors. An exposure report formatis designed to oversee the relevant activities of the Company's Management on the matter was subsequently approved for the sub-committee and the Board of Directors. The committee receives monthly reporting on the status of the exposures and from time to time conducts discussions.

Description of the risks and their management in the consolidated companies

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.

Report on linkage bases

Note 29 to the financial statements includes information about the linkage terms of the monetary balances of the Company and the Group as at December 31, 2004.

Positions in derivatives as at December 31, 2004 (consolidated)
(Amounts are in NIS thousands)

	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	1,178,681	17,232			(56,514)	191		
Hedging - not recognized for accounting	21,540				(920)			
Call option								
Hedging –not recognized for accounting	120,624				378			
Put option								
Hedging - not recognized for accounting		43,080				(255)		

Dollar / CPI-linked NIS								
	Nominal Value				Fair Value - asset (liability)			
	Up to one year		More than one year		Up to one year		More than one year	
Currency exchange transactions at predetermined interest rates								
Hedging - recognized for accounting	43,080				(8,174)			

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	1,335,817				44,917			

Euro / CPI-linked NIS								
	Nominal Value				Fair Value - asset (liability)			
	Up to one year		More than one year		Up to one year		More than one year	
Currency exchange transactions at predetermined interest rates								
Hedging - recognized for accounting	146,920				28,500			

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	520,000		130,000		(1,241)		(901)	

6. Utilization of proceeds from securities

An offer for sale and issuance to the public through a prospectus were 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 the internal auditor in a reporting corporation

A. 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: 20 years in various internal auditing positions.
Basis and scope of employment: Senior employee with personal contract, full-time position.

B. **Audit department employees**

The internal auditing department has 20 full time employees, including the internal auditor. Seventeen of the unit's auditing employees have academic degrees in the following fields: accounting, law, economics, business management, statistics, criminology, electrical engineering, political sciences.

C. **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:

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

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

(3) 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.

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In addition to the subjects determined in the annual work program, the audit performs '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.

D. **The audit's response to corporations comprising a material holding**

An internal auditor and audit committee have been appointed in all the corporations representing material holdings of Bezeq. The audit reports are discussed in the audit committees of these corporations. The Company auditor regularly receives the audit reports of the corporations which are fully held by Bezeq (Pelephone Communications, Bezeq Online, Bezeq International, and BezeqCall) 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 DBS Satellite Services (1998) – "YES". These examinations are not part of the work program of the YES internal auditor, but additional to it.

E. **Work standards**

The Bezeq internal audit is prepared pursuant to the binding standards of the IIA (Institute of Internal Auditors). This year 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 Bezeq's internal audit department is carried out in accordance with accepted professional internal audit standards.

F. Organizational officer responsible for the internal auditor

During the Report Period, the officers responsible for the Company's internal auditor were the Chairperson of the Board of Directors, Adv. Miriam (Miki) Mazar and the CEO, Mr. Amnon Dick.

Following the change in Bezeq's status from a government company to a mixed company, the Government Companies Law, which determined the above-mentioned dual responsibility, ceased to apply to the Company. On January 4, 2005, the Board's Audit Committee gave its approval for the auditor to be hierarchically subordinate to the Chairman of the Board of Directors. The decision will be submitted for approval by the Board of Directors.

G. Dates for submission of the audit reports

The internal auditor regularly submits the audit reports during the Report Period to the Chairman of the Board of Directors, the CEO, the Chairman of the Audit Committee and the committee members. During the Report Period, 28 reports were submitted, of which two were follow-up reports resulting from implementation of decisions made by management and the Audit Committee in 2002 and 2003.

H. Dates on which the Audit Committee convenes

The Board's Audit Committee regularly discusses the audit reports submitted by the internal auditor during the Report Period. The committee convenes on average once a month. The following table presents the meeting dates during the year of account , divided into quarters:

First quarter	Second quarter	Third quarter	Fourth quarter
January 6, 2004	April 20, 2004	July 15, 2004	October 28, 2004
January 29, 2004	May 13, 2004	August 5, 2004	November 4, 2004
March 30, 2004	June 10, 2004	September 21, 2004	January 4, 2005 This meeting was held instead of the meeting that was scheduled for December 2004 and which was postponed.

29 audit reports were discussed at these meetings. Most of the reports discussed were published during the Report Period and a few at the end of the prior Report Period. In addition to discussions of the audit reports, the committee discussed subjects that it is obligated by law to discuss.

I. Authority and responsibility of the internal auditor

(1) The authority and responsibility of the Company's internal auditor are determined in the procedure "The Internal Auditor of the Company". In view of the change in the Company's status (from a government company to a "mixed" company) and in accordance with the customary auditing standards, the procedure was revised and approved by the Board's Audit Committee on January 4, 2005.

(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 dealings 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 reaudit in order to follow up implementation of the recommendations in the various departments.

(3) Authorities of the Company's internal auditor in accordance with the procedure

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 transfer 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.

J. Opinion of the Board of Directors

Based on Sections A - I above, the members of the Company's Board of Directors believe that the scope of the Company audit performed in 2004, the nature and continuity of the internal auditor's activities, as well as the work program, are reasonable under the circumstances and they achieve the objectives of the audit.

8. <u>Critical accounting estimates</u>

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

Management bases its estimations 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 estimations that require significant discretion in preparing the consolidated financial statements. Management believes that these assessments and estimations are critical because every change in them and in these 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 expense that will be recorded during the Report 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 expectations, 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 during 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 are based on numerous assumptions and estimations. Significant assumptions and estimations 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, wage creep – for details, see the actuary's letter attached to the financial statements. Some of the severance pay liabilities, such as a provision for redemption of sick leave, a provision for severance and a provision for employee claims, are also based on assumptions and estimations which are likely to be clarified in the future.

With regard to changes in estimations 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 estimations 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 appropriate minimum number of directors who have accounting and financial expertise is 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 nature, activities and business of the Company.

B. Serving directors who have the above skills:

1. Yigal Cohen-Orgad (outside director)

B.A. in economics and education, studied for M.A. in economics and business administration (Finance track).
Former Minister of Finance of Israel.
Deputy Chairman of the Board of Bank Leumi le'Israel B.M., 1989-1993.

2. Hava Shechter

B.A. in economics, MBA – major in finance and accounting.
Currently serves as Chairperson of the Issuance /Privatization Committee of the Board of Directors of the Company, and member of the Finance Committee.
Owner of C. Shechter & Co. Investment House Ltd. – a company specializing in financial solutions, issuances, mergers and acquisitions.
Started her career in the Issuances department of Israel Discount Bank Ltd., and managed the analytical department of the Investments section at Bank Leumi le'Israel B.M.
Formerly a partner in Zmicha Investment House Ltd., and head of its Integrated Financial Services segment.
Lecturer at an investment banking course for M.A. students.

C. Directors with the above skills who served during the Report Period and who, as at the date of this report, no longer serve.

1. Yoram Aridor

B.A. in humanities, minors: economics and politics, LLM and licensed to practice law.
Former Minister of Finance and Minister of Communications in Israel, and member of the Knesset Finance Committee, 1983-1988.
Served as a director in Maalot Israeli Securities Rating Co. Ltd., 1994-2000.
Chairman of the Herut Movement Committee, 1979-1987.
Served as director until November 26, 2004.

2. Shilo Lifschitz

Qualified CPA, and M.B.A. from the Hebrew University of Jerusalem.
Economist at the Bank of Israel, 1988-1993.
Various positions at United Mizrahi Bank Ltd, 1994-2000, including manager of the bank's Asset and Liabilities Management department.
Deputy Director General at the Institute for Forward Contracts and Options Ltd., 2000-2001.
Lecturer in accounting and finance courses, 2000-2002, and since 2001 Director of Research Budget Control at the Hebrew University of Jerusalem.
Member of the Finance Committee of the Company Board of Directors and chairman of the sub-finance committee for market risk management.
Served as director until December 17, 2004.

3. Shoshana Weinshel

LLB and licensed to practice law.
Between 1956 and 1991, served in various positions at Bank Leumi le'Israel B.M., including Legal Counsel, and managed the Underwriting and Issuances Department at the bank. In her last position at Bank Leumi, she headed the Business Division and was a member of the bank's *"cabinet"*. From 1991 to the present, she has served as a director in public companies such as EL AL Israel Airlines Ltd., Israel Fuel Co. Ltd., Dan Hotels Ltd., Rafael Weapons Development Ltd., and Mercantile Discount Bank Ltd. – where she is currently Chairperson of the Loans Committee.
She is Chairperson of the Company Audit Committee and a member of the Finance Committee of the Board of Directors.
Served as director until February 17, 2005.

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

Adv. Miriam (Miki) Mazar Chairperson of the Board of Directors	Amnon Dick President &CEO