"BEZEQ" THE ISRAEL TELECOMMUNICATION CORP. LIMITED

FINANCIAL STATEMENTS

DECEMBER 31, 2003

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Auditor's Report to the Shareholders of
“Bezeq” The Israel Telecommunication Corp. Limited

We have audited the accompanying balance sheets of “Bezeq” The Israel Telecommunication Corp. Limited (the Company) as at December 31, 2003 and 2002, and the consolidated balance sheets as at such dates and the related statements of income, shareholders’ equity and cash flows for each of the three years the last of which ended December 31, 2003. These financial statements are the responsibility of the Company’s Board of Directors and its Management. Our responsibility is to express an opinion on these financial statements based on our audits.

We did not audit the financial statements of consolidated subsidiaries, including those consolidated by the proportionate method whose assets constitute approximately 20% of the total consolidated assets as at December 31, 2003 and 2002, and whose revenues constitute approximately 37%, 34%, and 28% of the total consolidated revenues for the years ended December 31, 2003, 2002, and 2001, respectively. Furthermore, we did not audit the financial statements of affiliates, in which the investment was approximately NIS 241 thousand and approximately NIS 380 thousand as at December 31, 2003 and 2002, respectively, and the Group's equity in their operating losses is approximately NIS 341 thousand, approximately NIS 349 thousand and approximately NIS 230 thousand for the years ended December 31, 2003, 2002 and 2001 respectively. The financial statements of those companies were audited by other auditors whose reports thereon were furnished to us and our opinion, insofar as it relates to amounts emanating from the financial statements of such companies, is based solely on the said reports of the other auditors.

We conducted our audits in accordance with generally accepted auditing standards, including standards prescribed by the Auditors’ Regulations (Manner of Auditor’s Performance), 1973. Such standards require that we plan and perform the audit to obtain reasonable assurance that the financial statements are free of material misstatement. An audit includes examining, on a test basis, evidence supporting the amounts and disclosures in the financial statements. An audit also includes assessing the accounting principles used and significant estimates made by the Board of Directors and by Management, as well as evaluating the overall financial statement presentation. We believe that our audits and the reports of the other auditors provide a reasonable basis for our opinion.

In our opinion, based on our audits and on the reports of the other auditors, the financial statements referred to above present fairly, in all material respects, the financial position of the Company and the consolidated financial position of the Company and its subsidiaries as at December 31, 2003 and 2002 and the results of their operations, the changes in the shareholders’ equity and their cash flows for each of the three years the last of which ended December 31, 2003, in conformity with generally accepted accounting principles. Furthermore, in our opinion, the financial statements referred to above are prepared in accordance with the Securities Regulations (Preparation of annual financial statements), 1993.

As explained in Note 2, the abovementioned financial statements are stated in values adjusted for the changes in the general purchasing power of the Israeli currency, in accordance with opinions of the Institute of Certified Public Accountants in Israel.

Without qualifying our opinion, we draw attention to the uncertainties relating to the following matters, the maximum possible exposure of which is significant:

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

2. A program for a early retirement, as described in Note 16D.

3. Claims made against the Company and against investee companies, as described in Note 19A.

4. The financial position of an affiliated company and the financing agreements between the affiliated company, banking corporations and the shareholders of the affiliated company. As described in Note 8E, the continuation of the activity of the affiliated company is dependent upon the continued receipt of loans from the shareholders within the framework of the financing agreements.

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

March 18, 2004

Balance Sheets

In terms of shekels of December 2003

	Note	Consolidated December 31 2003 NIS thousands	Consolidated December 31 2002 NIS thousands	Company December 31 2003 NIS thousands	Company December 31 2002 NIS thousands
Current assets					
Cash and cash equivalents	3	**1,954,350**	973,735	**1,896,518**	900,062
Short-term investments	4	**1,340,341**	1,157,823	**1,340,248**	1,157,733
Trade receivables	5	**1,667,623**	1,718,943	**1,021,267**	1,105,113
Other receivables and debit balances	6	**415,372**	505,047	**363,959**	467,802
Inventory		**83,995**	164,224	**–**	–
		5,461,681	4,519,772	**4, 621,992**	3,630,710
Materials and spare parts		**151,911**	119,883	**151,911**	119,883
Investments and long-term payables					
Investments, deposits and debit balances	7	**765,971**	754,310	**654,400**	662,940
Investments in investee companies	8	**240,667**	382,717	**1,509,101**	1,709,609
		1,006,638	1,137,027	**2,163,501**	2,372,549
Fixed assets	9				
Cost		**28,385,188**	29,391,408	**23,184,549**	24,516,224
Less – accumulated depreciation		**19,686,070**	19,609,491	**16,401,414**	16,627,334
		8,699,118	9,781,917	**6,783,135**	7,888,890
Other assets					
Deferred charges and other assets	10	**208,677**	277,464	**11,016**	15,124
Deferred taxes	11	**560,739**	394,492	**441,420**	232,509
		769,416	671,956	**452,436**	247,633
		16,088,764	16,230,555	**14,172,975**	14,259,665

	Note	Consolidated December 31 2003 NIS thousands	Consolidated December 31 2002 NIS thousands	Company December 31 2003 NIS thousands	Company December 31 2002 NIS thousands
Current liabilities					
Bank credit	12	**144,714**	518,851	**–**	–
Current maturities of:					
Long-term bank loans	13	**685,883**	534,782	**324,827**	366,145
Debentures	14	**598,153**	206,328	**598,153**	206,328
Trade payables	15	**1,130,716**	1,131,609	**686,517**	663,459
Employee severance benefits, net	16	**602,520**	208,620	**602,520**	208,620
Other current liabilities	17	**1,188,200**	1,097,013	**949,835**	866,581
		4,350,186	3,697,203	**3,161,852**	2,311,133
Long-term liabilities					
Long-term loans	13	**1,754,293**	2,051,477*	**1,046,212**	1,469,729*
Debentures	14	**2,324,582**	2,716,897	**2,324,582**	2,716,897
Employee severance benefits, net	16	**770,909**	1,118,321	**761,283**	1,107,521
Other long-term liabilities	18	**43,764**	56,013*	**34,104**	64,305*
		4,893,548	5,942,708	**4,166,181**	5,358,452
Minority rights		**88**	564	**–**	–
Contingent liabilities	19				
Shareholders' equity	20	**6,844,942**	6,590,080	**6,844,942**	6,590,080
		16,088,764	16,230,555	**14,172,975**	14,259,665

* Reclassified

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

Date of approval of the financial statements: March 18, 2004

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

Statements of Operations for the Year Ended December 31

In terms of shekels of December 2003

		Consolidated			Company		
	Note	2003 NIS thousands	2002 NIS thousands	2001 NIS thousands	2003 NIS thousands	2002 NIS thousands	2001 NIS thousands
Revenues from telecommunications services	21	**7,981,268**	8,063,480*	8,510,013*	**5,230,561**	5,447,068*	6,151,529*
Costs and expenses							
Operating and general expenses	22	**4,485,300**	4,525,933*	4,660,382*	**2,366,547**	2,399,726*	2,622,666*
Depreciation	9	**2,160,011**	2,270,214*	2,713,053*	**1,776,279**	1,888,511	2,247,563
Royalties to the State of Israel		**242,608**	250,146	282,521	**181,116**	179,027	197,809
		6,887,919	7,046,293	7,655,956	**4,323,942**	4,467,264	5,068,038
Operating income		**1,093,349**	1,017,187	854,057	**906,619**	979,804	1,083,491
Financing expenses, net	23	**157,522**	165,316	150,541	**62,372**	117,134	76,020
Earnings after financing expenses		**935,827**	851,871	703,516	**844,247**	862,670	1,007,471
Other expenses, net	24	**983,178**	1,206,704*	105,064*	**846,948**	1,207,182	2,615
Earnings (loss) before income tax		**(47,351)**	(354,833)	598,452	**(2,701)**	(344,512)	1,004,856
Income tax	11	**48,013**	207,333	240,940	**33,513**	229,641	362,318
Earnings (loss) after income tax		**(95,364)**	(562,166)	357,512	**(36,214)**	(574,153)	642,538
Equity in losses of investee companies	8	**343,334**	353,616*	237,455*	**401,622**	338,622	515,982
Minority share in losses of consolidated company		**(862)**	(3,007)	(6,499)	–	–	–
Net earnings (loss)		**(437,836)**	(912,775)	126,556	**(437,836)**	(912,775)	126,556
Earnings (loss) per share							
Primary and diluted earnings (loss) per NIS 1 par value of common shares (in NIS)		**(0.179)**	(0.379)	0.052	**(0.179)**	(0.379)	0.052

* Reclassified

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

Statements of Changes in Shareholders' Equity

In terms of shekels of December 2003

	Share capital	Capital reserve for distribution of bonus shares	Capital reserve – share premium	Capital reserve in respect of transactions between the Company and a controlling shareholder	Dividend proposed after the balance sheet date	Retained earnings (deficit)	Total
	NIS thousands						
Balance as at January 1, 2001	4,394,717	1,693,771	872,247	37,775	–	305,615	7,304,125
Changes in 2001 –							
Net earnings	–	–	–	–	–	126,556	126,556
Conversion of convertible debentures (1)	6,287	–	65,887	–	–	–	72,174
Distribution of bonus shares	1,715,374	(1,693,771)	–	–	–	(21,603)	–
Balance as at December 31, 2002	6,116,378	–	938,134	37,775	–	410,568	7,502,855
Changes in 2002 –							
Net loss	–	–	–	–	–	(912,775)	(912,775)
Dividend proposed subsequent to balance sheet date	–	–	–	–	186,416	(186,416)	–
Balance as at December 31, 2002	6,116,378	–	938,134	37,775	186,416	(688,623)	6,590,080
Changes in 2003 –							
Net loss	–	–	–	–	–	**(437,836)**	**(437,836)**
Dividend paid	–		–	–	**(186,416)**	**1,070**	**(185,346)**
Allotment of shares	**192,755**	–	**685,289**	–	–	–	**878,044**
Balance as at December 31, 2003	**6,309,133**	–	**1,623,423**	**37,775**	–	**(1,125,389)**	**6,844,942**

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

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

Statements of Cash Flows for the Year Ended December 31

In terms of shekels of December 2003

	Consolidated			Company		
	2003	**2002**	**2001**	**2003**	**2002**	**2001**
	NIS thousands			NIS thousands		
Cash flows for operating activities						
Net earnings (loss)	**(437,836)**	(912,775)	126,556	**(437,836)**	(912,775)	126,556
Adjustments to reconcile net earnings (loss) to net cash flows generated by operating activities (see A below)	**3,129,841**	3,742,957*	3,222,480*	**2,553,040**	3,324,909*	2,826,078
Net cash flow generated by operating activities	**2,692,005**	2,830,182	3,349,036	**2,115,204**	2,412,134	2,952,634
Cash flows for investing activities						
Investment in fixed assets	**(1,413,803)**	(1,353,916)	(1,320,668)	**(853,166)**	(876,038)	(936,329)
Proceeds from disposal of fixed assets	**86,492**	24,690	85,677	**7,742**	12,895	65,563
Proceeds from disposal of investment in affiliated companies	**–**	116,816	31,059	**–**	116,203*	31,059
Investment in long-term deposits and investments	**(159,564)**	(286,270)*	(1,140,616)*	**(150,808)**	(279,930)	(1,129,814)
Proceeds from long-term deposits and investments	**77,216**	159,745	38,217	**67,176**	149,614*	32,295
Increase in short-term investments, net	**(107,137)**	(754,311)	(250,558)	**(107,137)**	(769,565)	(255,978)
Decrease (increase) in materials and spare parts	**(260)**	22,769	51,094	**(260)**	22,769	51,094
Acquisition of a partnership consolidated for the first time (see C below)	**–**	(3,861)	–	**–**	–	–
Investment in investee companies	**(190,037)**	(359,517)	(547,310)	**(188,542)**	(472,414)	(819,451)
Investments in other assets	**(51,124)**	(126,328)	(204,651)	**–**	(8,824)	(5,840)
Net cash outflow used for investment activities	**(1,758,217)**	(2,560,183)	(3,257,756)	**(1,224,995)**	(2,105,290)*	(2,967,401)
Cash flows for financing activities						
Issue of other debentures (after deduction of issue expenses)	**–**	106,986	533,464	**–**	106,986	533,464
Repayment of other debentures	**(207,623)**	(221,386)	(236,446)	**(207,623)**	(221,386)	(236,446)
Receipt of long-term loans	**493,191**	207,332	767,060	**–**	–	452,995
Repayment of long-term loans	**(557,302)**	(826,605)	(1,081,745)	**(378,828)**	(619,755)*	(1,020,417)
Receipt (repayment) of short-term bank credit, net	**(374,137)**	75,938	(336,383)	**–**	–	
Proceeds from allotment of shares	**878,044**			**878,044**	–	–
Dividend paid	**(185,346)**	–	–	**(185,346)**	–	–
Net cash generated by (used for) financing activities	**46,827**	(657,735)	(354,050)	**106,247**	(734,155)*	(270,404)
Increase (decrease) in cash and cash equivalents	**980,615**	(387,736)	(262,770)	**996,456**	(427,311)	(285,171)
Cash and cash equivalents at beginning of year	**973,735**	1,361,471	1,624,241	**900,062**	1,327,373	1,612,544
Cash and cash equivalents at end of year	**1,954,350**	973,735	1,361,471	**1,896,518**	900,062	1,327,373

*Reclassified

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

Statements of Cash Flows for the Year Ended December 31 (contd.)

In terms of shekels of December 2003

	Consolidated			Company		
	2003	**2002**	**2001**	**2003**	**2002**	**2001**
	NIS thousands			NIS thousands		
A – Adjustments to reconcile net earnings (loss) to net cash flows generated by operating activities						
Revenues and expenses not involving cash flows:						
Depreciation	**2,160,011**	2,270,214*	2,713,053*	**1,776,279**	1,888,511	2,247,563
Disposal of assets and provision for impairment of fixed assets	**327,295**	–	106,605	**198,686**	–	–
Deferred taxes	**(137,670)**	30,149	(122,172)	**(182,167)**	63,829	(2,165)
Company's equity in losses of affiliated companies	**343,334**	353,616*	237,455*	**401,622**	338,622	515,982
Minority share in losses of a consolidated company	**(862)**	(3,007)	(6,499)	**–**	–	–
Increase (decrease) in employee severance benefits, net	**46,488**	(280,971)	(89,798)	**47,662**	(286,269)	(96,588)
Loss (gain) from disposal of fixed assets	**(1,634)**	(12,739)	(9,095)	**(1,570)**	(12,254)	2,615
Loss from disposal of investment in an affiliate	**–**	–	3,636	**–**	–	–
Provision for decrease in value of investments	**14,603**	1,219,566*	–*	**14,603**	1,219,566	–
Erosion (appreciation) of and interest on long-term deposits and investments	**36,407**	(204,341)*	(207,186)	**36,407**	(204,341)*	(207,186)
Erosion (appreciation) of short-term investments, net	**(75,381)**	56,916	(10,274)	**(75,378)**	55,509	(9,286)
Appreciation (erosion) of long-term liabilities:						
Other debentures	**207,133**	204,985	17,307	**207,133**	204,985	17,307
Long-term loans and other long-term liabilities	**(77,647)**	(13,380)	134,164	**(82,015)**	13,951	136,756
Amortization of deferred expenses and other adjustments	**127,191**	229,645*	256,554	**(8,466)**	11,444	4,444
Changes in asset and liability items:						
Decrease (increase) in trade receivables	**29,835**	29,422*	(432,872)*	**67,096**	97,636	(434,575)
Decrease (increase) in other receivables and debit balances	**129,706**	4,885	333,025	**163,158**	(27,828)*	300,103
Decrease (increase) in inventory	**78,083**	(44,803)	23,220	**–**	–	–
Increase (decrease) in trade payables	**(123,852)**	51,057	83,529	**(30,925)**	110,564	179,204
Increase (decrease) in other current liabilities	**63,054**	(131,416)	205,151	**45,460**	(123,727)	193,598
Decrease in deferred revenues	**(16,253)**	(16,841)	(13,323)	**(24,545)**	(25,289)	(21,694)
	3,129,841	3,742,957*	3,222,480*	**2,553,040**	3,324,909*	2,826,078

* Reclassified

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

Statements of Cash Flows for the Year Ended December 31 (contd.)

In terms of shekels of December 2003

	Consolidated			Company		
	2003	2002	2001	2003	2002	2001
	NIS thousands			NIS thousands		
B – Non–cash transactions						
Acquisition of fixed assets, other assets, materials and spare parts on credit	**313,119**	208,253	171,120	**180,463**	126,481	114,623
Sale of fixed assets on credit	–	5,800	–	–	5,800	–
Transfer of fixed assets in exchange for investment in a subsidiary	–	–	–	–	–	12,545
C – Affiliated partnership consolidated for the first time						
Operating capital (excluding cash and cash equivalents)		6,504				
Fixed assets		(6,018)				
Long-term liabilities		794				
Minority rights as at acquisition date		723				
Investment in an affiliate		1,066				
Goodwill		(6,930)				
		(3,861)				

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

NOTE 1 – GENERAL

A. "Bezeq" The Israel Telecommunication Corp. Limited (hereinafter – the Company) was until recently a government company. Towards the end of the reporting year the percentage of the State's holding in the Company decreased to 49.1% and accordingly, many of the provisions of the Government Companies Law, 5735-1975 ceased to apply to the Company. Nevertheless, certain provisions of that law continue to apply to the Company in its new status as a mixed company, as well as certain provisions which are similar to the provisions of that law, by virtue of the Company's Articles of Association. The Company operates under a general license for implementing telecommunications activities and providing telecommunications services pursuant to the Telecommunications Law (Telecommunications and broadcasts), 5742-1982. The Company's license, which was granted on March 1, 1994 (which replaced an earlier license and which was subsequently amended on various dates), sets out the terms under which the Company operates, and provides, *inter alia*, that the Company shall provide telephony, related services and infrastructure services. Under the terms of the license, the management of the subsidiaries is to be separate from the management of the Company, and the provision of a new service by the Company is contingent upon receipt of a license from the Minister of Communications. Additionally, limits were also imposed on the extent of the Company's financial exposure in projects undertaken outside Israel.

The Ministry of Communications submitted to the Company a draft amendment to its general license, which is intended to adapt the license, according to the Ministry of Communications, to a competitive environment. The Company submitted its objections and remarks to the Ministry of Communications, and is currently involved in a process of hearings on the matter. The Company's Management believes that certain provisions in the draft, if not amended, will restrict the Company in its operations and hinder its ability to compete. In addition, on February 5, 2004 the Government approved an amendment to the Telecommunications Order bringing it into line with an amendment to the decision on the privatization of the Company and amendments to the Telecommunications Law (to the extent required, the amendment will also be approved by the joint Economics, Foreign Affairs and Security Committee of the Knesset).

B. The Company's operations are supervised by the Government and most of the tariffs for its services are determined in accordance with Section 15 of the Telecommunications Law and are updated according to regulations.

Following recommendations of the committee for arrangement of the Company's tariffs, the Minister of Communications and Minister of Finance decided to adopt a new arrangement for the Company's tariffs. Accordingly, on August 5, 2003 the Knesset Finance Committee approved new regulations. Details of the changes in the Company's tariffs and how they are to be updated are as follows:

(1) Commencing on September 1, 2003, the overall average level of telecommunications tariffs was lowered compared with the level set at the date of the last tariff update (May 1, 2002) by an average of 5.97% in nominal terms, in an integrated process in which call tariffs were reduced by 23.84%, fixed fees were raised by 12.8% (fixed fees for minimum usage remained unchanged), and call completion fees in a telecommunications network and international interconnect fees were reduced by an average of 8.2%.

The lowering of call tariffs included cancellation of the minimum call tariff (which was 22.5 agorot, including VAT), setting a tariff of 13 agorot (including VAT) per call minute during peak hours and 5.5 agorot (including VAT) per call minute in off-peak hours.

(2) Tariff updates in the future will be based on the rise in the Consumer Price Index less an "efficiency coefficient" of minus 2.5% as long as Company's average output growth is in the range of minus 1% to minus 3% per year (the efficiency coefficient will decrease by one half of one percent with each decrease of 1% in the growth rate beyond minus 3%, and will increase by one half of one percent with each successive rise of one percent in the growth rate beyond minus 1%).

(3) This arrangement will remain in effect until December 31, 2007, with an option to extend it for a further year, where the date of the tariff update (after the first one) will be on June 1st of each year.

NOTE 1 – GENERAL (CONTD.)

The above changes in the Company's tariffs took effect on September 1, 2003 and led to a decrease in the revenues and operating income of the Company. The Company believes, based on its projections, that the above tariff reductions and the mechanism for updating them, can be expected to have a materially adverse effect on its revenues and operating income.

C. The Group companies are required to pay royalties to the Government of Israel. Commencing January 2001 the revenue base on which the royalties are calculated was broadened, together with a gradual reduction of the royalty percentage, until a uniform rate is attained for all communications operators. The rate of royalties in 2003 was 4%, and from 2004 onwards will be lowered to 3.5%.

D. In June 1995, the Commissioner of the Antitrust Authority declared the Company a monopoly in a number of areas: basic telephone service, communications infrastructure services, two–way unrestricted international telephone services, including the provision of international telephone service for incoming calls and relay transfer and transmission services for public broadcasting. In December 2000 the Antitrust Commissioner also declared the Company a monopoly in the field of telecommunications infrastructure for providing high–speed internet access services by means of internet providers. In April 2001 the Antitrust Commissioner cancelled the monopoly status of Bezeq International Ltd. in relation to the provision of international telephone services.

Two appeals filed by the Company are pending in the Antitrust Tribunal. One concerns non-cancellation of the Company's monopoly status in basic telephone services and the other concerns its declaration as a monopoly in telecommunications infrastructure for providing high-speed access services.

E. Below are the significant changes which have occurred in recent years in the various areas of telecommunications services in Israel which were formerly the exclusive domain of the Company.

(1) Cellular services

Cellular services are currently provided by four cellular communications providers (hereinafter – “the Operators”) of which one – Pelephone Communications Ltd. (a proportionally consolidated company) (hereinafter – “Pelephone”) – is 50% owned by the Company.

Commencing March 1, 2000, the Company introduced a new billing arrangement whereby the Company transferred to the Operators only the amounts it actually collected in respect of airtime, less a collection fee (in contrast to the previous arrangement, which was based on customer charges without deduction of a collection fee).

Following the objections of some of the Operators to the change in the arrangement, the Minister of Communications intervened in the matter several times. In its latest decision of July 2003, the Ministry of Communications gave notice of its decision as follows:

a. For to the period from October 2, 2000 through August 31, 2003, the Company will pay the Operators in full, irrespective of the amount collected, less 1.1%.

b. For the period from September 1, 2003 and thereafter, the Company will be required to transfer interconnect fees to the cellular companies according to actual traffic minutes, with no deduction of any kind. Based on the recommendation in the report of the Committee for Regulating Telecommunications Tariffs, this matter was reflected in the update of the Company's tariffs in September 2003, subject to receipt of the approvals required by law. (It should be noted that in accordance with the decision of the Ministers to approve the recommendations of the aforementioned committee, the additional revenues deriving to the Company in respect of their decision, compared with the recommendations of the committee, include the component of the bad debts).

NOTE 1 – GENERAL (CONTD.)

E. (1) CELLULAR SERVICES (CONTD.)

c. The Company appealed the Minister's decision in the District Court, alleging that the deduction rate set in the decision and its cancellation starting in September 2003, do not reflect the bad debts and collection expenses of the Company.

d. For the period from March 1, 2000 through October 1, 2000 – the Company and Partner agreed to abide by an arrangement proposed by the Supreme Court and the Ministry of Communications, whereby:

(1) The determination regarding the 1.1% deduction will apply also to the periods noted above.

(2) If and when the decision of the Minister is changed or amended by the Company's appeal against his decision, then the amended or changed decision will supersede the Minister's decision in all respects, including with regard to the period noted above.

The financial statements of the Company as at December 31, 2002 included a provision of approximately NIS 55 million in respect of the effects of the Minister of Communications' setting of the temporary deduction rate at 1.1% of the volume of traffic for the period starting October 2, 2000. The financial statements of the Company as at December 31, 2003 include a provision of approximately NIS 29 million in respect of the period from March 1, 2000 through October 1, 2000 for all the operators, based on the arrangement with Partner.

(2) International communication services

In July 1997, two additional companies started to provide international communication services. As a result, international call tariffs were significantly lowered, including those of Bezeq International Ltd. (a subsidiary) (hereinafter – "Bezeq International").

In September 2002 the Minister of Communications adopted the recommendation of the Committee for Formulation of a Policy and Rules for Opening Fixed-Line Domestic Communications to Competition (hereinafter – "the Kroll Committee") to postpone the broadening of competition in the international communications market until January 2004. In August 2003 the Ministry of Communications submitted to the existing operators a draft of regulations for conditions and proceedings for receipt of a general license for providing international telecommunication services. The draft determined, *inter alia*, that a license would not be granted to a corporation in which an interested party is an international operator, nor to a corporation which is a domestic operator, a cellular operator or a significant operator in the operation of international relay service sector (as defined in the draft regulations). In response to the draft regulations, Bezeq International notified the Ministry of Communications, *inter alia*, that it opposes the integration of the cellular operators in the international call market. The above regulations have not yet taken effect and their final form and effective date cannot be conjectured. In October 2003 the Ministry of Communications published a draft of the general license for providing international telecommunication services, and requested the response of the existing operators. Bezeq International informed the Ministry of Communications of its position on the matter. Bezeq International estimates that broadening the competition in the international communications market will lead to further lowering of international call prices. In addition, Bezeq International believes that broadening the competition can be expected to have a materially adverse effect on the results of its operations and on its financial position, but since the scope and conditions of the competition are still unknown, it is unable, at this stage, to estimate the extent of those effects.

NOTE 1 – GENERAL (CONTD.)

E. (CONTD.)

(3) Domestic communication services

In March 2002 the Ministry of Communications granted domestic operator licenses to the cable companies for providing broadband internet services on the cable infrastructure, and those licenses were subsequently broadened for providing data and transmission services, with certain restrictions. During 2002 the cable companies started to provide these services, and in 2003 they increased their marketing efforts for the service they provide, which competes with the broadband internet services provided by the Company. The application of the cable companies to merge was approved by the Antitrust Commissioner and by all the regulatory bodies. The matter is currently pending in the Antitrust Tribunal as part of an appeal filed by D.B.S. Satellite Services (1998) Ltd. (an affiliated company) (hereinafter – DBS).

In November 2003 a partnership owned by the cable companies was granted a general license for providing fixed-line domestic telecommunications services, including telephony, data communications and access to internet providers. This license replaced, *inter alia*, the licenses described above. The partnership is obligated to provide its services nationwide ("universal service").

Following adoption of the recommendations of the Kroll Committee, the Ministry of Communications amended the special licenses of Cellcom and MED-1 so as to permit them to provide high-speed data communication and transmission services for business customers, and later also to provide symmetric access services to internet providers, and broadened the licenses of the cable companies as described above. In addition, after adoption of the Kroll Committee recommendations, the Telecommunications Law was amended in June 2003 so that from September 2004, special general licenses for providing fixed-line domestic services would be able to be granted without the "universal service" requirement and without an obligation to provide services in a minimum number of areas.

As a result of the various changes in the communications market as described above, a significant deterioration has occurred in the business results of the Group. Further deterioration which cannot be estimated at this stage, is expected with the opening of domestic fixed-line communication services to full competition.

NOTE 2 – SIGNIFICANT ACCOUNTING PRINCIPLES AND REPORTING POLICIES

A. DEFINITIONS

In these financial statements –

(1) the Company – Bezeq, The Israel Telecommunication Corp. Limited.

(2) the Group - Bezeq, The Israel Telecommunication Corp. Limited and its investee companies, as listed in Appendix A – List of Group Companies.

(3) Subsidiaries – Companies, including a partnership or joint venture, whose financial statements are fully consolidated, directly or indirectly, with the financial statements of the Company.

(4) Proportionately consolidated companies – Companies, including a partnership or joint venture, whose financial statements are partially (proportionately) consolidated, directly or indirectly, with the financial statements of the Company.

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

A. DEFINITIONS (CONTD.)

(5) Affiliated companies – Companies other than subsidiaries or proportionately consolidated companies and including a partnership, the Corporation's investment in which is stated, directly or indirectly, on the equity basis.

(6) Investee companies – Subsidiaries, proportionately consolidated companies or affiliated companies.

(7) Investments in venture capital funds – Investment in a fund in which two conditions prevail:
   a. The principal occupation of the fund is research, development or marketing of innovative and high-tech products or processes;
   b. The source of at least 90% of the fund's financing is shareholder capital (including shareholder loans and credit guaranteed by the shareholders), with the support of State authorities or research grants.

(8) Related parties – As defined in Opinion No. 29 of the Institute of Certified Public Accountants in Israel (hereinafter – "ICPAI").

(9) Interested parties – As defined in Paragraph (1) of the definition of "Interested Party" in a corporation in Section 1 of the Securities Law.

(10) Controlling interest – As defined in the Securities Regulations (Presentation of transactions between a company and its controlling interest in financial statements), 5756-1996.

(11) CPI – The Consumer Price Index published by the Central Bureau for Statistics.

B. FINANCIAL STATEMENTS IN ADJUSTED VALUES

(1) The Company prepares its financial statements on the basis of historical cost adjusted for the effect of changes in the general purchasing power of the Israeli currency (data on the Company in nominal values appear in Note 30).

(2) The adjusted value of non–monetary assets does not necessarily reflect their market or economic value, but rather, their cost adjusted for the effect of the changes in the general purchasing power of the shekel.

(3) The term "cost" as used in the adjusted statements means adjusted cost.

(4) All the comparative figures for preceding periods (including those of monetary items) have been adjusted to the CPI of the end of the current reporting period.

C. PRINCIPLES OF ADJUSTMENT

(1) Balance sheet
Non-monetary items (mainly fixed assets, materials and spare parts, investments stated at cost, and capital) have been adjusted on the basis of the changes in the CPI from the index in respect of the month in which the item was acquired or arose, to the index in respect of the balance sheet month.
Monetary assets are stated in the adjusted balance sheet at their nominal value at that date.
The net asset value of the investments in investee companies is determined on the basis of the adjusted financial statements of those companies.

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

C. PRINCIPLES OF ADJUSTMENT (CONTD.)

(2) Statement of operations

Operational items were adjusted according to changes in the CPI as follows:

a. Income and expenses deriving from non-monetary items (such as depreciation, amortization, changes in materials and spare parts, prepaid expenses, prepaid income, etc.) or from provisions included in the balance sheet (such as for vacation pay, employee vacation expense allowance, etc.), were adjusted on the basis of the same specific indices as were applied to the related balance sheet items.

b. Other statement of operations items (such as sales, purchases, current production costs, etc.), other than the components of the financing item, were adjusted on the basis of the CPI from the date of receipt of payment or making payment, through the index in respect of the balance sheet month.

c. The Company's equity in operating results of investee companies and the minority share in the results of operations of subsidiaries, were included on the basis of the adjusted financial statements of those companies.

d. The financing item reflects finance income and expenses in real terms, erosion of monetary items during the year, earnings and losses from the disposal and revaluation of marketable securities, and earnings and losses from derivatives.

e. Income tax:
Current income tax expense comprises advance payments made during the year plus amounts payable (or less amounts refundable) at the balance sheet date. The advance payments were adjusted on the basis of the CPI at the time of making each payment, while the amounts payable (or refundable) were not adjusted. Therefore, the current income tax expense also includes the expenses deriving from erosion in value of the advance tax payments from the date of payment until the balance sheet date.
Deferred taxes – see section P below and Note 11D.

(3) Statement of changes in shareholders' equity

a. A dividend that was declared and actually paid during the reporting year was adjusted on the basis of the CPI at date of payment. A dividend that was declared/proposed in the reporting year but had not been distributed by the balance sheet date is stated unadjusted. The amount stated as "Erosion of value of a dividend declared/proposed in the preceding year" was actually paid in the current account year.

b. Amounts of capital and reserves created from retained earnings reflect capitalized real earnings.

D. CONSOLIDATION OF THE FINANCIAL STATEMENTS

(1) The consolidated financial statements include the financial statements of the Company and of those companies over which the Company has control. Jointly controlled companies are consolidated by the proportionate consolidation method.

(2) A list of the companies whose financial statements were included in the consolidated financial statements, the percentage of the holding of shares granting voting rights and the percentage of the holding of shares granting a share in profits, are included in Appendix A to the financial statements. In addition, a list of companies of the corporation which were not consolidated appears in the appendix to the financial statements.

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

D. CONSOLIDATION OF THE FINANCIAL STATEMENTS (CONTD.)

(3) For the purpose of the consolidation, the amounts appearing in the financial statements of the companies which were consolidated were taken after adjustments required in order to apply uniform accounting policies used by the Group.

(4) a. The excess cost of the investment over the fair value of its identified assets less the fair value of identified liabilities (after the attribution of taxes deriving from temporary differences) at the date of acquisition, is recorded as goodwill.

b. Excess cost attributed to assets and liabilities is recorded under the relevant items in the balance sheet.

(5) Goodwill is presented in the consolidated balance sheet under "Other assets and deferred charges" and is amortized in equal annual installments over ten years, commencing in the year of acquisition.

(6) Material inter-company balances and transactions between subsidiaries were eliminated. Earnings from inter-company sales not yet realized outside the Group, were also eliminated.

(7) a. The consolidated financial statements include the proportional part of the items of the assets, liabilities, expenses and revenues of the proportionately consolidated companies according to the percentage of the holding in those companies.

b. Earnings from the sales of the holding company to proportionately consolidated companies not yet realized outside the Group – were eliminated at a rate proportional to the holding.

c. Earnings from the sales of the proportionately consolidated companies to the holding company, not yet realized outside the Group – were eliminated at the full share of the earnings relating to the holding company.

E. USE OF ESTIMATES

Preparation of the financial statements in conformity with generally accepted accounting principles requires management to make estimates and assumptions which affect the reported amounts of assets and liabilities and disclosure relating to contingent assets and liabilities, as well as amounts of revenues and expenses for the reporting period. Actual results may differ from these estimates.

F. CASH AND CASH EQUIVALENTS

Cash and cash equivalents include short-term bank deposits and marketable government bonds with an original maturity at the time of making the investment that did not exceed three months.

G. SECURITIES

(1) Marketable securities
Marketable securities held for the short-term as a current investment are stated at the realizable value on the stock exchange at the balance sheet date. The changes in the values of securities are charged to the statement of operations in full. Marketable securities held as a permanent investment are stated at cost (regarding debentures – including accrued interest and linkage differentials and amortized premium and discount), less a provision for reduction in value of a non-temporary nature (see also section G(3) below).

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

G. SECURITIES (CONTD.)

(2) Non-marketable securities
Non-marketable securities are presented at cost (regarding debentures – including accrued interest and linkage differentials and amortized premium and discount) which, in the opinion of management, does not exceed the realizable value (see also paragraph G(3) below).

(3) Decrease in value of investments
The Company periodically checks to see whether a non-temporary decrease has occurred in the value of its permanent investments. The review is carried out upon the existence of signs indicating that the value of permanent investments has been impaired, including falling stock exchange prices, the business of the investee, the sector in which the investee operates and other parameters. The deductions for adjusting the value of these investments, which management estimates is based on examination of all the relevant aspects and giving them their proper weight, and which are not of a temporary nature, are recorded in the statement of operations.

H. PROVISION FOR DOUBTFUL DEBTS

The financial statements include specific provisions for doubtful debts which, in the opinion of management, properly reflect the loss inherent in debts, the collection of which is considered doubtful. In determining whether the provisions are appropriate, management considers, among other matters, the assessment of risk concerning the financial situation of the debtors as derived from the information in its possession, the scope of their operations, and the collateral they provided. Doubtful debts which management believes cannot be collected are written off in the Company's books following a management decision. Customer debts deposited at a discount in a bank against receipt of credit where the risk of collection was transferred in full to that bank, are removed in full from the books. The financial statements also contain a general provision in respect of doubtful debts.

I. INVENTORY

Inventory of subscriber equipment and user equipment is presented at the lower of cost or value to the business, where the cost is determined by the moving average method. BezeqCall Communications Ltd. (a subsidiary) (hereinafter – “BezeqCall Communications”) customarily reduces the value of slow stock items purchased in previous years. The amortization rate and the period that forms the basis for determining the need to record the amortization, were determined according to the assessments of the management of BezeqCall Communications.

As part of its current operations, Pelephone upgrades user equipment for its customers. As a result, inventory includes user equipment returned from customers, as well as spare parts which are used by Pelephone for the repair of user equipment in the framework of the repair service it provides for its customers.

J. MATERIALS AND SPARE PARTS

Materials and spare parts are valued at the lower of cost (which is determined by the moving average method) or market. Materials are intended primarily for use as components of fixed assets. The Company customarily reduces the value of slow materials and spare parts purchased in previous years.

K. INVESTMENTS IN AFFILIATED COMPANIES

(1) Investments in affiliates are accounted for by the equity method. In determining the equity of the investments in these companies, the amounts are taken into account as they are included in the financial statements of the companies, after adjustments necessitated by accepted accounting principles.

(2) On goodwill amortization policy – see D(5) above.

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

L. DECREASE IN VALUE OF INVESTMENTS IN INVESTEE AND NON–INVESTEE COMPANIES

Regarding decrease in value of investments in investee and non-investee companies, see G(3) above and Z below.

M. COMPANY INVESTMENT IN VENTURE CAPITAL FUNDS

(1) The Company's holdings in venture capital funds are presented at adjusted cost less a provision for decrease in value, if a decrease in value occurs which is not of a temporary nature.

(2) See also G(3) above.

N. FIXED ASSETS

(1) Fixed assets are stated at cost.

(2) The cost of an asset which the Company is constructing includes materials, subcontractors, wages and financing expenses in the construction period, but not exceeding their recoverable value.

(3) Improvements and enhancements are added to the cost of assets, while maintenance and repairs are charged to the statement of operations as incurred.

(4) In the event of a decrease in the value of assets to the business, a provision is recorded accordingly. Regarding provision for the impairment of assets, see Z below.

(5) Real financing expense for loans and credit used for financing the construction or purchase of fixed assets and other costs relating to the purchase or construction of the fixed assets, are attributed to the cost of those assets in accordance with Accounting Standard No. 3 – Capitalization of Credit Costs. (See also T below).

(6) Depreciation is calculated by the straight line method, based on the estimated useful lives of the assets.

Annual depreciation rates:

	% depreciation	Principal depreciation %
Buildings	4	4
Digital switching equipment	5-20	10
Transmission and power equipment	10-20	20
Network equipment	5-20	5
Subscriber equipment and public telephones	20	20
Motor vehicles	15	15
Office equipment	10-20	10
Computers	20-33	33
Cellular telephone infrastructure equipment	10-20	20

Improvements to leased premises are amortized over the term of the lease (including the Company's option to extend the lease period), which does not exceed the economic life of the asset.

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

N. FIXED ASSETS (CONTD.)

(7) Changes of estimates
In implementing its policy of periodically re-examining the useful lives of the assets, the Company appointed a committee in October 2001 to assess the need to revise those periods and to make recommendations to management. Based on the recommendations of the committee, starting from January 1, 2002 the balance of the useful life of certain investments in the Company's copper cable network was extended, while the balance of the useful life of certain switching systems was shortened.
The table below shows the effect of the above on the financial statements of the Company for 2002:

	Year ended December 31, 2002
	NIS thousands
Reduction in amortization expenses	254,142
Increase in net profit	162,886
Increase in profit per share	0.068

O. DEFERRED CHARGES AND OTHER ASSETS

(1) Cost of issue of debentures and raising loans
These costs (treated as a non–monetary item) are amortized over the term of the debentures, pro rata to the balance of the debentures in circulation.

(2) Cost of acquiring a subscriber
Since 1999, Pelephone has been capitalizing its net direct costs paid to a third party (hereinafter - "subscriber acquisition") in respect of a sale to subscribers who signed an undertaking to remain customers of Pelephone. Violation of the undertaking leads to payment of a penalty by the customer and the immediate charging of the amortization of the asset to the statement of operations. These costs are amortized throughout the period of the subscribers' undertaking, which is 36 months. Customer acquisition expenses incurred by Bezeq International in connection with recruiting customers from whom revenues are received over a period longer than one year, are amortized by the straight line method over the period of the contract with the customers (usually three years).

(3) Frequencies
For Pelephone's investment in cellular communication frequencies in third generation technology and its amortization, see Note 8D(4). The cost of the loans that are financing the investment in frequencies up to the date of completion of the network, is charged to the cost of the frequencies.

(4) Rights of representation of a communications corporation
The rights of representation of a communications corporation are amortized for the period of economic benefit over 10 years.

(5) Rights in channels
Rights in channels are amortized over the periods of use, which are 5 and 10 years.

(6) Acquisition of operations (resources)
a. The components of an operation acquired by BezeqCall Communications from Nortel Networks Israel (Sales & Marketing) Ltd. (hereinafter – "Nortel") are stated at cost and in accordance with the present value of the future long-term payments to Nortel (see Note 19B(5)).

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

O. DEFERRED EXPENSES AND OTHER ASSETS (CONTD.)

b. Acquisition of the operation is stated under other assets.

c. The cost of acquisition of the operations is amortized at actual realization of the relevant components, as well as at the estimated useful life of those components. The amortization period for the non-attributed part of the investment was set from January 1, 2003 for 6 years and 7 months. In the opinion of BezeqCall Communications' management, which relies on economic assessments and accumulated experience in the use of the acquired assets since their purchase, this period reflects a fair correspondence between investment amortization expenses and income attributed from the assets acquired.

d. BezeqCall Communications will regularly review the value of the components of the acquired operation, and in the event of a decrease in value will record a provision accordingly.

(7) For goodwill in respect of consolidated companies – see D(4) and D(5) above.

P. DEFERRED TAXES

The Group companies allocate taxes for temporary differences. Temporary differences are differences between the value of assets and liabilities for tax purposes and their book value in the balance sheet. Deferred tax balances (asset or liability) are calculated according to the tax rates which will be in effect at the time of utilization of the deferred taxes, or upon realization of tax benefits, based on the tax rates and tax laws enacted or the legislation of which is all but completed by the balance sheet date.

The main factors for which deferred taxes were not calculated are as follows:

(1) The amounts of the adjustment for changes in the purchasing power of the shekel which relate mainly to buildings and private cars, in accordance with the principles stated by the ICPAI.

(2) Investments in investee companies, since the Company intends to hold these investments and not to realize them.

(3) A tax receivable benefit in respect of temporary differences, where the likelihood of realizing the benefit is in doubt.

Q. CLASSIFICATION OF PROFIT AND LOSS ITEMS

Profit and loss items were classified and stated in the order dictated by the character of the Company's business as a telecommunications company.

R. INCOME RECOGNITION

(1) Income is attributed to the statement of operations upon being generated on the accrual basis.

(2) Income from sales of exchanges and business systems are charged upon completion of their installation on the customer's premises.

(3) Leasing of exchanges and other equipment is recorded proportionally over the term of the agreement, starting on the date of operation.

(4) Income from the development of telecommunications infrastructures is recorded upon completion of the work.

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

R. INCOME RECOGNITION (CONTD.)

(5) Income from sales of subscriber equipment is recorded upon delivery to the end user.

(6) Income from sales of subscriber equipment by installments is recorded at their present value upon delivery to the customer.

(7) Income from Pelephone services are recorded proportionally over the terms of the agreement or on the date of providing the service.

S. SUPPLIER DISCOUNTS

Current discounts from suppliers are included in the financial statements as received.

Discounts received from suppliers at the end of the year, for which the Company is not required to meet certain targets, are included in the financial statements upon making the proportional purchases that entitle the Company to those discounts.

T. CAPITALIZATION OF CREDIT COSTS

The Company capitalizes credit costs in accordance with Accounting Standard No. 3 – Capitalization of Credit Costs, which requires the capitalization of specific and non-specific credit and credit costs to qualified assets. Non-specific credit costs are capitalized to the investment or part thereof which was not financed by specific credit, at a rate which is the weighted average of the cost in respect of those credit resources whose cost was not specifically capitalized and in accordance with the Standard, credit costs attributed to assets under construction are capitalized until the date on which all significant activities required to prepare the assets for their intended use have been completed. See Note 9A.

U. EARNINGS PER SHARE

Earnings (loss) per share is calculated in accordance with Opinion No. 55 of the ICPAI.

V. SOFTWARE DEVELOPMENT COSTS

The accounting treatment of costs of development of software for internal use is determined according to the position paper of the American Institute of Certified Public Accountants – SOP 98-1: Accounting for the Costs of Computer Software Developed or Obtained for Internal Use. The costs of development of software for internal use are capitalized after completion of the preliminary design stage, the project is expected to be completed and the software will be used for its designated purpose. The capitalization is halted when the software is more or less completed and ready for its designated use. Capitalized software development costs are amortized by the straight line method according to the estimated useful life of the software.

W. FOREIGN CURRENCY AND LINKAGE

Assets (excluding securities) and liabilities denominated in or linked to a foreign currency are stated at the representative exchange rates published by the Bank of Israel on the balance sheet date.
Assets (excluding securities) and liabilities linked to the CPI are stated on the basis of the linkage terms of each balance.

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

W. FOREIGN CURRENCY AND LINKAGE (CONTD.)

Details of the CPI (2000 basis) and foreign currency exchange rates are as follows:

	Consumer Price Index	Exchange rate of the US dollar	Exchange rate of the euro	Consumer Price Index	Exchange rate of the US dollar	Exchange rate of the euro
				%	%	%
Year ended December 31, 2003	**106.2**	**4.379**	**5.533**	**(1.848)**	**(7.557)**	**17.824**
Year ended December 31, 2002	108.2	4.737	4.969	6.496	7.269	27.182
Year ended December 31, 2001	101.6	4.416	3.907	1.397	9.279	3.827

X. DERIVATIVES

(1) The result of derivatives held for hedging of existing assets and liabilities are attributed to the statement of operations in parallel with the accounting treatment of the result of the hedged item.

(2) Derivatives not designated for hedging are presented in the balance sheet at their fair value. Changes in the fair value are attributed to the financing item in the statement of operations in the period in which they occurred.

The fair value of derivatives is determined according to their market prices or to quotations from financial institutions.

Y. SEGMENTAL REPORTING

Segmental reporting is presented in accordance with Accounting Standard No. 11. See also Note 26.

Z. IMPAIRMENT OF ASSETS

The Group companies apply Accounting Standard No. 15 – Impairment of assets (hereinafter – “the Standard”), which defines procedures which the Company must apply in order to ensure that its assets in the consolidated balance sheet are nor stated in an amount exceeding their recoverable amount, which is the higher of net selling prices and usage value (the present value of the estimated future cash flows expected to derive from the use and disposal of the asset).

The Standard applies to all the assets of the consolidated balance sheet except tax assets and monetary assets (excluding monetary assets which are investments in investee companies that are not subsidiaries). The Standard also lays down the rules of presentation and disclosure for assets whose value has been impaired. Where the value of an asset in the consolidated balance sheet exceeds its recoverable amount, the Company recognizes a loss from impairment in the amount of the difference between the book value of the asset and its recoverable amount. The loss so recognized will be cancelled only if changes occur in the estimates that were used to determine the recoverable amount of the asset, from the date on which the last loss from impairment was recognized.

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

Z. IMPAIRMENT OF ASSETS (CONTD.)

In September 2003 the Israel Accounting Standards Board published Clarification Number 1 concerning the accounting treatment of an impairment of an investment in an investee company which is not a subsidiary (hereinafter – "the Clarification"). The Clarification states that in the reporting periods subsequent to the period in which the provision for impairment was first created in respect of an investee company which is not a subsidiary, the investment in the investee company should be stated according to the lower of the recoverable amount and the investment account according to the equity method, where the recoverable amount is calculated in each reporting period in which there are signs indicating that a change has occurred in the recoverable amount. Losses from the impairment of an investment in an investee company that is not a subsidiary, which were recognized or cancelled during the period, are included in the Company's equity in profits (losses) of investee companies item.

Until December 31, 2002, the Group's companies considered the need to record a provision for impairment of assets according to international accounting standards which are similar to the provisions of Standard 15.

AA. DISCLOSURE OF THE EFFECT OF ACCOUNTING STANDARDS IN THE PERIOD PRIOR TO THEIR APPLICATION

In October 2001 the Israeli Accounting Standards Board (IASB) published the following standards:

(1) Accounting Standard No. 12 – Discontinuance of Adjustment of Financial Statements. This standard provides for the discontinuance of the adjustment of financial statements for the effects of changes in the general purchasing power of the shekel, commencing January 1, 2003.
In December 2002, the IASB published Standard No. 17, postponing the commencement of the application of Standard No. 12 to January 1, 2004. Accordingly, the adjustment of the financial statements will end on that date. Until December 31, 2003 the Company will continue to prepare statements adjusted in accordance with Opinion No. 36 of the ICPAI. The adjusted amounts included in the financial statements as at December 31, 2003 will serve as the starting point for the nominal reporting which will commence on January 1, 2004. Implementation of Standard No. 12 is liable to have material implications for the reported business results of the Company, the extent of which depends on the rate of inflation, the composition of assets and the Company's financing sources.

(2) Accounting Standard No. 13 – Effect of Changes in Foreign Currency Exchange Rates. The standard deals with the translation of foreign currency transactions and the translation of the financial statements of overseas operations for integration in the financial statements of the reporting corporation. Implementation of Standard 13 has no effect on the financial statements.

(3) In March 2004 the IASB published Standard No. 20, concerning the period of amortization of goodwill (hereinafter – "the Standard"). The Standard states that goodwill will be amortized over its useful life by the straight line method. The amortization period should reflect the best estimate of the period in which future economic benefits are expected to derive from the goodwill The amortization period will not exceed 20 years from the date of first recognition. The Standard will apply to financial statements for periods starting on January 1, 2004 or thereafter. The change in the amortization period of goodwill balances as at January 1, 2004 will be treated as a prospective change of estimate ("from now on"). These goodwill balances will be amortized by the straight line method during the balance of the period remaining for completion of the amortization period determined. The Company is studying the implications of the new Standard but is unable, at this stage, to estimate the effects of the Standard on the financial statements.

NOTE 3 – CASH AND CASH EQUIVALENTS

	Consolidated		Company	
	December 31 2003	December 31 2002	December 31 2003	December 31 2002
	NIS thousands	NIS thousands	NIS thousands	NIS thousands
Israeli currency	**1,913,373**	945,671	**1,891,995**	896,047
Foreign currency	**40,977**	28,064	**4,523**	4,015
	1,954,350	973,735	**1,896,518**	900,062

NOTE 4 – SHORT-TERM INVESTMENTS

	Consolidated		Company	
	December 31 2003	December 31 2002	December 31 2003	December 31 2002
	NIS thousands	NIS thousands	NIS thousands	NIS thousands
Marketable securities:				
Government debentures				
Linked to the CPI	**599,819**	702,243	**599,819**	702,243
Linked to the U.S. dollar exchange rate	**23,605**	17,606	**23,605**	17,606
Unlinked	**167,498**	113,030	**167,498**	113,030
Debentures convertible to shares	**28,514**	17,366	**28,514**	17,366
Other debentures	**244,686**	184,007	**244,686**	184,007
Mutual fund participation certificates	**128,875**	108,764	**128,875**	108,764
	1,192,997	1,143,016	**1,192,997**	1,143,016
Short-term bank deposits:				
Linked to the CPI	**130,850**	–	**130,850**	–
Unlinked	**16,494**	14,807	**16,401**	14,717
	1,340,341	1,157,823	**1,340,248**	1,157,733

NOTE 5 – TRADE RECEIVABLES

	Consolidated		Company	
	December 31 2003	December 31 2002	December 31 2003	December 31 2002
	NIS thousands	NIS thousands	NIS thousands	NIS thousands
For domestic services:				
On open account	**1,407,667**	1,452,094*	**829,882**	905,358*
Income receivable	**282,101**	311,378	**205,767**	242,096
Credit cards and checks payable	**273,289**	238,995	**154,286**	126,106
Investee companies	**19,886**	13,976*	**31,629**	18,065*
For international services	**42,751**	31,741	**14,288**	10,159
	2,025,694	2,048,184	**1,235,852**	1,301,784
Less provision for doubtful debts	**358,071**	329,241*	**214,585**	196,671*
	1,667,623	1,718,943	**1,021,267**	1,105,113*

* Reclassified

NOTE 6 – OTHER RECEIVABLES AND DEBIT BALANCES

	Consolidated		Company	
	December 31 2003	December 31 2002	December 31 2003	December 31 2002
	NIS thousands	NIS thousands	NIS thousands	NIS thousands
Deferred tax asset (see Note 11D)	**208,797**	199,006	**170,213**	196,958
Income tax refundable	**13,254**	89,472	**14,561**	82,878
Prepaid expenses	**49,091**	38,638	**28,866**	24,388
Receivables in respect of derivatives	**114,372**	152,828	**113,867**	152,828
Other receivables and debit balances	**29,858**	25,103	**36,452**	10,750
	415,372	505,047	**363,959**	467,802

NOTE 7 – INVESTMENTS, DEPOSITS AND DEBIT BALANCES

	Consolidated		Company	
	December 31 2003	December 31 2002	December 31 2003	December 31 2002
	NIS thousands	NIS thousands	NIS thousands	NIS thousands
Investment in companies that are not investee companies:				
Investments in shares	**48,389**	56,347	**48,389**	56,347
Other investments (1)	**352,011**	239,164	**352,011**	239,164
Bank deposit for granting loans to employees (2)	**211,078**	211,864	**211,078**	211,864
Investment in venture capital funds	**19,769**	26,151	**19,769**	26,151
Income tax refundable	**–**	98,114	**–**	98,114
Receivables in respect of derivatives	**23,153**	31,300	**23,153**	31,300
Long term trade receivables(3)	**111,571**	91,370	**–**	–
	765,971	754,310	**654,400**	662,940

(1) Other investments

a. Linkage and interest terms

	Interest rate	Consolidated and Company	
		December 31 2003	December 31 2002
	%	NIS thousands	
Convertible corporate bonds linked to the dollar	6 month LIBOR + 3.4	**30,653**	32,534
	3 month LIBOR + 1.65	**30,653**	32,534
	3 month LIBOR + 1.75	**–**	32,534
Investments in fund – euro investments*	–	**33,199**	–
CPI-linked investments:			
Capital notes:	5.8 - 5.9	**109,860**	–
Galil CPI-linked convertible bonds **	4	**78,368**	77,643
Matrix ET Ltd. ***	4.95	**49,278**	44,296
Unlinked deposit	Variable 14.5	**20,000**	19,623
		352,011	239,164

NOTE 7 – INVESTMENTS, DEPOSITS AND DEBIT BALANCES (CONTD.)

(1) Other investments (CONTD.)

* In September 2003 the Company invested approximately 6 million euro in a security issued by Deutsche Bank. The security was issued on August 21, 2003 and matures on August 31, 2010. The security is 90% hedged from the investment fund. The yield is contingent on the performance of a solid fund that invests in hedging funds of liquid investments. The security bears no interest.

** In May 2002 the Company purchased convertible corporate bonds in a total amount of approximately NIS 77.4 million. The bonds are repayable in a single lump sum on August 31, 2011.

*** In August 2002 the Company purchased convertible debentures of Matrix ET Ltd. (hereinafter – “Matrix”) for a total amount of approximately NIS 43.57 million. The purchase was made in accordance with a prospectus issued at the Tel Aviv Stock Exchange as part of an issue by Matrix. The debentures are linked to the CPI and are repayable in a lump sum on August 5, 2005.

The Debentures are convertible from the first day of trading on the stock exchange until July 17, 2005, at a conversion rate of 1 : 9.

b. Repayment dates

	NIS thousands
2005	69,278
2006	–
2007	61,306
2008	–
2009 and thereafter	221,427
	352,011

(2) The deposit is unlinked and the average weighted monthly interest rate is approximately 0.33%. The Company is responsible for the loans to the employees. Withdrawal of the deposit is contingent upon repayment of the loans.

(3) Long-term receivables

a. Linkage and interest terms

	Interest rate	Consolidated December 31 2003	Consolidated December 31 2002
	%	NIS thousands	
CPI linked	7.5	**12,003**	13,288
Unlinked	8.6	**99,568**	78,082
		111,571	91,370

b. Repayment dates

	NIS thousands
2005	49,747
2006	39,754
2007	19,911
2008 and thereafter	2,159
	111,571

NOTE 7 – INVESTMENTS, DEPOSITS AND DEBIT BALANCES (CONTD.)

c. The balance of long-term receivables is presented net of deferred interest income which constitutes the difference between the amount of the original debt and its present value on the day of recognition of the revenue and after deducting a provision for doubtful debts.

d. In 2003, Pelephone made transactions with credit companies, constituting the final clearance of the liability of the credit companies towards Pelephone. In total, receivables amounting to NIS 262 million were deducted, the present value of which was NIS 230 million (in proportional consolidation NIS 131 million and NIS 115 million respectively). In 2002, receivable balances of NIS 39 million were advanced to Pelephone, the present value of which was NIS 36 million (in proportional consolidation approximately NIS 20 million and NIS 18 million respectively).

NOTE 8 – INVESTMENTS IN INVESTEE COMPANIES

A. COMPOSITION:

	Consolidated		Company	
	December 31 2003	December 31 2002*	December 31 2003	December 31 2002*
	NIS thousands	NIS thousands	NIS thousands	NIS thousands
Affiliated companies				
Shares – cost	**137,170**	123,654	**64,085**	50,974
Long-term loans (1)	**1,270,587**	1,083,885	**1,248,544**	1,066,795
Post–acquisition losses	**(1,052,937)**	(780,438)	**(990,673)**	(723,539)
Increase in the rate of holding – a partnership consolidated for the first time	**–**	(1,066)	**–**	(1,066)
Provision for impairment in respect of an affiliated company (2)	**(59,196)**	(21,108)	**(38,078)**	–
Amortization of goodwill	**(54,957)**	(22,210)	**(54,690)**	(22,030)
	240,667	382,717	**229,188**	371,134
Consolidated companies				
Shares – cost			**430,646**	424,304
Loans			**168,262**	168,350
Increase in the rate of holding – a partnership consolidated for the first time			**–**	1,066
Post–acquisition losses			**(251,480)**	(181,640)
Provision for impairment			**(4,716)**	–
Amortization of goodwill			**(1,074)**	(42)
			341,638	412,038
Proportionally consolidated company				
Shares – cost			**503,903**	503,903
Post-acquisition earnings			**395,228**	383,390
Amortization of surplus equity over cost charged to fixed assets			**39,144**	39,144
			938,275	926,437
			1,509,101	1,709,609

* Reclassified

(1) Loan balances of approximately NIS 170 million linked to the CPI ("known"), bearing 5.5% annual interest and for which no repayment date has yet been set (preferred loans – see also E below).
Loan balances of approximately NIS 110 million linked to the CPI ("known"), bearing annual interest of approximately 11%, for which no repayment date has yet been set (preferred loans – see also E below).
Loan balances of Pelephone amounting to approximately NIS 4.5 million, bearing annual interest at Prime less 0.3% and for which no repayment date has yet been set.

NOTE 8 – INVESTMENTS IN INVESTEE COMPANIES (CONTD.)

A. COMPOSITION: (CONTD.)

Loan balances of Pelephone amounting to approximately NIS 3.6 million linked to the CPI and bearing 7.5% annual interest and for which no repayment date has yet been set.
Loan balances of Bezeq International to Walla Communications Ltd. (a listed affiliate) (hereinafter – “Walla”) amounting to approximately NIS 14 million, linked to the CPI and interest-free. The loans will be repaid on a date soon after the date on which Bezeq International invests in Walla.
The loan balances are linked to the CPI ("known"), bear no interest and no repayment date has yet been set.

(2) See E and G below.

The market value of an affiliated company listed on the stock exchange as at December 31, 2003, is approximately NIS 23.3 million (book value NIS 12.7 million).

	Consolidated		Company	
	December 31 2003	December 31 2002	December 31 2003	December 31 2002
	NIS thousands	NIS thousands	NIS thousands	NIS thousands
Balance of goodwill not yet fully amortized	**347,046**	256,055	**352,831**	256,055

A list of the companies in the Group appears in an appendix to the financial statements.

B. INVESTMENT ACTIVITY IN 2003 IS AS FOLLOWS:

	Consolidated	Company
	NIS thousands	NIS thousands
Balance as at the beginning of the year	**382,717**	**1,709,609**
Activity during the year:		
Investment in shares	**14,582**	**19,453**
Investment in loans	**175,455**	**169,089**
Erosion in respect of loans	**11,247**	**12,572**
Equity in losses of affiliates	**(343,334)**	**(401,622)**
Balance as at the end of the year	**240,667**	**1,509,101**

C. SUMMARY OF COMPANY EQUITY IN ASSETS, LIABILITIES, INCOME AND EXPENSES OF A PROPORTIONATELLY CONSOLIDATED COMPANY, AS INCLUDED IN THE CONSOLIDATED STATEMENTS

	December 31 2003	December 31 2002
	NIS thousands	NIS thousands
Current assets	**594,577**	602,317
Other assets	**1,875,712**	1,888,402
Current liabilities	**838,626**	956,744
Long-term liabilities	**693,388**	543,720

NOTE 8 – INVESTMENTS IN INVESTEE COMPANIES (CONTD.)

C. SUMMARY OF COMPANY EQUITY IN ASSETS, LIABILITIES, INCOME AND EXPENSES OF A PROPORTIONATELLY CONSOLIDATED COMPANY, AS INCLUDED IN THE CONSOLIDATED STATEMENTS (CONTD.)

	For the year ended December 31		
	2003	2002	2001
	NIS thousands	NIS thousands	NIS thousands
Revenues	**1,899,709**	1,823,267	1,894,147
Costs and expenses	**1,803,052**	1,885,295	1,943,869

D. PELEPHONE COMMUNICATIONS LTD. ("PELEPHONE")

(1) In September 2000 a notice was received from Motorola Israel Ltd. ("Motorola"), informing the Company of negotiations between Motorola and a third party for the sale of its holdings in Pelephone. Under the Pelephone shareholders' agreement, if one party to the agreement wishes to sell its shares in Pelephone, it must offer them to the other party and the other party is entitled, *inter alia*, to propose an alternative offeree to buy the shares. At its meeting on November 22, 2000, the Board of Directors of the Company selected Shamrock Holdings of California, Inc. ("Shamrock") as the alternative offeree to purchase the shares of the Pelephone shareholder and sign an option agreement with the Company. The share purchase transaction was subsequently made by a corporation registered in the U.S.A. (hereinafter – "the Corporation") indirectly owned by Shamrock.

On February 27, 2001, after approval by the Ministry of Communications and the Antitrust Commissioner, the transaction was closed. The main points of the transaction are as follows :

a. Motorola's shares in Pelephone were transferred to the Corporation for a consideration of approximately $591 million. The consideration was partially financed by a loan of $240 million extended by the Company, for which it received debentures linked to the U.S. dollar exchange rate, bearing interest (LIBOR), which are repayable by redemption or constitute part of the converted amount and are convertible for up to four years, for 80% of the shares of the Corporation.

b. The Company was given a call option to purchase the remaining 20% of the share capital of the Corporation together with conversion of the debentures to shares as aforesaid. In the event of conversion of the debentures to shares the Company must exercise the aforementioned option.

c. The Company can exercise the options within six months of the date of purchase of the shares ("the Short Option"), or starting from the end of 24 months from the date of purchase of the shares until the elapse of four years from the date of the purchase ("the Long Option"). In addition, an "alternative period" was set, starting on the date on which the Company ceases to be a government company and expiring nine months thereafter, during which the Company must give notice of its wish to exercise the option. The Company was given three months from the date of the notice of exercise, to obtain all the requisite permits.

d. The exercise price of the option is the higher of the return of the nominal investment of the alternative offeree (about $60 million) or a market valuation of the 20% of the shares of the Corporation (which holds 50% of Pelephone's shares) according to the mechanism in the option agreement.

NOTE 8 – INVESTMENTS IN INVESTEE COMPANIES (CONTD.)

D. PELEPHONE (CONTD.)

(2) Following various indications of a decrease in the value of Pelephone and various valuations of Pelephone received during 2002, indicating that the value of Pelephone was between $650 million and $850 million, the Company wrote off its investment in the above debentures in the year 2002, since the bank financing obtained by Shamrock for purchasing the Pelephone shares (approximately $380 million, including interest) is secured by a first-ranking lien and no available balance remained for repayment of the debentures issued to the Company by Shamrock.

The write-down was included in the “other expenses, net” item, and as a result, the net earnings in 2002 decreased by approximately NIS 1.2 billion.

Updates of the valuation of Pelephone received in 2003 and a new valuation made in March 2004 indicate an increase in its value to between $950 million and $1,150 million. In view of the uncertainty as to the continued existence over time of the factors that led to this valuation, no change has been made, at this stage, in the provision for decrease in value recorded in 2002. The Company will re-examine the value of Pelephone at a later date.

(3) On November 18, 2003 the Company ceased to be a government company, which triggered the start of the "alternative period" during which the Company may give notice of exercise of the option. This period will end on August 17, 2004. If the Company does not give notice by that date of its wish to exercise the option, the option will expire. Since exercise of the option is still subject to the approval of the Government, the Minister of Communications and the Antitrust Commissioner, the management of the Company approached the Government Companies Authority, the Minister of Communications and the Antitrust Commissioner and requested clarification of their position on the matter. On February 26, 2004 the Board of Directors of the Company resolved to approve exercise of the option to acquire Pelephone.

(4) On December 18, 2001, the Minister of Communications notified Pelephone that it had won a tender for an additional band of frequencies (2000MHz) which it would use for cellular communications. Following the award of the tender, Pelephone's existing license was amended so as to extend its term until 2022. The grant of the frequencies was made contingent upon preconditions that include, *inter alia*, payment of NIS 225 million (NIS 112.5 million in proportional consolidation) (plus Accountant General's interest except for the first payment, which is linked to the CPI) for the new frequency ranges, and a guarantee of $20 million (proportionally consolidated – $10 million) to guarantee the terms of the license. The payment determined at the award is to be paid in six installments on various dates through 2006. On the contract for purchase of the frequencies, see also Note 19B(6).

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

At the beginning of May 2002 the Company was allotted additional shares in DBS, so that its holdings in DBS increased to 44.9%, and in August 2003 additional shares were allotted to the Company by DBS, so that the Company's holdings increased to approximately 49.8%. As a result, an excess cost of approximately NIS 391 million was generated to the Company. Regarding amortization of the surplus cost, see Note 2D(5) and Note 2AA(3).

NOTE 8 – INVESTMENTS IN AFFILIATED COMPANIES (CONTD.)

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

In January 1999 DBS received a license from the Ministry of Communications for satellite television broadcasts and commenced provision of services in July 2000. DBS suffers from considerable losses and negative cash flows. Its loss for 2003 amounts to approximately NIS 555 million and its negative operating cash flows from current activities amounts to approximately NIS 3 million. As a result of these losses and the structure of the bank credit, the capital deficit and working capital deficit of DBS amount to approximately NIS 2,806 million and NIS 1,755 million respectively. The working capital deficit includes bank credit amounting to NIS 1,305 million.

The Company's investment in DBS (mainly shareholders' loans) as at the balance sheet date was approximately NIS 1,191 million. The Company's share in the accumulated losses of DBS is approximately NIS 1,051 million, of which approximately NIS 286 million was recorded in the current year. The balance of DBS's current debt to the Company and its consolidated companies amounts to approximately NIS 65 million.

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

On December 30, 2002, DBS, its shareholders and the Banks signed an agreement increasing the credit line from the Banks (hereinafter – "the Interim Credit Line"), which will be implemented concurrently with additional investments of the shareholders of not less than a sum equal to 150% of the amount to be injected by the Banks. Receipt of the Interim Credit Line was subject, *inter alia*, to DBS meeting the financial and operative conditions prescribed in this agreement.

As at the date of approval of these financial statements, the shareholders and the Banks had transferred to DBS their full part in the Interim Credit Line. However, some of the conditions laid down in the Financing Agreement and the Interim Credit Line are not being met.
At the time of signing as aforesaid, the parties also negotiated an increase in the Interim Credit Line in the framework of an amendment to the Financing Agreement (hereinafter – "the Amendment Agreement").

An economic examination carried out by the Banks in March 2003 reveals that the overall financing needs of DBS do not exceed the Interim Credit Line plus the addition to the Interim Credit Line covered by the Amendment Agreement (including the proportional part of the shareholders). On August 6, 2003 the Amendment Agreement was signed by the Banks and DBS. Under the Amendment Agreement, the Banks will make amounts available to DBS, additional to those made available under the Financing Agreement and the Interim Credit Line, subject to DBS meeting the terms and milestones prescribed in the Amendment Agreement, including further investments by the shareholders of not less than 150% of the amounts made available by the Banks. The Amendment Agreement took effect in December 2003. As at the date of approval of these financial statements, DBS is not in compliance with some of the conditions prescribed in the Amendment Agreement. In accordance with the Amendment Agreement, in February 2004 DBS converted short-term credit to long-term loans. Some of the loans are linked to the CPI and some are unlinked, and bear interest of between 6% and 7.5%. The loans will be repaid over a period of 8 years in accordance with a repayment schedule that will be set on December 31, 2005.

NOTE 8 – INVESTMENTS IN AFFILIATED COMPANIES (CONTD.)

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

The grant of additional loans by the Company to DBS required (as long as the Company was a government company), *inter alia*, the approval of the Ministerial Committee for Privatization (hereinafter – "the Committee"), by virtue of the conditions laid down by the Committee in the approval it gave to the Company to invest in DBS. On January 14, 2003, the Committee approved an increase in the Company's investment in DBS up to the amount of the product of the percentage of its holding in DBS shares multiplied by $600 million, up to an exposure ceiling of $300 million. The management of DBS estimates that the total investments approved for the Company by the Committee cover the proportional part of the Company in the Interim Credit Line plus its proportional part in the Amendment Agreement.

The continued operation of DBS is contingent upon the receipt of additional loans from the shareholders as provided in the Amendment Agreement.

The management of DBS believes there is a good chance of arranging financial resources (including the shareholders' loans under the Amendment Agreement), that it will require in the coming year.

Under an agreement between DBS and its shareholders dated December 30, 2002, it was decided that the loans extended by the shareholders to DBS on July 10, 2002 (hereinafter – "the New Shareholders' Loans") would have priority over the shareholders' loans to DBS which were made earlier (hereinafter – "the Old Shareholders' Loans"). Under the agreement, the New Shareholders' Loans would be entitled to repayment in full by DBS before any distribution of dividends by DBS and/or the repayment of the Old Shareholders' Loans, subject to DBS's cash flow and its obligations under the agreements with the Banks (including the priority of repayment of the bank financing). The New Shareholders' Loans are linked to the CPI ("known") and bear annual interest of 5.5%. In addition, under the same agreement, the shareholders who invest in the New Shareholders' Loans are permitted to choose between an allotment of shares and options for shares deriving from their investments. The Old Shareholders' Loans are linked to the CPI ("known") and are interest-free. According to a note of amendment to that agreement, the New Shareholders' Loans made as a result of the Amendment Agreement will be linked to the "known" CPI and will bear interest at an annual rate of 11%. A change in the interest rate is subject to the consent of all the shareholders. No date was set for repayment of these loans.

The Company has signed a perpetual guarantee to the Banks for payment of DBS's debts. The guarantee is up to a maximum amount equal to the percentage of the Company's holding in DBS multiplied by the value of DBS as derives from disposal of the pledged shares of the remaining shareholders. If the Company joins the sale in the framework of disposing of the pledged shares of the remaining shareholders, the amount of the guarantee will not exceed the proceeds which the Company will receive from disposal of its shares in DBS. The deed of guarantee includes numerous restrictions on the Company with respect to disposing of its shares, and sets out violations which, if perpetrated, will enable the Banks to call in the guarantee.

A review commissioned by the Company from an economic consulting company of the business situation of DBS revealed that there is a negative difference between DBS's financial plans and its actual financing needs, which could be as much as NIS 360 million. The Company has asked DBS to study the report and propose a work plan that will resolve the problems raised in the report.

Following indications of a decrease in the value of DBS, *inter alia* as a result of DBS's failure to meet the targets set for it, the Company commissioned an update of the valuation of DBS which concluded that the estimated value of DBS to its shareholders is between minus $22 million and plus $88 million. In the opinion of management, the value of DBS is at least $57 million, taking into consideration the new business plan of DBS, the Company's tax shield and the advantages of the its potential strategies for DBS. Accordingly, no provision for a decrease in value is recorded in these financial statements.

NOTE 8 – INVESTMENTS IN AFFILIATED COMPANIES (CONTD.)

F. WALLA! COMMUNICATIONS LTD. ("WALLA")

Bezeq International invested in Walla, an Israeli company whose shares are listed on the Tel Aviv Stock Exchange and which provides internet services and operates internet portals. As at December 31, 2003, Bezeq International held 36.74% of the rights in Walla.

On December 31, 2000, Walla entered into an merger agreement with IOL Israel Online (2000) Ltd. ("IOL"). Following the merger, the percentage of Bezeq International's holding in Walla decreased from 38.5% to 24.8%, generating a loss of NIS 3,636 thousand which is included under the “other expenses” item in the statement of operations for the year ended December 31, 2001.

On March 14, 2002 Walla issued a prospectus for a rights issue. Bezeq International invested approximately NIS 10,975 thousand in exercise of the rights and approximately NIS 3,231 thousand in the purchase of additional rights from the public and exercise thereof. After exercise of the rights, the purchase from the public and the acquisition of additional shares in Walla from a shareholder during 2002, Bezeq International's holding in Walla increased from 24.83% on December 31, 2001 to 36.74% on December 31, 2002 and 2003.

In accordance with the investment agreement between Bezeq International and Walla and pursuant to the prospectus for a rights issue of Walla, Bezeq International undertook to invest a total of $5.9 million in Walla, either directly or through a strategic investor. Through December 31, 2003 Bezeq International had invested, by way of an investment in shares and extending loans, approximately NIS 80.1 million, of which NIS 2,676 thousand represents loans to Walla during 2003. These investments, on the dates they were made, constitute the total investment approved by the Government for Bezeq International to invest in Walla. On December 31, 2003, Bezeq International had met its entire prospectus and contractual undertaking to invest in Walla.

As part of its investments in Walla as described above, Bezeq International extended CPI-linked, interest-free loans to Walla during 2002 and 2003 amounting to approximately NIS 13,945 thousand and NIS 11,269 thousand as at December 31, 2003 and 2002 respectively.

In February 2004 Walla published a prospectus for an offering by way of rights to options.

Bezeq International made an advance commitment to exercise all the rights offered to it and to exercise options in a total amount equal to the amount of the shareholders' loan of NIS 13,922 thousand it had extended to Walla on September 30, 2003. The commitment is subject to Section 328 of the Companies Law, which means that Bezeq International will not exercise options in such a way that after the exercise it will hold more than 44.9% of the issued capital of Walla.

Following the valuation ratios determined for IOL and Walla on the eve of the merger and the amortization of goodwill in Walla following the merger with IOL, Bezeq International revalued its investment in Walla according to the valuation ratios and other components relating to the investment. Consequently, Bezeq International recorded amortization of NIS 8,019 thousand in 2001. The amortization was included in the losses of investee companies for that year.

During 2002, Bezeq International wrote down its investment in Walla by another NIS 13,089 thousand. The balance of Bezeq International's investment in Walla after this write-down plus the additional investments it made by way of loans, in the opinion of the management of Bezeq International, reflected the fair economic value of Walla to Bezeq International a that time.

NOTE 8 – INVESTMENTS IN AFFILIATED COMPANIES (CONTD.)

G. ADANET FOR BUSINESS GROUP LTD. (IN TEMPORARY LIQUIDATION) ("ADANET")

Adanet is a private company in temporary liquidation the activity of which was installation and servicing of networks and computer equipment.

In view of the uncertainty regarding the realization of Adanet's business plan and regarding the outcome of the discussions with the banks for arranging the financing required by Adanet, there was considerable concern about the continued existence of Adanet as a going concern. On November 10, 2003 Adanet filed an application for a stay of proceedings order while formulating a recovery plan for the Adanet group. Later, and in the absence of consensus among the banks, the stay of proceedings order was canceled and temporary liquidation orders were issued against Adanet and its subsidiaries or temporary receivers were appointed for their assets. Upon the fulfillment of certain conditions, the Company, Clal Information Technologies Ltd. ("Clal") and managers at Adanet had a Call and Put option, respectively, for the remaining 50% of Adanet's shares (beyond the 50% held by the Company), subject to the approvals required by law. The exercise price of the option was supposed to be about $5.5 million. A dispute arose between the Company, Clal and the founders of Adanet relating to exercise of the Put option. The dispute was resolved in a settlement agreement under which Clal and the managers waived the Put option in consideration of NIS 16.5 million which was paid to them by the Company. Due to the financial position of Adanet and the proceedings described above, the Company wrote off the balance of its investment in Adanet in the current year in the amount of NIS 38 million and also recorded additional costs in the amount of NIS 21.5 million in connection with the investment (including NIS 16.5 million relating to the settlement agreement in respect of the Put option).

In February 2004 the Company received a letter from the liquidator of some of the Adanet group companies, in which it is alleged that the Company undertook to provide the financing required for the current operations of Adanet until March 31, 2004, as well as additional financing. In the opinion of the Company, in view of Adanet's situation, the basis for the undertaking made by the Company, if and insofar as made, no longer exists, and therefore it rejected the allegations of the liquidator.

H. GOLDNET COMMUNICATIONS SERVICES – A REGISTERED PARTNERSHIP ("THE PARTNERSHIP")

In 2002, as a result of exercise of Put options with AT&T, the percentage of the Company's holdings in the Partnership increased to 54%. In March 2003, Malam Systems Ltd. ("Malam") notified the Company of its exercise of the Put option with the Company for the sale of 20.9% of its holdings in the Partnership. In May 2003, after receipt of the statutory approvals for a change in the holdings in the Partnership and after payment of the consideration of approximately NIS 6.4 million by the Company, the holdings of the Company in the Partnership increased to 74.9%, while the holdings of Malam decreased accordingly to 25.1%.

I. B-ONE GENERAL PARTNERSHIP ("B-ONE")

In February 2003 Pelephone, Bezeq International and BezeqCall Communications signed a preliminary agreement limited by time, for the establishment of a partnership for a limited period to be called B-One. The purpose of the partnership is to market telecommunications services to the customers of the three companies, where B-One will assist in increasing the sale of products and services of the parties to the agreement, acting as a main interface point with customers who purchase products and services through B-One which will be provided directly by each of the partners.

In July 2003, after receipt of letters of commitment from each of the partners, the Ministry of Communications approved the activities of the partnership. As at the date of approval of the financial statements, the parties are completing the negotiations for signing the full partnership agreement, which is at an advanced draft stage.

NOTE 8 – INVESTMENTS IN AFFILIATED COMPANIES (CONTD.)

I. B-ONE (CONTD.)

As at December 31, 2003, the share of the companies in the profits of the partnership are:

Pelephone	65%
Bezeq International	28%
BezeqCall Communications	7%

Bezeq International intends to act to reduce its share in the partnership to 10% by transferring 18% to the other two companies in a proportion not yet finally agreed.

The three partners have an equal vote on the Executive Committee. The resolutions of the partnership are adopted by a majority of not less than 70%, except for resolutions requiring a unanimous vote.

J. ATTACHMENT OF FINANCIAL STATEMENTS OF AFFILIATED COMPANIES

The Company attaches to these financial statements the financial statements of the affiliated company D.B.S. Satellite Services (1998) Ltd. See Appendix B.

NOTE 9 – FIXED ASSETS

A. Composition and Activity

Consolidated

	Land & buildings	Switching, transmission and power equipment	Network equipment	Subscriber equipment and public telephones	Motor Vehicles	Office equipment and computers	Total
	NIS thousands						
Cost –							
Balance as at January 1, 2003	2,248,082	13,209,922	11,698,443	648,217	231,690	1,355,054	29,391,408
Additions	37,417	746,396	178,205	231,796	3,982	290,500	1,488,296
Disposals (1)	14,956	2,022,022	39,216	246,886	33,066	138,370	2,494,516
Balance as at December 31, 2003	2,270,543	11,934,296	11,837,432	633,127	202,606	1,507,184	28,385,188
Accumulated depreciation –							
Balance as at January 1, 2003	1,325,076	8,482,550	8,527,866	409,822	138,022	726,155	19,609,491
Additions	101,314	1,282,118	401,238	119,529	26,610	229,202	2,160,011
Cancellation in respect of disposals (1)	7,439	1,782,569	26,300	231,053	27,892	133,503	2,208,756
Balance as at December 31, 2003	1,418,951	7,982,099	8,902,804	298,298	136,740	821,854	19,560,746
Provision for impairment –							
Losses from impairment	2,371	115,467	–	–	66	7,420	125,324
Balance as at December 31, 2003	2,371	115,467	–	–	66	7,420	125,324
Net book value –							
As at December 31, 2003	**849,221**	**3,836,730**	**2,934,628**	**334,829**	**65,800**	**677,910**	**8,699,118**
As at December 31, 2002	923,006	4,727,372	3,170,577	238,395	93,668	628,899	9,781,917

NOTE 9 – FIXED ASSETS (CONTD.)

A. COMPOSITION AND ACTIVITY (CONTD.)

Company

	Land & buildings	Switching, transmission and power equipment	Network equipment	Subscriber equipment and public telephones	Motor Vehicles	Office equipment and computers	Total
				NIS thousands			
Cost –							
Balance as at January 1, 2003	2,164,599	9,131,794	11,698,443	628,649	174,602	718,137	24,516,224
Additions	28,309	253,742	178,205	227,332	154	187,639	875,381
Disposals (1)	7,812	1,779,110	39,216	242,630	27,333	110,955	2,207,056
Balance as at December 31, 2003	2,185,096	7,606,426	11,837,432	613,351	147,423	794,821	23,184,549
Accumulated depreciation -							
Balance as at January 1, 2003	1,289,457	5,916,200	8,527,866	398,972	112,552	382,287	16,627,334
Additions	90,214	1,019,893	401,238	113,481	18,476	132,977	1,776,279
Cancellation in respect of disposals (1)	5,449	1,643,194	26,300	228,259	23,614	110,865	2,037,681
Balance as at December 31, 2003	1,374,222	5,292,899	8,902,804	284,194	107,414	404,399	16,365,932
Provision for impairment -							
Losses from impairment	–	35,482	–	–	–	–	35,482
Balance as at December 31, 2003	–	35,482	–	–	–	–	35,482
Net book value -							
As at December 31, 2003	**810,874**	**2,278,045**	**2,934,628**	**329,157**	**40,009**	**390,422**	**6,783,135**
As at December 31, 2002	875,142	3,215,594	3,170,577	229,677	62,050	335,850	7,888,890

(1) Fixed assets are written off the books at the end of the year in which they became fully depreciated, except for land, buildings and vehicles, which are written off the books when sold. In 2003, fully depreciated fixed assets with a cost of approximately NIS 1,769 million (2002 – NIS 1,306 million) were written off the consolidated and Company books.

(2) The cost includes the amount of NIS 8,761 thousand in the Company and NIS 11,377 thousand consolidated, which constitute real financing expenses in respect of loans and credit during the construction period, calculated at an average real interest rate of approximately 7.4% per annum (prior year – 2.9%).

NOTE 9 – FIXED ASSETS (CONTD.)

B. In view of the decline in traffic in the Company's communications network, which is due mainly to the decrease in the number of subscribers and the decline in dial-up connection to the internet, the Company no longer uses equipment with a net book value of approximately NIS 163 million and has written it off its books. Accordingly, an expense was recorded in that amount under the “other expenses” item in the statement of operations.

C. Most of the real estate assets used by the Company were transferred to it by the State under an agreement dated January 31,1984. Some of these assets are leased for 49 years with an option for an extension for another 49 years, and some are rented for renewable periods of two years each.

The Accountant General of the Ministry of Finance notified the Company in January 1998 that the State intends to terminate the lease of those assets rented for the renewable two-year periods, and that the Ministry of Finance will examine the use actually made by the Company of each specific asset and will take appropriate action with respect to the matter of making available alternative land and the payment of relocation expenses. The Company's Management opposed implementation of the plan. In May 1999, representatives of the Company and the Israel Lands Administration held a meeting in the presence of representatives of the Government Companies Authority in the office of the Attorney General. In summing up the meeting, the Attorney General said that the Company could not carry out a public offering of its shares before clarification of the factual basis and the questions in dispute, so that the discussions could be held on the best way for settling the dispute. Further to the decision of the Ministerial Committee for Privatization of August 27, 2000 concerning the privatization of the Company, the Attorney General confirmed, in February 2001, the description of the land dispute which was included in an immediate report issued by the Company. The description includes the positions of the parties in their own words, to which was attached a list of the properties which are the subject of the dispute. The main points of the Company's position are, *inter alia*, that it is entitled to receive rights of ownership or "quasi-ownership" in those assets which are rented for renewable two-year periods. With regard to the leased part of the assets, the Company also believes that it is entitled to ownership rights or rights of lease for the maximum period that the State could offer. The State did not agree to the claims of the Company, and asserted, *inter alia*, that it is authorized, with notice to the Company, to terminate the renewable rental, and in any case not to renew it.

In the opinion of the State, the Company's refusal to accede to the demands of the State has harmed the State's ability to make economically sound and efficient use of the land, and as an example the State mentions the value of two assets which, according to its preliminary estimates, are worth (together) approximately $440 million. On the leased assets, the State's position is that the Company's rights therein are rights of lease as stipulated in the agreements signed by the parties on this matter.

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

The claim sued for declaratory relief whereby the interpretation of the "Asset Transfer Agreement" signed between the State and the Company in connection with the transfer of the real estate assets ("the Real Estate") to the Company before it commenced operations in 1984 and the "umbrella contract " signed in 1993 in connection with some of these assets, requires, *inter alia*, reaching the conclusion that the State is the sole and exclusive owner of the Real Estate and the Company has no rights of ownership in the Real Estate and is not entitled to act as if it were the owner.

NOTE 9 – FIXED ASSETS (CONTD.)

C. (CONTD.)

On May 15, 2003 a settlement agreement was signed between the Company and the Government of Israel in the name of the State of Israel and the Israel Lands Administration ("the Administration"). The agreement regulates the dispute between them relating to the rights of the Company in various Real Estate assets which were transferred to the Company when it commenced operations in 1984, under the Asset Transfer Agreement signed between the Company and the State. Under the settlement agreement, 14 Real Estate assets out of the 28 in the Company's possession with Renewable Lease status (assets leased entire to the Company for a period of two years, renewable each time for a further two years, unless the State exercised its right to terminate the lease on terms prescribed in the Asset Transfer Agreement), as well as three assets which were returned to the Administration before the settlement agreement, and the Administration will allocate three substitute assets to replace part of the assets which the Company will return to the State. The remainder of the Renewable Lease Assets in the Company's possession and assets which were leased to the Company under the Asset Transfer Agreement, will remain in the Company's possession on capital lease terms set out in the agreement. The Administration will also allocate and lease to the Company, after the completion of planning proceedings, an area of 70 dunams at the Sakia site, on the lease terms set out in the agreement. The agreement also includes several arrangements concerning individual disputes which arose between the parties, some of which related to particular assets of those which were the subject of the dispute and some of which were not part of the dispute. These arrangements include, *inter alia*, agreement that the Company will return some additional assets (one of which is not among the assets in dispute), as set out in the agreement.

The agreement was approved by the Audit Committee of the Board of Directors of the Company, the Board of Directors and the General Meeting of the Shareholders (as an exceptional transaction between the Company and its controlling interest – the State of Israel). It was also approved by the Israel Lands Administration. On March 10, 2004 the agreement was validated as a decision by the Court, without an order to pay costs, subject to any application to the Court in connection with the settlement agreement being made in a separate proceeding and not as part of the same case. The agreement took effect on the same date. The aforesaid has no material effect on the financial statements of the Company.

D. During September 2003 Pelephone signed an agreement for upgrading the CDMA technology system sites to 1X technology. The contract value is approximately $92 million ($46 million in proportional consolidation). The technology upgrade, which was carried out at the end of 2003, will considerably increase the capacity and quality of the existing network, and will enable advanced services to be provided to Pelephone's customers. According to the plan, the sites will be added in stages, starting in 2003. Most will be installed in 2004, with completion scheduled for 2006. Concurrently, the contractor upgrading the network and adding the sites undertook to buy old equipment valued at $41 million ($20.5 million in proportional consolidation).

E. During September 2003, Pelephone signed an annex to an earlier agreement from April 2002 (the value of the basic contract is approximately $147 million, $73.5 million in proportional consolidation), for the additional purchase and installation of cellular communication sites using 1X technology (CDMA 2000), valued at approximately $19 million ($9.5 million in proportional consolidation).

F. As at the balance sheet date, there are commitments to purchase fixed assets (mainly switching equipment) amounting to approximately NIS 531 million consolidated and NIS 288 million for the Company (the amounts include the equipment referred to in E and F above).

G. In September 2003 the Board of Directors of the Company adopted a resolution to close the Inmarsat station (a satellite communications station) and to try to sell the equipment and/or operation. In view of the uncertainty as to the consideration it would receive, if any, a loss of approximately NIS 35 million due to impairment of assets was recorded in the financial statements against fixed assets, which was included under the "other expenses" item in the statement of operations. The Ministry of Communications notified the Company that it is not authorized to decide on the closing of the station. The Company is discussing with the Ministry of Defense and the Ministry of Communications the possibility of selling the operation or of contracting with a partner for its continued operation.

NOTE 9 – FIXED ASSETS (CONTD.)

H. In accordance with the Company's policy of regular review of the useful life of the assets, a committee was appointed with a mandate to examine the need for updating the duration of the lives of assets and to make recommendations to the management. The review covers only the fixed assets of the Company, and is based on the balance of its fixed assets as at December 31, 2003. The committee is scheduled to present its conclusions and recommendations in May 2004.

I. BEZEQ INTERNATIONAL – PROVISION FOR IMPAIRMENT, CHANGE OF ESTIMATE AND REMOVAL OF ASSETS

During 2003, Bezeq International conducted a general review of the book value of all its fixed assets, as required, *inter alia*, by virtue of Standard 15 of the IASB concerning impairment of assets (hereinafter – "Standard 15"). Following the review, expenses were recorded in 2003 derived from fixed assets in an aggregate amount of NIS 146.8 million. Of this amount, NIS 89.8 million included in the "the other expenses, net" item in the statement of operations, derives from writing down assets, mainly underwater cables, which Bezeq International believes, based on the opinions of external experts, to have an economic value lower than their book value; NIS 21.1 million stated mainly in the "operating expenses" item in the statement of operations, derives from changes of estimate of the balance of the economic life of some of the assets of Bezeq International as described below, and NIS 35.9 million stated in the "other expenses, net" item in the statement of operations, derives from the removal of assets since they are no longer used. The amount of the deduction according to Standard 15, is determined, *inter alia*, on the basis of the assessments of experts as stated below and the assessments of the management of Bezeq International of the net sale price and the usage value of the assets under review.

As part of this review of the book value of all its fixed assets, the management of Bezeq International decided to examine the economic life of its assets. Examination of the balance of economic life was carried out with the assistance of external and internal experts in the field, mainly for switching equipment and systems, transmission equipment (old-generation undersea cables) and internet equipment. Based on the opinions of these experts, the balance of the economic life of the assets examined is shorter than the economic life attributed to them by Bezeq International in the past.

The change of estimate led to an increase of NIS 21.1 million in depreciation expenses for 2003. The effects of the change of estimate on the depreciation expenses of Bezeq International for 2004 is expected to amount to an increase of approximately NIS 45 million.

The sum of NIS 35.9 million in respect of assets removed due to termination of their use, represents their net book value as at the date of their removal, and includes mainly the net book value of NIS 24.7 million of old-generation undersea cables which Bezeq International decided would no longer be operated, and the net book value of improvements to leased premises amounting to NIS 4.6 million which Bezeq International had vacated.

NOTE 10 – DEFERRED CHARGES AND OTHER ASSETS

Consolidated

	Cost	Accumulated amortization	Balance for amortization December 31 2003	Balance for amortization December 31 2002
	NIS thousands	NIS thousands	NIS thousands	NIS thousands
Capitalized subscriber acquisition costs	427,548	347,818	**79,730**	159,889
Rights in channels	5,477	2,782	**2,695**	3,231
Representation rights in a communications corporation	3,761	3,761	**–**	1,598
Acquisition of operations (1)	27,659	8,999	**18,660**	22,125
Frequencies (2)	77,948	–	**77,948**	55,751
	542,393	363,360	**179,033**	242,594
Expenses for issue of debentures and raising other loans			**11,016**	15,124
Goodwill not yet fully amortized in consolidated companies (3)			**18,628**	19,746
			208,677	277,464

Company

	Balance for amortization December 31 2003	Balance for amortization December 31 2002
	NIS thousands	NIS thousands
Deferred expenses		
Expenses for issue of debentures and raising loans and others	**11,016**	15,124

(1) BezeqCall Communications acquired an operation – the acquisition of resources, from Nortel Networks Israel (Sales and Marketing) Ltd. (see Note 19B(5)), to obtain independent capability for providing maintenance, support and installation services to its customers.
(2) On the amortization of Pelephone's investment in cellular frequency ranges in third generation technology, see Note 8D(4).
(3) On the amortization of goodwill, see Note 2D(5).

NOTE 11 – TAXES ON INCOME

A. General

The Income Tax Law (Adjustments for inflation), 5745-1985, effective since the 1985 tax year, introduced a method of measuring operating results for tax purposes on a real basis. The various adjustments required by this law are intended to bring about taxation on the basis of real income. However, adjustment of the nominal profit in accordance with the tax laws is not always identical to the inflation adjustments prescribed for financial reporting purposes by opinions of the ICPAI. As a result, differences arise between the inflation–adjusted profit in the financial statements and adjusted taxable income.

On deferred taxes in respect of these differences – see Notes 2P above and 11D below.

NOTE 11 – TAXES ON INCOME (CONTD.)

B. INCOME TAX INCLUDED IN THE STATEMENTS OF OPERATIONS

Consolidated

	For the year ended December 31		
	2003	**2002**	**2001**
	NIS thousands	**NIS thousands**	**NIS thousands**
Current taxes	**220,452**	216,192	355,088
Deferred taxes	**(169,588)**	10,786	(126,840)
Taxes for prior years, net	**(2,851)**	(19,645)	12,692
	48,013	207,333	240,940

Company

	For the year ended December 31		
	2003	**2002**	**2001**
	NIS thousands	**NIS thousands**	**NIS thousands**
Current taxes	**216,941**	214,062	351,820
Deferred taxes	**(178,351)**	44,466	(2,164)
Taxes for prior years, net	**(5,077)**	(28,887)	12,662
	33,513	229,641	362,318

C. RECONCILIATION BETWEEN THE THEORETICAL TAX COMPUTED IN RESPECT OF THE PRE–TAX INFLATION-ADJUSTED EARNINGS AND THE ACTUAL TAX EXPENSE IN THE BOOKS

Consolidated

	For the year ended December 31		
	2003	**2002**	**2001**
	NIS thousands	**NIS thousands**	**NIS thousands**
Tax computed at the regular tax rate	**(17,046)**	(127,740)*	215,433*
Increase (savings) in tax liability in respect of:			
Inflationary erosion of advance tax payments	**(2,227)**	1,292	394
Exempt income and capital gains	**(1,411)**	(38,406)	(36,636)
Non-deductible expenses	**9,737**	6,831	31,769
Losses and timing differences in respect of which a deferred tax asset was not created	**33,926**	400,592*	17,640*
Taxes for prior years, net	**(2,851)**	(19,645)	12,692
Differences in the definition of equity and non-monetary assets for tax purposes	**27,511**	(15,661)	259
Other	**374**	70	(611)
	48,013	207,333	240,940

* Reclassified

NOTE 11 – TAXES ON INCOME (CONTD.)

C. RECONCILIATION BETWEEN THE THEORETICAL TAX COMPUTED IN RESPECT OF THE PRE–TAX INFLATION-ADJUSTED EARNINGS AND THE ACTUAL TAX EXPENSE IN THE BOOKS (CONTD.)

Company

	For the year ended December 31		
	2003	2002	2001
	NIS thousands	NIS thousands	NIS thousands
Tax computed at the regular tax rate	**(972)**	(124,024)	361,748
Increase (savings) in tax liability in respect of:			
Inflationary erosion of advance tax payments	**(2,051)**	1,230	395
Exempt income and capital gains	**(1,275)**	(38,407)	(35,772)
Non-deductible expenses	**8,726**	3,267	29,129
Losses and timing differences in respect of which no tax asset was created	**7,678**	435,353	-
Taxes for prior years, net	**(5,077)**	(28,887)	12,662
Differences in the definition of equity and non-monetary assets for tax purposes	**25,755**	(17,525)	(5,384)
Other	**729**	(1,366)	(460)
	33,513	229,641	362,318

D. DEFERRED TAXES

	Consolidated		Company	
	December 31 2003	December 31 2002	December 31 2003	December 31 2002
	NIS thousands	NIS thousands	NIS thousands	NIS thousands
Activity –				
Balance at beginning of year	**593,498**	623,648	**429,467**	493,296
Charged to statement of operations for the year	**169,588**	(10,787)	**178,351**	(44,466)
Charged to statement of operations for prior years	**6,450**	(19,363)	**3,815**	(19,363)
Balance as at end of year	**769,536**	593,498	**611,633**	429,467

NOTE 11 – TAXES ON INCOME (CONTD.)

D. DEFERRED TAXES (CONTD.)

	Consolidated		Company	
	December 31 2003	December 31 2002	December 31 2003	December 31 2002
	NIS thousands	NIS thousands	NIS thousands	NIS thousands
Composition of deferred taxes –				
Difference between the adjusted value of fixed assets and other assets and their value for income tax purposes	**(566,381)**	(617,047)	**(376,792)**	(448,810)
Adjustment of materials and spare parts	**2,784**	(513)	**–**	(235)
Deductions and losses carried forward for tax purposes	**365,184**	302,705	**61,600**	–
Differences in the recognition of expenses relating to employee rights, doubtful debts and other	**967,949**	908,353	**926,825**	878,512
Total	**769,536**	593,498	**611,633**	429,467
Stated as follows:				
As part of current assets	**208,797**	199,006	**170,213**	196,958
As part of other assets	**560,739**	394,492	**441,420**	232,509
Total	**769,536**	593,498	**611,633**	429,467

Deferred taxes are computed at a tax rate of 36%.

E. AMENDMENTS TO THE INCOME TAX ORDINANCE

On July 24, 2002 the Knesset enacted the Law for the Amendment of the Income Tax Ordinance (Amendment No. 132), 2002, and in December 2002 an amendment to that law was enacted (hereinafter – "the Tax Reform"), which took effect on January 1, 2003. The Tax Reform changed the nature of the basis for charging tax in Israel, so that it is now on a personal basis rather than on a territorial/ geographical basis. Commencing on January 1, 2003, an Israeli resident is taxed on his worldwide income.

The main points of the Tax Reform that are liable to affect Israeli resident companies are these:

(1) Source rules – Source rules were set for determining where the income is generated.

(2) Tax credit – Special directives were prescribed for tax credits granted to an Israel resident body of persons which paid foreign tax on income from abroad and which is liable to corporate tax.

(3) Capital gains – The tax on capital gains from non-marketable assets was lowered from 36% to 25% (applicable on a linear basis according to the ratio of the periods), except for capital gains on tradable securities for a company subject to the Adjustments Law.

(4) The "seven year" limit on the utilization of capital losses carried forward was canceled (applicable to losses accumulated from the 1996 tax year onwards).

NOTE 11 – TAXES ON INCOME (CONTD.)

F. Deferred taxes are computed at a rate of 36%. Realization of the deferred tax asset is contingent upon the existence of adequate taxable income in appropriate amounts in the future. The deferred tax asset is included in the financial statements since, according to the Company's business plans, its realization is anticipated. The deferred tax asset in respect of a loss accumulated in Pelephone was recorded according to the assessment of Pelephone's Management that there is a high degree of certainty that these losses will be realized in the foreseeable future.

(1) The Company recorded a tax asset in respect of an accumulated loss of approximately NIS 221,575 thousand, based on the assessment of the Management that there is a high degree of certainty that these losses will be realized in the coming years. The balance of the losses and the deductions carried forward in respect of which no deferred taxes were charged due to the uncertainty regarding the possibility of its realization, is the adjusted amount of approximately NIS 21,237 thousand (2002 – NIS 21,806 thousand).

(2) Losses for tax purposes and capital losses of subsidiaries carried forward to the coming years, at balance sheet date total the adjusted amount of approximately NIS 121,231 thousand (2002 – NIS 162,823 thousand).

(3) Losses for tax purposes and a deduction for inflation of Pelephone carried forward to next year, at balance sheet date total the adjusted amount of approximately NIS 1,686 million (in proportional consolidation NIS 843 million) (2002 – NIS 1,682 million, in proportional consolidation – NIS 841 million).

The balance of the losses and deductions carried forward to next year are linked to the CPI in accordance with the above-mentioned law.

G. The adjustment amounts of buildings, the depreciation of which will not be tax-deductible and in respect of which no deferred tax provision can be created:

	Company	
	For the year ended December 31	
	2003	**2002**
	NIS thousands	**NIS thousands**
The total non-deductible amount as at the beginning of the year	**77,600**	80,037
Changes in the reported year	**(140)**	(2,437)
The total non-deductible amount as at the end of the year	**77,460**	77,600

H. **FINAL TAX ASSESSMENTS**

(1) The Company has final assessments up to and including 1999.

(2) Under an assessment agreement signed on January 30, 2003, between Bezeq International and the assessment officer, concerning final tax assessments issued to Bezeq International for the years 1996-1999, Bezeq International paid approximately NIS 13.7 million, of which approximately NIS 2.9 million represents interest and linkage differentials.

(3) Pelephone has final assessments up to and including 1999.

(4) BezeqCall Communications Ltd. has final assessments up to and including 1998.

NOTE 11 – TAXES ON INCOME (CONTD.)

I. VALUE ADDED TAX

The Company files a consolidated Value Added Tax return together with its subsidiaries.

NOTE 12 – BANK CREDIT

	Interest rate	Consolidated	
		December 31 2003	December 31 2002
	%	NIS thousands	NIS thousands
Unlinked loans	6.1-6.2	**94,714**	361,180
CPI-linked loans	7.25	**50,000**	122,824
Dollar-linked loans	2.69-2.94	**–**	34,847
		144,714	518,851

NOTE 13 – LONG-TERM LOANS

A. COMPOSITION

	Consolidated		Company	
	December 31 2003	December 31 2002	December 31 2003	December 31 2002
	NIS thousands	NIS thousands	NIS thousands	NIS thousands
Banks	**2,406,686**	2,522,844*	**1,344,520**	1,785,847*
Pension fund	**49,990**	70,695	**49,990**	70,695
Others	**–**	890	**–**	–
Supplier credit	**11,350**	17,244	**–**	–
	2,468,026	2,611,673	**1,394,510**	1,856,542
Less –				
Current maturities from	**685,883**	534,782	**324,827**	366,145
Current maturities from others	**27,850**	25,414	**23,471**	20,668
	1,754,293	2,051,477*	**1,046,212**	1,469,729*

* Reclassified

NOTE 13 – LONG-TERM LOANS (CONTD.)

B. LINKAGE TERMS AND INTEREST

		Consolidated		Company	
		December 31 2003	December 31 2002	December 31 2003	December 31 2002
	Interest rate	NIS thousands		NIS thousands	
Loans in foreign currency					
US dollar (*)	LIBOR+(0.45-0.65)	**1,235,280**	1,538,672	**1,223,930**	1,522,106
Loans linked to the CPI	7.45-3.6	**893,073**	766,832	**120,590**	263,741
Pension fund	6.1	**49,990**	70,695	**49,990**	70,695
		943,063	837,527	**170,580**	334,436
Shekel/dollar loans(**)	1.17-3.77	**109,475**	–	–	–
Unlinked loans	7.31-6.85	**180,208**	235,474	–	–
		2,468,026	2,611,673	**1,394,510**	1,856,542

(*) These loans bear interest at LIBOR plus a margin. The rate shown in the above table is a weighted average rate as at the balance sheet date.

(**) The loan is renewed every three months in a mechanism determined for three years. The interest is computed under two possible alternatives – a shekel track and a dollar track.

C. REPAYMENT SCHEDULE

December 31	Consolidated	Company
	NIS thousands	NIS thousands
2005	871,857	507,799
2006	777,773	505,570
2007	81,095	32,843
2008	17,456	–
2009 and thereafter	6,112	–
	1,754,293	1,046,212

D. SECURITY

(1) Long-term loan agreements of the Company, aggregating NIS 1,126,125 thousand, include certain conditions upon the occurrence of which the lender may demand immediate repayment of the loans, including:

– The intervention of an authority in the administration of the Company's affairs.

– In respect of loans aggregating NIS 381,695 thousand, upon the occurrence of an event which allows a demand for immediate repayment of other loans of the Company, and in respect of a balance of approximately NIS 184,640 thousand of this balance, when the percentage of the State's holdings in the share capital of the Company falls below 26%.

NOTE 13 – LONG-TERM LOANS (CONTD.)

D. SECURITY (CONTD.)

The Company and the banks are discussing cancellation of the stipulation made by the banks that if the State reduces its holdings in the Company to below 26%, the banks will be entitled to immediate repayment of the loans they have extended to the Company.

– In respect of the remaining loan balance of NIS 744,430 thousand, upon the occurrence of an event which allows a demand for immediate repayment of other loans of the Company and of material consolidated companies, or failure to comply with the following financial covenants relating to the Group:

a. Net financial debt to Earnings Before Interest Taxes Depreciation and Amortization (EBITDA) ratio of not more than 3 : 1.

b. Tangible shareholders' equity to be at least 35% of total tangible assets.

As at the balance sheet date, the Company is in compliance with these financial covenants.

After the balance sheet date the Company reached agreement with some of the foreign banks on a reduction of this ratio to 25% for a period of one year (starting from exercise of the Company's option to purchase the shares of Pelephone, if the Company exercises the option, with an option to extend that period by an additional year – see also Note 8D(3). The Company is negotiating with the other foreign banks for a similar amendment.

– A change, made without the lenders' consent, in the nature of the Company's business which would have a materially adverse effect on its business, assets or financial condition.

Regarding the possibility of existence of the above conditions, including a decrease in the voting rights of the State and the possibility of the complete opening of the communications market to competition – see Note 1.

The Company created a negative pledge in favor of the lenders.

(2) Bank loans to Pelephone are secured by an irrevocable undertaking towards the banks, whereby Pelephone created a negative pledge in favor of the banks. This undertaking includes, *inter alia*, a declaration that Pelephone will not encumber in any way or form, by a fixed or floating lien of any kind or rank, its assets (as they may be from time to time), in whole or in part, in favor of any third party, without the prior written consent of the banks. The undertaking that the liability of Pelephone will not exceed three times its shareholders' equity and an undertaking that as long as that ratio exceeds 1.5, no dividends will be distributed and no management fees will be paid to the shareholders. In addition, Pelephone undertook that the amount of its debts would not exceed NIS 3.8 billion (linked to the known index from January 2002). As at the date of the financial statements, Pelephone is in compliance with its undertakings to the banks, the balance of which as at the balance sheet date, in proportional consolidation, is NIS 1,033,225 thousand.

(3) Bezeq International provided a negative pledge in favor of banks, whereby it may not encumber its assets without the bank's consent. As at December 31, 2003, Bezeq International has no obligations towards banks.

(4) BezeqCall Communications provided a negative pledge and undertook to meet certain financial conditions in respect of loans from banking institutions, the balance of which as at the balance sheet date is approximately NIS 38 million.

NOTE 13 – LONG-TERM LOANS (CONTD.)

D. SECURITY (CONTD.)

(5) The terms of loans received by DBS from banks impose various restrictions, including a demand to comply with financial criteria. The values for compliance with these criteria vary and are measured every quarter. Failure to comply with the criteria entitles the banks to demand early repayment of the loans received by DBS. As at December 31, 2003, DBS is not in compliance with all of the aforementioned criteria (see Note 8E).

E. LOAN PROCUREMENT EXPENSES

Deferred expenses for raising loans as at December 31, 2003, and December 31, 2002 amounted to NIS 9,106 thousand. The expenses are presented after deduction of accumulated amortization amounting to NIS 5,557 thousand and NIS 3,863 thousand respectively.

NOTE 14 – OTHER DEBENTURES

A. COMPOSITION AND TERMS

		Consolidated and Company	
	Interest rate	December 31 2003	December 31 2002
	%	NIS thousands	NIS thousands
CPI-linked debentures issued to the public			
Debentures Series 1 (1)	4.5	**69,587**	139,280
Debentures issued to the public:			
Linked to the euro (2)	3.1-6.5	**1,645,811**	1,448,950
Debentures issued:			
Unlinked (3)	7-8.5	**500,372**	490,806
Debentures issued to financial institutions and others:			
CPI-linked	3.9-6.35	**706,965**	844,189
		2,922,735	2,923,225
Less – current maturities		**598,153**	206,328
		2,324,582	2,716,897

(1) The outstanding balance of the debentures is NIS 19,950,293 par value (2002 – NIS 39,900,581 par value).
(2) The outstanding balance of the debentures is € 315,000,000 par value.
(3) The outstanding balance of the debentures is NIS 500,656,980 par value.

NOTE 14 – OTHER DEBENTURES (CONTD.)

B. REPAYMENT SCHEDULE

	NIS thousands
2005	210,634
2006	159,842
2007	1,689,390
2008	96,668
2009 and thereafter	168,048
	2,324,582

C. SECURITY

The debentures are not secured, except for a nominal lien. However, the Company has undertaken that as long as the debentures are outstanding, it will refrain from encumbering its property with other liens.

Some of the lenders, the balance of whose loans as at December 31, 2003 amounts to approximately NIS 586,213 thousand, are entitled to demand the immediate repayment of the debentures if the State's holdings in the share capital of the Company falls below 26% (see Note 1).

In addition, in respect of a balance of NIS 1,645,811 thousand of debentures listed on the Luxembourg bourse which were issued to the public and are linked to the euro, upon the occurrence of an event enabling demand for early repayment of other loans of the Company and of material subsidiaries.

The Company has created a negative pledge in favor of the holders of the above euro-linked debentures.

D. ISSUANCE EXPENSES

Deferred expenses with respect to issuance of the debentures amounted to NIS 33,844 thousand (2002 – NIS 33,847 thousand) and are stated net of accumulated amortization of NIS 27,657 thousand (2002 – NIS 25,246 thousand).

NOTE 15 – TRADE PAYABLES

	Consolidated		Company	
	December 31 2003	December 31 2002	December 31 2003	December 31 2002
	NIS thousands	NIS thousands	NIS thousands	NIS thousands
Suppliers of goods and services	**1,126,337**	1,126,863	**686,517**	663,459
Current maturities of long-term supplier credit	**4,379**	4,746	**–**	–
	1,130,716	1,131,609	**686,517**	663,459
Including subsidiaries	**–**	–	**24,206**	36,521
Including a proportionally consolidated company	**41,233**	60,786	**82,466**	121,572

NOTE 16 – LIABILITY FOR EMPLOYEE SEVERANCE BENEFITS

A. COMPOSITION

	Consolidated		Company	
	December 31 2003	December 31 2002	December 31 2003	December 31 2002
	NIS thousands	NIS thousands	NIS thousands	NIS thousands
Provision for early retirement (see D below)	**1,300,493**	1,244,781	**1,300,493**	1,244,781
Compensation for unutilized sick leave (see F below)	**50,682**	56,225	**50,682**	56,225
	1,351,175	1,301,006	**1,351,175**	1,301,006
Provision for severance pay (see B below)	**53,634**	70,876	**12,628**	15,135
Less – reserve in compensation fund	**31,380**	44,941	–	–
	22,254	25,935	**12,628**	15,135
	1,373,429	1,326,941	**1,363,803**	1,316,141
Stated as follows:				
In current liabilities	**602,520**	208,620	**602,520**	208,620
In long-term liabilities	**770,909**	1,118,321	**761,283**	1,107,521
	1,373,429	1,326,941	**1,363,803**	1,316,141

B. ELIGIBILITY OF EMPLOYEES UPON REACHING RETIREMENT AGE

(1) The liability of the Company and its investee companies for severance benefits to employees is fully covered by current payments to pension funds and insurance companies and the above liabilities. The accumulated amounts in the funds mentioned above are not under the management or control of the companies and therefore, are not reflected in the balance sheet.

(2) The pension rights of the Company's employees with respect to the period of their employment in government service, until January 31, 1985, are covered by a pension fund ("Makefet Fund") which assumed the Government's liability in accordance with an agreement between the Government, the Company, the New General Federation of Labor (Histadrut) and the Fund.

C. EMPLOYEE RIGHTS BEFORE RETIREMENT AGE

The Company's liability to pay severance pay to employees leaving their employment under conditions entitling them to such benefits is covered, in respect of the period from February 1, 1985, by current deposits in pension funds and with insurance companies, as stated in section B above. Severance pay in respect of the period of government service up to January 31,1985, is actually paid by the Company, and the amounts accumulated with the Makefet Fund with respect to this period are held in that Fund for use in connection with the employees' rights. For a small number of employees (employed under special contracts), the Company has a commitment to pay severance pay exceeding the amount accumulated in the employee severance pay fund.

The liability of Group companies for pension and severance payments are mainly covered by current deposits in the employees' name in recognized pension and severance funds, and/or by acquisition of policies from insurance companies. The aforementioned deposited amounts are not included in the balance sheet since they are not under the control and management of the companies.

NOTE 16 – LIABILITY FOR EMPLOYEE SEVERANCE BENEFITS (CONTD.)

C. EMPLOYEE RIGHTS BEFORE RETIREMENT AGE (CONTD.)

The severance pay liability included in the balance sheet represents the balance of the liability not covered by deposits and/or insurance policies as aforesaid, in accordance with existing labor agreements and with the wage components which the management of the companies believe entitle the employees to severance pay. In respect of this part of the liability, there is a reserve deposited in the Company's name in a recognized compensation fund. The reserves in compensation funds include linkage differentials and accrued interest, and are deposited in compensation funds in banks and insurance companies. Withdrawal from the funds is contingent upon fulfillment of the provisions of the Severance Pay Law.

Employees who transferred to the Company from government service and who leave the Company before reaching retirement age, are entitled, under certain conditions, if they so choose, to receive early pension benefits in lieu of severance pay. The cost of the early pension benefits, except for cases of sickness or disability up to retirement age, are to be borne by the Company. The costs of retirement of such employees is included in the provision for early retirement plans, as described below.

D. EARLY RETIREMENT PLANS

In September 2000 the Company reached agreement with the workers' representatives, to extend the collective early retirement agreement from 1997 ("the Retirement Agreement"). Under the agreement, which applies from April 1, 2001 to December 31, 2006 (with an option to extend the final retirement date for certain employees to December 31, 2008), another 1,770 employees will take early retirement, of whom up to 300 who are not former government employees. Furthermore, pursuant to the agreement, the Company will be able to dismiss employees under a compensation arrangement over and above the number stated in the agreement. The Company's Management estimates that as at the balance sheet date, the possibility of additional employees retiring in the compensation track is remote, and accordingly, no provision was made for them in the financial statements. The number of employees who retired under this plan up to December 31, 2003, is 853.

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

In view of the uncertainty engendered by the amendment to the law, including with regard to the possibility of a considerable increase in the costs of implementing the Retirement Agreement in the future and with regard to how it would be financed, the Management of the Company and the workers' representatives agreed, in July 2003, that without derogating from the validity of the Agreement, each of the parties would have the right, on its own initiative, to hold discussions with the other party on the matter of a change and/or implementation of its provisions, and the other party would consent to such discussions. On the same date it was agreed with the workers' representatives that in 2004 the retirement quota would be 100 employees who would retire on the terms of the collective early retirement agreement from 1997, as amended in September 2000 with terms corresponding to the terms of the uniform constitution.

The aforementioned amendment has expedited the implementation of the early retirement plan beyond the original plan, and in June to October 2003 another 363 former government employees retired ("the Special Retirees"). Since as a result of the changes in the legislation, the Makefet Fund did not recognize the Special Retirees as "pensioners" of the Fund, the Company negotiated with the Supervisor of the Capital Market, Insurance and Savings Division at the Ministry of Finance and the Makefet Fund, and arrived at the following arrangement:

NOTE 16 – LIABILITY FOR EMPLOYEE SEVERANCE BENEFITS (CONTD.)

D. EARLY RETIREMENT PLANS (CONTD.)

(1) The Company will pay the Makefet Fund in addition to payments already made, an additional amount of approximately NIS 30 million, in respect of the early retirement of the Special Retirees.

(2) The Special Retirees will be recognized by the Makefet Fund as pensioners of the Fund from the date of their retirement from the Company, on the terms which were in effect before the amendment of the law.

(3) The Company undertook not to make any allegation and/or claim against the Makefet Fund in respect of the Special Retirees.

(4) The Company agreed that the remainder of the former government employees who have not yet retired from the Company, will be deemed to be members of the Makefet Fund and the arrangements that are and/or will be applicable to every other member of the pension fund will apply also to them.

In October – December 2003 another 29 employees retired on the terms that were in effect before the amendment of the law. The cost of their retirement was financed by the Company.

Towards the end of 2003 the Company commenced negotiations with the workers' representatives for amendment and extension of the collective retirement agreement, and for clarification of the legal questions that arose from the existing agreement due to the aforementioned amendment of the Insurance Business Law. On March 18, 2004 the Company, the Histadrut and the workers' representatives signed an amendment to the Retirement Agreement. It was agreed, *inter alia*, that by September 30, 2004, 400 employees would retire, and also that the pension terms of the former government employees accepting retirement under the Retirement Agreement of September 2000 would remain in effect despite the amendments to the pensions law, and that the Company would bear any additional costs required. Based on the calculations of an external actuary, the management estimates that the Company will incur an additional amount of approximately NIS 420 million in expenses due to this arrangement. An additional provision was made accordingly in these financial statements. In addition, the parties agreed that they would commence intensive negotiations to regulate the retirement of the remaining former government employees by 2011, as well as the demands of Management for organizational and other changes. A provision will be recorded in the financial statements when the negotiations mature into an agreement requiring the approval of the Board of Directors and the Government Companies Authority.

On January 25, 2004 a draft circular entitled "Early retirement financed by the employer in veteran pension funds" appeared on the website of the Capital Markets Division of the Ministry of Finance. Since it is a draft, and the Company has no knowledge of if, when and how it will be accepted, its financial effect on the Company cannot be estimated.

E. The Company filed a claim against the Makefet Fund by means of which the early retirement plan is executed. Under the collective agreements applicable to labor relations in the Company and in accordance with agreements with the Fund, Company employees who are former government employees have the option to retire on one of two retirement tracks. The method of calculating the cost of early retirement of these employees is determined in the provisions of several agreements and documents which were drawn up between the Company and the Fund during the years 1990-1996, including a letter of understanding drawn up and signed by the parties in 1996. The Company contends that the Makefet Fund violated the provisions of the agreements in general and those of the letter of understanding in particular, in that when it calculated the costs of early retirement for former government employees, it determined the data on the basis of the assumption that those employees had chosen the track with the higher cost of purchase, irrespective of the track which those employees had actually chosen.

NOTE 16 – LIABILITY FOR EMPLOYEE SEVERANCE BENEFITS (CONTD.)

E. (CONTD.)

According to an actuarial opinion prepared for the Company, the difference between the payments collected by the Makefet Fund from the Company according to its calculations and the rate of those costs had they been made, as the Company alleges, on the basis of the retirement track actually chosen by those employees, is a nominal cumulative amount of more than NIS 128 million, for the reimbursement of which the Company is suing the Fund. On November 20, 2003 the Company filed another claim against the Fund for additional amounts of approximately NIS 80 million in respect of other components.

F. COMPENSATION FOR UNUTILIZED SICK LEAVE

The financial statements include a provision for compensation in respect of unutilized sick leave for all employees, in accordance with the conditions fixed in the employment agreement.

NOTE 17 – OTHER CURRENT LIABILITIES

	Consolidated		Company	
	December 31 2003	December 31 2002	December 31 2003	December 31 2002
	NIS thousands	NIS thousands	NIS thousands	NIS thousands
The Government of Israel in respect of royalties	**204,768**	194,843	**153,110**	155,459
Wages and salaries [1]	**250,739**	302,231	**203,358**	238,300
Provision for vacation pay	**85,299**	89,766	**79,308**	84,790
Governmental agencies	**24,474**	68,355	**-**	48,976
Accrued interest	**106,647**	107,661	**92,959**	98,793
Payables in respect of derivatives	**65,304**	19,068	**65,304**	18,573
Other accrued expenses	**168,544**	158,827	**80,623**	79,114
Current maturities in respect of prepaid income	**24,830**	39,884	**17,578**	26,198
Provision for claims in respect of salary and pension components	**257,595**	116,378	**257,595**	116,378
	1,188,200	1,097,013	**949,835**	866,581
[1] Including current maturities of a long-term loan from a pension fund	**23,471**	20,668	**23,471**	20,668

NOTE 18 – OTHER LONG-TERM LIABILITIES

	Consolidated		Company	
	December 31 2003	December 31 2002	December 31 2003	December 31 2002
	NIS thousands	NIS thousands	NIS thousands	NIS thousands
Prepaid income (1)	**27,544**	43,797	**27,544**	52,089
Liabilities in respect of an onerous contract (2)	**9,660**	–	**–**	–
Liabilities in respect of derivatives	**6,560**	12,216*	**6,560**	12,216*
	43,764	56,013*	**34,104**	64,305*

* Reclassified.

NOTE 18 – OTHER LONG-TERM LIABILITIES (CONTD.)

(1) Prepaid income consists mainly of receipts in respect of making infrastructures available for the use of external entities and from compensation in respect of a purchase agreement with a proportionately consolidated subsidiary.

(2) In the course of its business and as part of the setting up of Bezeq International and receipt of assets from the Company, Bezeq International entered into agreements granting it rights to use transmission equipment (old-generation undersea cables) for periods ending between 2016 and 2024. Under those agreements, Bezeq International is obligated to pay fixed monthly amounts, irrespective of the extent of the use it makes of those cables. The management of Bezeq International estimates that the unavoidable costs for compliance with those agreements exceed the anticipated financial benefit that will accrue to it from use of the undersea cables. This assessment, together with the decision of Bezeq International's management not to operate the undersea cables, formed the basis for charging a provision of NIS 9,660 thousand in the financial statements as at December 31, 2003, which reflects the capitalized value of all the unavoidable costs that Bezeq International must pay the owners of the undersea cables until the end of the terms of the agreements.

NOTE 19 - CONTINGENT LIABILITIES

A. CLAIMS

Below are details of the status of contingent liabilities of the Company and investee companies as at December 31, 2003, in respect of which the maximum possible exposure is considerable.

(1) In December 1998 the Antitrust Commissioner published notice that the Investigations Department of the Antitrust Authority ("the Authority") had completed an investigation it had carried out over the past year, regarding *prima facie* suspicion of binding agreements between Koor Industries, Telrad, Tadiran, the Company and BezeqCall Communications, concerning the supply of large exchanges and Network End Point ("NEP") exchanges.

Below are the main points of the Commissioner's notice:

The investigation focused on two main areas: the public switching market, which includes the supply of digital exchange equipment and related services by Tadiran and Telrad to the Company; and the NEP exchange market.

According to the Commissioner, the Authority investigators recommended that concerning some of the suspicions investigated, indictments be filed against some of those who were investigated. The Legal Department at the Antitrust Commission will now examine the investigation material and the recommendations of the investigators, in order to determine whether offenses against the Antitrust Law were indeed perpetrated and whether there is sufficient evidentiary basis for trial. This examination is expected to last several months.

The Commissioner added that the findings of the investigation paint a harsh picture of the manner in which the Company purchased exchanges from Koor and of the manner in which the NEP market had been operated until recently.

In the area of public switching, the Authority's investigation raises suspicions of collaboration between Telrad and Tadiran against the Company. Among other matters, there is *prima facie* suspicion that Telrad and Tadiran coordinated various aspects of the competition between them in relation to the Company, in some cases with the knowledge of the Company and in other cases without its knowledge. The Authority also investigated suspicion of coordination between Telrad and Tadiran relating to telecommunications tenders in 1998 and relating to framework agreements with the Company in 1994 and 1996.

NOTE 19 - CONTINGENT LIABILITIES (CONTD.)

A. CLAIMS (CONTD.)

The second area of suspicion investigated in connection with the large exchanges, concerns suspicion of binding agreements between the Company and Koor, Telrad and Tadiran, which includes a commitment by the Company not to purchase exchanges from a third vendor; division of purchases between Telrad and Tadiran according to a predetermined calculation, i.e. the ostensible pre-arrangement of the competition between the companies in relation to the Company and an undertaking by the Company not to purchase equipment through tenders from the two companies. It is suspected that these undertakings, or some of them, in the relevant circumstances, constitute violation of the provisions of the Antitrust Law. From the findings of the investigation, it appears, ostensibly, that in fact the Company purchased exchanges from one vendor (Koor Industries) – at prices which were seemingly much higher than those the Company would have paid had it not bound itself and had the entire market not been blocked by the aforementioned arrangement in relation to other equipment vendors.

The investigation of the Authority also revealed, ostensibly, that in some of these contracts the Company acted in clear contravention of legal advice it had received. In the opinion of the Authority investigators, this element of willful blindness constitutes not only proof that the relevant parties knew they were involved in an offense, but also defines aggravated circumstances for this offense.

The findings of the Authority's investigation in this area appear to indicate a series of binding agreements and attempted offenses in the field of NEP, between BezeqCall Communications, Telrad and Tadiran. Amongst other matters, suspicions are raised of cartels or attempts at such arrangements – in providing maintenance service for private exchanges, in the prices of buying the service, in customer transfer arrangements and in price discrimination arrangements; in the field of providing maintenance services for private exchanges and NEP infrastructures that determine the type, composition and price of the service which will be offered to customers for the exchanges in their possession; in ongoing coordination between those entities or some of them; in tenders which were held by final customers for the purchase of NEP exchanges. It is suspected that these companies or some of them, in various instances, coordinated the prices of the proposals they would submit in the tenders of final customers. In addition, *prima facie* evidence was found of an arrangement for dividing the market between the companies, as well as agreements concerning non-marketing of the product of an additional third vendor in the field of NEP exchanges.

In November 2000 a shareholder approached the Company with an application that the Company take legal action against the suppliers, stating that in his opinion the Company had suffered a loss of about NIS 392 million due to the binding agreement. In his application, the shareholder reserves the right to file a derivative action pursuant to Section 194 of the Companies Law. The Company replied that it is monitoring developments in the matter and has requested the investigation material from the Antitrust Authority, and that it would formulate its position in accordance with the decision of the Authority and its findings, if any. In November 2001 a similar approach was made by another shareholder, to which the Company replied that it was still awaiting the decision of the Antitrust Authority.

On March 3, 2002 the Company was summonsed to a hearing by the Antitrust Authority. The summons (which relates to the investigation of the public switching issue only, and not to the case of the NEP exchange market, which is still being examined by the Authority's legal department) states that the Authority is considering committing the Company for trial for offenses against the Antitrust Law, 5748-1988 ("the Antitrust Law"), and has not yet decided whether or not to file an indictment in this matter. It was decided to allow the Company to voice its allegations in the hearing proceeding, and to read the relevant investigation material in respect of which no immunity would be granted. According to the summons, the findings of the investigation raise suspicions that the Company was a party to the cartel arrangements concerning the purchase of equipment and receipt of various services in the field of public switching and the dividing up of the market and the non-entry of a new competitor in the framework agreements for the years 1994-1997 and 1997-2000.

NOTE 19 - CONTINGENT LIABILITIES (CONTD.)

A. CLAIMS (CONTD.)

The Antitrust Law forbids contracting as a party to a binding agreement which was not duly approved or which was not granted exemption or a temporary permit. The perpetration of such an act is a criminal offense and also constitiutes a tort, and possible basis for proceedings against a party to the arrangement and for a class action.

The last date set by the Authority for a hearing in connection with its intention to commit the Company and former senior employees for trial in respect of suspicions of cartels in the field of public switching, has already elapsed, and the legal advisers of the Company refuse to attend the hearing without first having read all the relevant material, including the "security" material. The Authority contends that the material is confidential (even though no certificate of immunity was issued for it) and that it is excused from transferring it to the Company at the hearing stage.

The Company, relying on its legal advisers, is unable at this stage to estimate whether the Authority will eventually decide to indict the Company. In any case, if an indictment is filed, the Company has meritorious defense arguments on the criminal level. These arguments are based partially on the security aspects relating to the purchase of public switching (combined with the "State action" doctrine) and partially on other arguments (such as the restrictive application adopted by the courts recently in applying the Antitrust Law to vertical arrangements between customer and supplier, reliance on legal advice, the corporate connection between Telrad and Tadiran, equitable defense cause, etc.).

With regard to civil claims, if any such claims are filed against the Company alleging financial damages to its shareholders, in that it was a party to cartel as alleged by the Authority, it is not possible at this stage, according to the legal advisers of the Company, to estimate the chances that such claims will indeed be filed, nor the exposure of the Company if they are filed. However, it can be said that the defense arguments of the Company on the criminal level, together with other arguments, will be of considerable assistance in the defense of the Company if civil claims are filed in connection with this affair. Accordingly, no provision is made in the financial statements in respect of this matter.

(2) In March 1999 a claim was filed against the Company by a group of employees who were employed as temporary workers at the Ministry of Communications and were transferred to the Company when it commenced operations. The plaintiffs are requesting that the Labor Court determine that they are entitled to all the benefits which were granted to transferred permanent employees, graduates of Bezeq College and retired Ministry of Communications employees. The Company filed an application for dismissal of the claim *in limine* due to its prescription. In the hearing of the Company's application to dismiss, the parties reached agreement regarding partial dismissal and a narrowing of the claim in respect of some of its components, following which, exposure decreased in respect of the claim. During 2002, the plaintiffs withdrew their consent to narrow the claim, and the Labor Court must now rule whether it approves the withdrawal of consent. In the opinion of the Company the plaintiffs are not considered transferred permanent employees and collective labor agreements differentiate between transferred employees and other employees regarding pension and other rights.

The questions raised in this claim are liable to have a broad effect on the Company. However, in view of the above agreements, exposure has been significantly reduced provided that the court does not approve the plaintiffs' withdrawal of consent. The Company, relying on its legal advisers representing it in this matter, estimates that the chances for success are low, and accordingly no provision has been made in the financial statements in respect of this claim.

NOTE 19 - CONTINGENT LIABILITIES (CONTD.)

A. CLAIMS (CONTD.)

(3) On February 15, 2000 a claim was filed against the Company in the Jerusalem District Court in the amount of NIS 22 million. The plaintiff alleges in its claim that the Company violated its undertakings and representations to it to purchase large quantities of equipment from it. The plaintiff further alleges that the procedure adopted for selecting the equipment which would be purchased by the Company was unlawfully managed, with infringement of the tenders laws and the rules of proper administration, with negligence and while exploiting the status of the Company as a monopoly or monopsony. Following the Court’s recommendation, the parties transferred the claim to a mediation proceeding. At this stage of the proceedings the Company is unable, relying on the legal adviser who is handling the claim on its behalf, to estimate the chances of the claim. Accordingly, no provision has been made in the financial statements in respect of this claim.

(4) In September 2000, a declaratory claim was filed against the Company in the Jerusalem Labor Court, by 2,423 retired employees of the Company, who were transferred from the Ministry of Communications to the Company when it commenced operations. The plaintiffs are requesting from the Labor Court declaratory relief which will determine that the payments they received for grossing up of tax, clothing allowance and incentive pay are regular salary which should be seen as part of their determining wage for the purpose of calculating their pension and for the payments made to them upon retirement. Regarding the overall exposure in respect of these components for all Company employees, see Note 19A(13) below. The plaintiffs are also seeking declaratory relief which will determine that their last determining salary for pension should be calculated according to the last salary paid to each of them for the last month of work, and not according to the average rank which each of them held. The Company filed a preliminary application for dismissal of the claim *in limine*. The allegations made in that application are dismissal for limitation, strike for absence of material details, strike for absence of financial quantification and causal arguments relying on the retirement agreements. The Court ruled that as long as no decision is given on the preliminary application, the Company need not file a statement of defense that includes specific reference to the allegations of the plaintiffs. In the opinion of the Company, relying on the opinion of its legal adviser, the chances of the claim cannot be estimated at this stage. Accordingly, no provision has been made in the financial statements in respect of this claim.

(5) In September 2000, an action and an application for approval as a class action were filed against the Company by virtue of Regulation 29 of the Civil Proceedings Regulations, 5744-1984 ("Regulation 29"). The amount of the claim is estimated at approximately NIS 108 million. According to the plaintiff, the Company unlawfully collected "collection fees" from its subscribers for Company bills which were not timely paid, before it had started any collection actions in connection with the plaintiff. There are two main reliefs requested by the plaintiff – declaratory, in which the Court is requested to declare that the collection of "collection expenses" by the Company in the instances described in the claim was unlawful, and that the Company may not continue to collect such expenses in the future, and "operative – financial", for reimbursement of said amounts. On January 7, 2001 the Company filed its response to the application for approval of the class action, in which it alleges that Regulation 29 does not constitute legal grounds for filing class actions and therefore the application for approval should be dismissed *in limine*. Alternatively, the Company alleged that the claim does not meet the criteria of Regulation 29 for filing a class action. The Company also alleged in its response that it charges the collection expenses only to subscribers who have caused it to incur expenses due to arrears in payments, that the plaintiff's interpretation of the provisions of the collection regulations are incorrect, and that it acted lawfully. The plaintiff filed his reply to the Company's response.

NOTE 19 - CONTINGENT LIABILITIES (CONTD.)

A. CLAIMS (CONTD.)

On October 18, 2001 an additional class action was filed on the same matter as the above claim – unlawful charging of collection fees of Company bills not paid on time, before the Company had started any collection actions. The plaintiff alleges that this action constitutes exploitation of the consumer's difficulties, in contravention of the Consumer Protection Law, as well as unjust enrichment. The amount of the class action is estimated by the plaintiff at about NIS 21 million. On December 16, 2001 the court approved a continuance until after giving a decision on the application for approval as a class action of the claim described in this sub-section, in view of the similarity of the causes of action in the two cases.

On February 20, 2003 the District Court approved the first action as a class action in the name of whoever was charged collection fees by the Company despite having paid the relevant bill before the Company commenced collection actions as explained in the statement of claim, from March 7, 1997 to the date of filing the claim. On March 17, 2003 the District Court continued the proceedings in the claim until a decision on the application for leave to appeal which was filed by the Company. On March 20, 2003 the Company filed an application for leave to appeal the decision to allow the action as a class action.

On April 2, 2003 a precedent setting ruling was issued by the Supreme Court (in another case, to which the Company is not a party), that a class action cannot be filed by virtue of Regulation 29 where no specific arrangement is made in principal legislation for filing such action. It should be noted that an application for an additional hearing of this Supreme Court ruling was filed (and approved). Based on the above, the court ruled that the response to the Company's application for leave to appeal in the matter of the first action described in this sub-section would be postponed until a decision is given from the additional hearing in the other case. In the opinion of the Company, relying on the legal adviser handling the case on its behalf, the application for leave to appeal and the appeal itself have a reasonable chance of success. Accordingly, no provision has been included in the financial statements in respect of these claims.

(6) In September 2000 a claim and application for approval as a class action were filed against the Company in the name of all those who were charged collection expenses by the Company despite having paid the relevant bill before the Company started collection actions, as explained in the statement of claim, from March 7, 1997 until the date of filing the claim. On March 17, 2003 the District Court continued the proceedings in the claim until a decision is given in the Company's application for leave to appeal. The amount of the action cannot be assessed, and is estimated at more than NIS 795 million. According to the plaintiffs, the Company unlawfully collected from its subscribers a fixed payment for the lease of telephones which the Company made available to them, so they allege, since the telephones were supplied to subscribers without a specific lease agreement being made, without disclosure and proper publication of the fact that this was a "lease" transaction for an unlimited term, and also concerns the amount of the "lease fee" demanded and the continued collection of the "lease fee" even after the date on which the Company's subscribers had paid the "lease fees" in an amount equal to the full valuation of the telephones supplied. The plaintiffs further allege that the Company collected "lease fees" unlawfully in that it did not give its subscribers the choice of whether to "lease" or purchase the telephones and in that it did not inform them of the option to cease payment of the fixed lease fee in exchange for a lump-sum payment which of itself, according to the plaintiffs, is unlawful. The relief requested by the plaintiffs is mainly financial, for reimbursement of the aforesaid amounts.

In addition, on November 21, 2000 the Company received another class action claim with an application for approval as a class action. The amount of this claim is currently estimated at approximately NIS 254 million. It should be noted that the additional action makes allegations which are similar or identical to those in the above action from September 2000.

NOTE 19 - CONTINGENT LIABILITIES (CONTD.)

A. CLAIMS (CONTD.)

The plaintiffs filed an application for consolidation of the hearings in the two claims, which was approved on April 25, 2001. On June 10, 2001 the plaintiffs filed an amended statement of claim and amended application for approval as a class action. Additional allegations are made in the amended statement of claim, *inter alia* concerning unlawful charging of "maintenance fees". The amount of the claim of all the plaintiffs is estimated at more than one billion shekels. In its response, the Company alleged that the amounts were maintenance fees collected in connection with Company equipment which was made available to subscribers and that the charge and the rate of such charge were prescribed in law and covered the considerable costs to the Company for providing the service.

On June 10, 2003 the court dismissed the application for approval as a class action. The plaintiffs filed an appeal in the Supreme Court against this decision, and on December 21, 2003 the Company filed a counter appeal in respect of non-ruling of reimbursement of legal fees in its favor in the decision that dismissed the amended application for approval.

In the hearing of the appeal on March 11, 2004, the parties acceded to the court's request and agreed to mutual dismissal of the appeal and the counter appeal.

(7) In September 2000 a class action and application for approval as a class action were filed in the Tel Aviv District Court against the Company, Bezeq International Ltd. and the other international communications operators.

According to the plaintiffs, commencing October 20, 1998, the Company unlawfully collected 17% VAT for some of the collect calls originating outside Israel and received by its subscribers in Israel, in contravention of the VAT law and its regulations and in violation of a legislated duty, in a way that breaches existing agreements, while acting in bad faith in the fulfillment of such contracts and with negligent conduct. The plaintiffs make further allegations against the international operators concerning the collection of VAT in respect of calls made from abroad to Israel using phone cards. The plaintiffs estimate the total loss incurred by the group due to the unlawful collection of VAT for all the calls made from abroad to Israel in the relevant period (since October 20, 1998) at millions of shekels per year.

There are two main reliefs requested by the plaintiffs – declaratory, in which each of the defendants violated its obligations under the contractual agreement between it and the member of the group with which it contracted and financial, for restitution of said amounts, compensation for the loss incurred by the members of the group in the aforesaid amounts. The defendants filed their responses and Bezeq International filed an application for dismissal of the application for approval as a class action *in limine*. On June 21, 2001 the Attorney General gave notice that he would appear in this proceeding. On January 6, 2002 the Court decided to conjoin the Director General of the VAT authority as an additional defendant in the action and the application for its approval as a class action, and denied the application of Bezeq International for dismissal *in limine*. At a hearing on February 28, 2002, the plaintiffs' attorney clarified that the plaintiffs are not demanding independent relief from the communications companies, but rather, reimbursement of the VAT which the Director General of the VAT authority will pay them if the claim is successful. The plaintiffs' attorney also proposed that the communications companies be considered formal defendants. A date was set for filing summations on the matter of approval of the claim as a class action, while excusing the communications companies from filing them. On April 2, 2003 a precedent setting ruling was issued by the Supreme Court, in a case to which the Company is not a party. It should be noted that an application for an additional hearing of this Supreme Court ruling was filed (and approved). In view of this ruling of the Supreme Court, the court decided on August 25, 2003 to strike the application for approval as a class action, and therefore also the action itself.

NOTE 19 - CONTINGENT LIABILITIES (CONTD.)

A. CLAIMS (CONTD.)

On October 13, 2003 the plaintiffs filed an appeal against this decision in the Supreme Court. The appeal proceeding is at the summations stage. In the opinion of the Company, relying on its legal advisers, in the circumstances to date and focusing, *inter alia*, on the position of the Company (and of the other communications companies who are being sued as formal respondents) and to the statements of the plaintiffs' attorneys that there is no claim for independent relief from the communications companies, including the Company – no financial exposure of the Company seems likely in connection with this claim, and if any such exposure exists, then it is minimal. In addition, the Company has credible defense arguments pertinent to the matter itself for refuting the action. Accordingly, no provision has been made in the financial statements in respect of this claim.

(8) In September 2001, an application was filed for approval of a class action against the Company. The plaintiffs allege that in view of certain amendments to the Telecommunications Regulations, the maximum payment that could be collected from a Bezeq subscriber who called a Pelephone subscriber during the period between October 2, 2001 and December 31, 2001 was lower than the amount actually collected. The applicants estimate the amount of the claim at about NIS 44 million. The Company filed a response to the application for approval, in which it alleged mainly that it simply acts as a non-discretionary collection contractor. On May 12, 2002 the Company's request to conjoin Pelephone as a party to the proceeding was allowed. In the opinion of the Company and Pelephone relying on the legal advisers who are handling the case on behalf of each of them, it is not possible at this stage to estimate the chances or the implications of the claim. Accordingly, no provision has been made in the financial statements in respect of this claim.

(9) In October 2001 the Company received a letter of demand in the name of the Moshav Porath Committee, containing allegations in connection with direct and indirect damages that were and are being sustained, according to the *moshav* members, as a result of the erection of the Hillel station near the *moshav* and the station's broadcasts. The Company replied to the letter, rejecting the said allegations. In March 2003 a statement of claim was filed in the Tel Aviv District Court against the Company, the Broadcasting Authority and the State of Israel by various plaintiffs from Moshav Porath in the Sharon region, including the estates of deceased persons, for compensation due to physical harm pursuant to the Torts Ordinance. The statement of claim alleges violation of legislated duties and acts and/or failures allegedly perpetrated by the defendants jointly and/or severally in connection with the operation of the Hillel broadcasting station, which is located near the homes of the plaintiffs. It is alleged that as a result, the plaintiffs were subjected to illegal radiation from the broadcasting station causing bodily harm, which in the most part, had ended in the death of some of the plaintiffs.

The amount of the claim stated by the plaintiffs is "more than NIS 15 million", and the same claim notes that the plaintiffs will also petition to split the reliefs sought so that they will reserve the right to sue later for other financial damages which are not bodily harm, such as damage to crops and loss of value of land. According to the notice of the plaintiffs' lawyer, which was given before the claim was filed, this claim is an initial claim and it is intended that additional claims of other residents who have been harmed by radiation from the Hillel station will be filed later.

The Company filed an application for dismissal of the claim *in limine* but has not yet filed a statement of defense and therefore the chances of the claim cannot be estimated. Accordingly, no provision has been made in the financial statements. Nevertheless, the Company has approached two experts on electromagnetic radiation, who are in the process of preparing their opinions and have already stated that international professional consensus today finds that no causal connection has been proven between exposure to electromagnetic radiation in the ranges of the frequencies for broadcasting on radio and television in accordance with international standards, and the incidence of cancer. The Company has arguments against the State and the Broadcasting Authority, as well as against the insurers who insured it, and it is reserving those arguments and its rights. The hearing of the application to dismiss *in limine* and the other applications is still in progress (some are in appeal

NOTE 19 - CONTINGENT LIABILITIES (CONTD.)

A. CLAIMS (CONTD.)

proceedings), except for the partial decision given in favor of the Company to dismiss the claim of five plaintiffs.

In the meantime, on December 31, 2003 the Company ceased all broadcasts from the station as demanded by the State and the Broadcasting Authority, and since that date the station no longer serves as a broadcasting site.

(10) In January 2002 a claim for payment of monetary compensation of approximately NIS 55 million and for writs of mandamus was received at the Company's offices, which was filed in the Tel Aviv District Court by an international communications operator against the Company and a subsidiary, Bezeq International Ltd. The claim makes allegations concerning the process of customer allocation to the international communications operators. According to the plaintiff, it is entitled to compensation from the Company and from Bezeq International in respect of postponement of implementation of the allocation process, in respect of diverting those being allocated to Bezeq International by unlawfully including them in the coordinated listing and removing them from the customer allocation process, and in respect of losses it sustained due to the method of the voice announcement of the possibility of dialing from card-operated public telephones. Alternatively, the plaintiff alleges that it is entitled to reimbursement of access fees which it paid to the Company under an interconnect agreement which was allegedly imposed upon it unlawfully. The plaintiff also requests that the court give orders directing investigations and accounts be made in relation to certain actions in the allocation process and for changing the order of the voice announcement in public telephones so as to ensure, in its opinion, equality among the international operators. On April 22, 2002 the Company filed a statement of defense, in which it denied the allegations of the plaintiff.

The Company also filed a third party notice against the Ministry of Communications in the amount of approximately NIS 55 million, in which the Company claims full indemnity and/or full participation and/or full compensation from the Ministry of Communications for any amount ruled against the Company, if ruled as part of the claim. In the notice, the Company alleges, *inter alia*, that in all its actions relating to implementation of the allocation process, the Company acted as the agent and long arm of the Ministry of Communications and in accordance with its directives, that the Ministry of Communications devised and planned the allocation process, directed it and dictated the manner of its implementation and to the extent that the process was flawed in any way, the Ministry of Communications is exclusively responsible. On July 3, 2002 the plaintiff filed its reply. On October 14, 2002 the Ministry of Communications filed a statement of defense to the third party notice filed against it by the Company and the subsidiary. The Company and Bezeq International relying on their legal advisers are unable, at this stage, to estimate the chances and the implications of the claim. Accordingly, no provision has been made in the financial statements in respect of this claim.

(11) In January 2002 the Company received a letter of demand from a supplier, in which it was alleged that an order issued by the Company to the supplier for a total sum of about NIS 31 million, is valid. According to the Company, the order was contingent upon suspending conditions which were not fulfilled, and therefore the order is not valid. The supplier recently sent the Company a draft statement of claim and the Company replied to that letter, rejecting the allegations contained therein and repeating its own allegations. In the opinion of the Company, relying on the legal adviser who is handling the demand on its behalf, the chances of the Company's defense cannot be estimated were a claim to be filed against it in this matter. Accordingly, no provision has been included in the financial statements in respect of this claim.

NOTE 19 - CONTINGENT LIABILITIES (CONTD.)

A. CLAIMS (CONTD.)

(12) In February 2002 a claim and application for recognition as a class action were filed against the Company in the District Court, concerning reimbursement of a commission which the plaintiff alleges was collected unlawfully, for calls in Israel from a public telephone operated by means of a BezeqCard. The amount of the class action is estimated by the plaintiff at about NIS 15 million as at the date of filing the claim. Summations have been filed in the matter of the application for recognition as a class action and the case is awaiting a decision on that application. In the opinion of the Company, relying on the legal adviser who is handling the claim on its behalf, the chances of the claim cannot be estimated at this stage. Accordingly, no provisions has been made in the financial statements in respect of this claim.

(13) On February 24, 2002 a "notice of a party to a collective dispute" ("the Notice"), was received at the Company’s offices, which was filed in the Regional Labor Court in Jerusalem on February 21, 2002 by the New General Federation of Workers ("the Applicant") in the name of Company employees. The Applicant alleges that payments for grossing up of tax, the administrative component of call duty benefits and clothing allowances which were and are paid to Company employees are regular pay which form part of the determining salary of every employee, and that various payments and provisions should be made in respect thereof, including for pension purposes. The Notice states that the requested reliefs are for all Company current and former employees, including those who were transferred from government service to the Company. On October 20, 2002 the Attorney General gave notice that he would be joining the claim, and he later submitted his position, stating that the application and all its parts should be rejected. Regarding a decision concerning one of the said components, given by the National Labor Court in another case (to which the Company is not a party), which could have changed the Company's position on this matter for the worse, on October 20, 2003 the Supreme Court issued a decree nisi against that decision. In the opinion of the Company' legal advisers, the chances of the Company with regard to this component cannot be estimated.

On July 14, 2003, the National Labor Court gave a decision on an appeal in another case which was filed by seven former Company employees, recognizing one of the above payments as a pension component in view of the factual circumstances in that case. The legal advisers of the Company believe that the decision, insofar as it relates to that component, increases the risk considerably. However, the decision in the appeal does not deal with several credible legal arguments raised in the pleadings filed on behalf of the Company in response to the "Notice of a party to a collective dispute", on which the court will have to decide. The main points of these arguments are that under collective agreements signed by the Company and the conduct of the parties over the years, the components which are the subject of the application are not part of the regular pay, the demands of the Applicant are new economic demands and not legal demands that can be sued for in a labor court, and the application is contrary to the Budget Foundations Law.

Several additional individual claims of employees and former employees are pending against the Company, dealing mainly with recognition of various wage components as pension components.

The financial significance of the claims described in this sub-section is considerable, and could, under certain assumptions, reach as much as NIS 2.4 billion. In the opinion of the Company's legal advisers, presentation of that financial significance to the court would support and reinforce the legal arguments of the Company.

NOTE 19 - CONTINGENT LIABILITIES (CONTD.)

A. CLAIMS (CONTD.)

In view of all of the aforesaid, the Management and the legal advisers of the Company are unable, at this stage, to estimate the results of the above claims in relation to certain components, and accordingly no additional provisions have been made in the financial statements beyond those made on the basis of the assessment of the Management prior to the decision given by the National Labor Court in the other case to which the Company is not a party. Nevertheless, in respect of that particular component which the Company and its legal advisers believe to be a material risk, a provision has been included in these financial statements, calculated according to certain assumptions which the Company considers appropriate.

In respect of a group of employees who filed a claim against the Company for the inclusion of a number of components as part of the wage that determines pension, the Company is negotiating with that group. The financial statements include an appropriate provision, which was made on the basis of the Management's assessments.

(14) In July 2002 a claim and an application for recognition as a class action by virtue of Regulation 29 of the Civil Proceedings Regulations and of the Antitrust Law, was received at the Company’s offices, which were filed in the Tel Aviv District Court against the Company. The plaintiffs, who contend that they are Company subscribers or use its services, allege that the Company unlawfully collects interest on arrears, as defined in a directive from the Accountant General concerning interest rates in respect of arrears in payment for services provided by other communications service providers, which are included in the invoice which the Company issues to its subscribers. The plaintiffs allege that the Company may collect such interest only in respect of arrears in payment for the telecommunication services provided by the Company itself. They further allege that the Company does not transfer to the other communications providers the full amount of interest on arrears it collects. The plaintiffs are requesting declaratory relief for the Company's exploitation of its monopolistic status and that the Company be directed to reimburse the interest on arrears that the Company is alleged to have collected unlawfully. If approved as a class action, the total amount of the claim is estimated by the plaintiffs to be in the tens of millions of shekels. On February 11, 2003 the Company filed its response to the application, arguing that it is entitled to interest for arrears in payment of bills both by law and under the licenses of the other communications providers, that according to a practical interpretation of the interest regulations it is entitled to collect the additional arrearage interest at the rate prescribed in those regulations, and that the plaintiffs had disregarded several benefits that the Company grants its subscribers, as a result of which some of the plaintiffs suffer no damages and some suffer damages that are much lower than alleged in the claim, and in any case the plaintiffs in the class action suffered no damages and therefore cannot serve as appropriate plaintiffs in a class action. Following a precedent setting ruling by the Supreme Court on April 2, 2003, the parties filed an agreed application on May 26, 2003, which was allowed, to strike the parts relating to approval as a class action on the basis of Regulation 29. On June 9, 2003 the plaintiffs filed an amended application relying only on the Antitrust Law. On June 19, 2003 the Company filed an application to strike parts of the application for approval based on Regulation 29. On September 29, 2003 it was agreed that the plaintiffs would file an amended action and application for approval, from which they would delete causes of claim which are not based on the Antitrust Law. The action and the amended applications for approval were submitted to the Company and the Company is required to file its amended response. In the opinion of the Company, relying on its legal advisers, the chances of the claim cannot be estimated at this stage, and therefore no provision has been included in the financial statements in respect of this claim.

NOTE 19 - CONTINGENT LIABILITIES (CONTD.)

A. CLAIMS (CONTD.)

(15) On December 22, 2002 a claim and application for recognition as a class action were filed in the Tel Aviv District Court against the Company. The plaintiffs, who contend that they are subscribers of cellular communications providers, allege that the Company is misleading the consumer public regarding calls to 1-800 or 177 numbers, into thinking that such numbers are toll-free calls, whereas in fact, the consumer who calls such a number from a cellular telephone is charged by the cellular companies for air-time for such calls. According to the plaintiffs, in so doing, the Company is perpetrating a tort according to the Consumer Protection Law, and all the members of the group represented in the action (all the consumers who called 1-800 or 177 from a cellular telephone in the seven years prior to the date of filing the claim) have consequently sustained losses. The estimated amount of the claim is approximately NIS 687 million, which includes compensation for financial loss, non-financial damages and punitive damages. The court is also requested to give temporary and permanent injunctions against the Company, to cease misleading consumers and to refrain in the future from advertising or making any other representation liable to mislead consumers regarding the price of such calls.

On March 27, 2003 the Company filed its response to the application for approval, in which it alleges, *inter alia*, that no transaction was made between it and the plaintiffs, that the advertisements did not make representations towards the plaintiffs and that all the representations of the Company were correct. On July 22, 2003 the plaintiffs filed a reply that includes many new allegations which did not appear in the application for approval, and on September 3, 2003 the Company filed an application to strike the reply, and alternatively, to strike all the "new" allegations contained therein. On February 15, 2004 the court ruled that the plaintiffs must file an amended reply. In the opinion of the Company, relying on its legal advisers, the chances and implications of the claim cannot be estimated at this stage, and therefore no provisions has been made in the financial statements in respect of this claim.

(16) On April 24, 2003 a derivative statement of claim was received at the Company's offices, which includes an application to the court to approve the filing of the claim as a derivative claim (a claim which is filed by a shareholder or director of a company in the name of the company, with the approval of the court). The claim was filed by a shareholder of the Company against 20 directors and certain senior managers who served in the Company during October and November 2000 ("the Officers") and against the Company. The statement of claim alleges as the main cause of the action, the negligent conduct of the Officers in the “Pelephone-Shamrock” transaction. In that transaction, the shares of Motorola Israel Ltd. in Pelephone were sold to Pelephone Holdings L.L.C., a corporation registered in the U.S.A. ("the Foreign Corporation"), in consideration of approximately $591 million.

The consideration of the purchase was financed partly by a loan of $240 million extended by the Company against convertible debentures for 80% of the shares of the Foreign Corporation (a detailed description of the transaction has been included in the financial statements of the Company since 2000). This negligence is mainly reflected, according to the statement of claim, in that the Officers did not ensure that the Company would receive collateral for the above loan extended to the Foreign Corporation by the Company. The claim further alleges that as a result of the alleged negligence of the Officers, the Company was obliged to record a provision in its books for the full amount of the loan, which is tantamount to an admission that the chances of collecting the loan are non-existent, and therefore, the loss to the Company as a result of the Officers' alleged negligence amounts to approximately $240 million. The plaintiff petitioned the court to order the Officers to pay the Company the amount of the loss it sustained, i.e. approximately $240 million.

NOTE 19 - CONTINGENT LIABILITIES (CONTD.)

A. CLAIMS (CONTD.)

It should be noted that the Company rejected a prior approach sent to it by the plaintiff's lawyer, demanding full exercise of the rights of the Company in the matter by way of filing suit, citing as the reasons, *inter alia*, that the facts creating the cause of action were not described in accordance with the requirements of the Companies Law, 5759-1999 and that in any case, since the loan extended by the Company would fall due only when the term set in the agreement had elapsed and since the Company still has an option to convert the loan to shares of the Foreign Corporation, then from a legal standpoint, the claim is speculative. It should be further noted that contrary to the statement of claim, which alleges that the Company did not receive collateral for the loan it extended, the Company has registered a second ranking lien on the shares of Pelephone Holding L.L.C. in Pelephone against the same loan (convertible debenture) (after a first lien was given to the bank that financed part of the transaction – see also Note 8D(2) to the financial statements).

On June 12, 2003 the Company filed an application for the dismissal *in limine* of the claim, citing as its reason that the plaintiff had not filed a preliminary application for approval of his claim as a derivative claim, as required by law. Concurrently, the Company filed an application for extension of the date for filing a statement of defence until a decision was given on the application for dismissal *in limine*. The Company's application to extend the date was allowed. A similar application for dismissal *in limine* was also filed by the Officers. On January 8, 2004 the plaintiff filed an application for, *inter alia*, leave to file a preliminary independent application for approval of the claim as derivative, and on that basis he requested dismissal of the of the applications for dismissal *in limine*.

On January 15, 2004 the court determined that the plaintiff my file an independent application for approval of the claim as derivative, and the Company will be required to file its response to that application. The Company, relying on its legal advisers, cannot estimate the chances of the claim at this stage, and accordingly no provision has been made in the financial statements in respect of this claim.

(17) On May 27, 2003, a statement of claim was received at the Company's offices together with an application for recognition as a class action, which were filed in the Tel Aviv District Court against the Company. The plaintiff, who describes himself as "a private internet user", alleges in his claim that the Company refuses to install splitters for high speed internet lines of the broadband ADSL/frame relay type used for internet service in condominiums and does so, allegedly, in order to increase its profits. The plaintiff, who is seeking to represent all the internet users in Israel, further alleges that the Company's refusal to install the splitters causes losses of thousands of shekels each year to every private internet user in Israel, since the connection of a number of tenants in a condominium on one telephone line using the aforementioned splitters would considerably reduce the fees paid to the Company by each consumer. The causes of the claim as appear in the statement of claim, are cited by virtue of the Antitrust Law, the Torts Ordinance and the Unjust Enrichment Law. The plaintiff also alleges fraud and material deception under the Consumer Protection Law. The amount of the claim is estimated by the plaintiff at NIS 2.5 billion (NIS 10,000 per consumer), which he alleges is the loss sustained by the plaintiffs. The plaintiff also petitions to charge the Company, in addition, with special and punitive damages, and for an order for the Company to give accounts for all private internet users in respect of the amounts received from them from the time each user started using the service until the date of the Company's reply. On September 30, 2003 the Company filed its response to the application, after which the plaintiff filed his reply to the Company's response. The main points of the Company's arguments are that there is no basis in law for obligating it to connect a number of users on one "broadband" and that the service and the tariff collected by the Company for it were approved by the Ministry of Communications. In the opinion of its legal advisers, the Company has credible arguments in its defense. Nevertheless and relying on its legal advisers, the Company is unable at this stage to estimate the chances of the claim, and therefore no provision has been made in respect of the claim in the financial statements.

NOTE 19 - CONTINGENT LIABILITIES (CONTD.)

A. CLAIMS (CONTD.)

(18) On June 5, 2003 a statement of claim was received at the Company's offices together with an application for recognition as a class action, which were filed in the Tel Aviv District Court against the Company by two of its subscribers. According to the allegations in the statement of claim, the Company overcharged its subscribers by NIS 0.021 (plus VAT) compared with the charge set in the regulations, for calls from Company subscribers to subscribers in the cellular networks of Cellcom and Pelephone, during a period (estimated) from June 1996 to August 31 of that year. The plaintiffs allege that in so doing, the Company violated the ban on misleading consumers as laid down in the Consumer Protection Law, breached duties under the Contracts Law, the Torts Ordinance and the Sale Law, as well as unjust enrichment. The group in whose name the claim is filed is defined by the plaintiffs as "a group of Bezeq subscribers in Israel who dialed to subscribers of Cellcom and Pelephone in June, July, August 1996" and estimated by them as numbering more than four million subscribers. (It should be noted that at the relevant time, the Company's subscribers numbered about 2.5 million.) Based on the (erroneous, as aforesaid) estimate of the number of subscribers and the average "loss" to the plaintiffs (NIS 7.5), the plaintiffs estimate the amount of their claim at about NIS 30 million and are claiming compensation in respect of that loss. A calculation made by the Company found that the difference between actual collection and collection by the applicants' method amounts to about NIS 6 million. Alternatively, the plaintiffs are requesting that the court recognize the claim as a claim for declaratory relief or as a claim for a mandamus against the Company. Concurrently, and according to the statement of claim, claims for similar cause were filed against Cellcom and Pelephone where the claim against Pelephone was dismissed by the District Court and an appeal against the dismissal of the application against Pelephone was also dismissed on January 5, 2004. The Company, relying on its legal advisers, is unable at this stage to estimate chances of the claim, and therefore no provision has been included in the financial statements in respect of the claim.

(19) In November 1997 a claim was filed in the District Court, together with an application to recognize the claim as a class action, against the Company, Bezeq International Ltd., the Chairman of the Board of Directors of Bezeq International and the then CEO of Bezeq International. The claim alleges, *inter alia*, that the Antitrust Commissioner determined that Bezeq International had unfairly exploited its status in the international calls market and had implemented a deliberate policy of misleading the public on the subject of overseas call tariffs when it refrained from clarifying to the public that only those who register as Bezeq International subscribers would enjoy the reduced tariffs. The amount of the class action is estimated by the plaintiffs at approximately NIS 50 million. In December 1997 the Company was struck from the claim. On June 19, 2001 the District Court decided to reject the application for approval as a class action. On September 20, 2001 the decision of the District Court was appealed in the Supreme Court. On October 28, 2001 Bezeq International filed an application to strike the appeal *in limine*. On January 7, 2002 the court rejected the application of Bezeq International and ruled that the appeal would be heard on its merits. On October 30, 2002 the plaintiffs requested to reduce the amount of the guarantee required as a condition to hearing the appeal and to extend the date of filing. On November 19, 2002 Bezeq International submitted its objection to this request and on December 3, 2002 the Supreme Court allowed the position of Bezeq International, and the parties filed their summations. On May 28, 2003 a hearing was held in the Supreme Court, which ruled that the District Court had erred procedurally, since it should have decided only on the application to join another plaintiff to the class action and not on the question of dismissal of the application for approval of the claim as a class action. Accordingly, the appeal of Bezeq International was allowed and the case was returned to the District Court and instead of a hearing it was agreed that the parties will submit their summations on the question of approval of the claim as a class action and on the question of establishment of the plaintiffs' personal cause of action. The legal advisers of Bezeq International are unable, at this stage, to estimate the chances of the claim and the application for its recognition as a class action, and therefore no provision has been included in the financial statements in respect of this claim.

NOTE 19 - CONTINGENT LIABILITIES (CONTD.)

A. CLAIMS (CONTD.)

(20) On September 16, 2001 a revised statement of claim and an application for recognition as a class action were filed against Bezeq International and the State of Israel. The plaintiff alleges that the tariffs for international telecommunication services in the period from May 10, 1996 to July 8, 1997 were exorbitant and unreasonable, while exploiting the status of Bezeq International as a monopoly, in view of reducing prices as the international calls market was opening up to competition. On February 18, 2002 Bezeq International filed its response to the court, in which it rejected the allegations of the plaintiff and alleged that the conditions for allowing the claim as a class action had not been established. The Court allowed the application of the Applicant to study the financial statements of Bezeq International for the relevant period, and the minutes of the meetings of its board of directors from the same period. On December 25, 2003 the court allowed the application by virtue of the Antitrust Law and not by a cause arising from the Unjust Enrichment Law, and approved the claim as a class action. On January 14, 2004 the daily press included an item about the decision to approve the claim as a class action under Chapter F of the Antitrust Law. On January 15, 2004 an application was filed in the District Court for a stay of implementation of the decision. On February 2, 2004 the respondent filed its reply to the application, requesting its dismissal *in limine.* On February 11, 2004 the District Court decided to delay implementation of the decision. to approve the claim as a class action. On February 2, 2004 the plaintiff filed an appeal in the Supreme Court against the decision of the District Court relating to the cause prescribed in the Unjust Enrichment Law. Bezeq International intends to appeal in the Supreme Court against the decision of the District Court to approve the claim as a class action.

The legal advisers of Bezeq International are of the opinion that if the actions will also subsequently be approved by the Supreme Court as class actions and if the action is allowed, the amount of the action is liable to reach hundreds of millions of shekels. The legal advisers of Bezeq International are unable, at this stage, to estimate the chances of the claim, and therefore no provisions were made in respect of this claim in the financial statements.

(21) On March 3, 2003 a claim was filed against Bezeq International by a systems vendor for approximately NIS 18.5 million. According to the vendor, Bezeq International unlawfully canceled an agreement to supply and install a customer care and billing system, and it is suing for enforcement of the agreement against Bezeq International, and compensation for the losses deriving from the delay in the project, and alternatively – if the claim for enforcement is not allowed – compensation in respect of all the losses it sustained as a result of breach of the contract. On May 26, 2003 Bezeq International filed a statement of defense and a statement of counter-claim in the amount of NIS 10 million, in which it alleged that the contract was canceled because the vendor violated the undertakings it made in the contract. On September 14, 2003 the vendor filed a reply to the counter-claim, in which it denied the allegations of Bezeq International. The vendor recently requested that a date be set for a pre-trial hearing. The legal advisers of Bezeq International are unable, at this stage, to estimate the chances of the claim. Accordingly, no provision has been included in its financial statements in respect of this claim.

NOTE 19 - CONTINGENT LIABILITIES (CONTD.)

A. CLAIMS (CONTD.)

(22) In October 1999, a class action was filed against Pelephone in the District Court, by virtue of the Consumer Protection Law, 5741-1981 and the Antitrust Law, 5748-1988. The statement of claim is based on the applicants' allegation that throughout the years when Pelephone was a monopoly in the cellular telephone market, it abused its status and collected exorbitant prices for all its services. The applicants were therefore seeking to order Pelephone to make restitution to its customers of the excess profits it collected and which allegedly amount to the total of the claim (NIS 12 billion, NIS 6 billion in proportional consolidation). On November 14, 2002 an application was filed for leave to appeal the decision of the Tel Aviv District Court of October 1, 2002 to dismiss the applicants' request to approve their claim against Pelephone as a class action. On February 2, 2003 Pelephone responded to the application for leave to appeal. At this stage, Pelephone and its legal advisers are unable to estimate the chances of the appeal.

(23) In December 2000 a claim was filed in the District Court against Pelephone by the State of Israel, for royalties allegedly payable for the period from January 1994 to February 1996. The amount claimed is approximately NIS 260 million, consisting of principal, linkage differentials and interest.

In the opinion of the management of Pelephone, based on the opinions of its external legal advisers, Pelephone has a genuine defense against the claim, the amount of which is also deemed to be highly exaggerated.

On March 11, 2001 Pelephone filed a defense and a counter-claim relating to the State's claim for payment of royalties for the period from January 1, 1994 until February 7, 1996. In the counter-claim, Pelephone claims reimbursement of NIS 66 million (including interest and linkage differentials) in respect of an advance payment it made to the State as a goodwill gesture for reaching a settlement in 1996, a payment which was contingent upon the State not suing Pelephone for royalties. Before the case came to court, the parties agreed to transfer the matter for clarification in a mediation proceeding. The mediation proceedings commenced in 2002.

It should be noted that the claim includes sums in respect of the period January – October 1994, in respect of which the Company had made an undertaking in a settlement agreement from 1995 covering a number of issues. According to the Company, it had already paid the royalties in respect of that period as part of that settlement agreement. If the mediation proceeding between Pelephone and the State fails, the Company will pay Pelephone, in accordance with an undertaking it made, any amount Pelephone is obligated to pay the State, if obligated in a final court decision in respect of royalties for that period.

(24) In July 2001 a claim was filed in the District Court against Pelephone. The plaintiffs allege that Pelephone's pre-paid service constitutes infringement of their patent. Among the reliefs claimed are that Pelephone be directed to refrain from infringing the patent, ordered to submit a report on the number of cards, the revenues and profits, etc., received in respect of the sale of the cards, and ordered to pay NIS 100,000 in damages. The claim is pending in the District Court and is in proceedings before the Registrar of Patents. At this stage, Pelephone is unable to estimate the outcome and the implications of the claim.

NOTE 19 - CONTINGENT LIABILITIES (CONTD.)

A. CLAIMS (CONTD.)

(25) In September 2001 a claim was filed in the Ramallah District Court by the General Public Palestinian Communications Co. Ltd., against Pelephone and another cellular company. The plaintiff alleges that its license grants it, *inter alia*, full right and authority to set up, operate, supply, sell and manage services and stations for telephone communication, both landline and mobile, for the supply of fixed and cellular communications services for an extended period, during part of which it was granted exclusivity. According to the plaintiff, it commenced providing cellular communications services in September 1999, and despite its approaches to the defendants, they are continuing to provide cellular communications services to the inhabitants of the West Bank and the Gaza Strip, without restraint and without a license from the Palestinian communications authority, thereby violating various provisions of the law and prejudicing the exclusive rights of the plaintiff and causing it losses and damages. The reliefs requested are a permanent judicial injunction preventing the defendants from providing communications services in the areas of the Palestinian National Authority and a financial claim for NIS 676 million from Pelephone alone.

As at February 24, 2004 service of process of this claim was halted by the Attorney General, and alternative service by registered mail was returned by the Ministry of Justice and therefore, the case is not included in the pending claims against Pelephone. It is noted that Pelephone does not recognize the authority of the court in Ramallah.

(26) In December 2002 a claim was filed in the District Court against Pelephone and against Cellcom, together with an application for recognition as a class action in the amount of about NIS 4 billion, of which about NIS 2.4 billion against Pelephone.

The claim relates to amounts collected by Pelephone and Cellcom for incoming calls from May 5,1996 to October 2, 2000. The applicants, through their lawyers, base their claim on the following allegations:

a. Every cellular operator is a monopoly in the incoming call service to its network. Pelephone and Cellcom abused their monopoly status in that they set high and unfair prices for the incoming call service to their networks. The correct and fair tariff for the incoming call service is 25 agorot per minute, and not as collected in the past by Pelephone and the other company or as stipulated today in the Telecommunications Regulations (Payments for interconnect), 5760-2000.

b. Pelephone and Cellcom violated legislated obligations under the Telecommunications Law, their licenses and the duty of good faith to demand a reasonable price for a telecommunications service for which no price is set.

In July 2003 Pelephone filed its response to the application. Pelephone and its legal advisers are unable, at this stage, to estimate the chances of the claim.

(27) In April 2003 an application was filed in the Tel Aviv District Court for approval of a class action in a total amount of approximately NIS 90 million against Pelephone and against all the other cellular operators. The applicants allege that the three cellular companies formed a cartel among themselves for the collection of a tariff of 38 agorot plus VAT for SMS messages coming in to the network of each of them. The plaintiffs allege that this is a uniform, exaggerated, unreasonable and unfair tariff. The period to which the claim relates is March-June 2002 and up to the date of filing the claim. In October 2003 Pelephone filed its response to the application. Pelephone and its legal advisers are studying the claim and are unable, at this stage, to estimate its chances.

NOTE 19 - CONTINGENT LIABILITIES (CONTD.)

A. CLAIMS (CONTD.)

(28) On December 9, 2003 a claim was filed in the Tel Aviv District Court together with an application for approval as a class action, in the amount of approximately NIS 317 million, against Pelephone. The plaintiffs allege that since June 2003 they have suffered a high percentage of dropped calls and blocked calls, exceeding the bar set in Pelephone's license. The plaintiffs are seeking restitution of the monthly subscriber fees collected from them, from June 2003 until the date of filing the claim and recognition of the claim as a class action for a group of 1,900,000 subscribers.

The application for approval as a class action was filed by virtue of Regulation 29 of the Civil Procedures Regulations, 5744-1984. On February 29, 2004 Pelephone filed its response to the application as well as an application for dismissal *in limine* of the action since it was based entirely on the Civil Proceedings Regulations. On March 9, 2004 the applicants filed their reply to the response to the application, in which they alleged that the application for approval of the claim as a class action was filed by virtue of the Consumer Protection Law and not by virtue of Regulation 29. At this stage, Pelephone is unable to estimate the chances of the claim or its implications.

(29) On December 3, 2002 an application was filed for recognition of a claim as a class action against DBS, the Council for Cable and Satellite Broadcasts and the Ministry of Communications, in connection with the broadcasts of the Channel 5+ sports channel. According to the applicants, the broadcasts of Channel 5+ contravene the terms laid down with the approval of the Council for its broadcasting, while emptying Channel 5 of its content in contravention of the aforementioned approval. The applicants, who wish to sue DBS for deception, violation of fiduciary duty and good faith in a contracted agreement, fundamental breach of the contract between DBS and its customers and unjust enrichment, estimate the amount of the claim at about NIS 126 million up to the date its filing, and an additional amount of approximately NIS 10.5 million for each month from the date of filing the claim until the date on which the decision is given. In the opinion of the legal advisers of DBS, it is difficult, at this stage, to estimate whether the claim will be approved as a class action, and if it is approved, what its chances will be. Accordingly, no provision has been made in the financial statements in respect of the application.

(30) On March 25, 2003, an application was filed in the District Court against DBS for approval as a class action of a claim alleging that DBS must pay for the electricity consumption of installations connected by and/or for it in various premises and that it must reimburse the members of the group for all the monies they paid for the electricity consumption of DBS's installations, as well as compensation for and/or restoration of monies paid in respect of such electricity consumption. The amounts assessed by the applicants as damages for which they are demanding restoration is approximately NIS 25 million. In the opinion of the legal advisers of DBS it is difficult, at this stage, to estimate whether the claim will be approved as a class action, and if it is approved, what its chances will be. Accordingly, no provision has been made in the financial statements in respect of the application.

(31) In 1995, the Company, together with others, through a joint venture company, submitted bids in tenders of the Government of India for the construction of a basic communications system in India. Letters of intent and draft concession agreements for development of the basic telephone system in four provinces for which the joint venture company won the tender, were submitted to the joint venture company in which the Company has a share. However, the joint venture company did not sign the letters and drafts because in its opinion, *inter alia,* these documents did not correspond to the terms of the tender. At the time of the tender, the joint venture company gave the Indian Ministry of Communications bank guarantees in which the Company’s part was 273 million rupees (approximately NIS 26 million). The Indian Ministry of Communications demanded foreclosure on the guarantees at the end of June 1996. On September 19, 1997 the court gave a permanent injunction, preventing the Indian Ministry of Communications from foreclosing on the guarantees. At the end of October 1997 the Indian Ministry of Communications appealed that decision.

NOTE 19 - CONTINGENT LIABILITIES (CONTD.)

A. CLAIMS (CONTD.)

During 2003, the proceeding was struck for "inaction" and an application to revive the proceeding was filed. The Indian lawyer who is handling the case on behalf of the Company believes that the chances that the renewal application will be allowed are very good. The Company's Management and legal advisers are unable to estimate the chances of the appeal in those proceedings. Accordingly, no provision has been made in the financial statements in respect of this matter.

(32) Keren Makefet was instructed by the Capital Markets Division at the Ministry of Finance to fulfill its undertakings in connection with the change in the retirement tracks of about 600 Company retirees, contingent upon the Company paying Keren Makefet NIS 50 million. The Company notified Keren Makefet that it is demanding the continued application of the agreement that enabled transfer from one retirement track to another at no additional cost to the Company, since Keren Makefet had undertaken not to impose any additional cost on the Company. Subsequently Keren Makefet stopped allowing Company retirees to switch from one track to another and also ceased completely or partially execution of the retirement agreement with regard to pensions paid in respect of April 2002. On January 11, 2004 a claim was filed against the Company by 65 retirees who had retired under the retirement agreement of November 1997, alleging that they had elected to receive their pensions under Track B since the personal agreement signed with them in that track embodied a promise of amendment of the wage that determines their pensions in accordance with the "Yellow Note" agreement (i.e. additional payment up to NIS 650).

According to the plaintiffs, that promise had not been kept, and therefore a collective agreement was signed on April 2, 2001 which was intended to enable employees to switch from Track B to Track A. The plaintiffs contend that the April 2001 agreement was applied to only about 70 employees of the 600 or so who wished to exercise their right under it. The claim is therefore for enforcement of the April 2001 agreement. It is the opinion of the Management of the Company, relying on its external legal advisers, the Company is not at risk of actual legal exposure in respect of the claim and accordingly, no provision has been made in respect thereof, in the financial statements.

(33) For possible demand for early repayment of bank loans, see Notes 13D and 14C.

(34) Miscellaneous claims - Various claims are pending against the Company in the normal course of business. It is the opinion of the Company's Management that the risk inherent in each of these claims will not cause the Company material financial losses beyond the amounts included in the financial statements.

The amounts of the claims referred to above are adjusted (without the addition of interest) in terms of shekels of December 31, 2003.

NOTE 19 - CONTINGENT LIABILITIES (CONTD.)

B. COMMITMENTS

(1) Lease Contract Commitments

Forecast contractual rent for the coming five years computed according to the rent in effect on December 31, as follows

For the year ended December 31	Consolidated NIS thousands	Company NIS thousands
2004	**120,287**	**64,165**
2005	**114,760**	**56,066**
2006	**102,643**	**55,485**
2007	**82,292**	**55,263**
2008	**81,128**	**54,183**
2009 and thereafter	**284,256**	**261,816**
	785,366	**546,978**

(2) DBS is committed to agreements to purchase broadcasting rights which amount to approximately NIS 149 million as at December 31, 2003 (2002 – approximately NIS 212 million).

(3) DBS entered into an agreement to lease space segments of the Amos 1 satellite. The agreement is for 8.5 years, commencing on April 14, 2000, with an option to extend for additional periods of six months each. In addition, DBS entered into an agreement on May 16, 2001, to lease space segments of the Amos 2 satellite. The lease period will end after ten years from the date of the satellite's launch or at the end of the satellite's life, whichever is earlier. The satellite was launched on December 28, 2003.

(4) BezeqCall Communications has commitments to provide maintenance services in the network end point field for a period of three years ending on December 31, 2004, amounting to approximately NIS 14 million.

(5) On June 27, 2002, BezeqCall Communications and Nortel Networks Israel (Sales and Marketing) Ltd. ("Nortel") signed three agreements intended to provide BezeqCall Communications with the ability to operate independently with respect to sales, maintenance, support and installation services for its customers who have Nortel exchanges on their premises, as follows:

a. An agreement whereby BezeqCall Communications was granted, on a non-exclusive basis, resources, manpower, abilities and licenses for maintaining an independent ability to provide maintenance, support and installation services of voice enterprise products of the Meridian family. The consideration in the purchase agreement for the resources was set at approximately $6 million, as follows –

- $2 million paid to Nortel on the closing date of the transaction (July 31 ,2002)
- $4 million spread over 16 quarterly installments.

b. A non-exclusive distribution agreement for three years, whereby BezeqCall Communications will serve as a distributor of Nortel voice enterprise products. BezeqCall Communications made a commitment to purchase not less than $4 million of these products per year from Nortel.

NOTE 19 - CONTINGENT LIABILITIES (CONTD.)

B. COMMITMENTS (CONTD.)

c. A services agreement whereby Nortel undertook to supply BezeqCall Communications with various services over a period of four years, mainly high-level support services (software level), repair or replacement services for hardware products and training services and future know-how transfer.

(6) In winning a tender for frequencies, Pelephone undertook to pay NIS 225 million (proportionately consolidated – approximately NIS 112 million) to the Ministry of Communications in six installments (see Note 8D(4)). During 2002 Pelephone paid approximately NIS 117 million (proportionately consolidated – approximately NIS 58 million).

In June 2003 a further installment payment of approximately NIS 36 million came due (proportionately consolidated – approximately NIS 18 million) in respect of the above frequencies. Pelephone decided not to make the payment, *inter alia* since it expected that it would be able to use the frequencies only several years later. The payment was recorded in Pelephone's books as Frequencies in the “other assets” item against trade payables.

Pelephone requested that the Ministry of Communications agree to a freeze on the payments for the frequencies until they were in use – their use will solve the problem of interference in the present frequency range and/or will enable Pelephone to provide advanced roaming services and/or services enabled by third generation technology.

On March 16, 2004 Pelephone accepted the proposal of the Ministries of Communications and Finance concerning a reduction of NIS 33 million from the original payment stipulated in the tender, against –

a. payment of the balance of the license fee in the amount of approximately NIS 99 million, during 2004; and
b. return of the frequencies to the State, so that it will not have to pay frequency fees from 2003 onwards.

In addition and concurrently, Pelephone was granted a right to a future allocation of the frequencies, at which time Pelephone would complete payment of the reduced amount. plus the frequency fee in respect of the relevant period, and all plus linkage differentials and interest as is customary

(7) On March 17, 2004 Pelephone signed a declaration of intent, in the wake of which an agreement will be signed for upgrading cellular sites with EVDO technology. The contract value will be about $48 million.

(8) In December 2003 an agreement was signed between Bezeq International, Cardan Ltd. and Infomet Israel Ltd. ("Infonet"), whereby Bezeq International is purchasing all the rights in the operations of Infonet, including assignment of Infomet's agreements with its customers to Bezeq International, in consideration of payment of $2 million. Completion of the agreement is subject to meeting certain suspending conditions, among them receipt of the approval of the Antitrust Authority and signature of other related agreements. As at the date of approval of the financial statements the approval of the Antitrust Commissioner had been obtained but not all of the suspending conditions had been met. It was further agreed that if the suspending conditions are not met within 90 days of the date of signing the agreement, any of the parties may cancel the transaction.

(9) In February 2004 Bezeq International entered into an agreement with Mediterranean Nautilus Limited ("Med Nautilus") for acquisition of an irrevocable right of use of undersea cable capacity. In addition, the agreement grants Bezeq International options to an additional purchase of an irrevocable right of use of undersea cable capacity from Med Nautilus. Some of the options can be exercised during 2005, and the others over a period of one year starting in June 2006

NOTE 19 - CONTINGENT LIABILITIES (CONTD.)

C. SECURITY AND LIENS

For security, liens and stipulations given by the Company and investee companies in connection with loan covenants, see Note 13D and Note 14C.

D. GUARANTEES

(1) The Company has provided guarantees to third parties in the amount of approximately NIS 4,298 thousand.

(2) In May 2003, the Company, upon the demand of the Ministry of Communications, provided a bank guarantee in the amount of $10 million in connection with its general license for performing telecommunications operations and providing telecommunications services.

(3) The Company provided a guarantee to the banks in connection with credit granted to consolidated companies amounting to up to NIS 70 million.

(4) Regarding guarantees provided by the Company with regard to its investments in India, see Note 19A(31).

(5) The Company provided a guarantee of approximately NIS 10 million for an affiliated company in respect of a bank guarantee of about NIS 33 million that the affiliate provided in favor of the State of Israel. The guarantee is valid until December 31, 2010.

(6) Bezeq International provided a bank guarantee of $2 million upon the demand of the Ministry of Communications, for fulfillment of all the terms of the license to provide international telecommunications services.

(7) BezeqCall Communications provided a guarantee of approximately NIS 8 million for third parties

(8) Pelephone gave a guarantee to third parties amounting to approximately NIS 119 million (proportionately consolidated – NIS 59 million), of which approximately NIS 92 million (proportionately consolidated – NIS 46 million) is in connection with the tender for third generation frequencies for cellular telephones.

(9) To secure its obligations, DBS provided documentary credit and guarantees amounting to approximately NIS 63 million (including a bank guarantee of NIS 3.3 million in favor of the State of Israel).

(10) Regarding another guarantee provided in connection with the Company's investments in DBS, see Note 8E.

NOTE 20 – SHAREHOLDERS' EQUITY

A. SHARE CAPITAL

	Registered		Issued and fully paid	
	December 31 2003	December 31 2002	December 31 2003	December 31 2002
	No. of shares	No. of shares	No. of shares	No. of shares
Ordinary shares of NIS 1 par value each	2,625,000,000	2,565,000,000	2,605,045,611	2,411,657,538

B. In a framework agreement signed on January 13, 2002 (including amendments to that agreement which were signed later) between the State and the Company, it was agreed that capital would be raised by way of a private placement of the State's shares in the Company in accordance with Sections 15A and 15C(b) of the Securities Law, 5728-1968 (in one sale or several sales). Concurrently with the sale of the shares, the Company would allot shares to the State in consideration of the amount received by the State for its shares less a margin of 1%, where the total number of shares to be allotted to the State by the Company would not exceed, at any point in time, the number of shares sold by the State and the State's holdings in the Company would not fall below 30% - 40%. The proceeds from raising the capital were designated for financing the costs involved in the retirement of Company employees.

The agreement also stated that if the State were to sell shares in a total number exceeding the limit of the registered share capital of the Company at that date and the registered capital of the Company did not comprise sufficient shares for their allotment to the State, then the Company's obligation to allot shares to the State against receipt of the consideration for them would be postponed until not later than 120 hours from the time of the Company increasing its share capital.

Pursuant to the framework agreement, on July 24, 2003 the Company approached several institutional bodies and requested offers for the purchase of 86,500,000 ordinary shares of NIS 1 par value each of the State's shares in the Company. Subsequently, on July 29, 2003, the State sold those shares to Gmul Sahar Underwriters Ltd. (which offered the highest price) at a price of NIS 4.338 per share. Accordingly, on July 30, 2003 the Company allotted the entire balance of its registered un-issued capital to the State at that time, a total of 23,342,462 ordinary shares of NIS 1 par value each, in consideration of NIS 101,261,807. On October 23, 2003 the registered capital of the Company was increased by 190,000,000 shares, increasing it to 2,625,000,000 shares (this was subsequent to the cancellation, at the beginning of February 2003, of registered capital of 130,000,000 shares in accordance with a decision of the General Meeting of the Company as capital un-allotted in raising capital on the terms prescribed). Immediately after increasing its registered capital, the Company allotted to the State, on October 31, 2003, the balance of the shares in respect of those sold by the State to Gmul Sahar Underwriters Ltd, as well as additional shares in accordance with the framework agreement (a total of 64,398,076 additional shares). The proceeds from this additional allotment amounted to NIS 279,364,943.

On November 12, 2003 the State once again approached institutional bodies, requesting offers for the purchase of 130,000,000 ordinary shares of NIS 1 par value each which the State held in the Company ("the Transaction Shares"). In addition, an option was granted to purchase up to 30,000,000 additional shares of the State and not less than 10,000,000 such shares, at the share price offered by the bidder for the Transaction Shares.

Subsequently, on November 18, 2003, the State sold the Transaction Shares to UBS Securities Israel Ltd. ("UBS"), which had submitted the highest bid, plus 15,000,000 additional shares of NIS 1 par value each after UBS gave notice of partial exercise of the option, all of them at a price of NIS 4.82144 per share.

NOTE 20 – SHAREHOLDERS' EQUITY (CONTD.)

B. (CONTD.)

Part of this share sale was also in accordance with the framework agreement described above between the State and the Company and accordingly, on November 18, 2003 the Company allotted 105,647,535 shares to the State. The proceeds from this allotment amounted to NIS 509,373,249.

After completion of the sale of the State's shares and allotment of Company shares to the State, the State's holding in the Company is 49.1%.

C. On January 27, 2003, the Special General Meeting of the Company approved the recommendation of the Board of Directors from January 2, 2003, for the distribution of a cash dividend to holders of Company shares recorded in the Register of Shareholders at the end of the business day on February 5, 2003. The ex-date was February 6, 2003, and the date of payment was February 20, 2003. The cash dividend, amounting to approximately NIS 190,000 thousand, represents a dividend of 7.8784 agorot per share.

D. On November 23, 2000 the General Meeting of the Company resolved to approve the recommendation of the Board of Directors of the Company and increase the registered capital of the Company by 1.6 billion ordinary shares and to distribute bonus shares in the same amount, so that for each share of NIS 1 par value, two bonus shares of NIS 1 par value would be distributed. In January 2001 the Ministerial Committee for Privatization approved the increase in the registered capital for the purpose of allotting the bonus shares. The increase in registered capital and the allotment of the bonus shares were effected in February 2001.

NOTE 21 – REVENUES FROM TELECOMMUNICATION SERVICES

Consolidated

	For the year ended December 31		
	2003	2002	2001
	NIS thousands	NIS thousands	NIS thousands
Revenues from communications services –			
Domestic fixed–line communications	**1,990,649**	2,263,292	2,507,940
Fixed fees	**2,289,868**	2,106,944	2,167,026
Cellular telephone (1)	**1,989,970**	2,094,288	2,164,805
International communications and internet services	**683,037**	662,767	819,621
Installation and sale of equipment to subscribers	**590,866**	526,594	444,632
Other	**74,851**	93,528*	116,870*
	7,619,241	7,747,413	8,220,894
Other revenues	**362,027**	316,067	289,119
	7,981,268	8,063,480*	8,510,013*

Company

	For the year ended December 31		
	2003	2002	2001
	NIS thousands	NIS thousands	NIS thousands
Revenues from communications services –			
Domestic fixed–line communications	**2,006,567**	2,285,628	2,536,536
Fixed fees	**2,184,650**	1,978,721	2,050,608
Cellular telephone (1)	**428,149**	546,130	698,202
International communications	**134,212**	135,794	342,272
Installation and sale of equipment to subscribers	**144,338**	152,212	146,059
Other	**80,105**	99,077*	124,046*
	4,978,021	5,197,562	5,897,723
Other revenues	**252,540**	249,506	253,806
	5,230,561	5,447,068*	6,151,529*

(1) See Note 1E(1).
* Reclassified

NOTE 22 – OPERATING AND GENERAL EXPENSES

Consolidated

	For the year ended December 31		
	2003	2002	2001
	NIS thousands	NIS thousands	NIS thousands
Salaries and related expenses	**1,952,878**	1,981,770	2,003,906
General expenses	**733,412**	728,051*	848,667*
Materials and spare parts	**597,676**	599,736*	531,285
Cellular telephone expenses (1)	**480,536**	473,141	365,985*
Building maintenance	**352,405**	351,683	398,770
Services and maintenance by sub-contractors	**250,220**	255,484*	337,915
International communications expenses	**159,478**	152,184	208,860
Motor vehicle maintenance expenses	**118,050**	96,613	87,036
Collection fees	**36,160**	34,819	38,291
	4,680,815	4,673,481	4,820,715
Less – wages charged to investment in fixed assets (2)	**195,515**	147,548	160,333
	4,485,300	4,525,933*	4,660,382*

Company

	For the year ended December 31		
	2003	2002	2001
	NIS thousands	NIS thousands	NIS thousands
Salaries and related expenses	**1,447,829**	1,524,599	1,585,866
General expenses	**342,492**	304,480	379,892*
Materials and spare parts	**93,601**	65,724	65,832
Building maintenance	**322,099**	324,031	349,051
Services and maintenance by sub–contractors	**207,843**	205,919*	281,867
International communications expenses	**10,685**	4,943	10,128
Vehicle maintenance expenses	**101,597**	82,842	72,417
Collection fees	**35,916**	34,736	37,946
	2,562,062	2,547,274	2,782,999
Less – wages charged to investment in fixed assets (2)	**195,515**	147,548	160,333
	2,366,547	2,399,726*	2,622,666*

* Reclassified

(1) See Note 1E(1)
(2) Commencing February 2003, following the establishment of a new reporting system in the Company which allows precise measurement of the direct costs of employees in the Engineering Division and the Technology Systems Division, the Company capitalized an additional sum for self-constructed fixed assets. The additional amount for the period ended December 31, 2003 is approximately NIS 46 million.

NOTE 23 – FINANCING EXPENSES, NET

Consolidated

	For the year ended December 31		
	2003	**2002**	**2001**
	NIS thousands	**NIS thousands**	**NIS thousands**
Expenses in respect of long-term liabilities			
Debentures	**395,393**	395,659	194,589
Loans	**21,015**	122,413	316,292
	416,408	518,072	510,881
Income in respect of deposits and investments	**(249,677)**	(21,597)	(194,462)
Expenses (income) in respect of derivatives	**806**	(331,500)	(121,639)
Short-term bank credit	**33,470**	7,515	35,161
Interest income from income tax	**–**	(5,866)	(82,058)
Other expenses (income), net	**(43,485)**	(1,308)	2,658
	157,522	165,316	150,541

Company

	For the year ended December 31		
	2003	**2002**	**2001**
	NIS thousands	**NIS thousands**	**NIS thousands**
Expenses (income) in respect of long-term liabilities			
Debentures	**395,393**	395,659	194,589
Loans	**(43,618)**	92,114	278,071
	351,775	487,773	472,660
Income in respect of deposits and investments	**(248,629)**	(23,004)	(192,881)
Income in respect of derivatives	**(21,024)**	(325,515)	(115,479)
Interest income from income tax	**–**	(8,810)	(82,058)
Other income, net	**(19,750)**	(13,310)	(6,222)
	62,372	117,134	76,020

NOTE 24 – OTHER EXPENSES, NET

Consolidated

	For the year ended December 31		
	2003	**2002**	**2001**
	NIS thousands	**NIS thousands**	**NIS thousands**
Provision for claims for salary and pension components (1)	**195,000**	–	–
Provision for employee severance benefits upon early retirement (2)	**419,016**	–	–
Write-off and impairment of fixed assets (3)	**327,295**	–	106,605
Provision for impairment of investments in other companies	**42,908**	10,254*	–
Capital gains, net	**(1,634)**	(12,739)	(9,095)
Provision for decrease in value of investment in convertible debentures (4)	**–**	1,209,312	–*
Direct expenses for the customer allocation process	**–**	–	1,544
Loss in respect of decrease in holding in an affiliated company	**–**	–	3,636
Other	**593**	(123)	2,374
	983,178	1,206,704*	105,064*

Company

	For the year ended December 31		
	2003	**2002**	**2001**
	NIS thousands	**NIS thousands**	**NIS thousands**
Provision for claims for salary and pension components (1)	**195,000**	–	–
Provision for employee severance benefits upon early retirement (2)	**419,016**	–	–
Write-off and impairment of fixed assets (3)	**198,686**	–	–
Provision for impairment of investments in other companies	**36,110**	10,254	–
Provision for decrease in value of investment in convertible debentures (4)	**–**	1,209,312	–
Capital losses (gains), net	**(1,570)**	(12,254)	2,615
Other	**(294)**	(130)	–
	846,948	1,207,182	2,615

* Reclassified
(1) See Note 19A(13)
(2) See Note 16D
(3) See Note 9B, 9G and 9I
(4) See Note 8D(2)

NOTE 25 – EARNINGS PER SHARE (CONSOLIDATED AND COMPANY)

	For the year ended December 31		
	2003	**2002**	**2001**
	NIS thousands	**NIS thousands**	**NIS thousands**
Primary and diluted earnings (loss)	**(437,836)**	(912,775)	126,745
Weighted number of shares in primary earnings and diluted earnings	**2,444,891**	2,411,658	2,411,658

NOTE 26 – BUSINESS SEGMENTS

The Company and the investee companies operate in various segments of the telecommunications sector. The data concerning operations by segment are presented according to the operating segments of those companies.

Consolidated

	For the year ended December 31, 2003					
	Fixed–line domestic communications	Cellular telephone	International communications and internet services	Others	Adjustments	Consolidated
	NIS thousands	NIS thousands	NIS thousands	NIS thousands	NIS thousands	NIS thousands
Revenues						
Revenues from external sources	5,023,754	2,021,807	689,378	246,329	–	7,981,268
Inter-segment revenues	206,807	5,568	13,958	40,236	(266,569)	–
Total revenues	5,230,561	2,027,375	703,336	286,565	(266,569)	7,981,268
Segment results	906,619	96,013	90,001	72	644	1,093,349
Financing expenses						157,522
Earnings after financing expenses						935,827
Other expenses, net						983,178
Earnings before income tax						(47,351)
Income tax						48,013
Loss after income tax						(95,364)
Equity in losses of affiliated companies	2,280			341,054		343,334
Minority share in losses of a consolidated company	(862)					(862)
Net loss						(437,836)
Identified assets	9,903,468	2,258,000	527,565	213,574	(106,196)	12,796,411
Investment by equity method				240,667		240,667
General assets						3,051,686
Total consolidated assets						16,088,764
Segment liabilities	1,609,316	500,091	270,031	126,516	(102,649)	2,403,305
General liabilities						6,840,517
Total consolidated liabilities						9,243,822
Capital investments	815,382	524,644	114,456	11,637		
Depreciation and amortization	1,776,279	394,203	99,868	7,498		

NOTE 26 – BUSINESS SEGMENTS (CONTD.)

Consolidated

	For the year ended December 31, 2002					
	Fixed–line domestic communications	Cellular telephone	International communications and internet services	Others	Adjustments	Consolidated
	NIS thousands	NIS thousands	NIS thousands	NIS thousands	NIS thousands	NIS thousands
Revenues						
Revenues from external sources	5,241,263	1,958,582	670,449	193,186	–	8,063,480*
Inter-segment revenues	205,825	7,642	8,272	29,444	(251,183)	–
Total revenues	5,447,088	1,966,224	678,721	222,630	(251,183)	8,063,480
Segment results	979,807	(62,672)	108,023	(8,615)	644	1,017,187
Financing expenses						165,316
Earnings after financing expenses						851,871
Other expenses, net						1,206,704*
Loss before income tax						(354,833)
Income tax						207,333
Loss after income tax						(562,166)
Equity in losses of affiliated companies	5,851*			347,765*		353,616*
Minority share in losses of a consolidated company	(3,007)					(3,007)
Net loss						(912,775)
Identified assets	10,046,942*	2,258,690	685, 059*	189,419*	(120,838)	13,059,272*
Investment by equity method				382,717*		382,717*
General assets						2,788,566*
Total consolidated assets						16,230,555
Segment liabilities	1,520,047	858,703	327,518	95,437	(116,771)	2,684,934
General liabilities						6,955,541
Total consolidated liabilities						9,640,475
Capital investments	854,512	471,603	136,389	6,151		
Depreciation and amortization	1,925,472	505,539	83,242	4,898		

* Reclassified

NOTE 26 – BUSINESS SEGMENTS (CONTD.)

Consolidated

	For the year ended December 31, 2001					
	Fixed–line domestic communications	Cellular telephone	International communications and internet services	Others	Adjustments	Consolidated
	NIS thousands	NIS thousands	NIS thousands	NIS thousands	NIS thousands	NIS thousands
Revenues						
Revenues from external sources	5,798,682	1,858,421	687,199	165,711	–	8,510,013*
Inter-segment revenues	352,847	6,322	11,646	22,632	(393,447)	–
Total revenues	6,151,529	1,864,743	698,845	188,343	(393,447)	8,510,013
Segment results	1,083,490	(189,450)	(41,932)	1,304	645	854,057
Financing expenses						150,541
Earnings after financing expenses						703,516
Other expenses, net						105,064*
Earnings before income tax						598,452
Income tax						240,940
Earnings after income tax						357,512
Equity in losses of affiliated companies	(29,736)			267,191*		237,455*
Minority share in losses of a consolidated company	(6,499)					(6,499)
Net earnings						126,556
Identified assets	11,644,406	2,176,087	607,035	125,949	(59,749)	14,493,728
Investment by equity method	132,486			349,271		481,757
General assets						2,948,204
Total consolidated assets						17,923,689
Segment liabilities	1,522,678	776,145	305,165	52,970	(59,011)	2,597,947
General liabilities						7,822,888
Total consolidated liabilities						10,420,835
Capital investments	833,555	507,410	123,585	8,601		
Depreciation and amortization	2,247,563	738,942	79,237	5,329		

* Reclassified

NOTE 27 – TRANSACTIONS WITH INTERESTED AND RELATED PARTIES

A. The Company is a mixed company under the control of the Government of Israel which transacts a significant volume of business in the ordinary course of its operations with government ministries, agencies and companies, banks and their related companies. The business transacted is primarily the provision of telecommunications services and the execution of development work, as well as the receipt of various types of services. It is not practicable to determine the identity of the interested parties involved in such transactions, nor to make a distinction in the recording thereof. The Securities Authority, pursuant to its authority under the Securities Regulations (Preparation of annual financial statements), 5753-1993, exempted the Company from detailing its transactions with interested parties (exemption for 2003 is dated February 1, 2004), other than extraordinary transactions. In the opinion of the Company, the exemption is not harmful to the affairs of the investor in Company securities.

In July 2002 the Company reached agreement with the Ministry of Defense on behalf of the State of Israel, for the provision of communications services by the Company.

The main points of the agreement are as follows:

(1) The Company will provide telecommunications services to the IDF at a special discount rate of approximately 28% for services which the Company provided to the IDF prior to signing the agreement and at 14% for services which did not exist or which the Company did not provide for the IDF prior to signing the agreement. Based on the volume of the services which the Company provided to the IDF prior to the date on which the agreement takes effect, the discount in respect of the services under the agreement is not materially different from the discount which was granted pursuant to the memorandum by which the parties acted prior to signing the agreement.

(2) The Ministry of Defense undertakes to purchase Company services for which the consideration will be not less than approximately NIS 81.2 million (excluding VAT) for each year of the commitment, and additionally to order from the Company cabling and communications infrastructure development works inside IDF bases which are used to provide the Company's services, for which the consideration will not be less than 80% of the total financial volume of Ministry of Defense orders for such infrastructures for the IDF in each year of the commitment.

(3) The agreement ends and exhausts all the disputes between the parties up to April 1, 2001, including the disputes which were brought before the special professional committee ("the Gabai Committee"), but excludes the matter of an 18% discount which the Ministry of Defense deducted from payments which the Company collected for other communications providers.

(4) Ownership of the infrastructures inside IDF bases will remain at the end of the term of the agreement with the Ministry of Defense and ownership of infrastructures outside the IDF bases will remain with the Company.

(5) The term of the contract is from the date of signing the agreement – July 21, 2002, until March 31, 2005 (under the terms of the agreement, retroactive accounting was carried out starting from April 1, 2001, subsequent to which the Company received a refund in an immaterial amount).

On December 16, 2003 the Company filed a claim against the Ministry of Defense for payment of amounts in connection with a dispute in the matter of a discount of 18% deducted by the Ministry in item (3) above.

B. On guarantees to related parties, se Note 19D.

NOTE 27 – TRANSACTIONS WITH INTERESTED AND RELATED PARTIES (CONTD.)

C. Transactions with investee companies (Company)

	For the year ended December 31		
	2003	2002	2001
	NIS thousands	NIS thousands	NIS thousands
Revenues –			
Interconnect and access fees	**155,430**	170,521	287,069
Services, royalties and commissions	**141,413**	140,201	332,546
Rent and usage fees for buildings and equipment	**14,177**	24,484	42,644
Interest	**–**	–	6,824
Expenses –			
Purchase of services	**52,053**	40,349	35,782
Interest	**1,102**	6	–

Transactions with a proportionally consolidated company were presented in full (100%).

For balances with subsidiaries and a proportionately consolidated company, see relevant notes.

D. Benefits for directors and CEO

	For the year ended December 31		
	2003	2002	2001
	NIS thousands	NIS thousands	NIS thousands
Total cost of compensation of the CEO and the Chairman of the Board *	**1,678**	1,648	1,508
Number of employees	**3**	2	2
Compensation of members of the Board of Directors who are not Company employees**	**1,695**	1,554	1,404
Number of directors receiving compensation	**16**	19	19

* The cost in respect of 2003 includes payment of severance pay to the CEO of the Company in the amount of approximately NIS 152 thousand, and in respect of 2002 includes payment of severance pay to the Chairman of the Board in the amount of approximately NIS 100 thousand.

** Compensation for directors in a proportionally consolidated company is presented at the proportional share of the Company (50%).

The Company holds an insurance policy for the directors and officers of the Company. The maximum insurance is $150 million per event and per period (of 12 months) and up to an additional $30 million for legal expenses in Israel. In addition, the Company will indemnify directors and officers in an amount not exceeding $50 million per officer for a financial obligation imposed upon them in any matter connected with the Company's prospectus from February 27, 1998, and which is not covered by the insurance policy.

On December 3, 2003 the General Meeting of the Company approved a commitment to indemnify officers of the Company in the matter of the framework agreement signed between the Company and the State, including in connection with an allotment of shares to the State by virtue of that agreement. The commitment was limited to NIS 890,000 thousand (the amount of the capital raising), linked to the CPI published after the capital was raised in accordance with the framework agreement.

NOTE 28 – FINANCIAL INSTRUMENTS AND RISK MANAGEMENT

A. DERIVATIVES

The Group is exposed to credit and currency risks during the normal course of its business, and uses derivatives to minimize its exposure to these risks.

The Group has an excess of monetary liabilities over monetary assets in or linked to foreign currency in the amount of approximately NIS 2,907 million, of which the excess of current liabilities over current assets is approximately NIS 232 million. Most of the excess of current liabilities is covered by forward exchange contracts, as described in section C below. The Group has revenues in foreign currency from international communications.

As at December 31, 2003, the excess of CPI-linked monetary liabilities over CPI-linked monetary assets amounted to approximately NIS 676 million, of which the excess of current liabilities over current assets was approximately NIS 161 million. As stated in Note 1B, most of the Company's tariffs are subject to government regulation and are revised from time to time in accordance with the rise in the CPI, net of an efficiency factor.

The Company has limited commitments in derivatives which are intended solely for purposes of hedging. Regarding the Company's commitments to execute forward exchange contracts as at December 31, 2003 – see section C below.

B. CREDIT RISKS

At December 31, 2003, most of the cash and cash equivalents, as well as bank deposits, are deposited in large Israeli banks. Short-term investments primarily represent investments in government bonds and bank deposits, while a small part is invested in debentures of companies traded on the stock exchange in Israel. Accordingly, Management does not expect significant losses deriving from credit risks.

The Group's revenues derive mainly from providing services to customers in Israel. Management reviews customer debts on a current basis and the financial statements include specific provisions which, in Management's opinion, adequately reflect the loss inherent in doubtful debts. The exposure to credit risk in connection with customers is limited, considering their large number.

C. CURRENCY RISKS

The Company and consolidated companies manage their exposure to currency risks deriving from fluctuations in foreign currency exchange rates in respect of assets, liabilities and cash flows denominated in foreign currency. The Group acts to minimize the currency exposure by forward transactions in foreign currency and by purchasing currency options. Hereunder the details of the derivatives of the Company and consolidated companies as at December 31, 2003:

NOTE 28 – FINANCIAL INSTRUMENTS AND RISK MANAGEMENT (C0NTD.)

C. CURRENCY RISKS (CONTD.)

Consolidated

(1) Forward currency transactions - hedging transactions

	Purchased currency	Currency payable	Last repayment date	Amounts receivable	Amounts payable	Fair value	Book value
				NIS millions		NIS millions	
Currency exchange transactions at predetermined interest rates -							
	Dollar	CPI-linked shekel	February 2005	576	635	(61)	(59)
	Euro	CPI-linked shekel	September 2005	835	728	109	107
Forward transactions at predetermined currency exchange rate (excluding premium/discount) **-**							
	Dollar	Shekel	December 2005	620	644	(11)	(10)
	Euro	Shekel	December 2005	766	756	26	30
	CPI-linked Shekel	Shekel	December 2005	442	450	(5)	(2)
Options purchased (Call)	Dollar	Shekel	March 2004	13	14	–	(1)

(2) Forward currency transactions - non-hedging transactions

	Purchased currency	Currency payable	Last repayment date	Fair value	Scope of commitment
				NIS millions	
Options purchased (Call)	Dollar	Shekel	March 2004	0.5	156

NOTE 28 – FINANCIAL INSTRUMENTS AND RISK MANAGEMENT (C0NTD.)

C. CURRENCY RISKS (CONTD.)

Company

(1) Forward currency transactions - hedging transactions

	Purchased currency	Currency payable	Last repayment date	Amounts receivable	Amounts payable	Fair value	Book value
				NIS millions		NIS millions	
Currency exchange transactions at predetermined interest rates -							
	Dollar	CPI-linked shekel	February 2005	576	635	(61)	(59)
	Euro	CPI-linked shekel	September 2005	835	728	109	107
Forward transactions at predetermined currency exchange rate (excluding premium/discount) **-**							
	Dollar	Shekel	December 2005	607	631	(11)	(10)
	Euro	Shekel	December 2005	766	756	26	30
	CPI-linked Shekel	Shekel	December 2005	442	450	(5)	(2)

NOTE 28 – FINANCIAL INSTRUMENTS AND RISK MANAGEMENT (C0NTD.)

D. INTEREST RISKS

The Company takes loans at variable interest rates, and therefore its financial results (financing expenses) are exposed to the risk of changing interest rates. The Company also has loans at fixed interest rates which are exposed to possible changes in their fair value.

E. FAIR VALUE OF FINANCIAL INSTRUMENTS

The book value of the cash and cash equivalents, short-term investments, trade receivables, other receivables, other current assets, most of the long-term liabilities, trade payables and accrued expenses, are equal or are close to their fair values. The fair value of loans from banks is also close to their book value since they bear interest at roughly the market rate.

Hereunder the differences between the amount recorded in the books and their estimated fair value:

	Consolidated	
	December 31, 2003	
	Book value	Fair value
	NIS thousands	NIS thousands
Debentures:		
Issued to the public	69,587	66,999
CPI-linked	706,965	679,172
Euro-linked	1,645,811	1,588,776
Unlinked, issued to others	500,372	417,549
CPI-linked loans	893,073	840,332
Unlinked loans	180,208	172,626
Foreign currency loans	1,235,280	1,217,618

The fair value of debentures issued to the public is based on their market price. The fair value of the other liabilities presented above is based on the present value of the cash flows related thereto.

NOTE 29 – LINKAGE TERMS OF MONETARY BALANCES AS AT DECEMBER 31, 2003

Consolidated

	In or linked to foreign currency					
	Dollar-linked	Euro-linked	Other	CPI-linked	Unlinked	Total
	NIS thousands			NIS thousands		
Assets						
Cash and cash equivalents	39,179	1,798	–	–	1,913,373	1,954,350
Short-term investments	164,190	18,319	–	887,423	270,409*	1,340,341
Trade receivables	31,448	–	–	(3,433)	1,639,608	1,667,623
Other receivables and debit balances	1,614	113,023	–	20,387	22,460	157,484
Investments, long-term deposits and debit balances	61,306	56,352	–	249,509	330,646	697,813
	297,737	189,492	–	1,153,886	4,176,496	5,817,611
Liabilities						
Short-term bank credit	–	–	–	50,000	94,714	144,714
Current maturities of long-term liabilities	210,192	–	–	609,661	464,183	1,284,036
Trade payables	278,999	3,512	32	–	848,173	1,130,716
Other current liabilities	65,318	43,542	–	83,833	972,417	1,165,110
Long-term loans	1,130,183	–	–	516,759	107,351	1,754,293
Other long-term debentures	–	1,645,811	–	569,725	109,046	2,324,582
Employee severance benefits	–	–	–	–	1,373,429	1,373,429
Other long-term liabilities	16,220	–	–	–	–	16,220
	1,700,912	1,692,865	32	1,829,978	3,969,313	9,193,100

Company

	In or linked to foreign currency					
	Dollar-linked	Euro-linked	Other	CPI-linked	Unlinked	Total
	NIS thousands			NIS thousands		
Assets						
Cash and cash equivalents	2,725	1,798	–	–	1,891,995	1,896,518
Short-term investments	164,190	18,319	–	887,423	270,316*	1,340,248
Trade receivables	9,189	–	–	–	1,012,078	1,021,267
Other receivables and debit balances	1,057	113,023	–	21,695	29,105	164,880
Investments, long-term deposits and debit balances	61,306	56,352	–	237,506	231,078	586,242
	238,467	189,492	–	1,146,624	3,434,572	5,009,155
Liabilities						
Current maturities of long-term liabilities	210,192	–	–	321,462	391,326	922,980
Trade payables	3,666	3,512	32	–	679,307	686,517
Other current liabilities	65,318	43,542	–	44,308	779,089	932,257
Long-term loans	1,013,737	–	–	32,475	–	1,046,212
Other long-term debentures	–	1,645,811	–	569,725	109,046	2,324,582
Employee severance benefits	–	–	–	–	1,363,803	1,363,803
Other long-term liabilities	6,560	–	–	–	–	6,560
	1,299,473	1,692,865	32	967,970	3,322,571	7,282,911

* Including mutual fund participation certificates of approximately NIS 129 million consolidated and for the Company.

For details of forward exchange contracts for covering exposure to foreign currency, see Note 28C.

NOTE 29 – LINKAGE TERMS OF MONETARY BALANCES AS AT DECEMBER 31, 2002

Consolidated

	In or linked to foreign currency					
	Dollar-linked	Euro-linked	Other	CPI-linked	Unlinked	Total
	NIS Thousands		NIS Thousands			
Assets						
Cash and cash equivalents	26,480	1,584	–	–	945,671	973,735
Short-term investments	162,626	–	–	725,128	270,069*	1,157,823
Trade receivables	19,249	–	–	6,557	1,693,137	1,718,943
Other receivables and debit balances	7,410	146,263	–	90,792	22,938	267,403
Investments, long-term deposits and debit balances	97,602	31,300	–	233,341	309,569	671,812
	313,367	179,147	–	1,055,818	3,241,384	4,789,716
Liabilities						
Short-term bank credit	34,847	–	–	122,824	361,180	518,851
Current maturities of long-term liabilities	223,087	–	–	459,359	58,664	741,110
Trade payables	351,380	1,309	1,631	491	776,798	1,131,609
Other current liabilities	26,529	38,364	–	78,970	926,951	1,070,814
Long-term loans	1,310,839**	–	–	563,829	176,809	2,051,477**
Other long-term debentures	–	1,448,950	–	777,141	490,806	2,716,897
Employee severance benefits	–	–	–	–	1,326,941	1,326,941
Other long-term liabilities	12,216**	–	–	–	–	12,216**
	1,958,898	1,488,623	1,631	2,002,614	4,118,149	9,569,915

Company

	In or linked to foreign currency					
	Dollar-linked	Euro-linked	Other	CPI-linked	Unlinked	Total
	NIS Thousands		NIS Thousands			
Assets						
Cash and cash equivalents	2,431	1,584	–	–	896,047	900,062
Short-term investments	162,626	–	–	725,128	269,979*	1,157,733
Trade receivables	5,406	–	–	–	1,099,707	1,105,113
Other receivables and debit balances	5,612	146,263	–	84,197	10,384	246,456
Investments, long-term deposits and debit balances	97,602	31,300	–	220,053	231,487	580,442
	273,677	179,147	–	1,029,378	2,507,604	3,989,806
Liabilities						
Short-term bank credit						
Current maturities of long-term liabilities	223,087	–	–	349,386	–	572,473
Trade payables	5,375	1,309	1,631	–	655,144	663,459
Other current liabilities	25,911	38,364	–	45,833	730,275	840,383
Long-term loans	1,299,019**	–	–	170,710	–	1,469,729**
Other long-term debentures	–	1,448,950	–	777,141	490,806	2,716,897
Employee severance benefits	–	–	–	–	1,316,141	1,316,141
Other long-term liabilities	12,216**	–	–	–	–	12,216**
	1,565,608	1,488,623	1,631	1,343,070	3,192,366	7,591,298

* Including mutual fund participation certificates of approximately NIS 109 million, consolidated and for the Company.

** Reclassified.

For details of forward exchange contracts for covering exposure to foreign currency, see Note 28C.

NOTE 30 – CONDENSED FINANCIAL STATEMENTS OF THE COMPANY IN NOMINAL VALUES

A. BALANCE SHEETS

	December 31 2003	December 31 2002
	NIS thousands	NIS thousands
Assets		
Current assets	**4,621,820**	3,700,531
Materials and spare parts	**151,911**	121,427
Investments, long-term deposits and debit balances	**651,798**	670,610
Investment in investee companies	**1,397,803**	1,506,519*
Fixed assets	**5,234,511**	5,866,740
Other assets	**917,553**	867,487
	12,975,396	12,733,314
Liabilities		
Current	**3,161,852**	2,355,562
Long-term	**4,166,181**	5,458,668
	7,328,033	7,814,230
Shareholders' equity	**5,647,363**	4,919,084*
	12,975,396	12,733,314

* Restated

NOTE 30 – CONDENSED FINANCIAL STATEMENTS OF THE COMPANY IN NOMINAL VALUES (CONTD.)

B. STATEMENTS OF OPERATIONS

	For the year ended December 31		
	2003	**2002**	**2001**
	NIS thousands	**NIS thousands**	**NIS thousands**
Revenues from telecommunications services	**5,285,062**	5,523,013*	5,868,591*
Costs and expenses			
Operating and general expenses	**2,397,800**	2,440,957*	2,496,075*
Depreciation	**1,334,060**	1,362,889	1,466,867
Royalties to the Government of Israel	**182,181**	187,596	188,853
	3,914,041	3,991,442	4,151,795
Operating income	**1,371,021**	1,531,571	1,716,796
Financing expenses, net	**45,667**	173,769	117,455
Earnings after financing expenses	**1,325,354**	1,357,802	1,599,341
Other expenses, net	**806,725**	1,317,364	18,193
Earnings before income tax	**518,629**	40,438	1,581,148
Income tax	**195,754**	236,439	494,736**
Net earnings (loss) after income tax	**322,875**	(196,001)	1,086,412
Equity in losses of investee companies	**285,464**	423,341**	447,964
Net earnings (loss)	**37,411**	(619,342)**	638,448**

* Reclassified
** Restated

NOTE 30 – CONDENSED FINANCIAL STATEMENTS OF THE COMPANY IN NOMINAL VALUES (CONTD.)

C. STATEMENT OF CHANGES IN SHAREHOLDERS' EQUITY

	Share capital	Capital reserves	Dividend proposed after the balance sheet date	Retained earnings (accumulated loss)	Total
			NIS thousands		
Balance as at January 1, 2001	797,981	4,971,116	–	(936,902)	4,832,195
Changes in 2001					
Net earnings	–	–	–	638,448*	638,448*
Conversion of convertible debentures	5,905	61,878	–	–	67,783
Distribution of bonus shares	1,607,772	(1,600,000)	–	(7,772)	–
Balance as at December 31, 2001	2,411,658	3,432,994	–	(306,226)	5,538,426
Changes in 2002					
Net loss	–	–	–	(619,342)*	(619,342)*
Dividend proposed after the balance sheet date	–	–	190,000	(190,000)	–
Balance as at December 31, 2002	2,411,658	3,432,994	190,000	(1,115,568)*	4,919,084*
Changes in 2003					
Net earnings	**–**	**–**	**–**	**37,411**	**37,411**
Dividend paid	**–**	**–**	**(190,000)**	–	**(190,000)**
Allotment of shares	**193,388**	**687,480**	**–**	–	**880,868**
Balance as at December 31, 2003	**2,605,046**	**4,120,474**	**–**	**(1,078,157)**	**5,647,363**

* Restated

NOTE 30 - CONDENSED FINANCIAL STATEMENTS OF THE COMPANY IN NOMINAL VALUES (CONTD.)

D. RESTATEMENT

The Company has restated its nominal financial statements in order to retroactively reflect the amendment of the accounting treatment of deferred taxes generated in respect of fixed assets and in respect of recording the equity of the Company in the losses of investee companies.

Effect on net earnings:

	For the year ended December 31	
	2002	2001
	NIS thousands	NIS thousands
Net earnings (loss) as reported in the past	(664,960)	555,753
Effect of restatement:		
Increase in income tax	–	82,695
Decrease in losses of investee companies	45,618	–
	(619,342)	638,448

NOTE 31 – CONDENSED FINANCIAL STATEMENTS OF BEZEQ INTERNATIONAL LTD. AND PELEPHONE COMMUNICATIONS LTD.

1. BEZEQ INTERNATIONAL LTD.

A. BALANCE SHEET

	December 31 2003	December 31 2002
	NIS thousands	NIS thousands
Current assets	**149,765**	193,599
Investments in an affiliate	**12,704**	10,693
Fixed assets	**375,703**	484,183
Other assets	**2,695**	8,430
	540,867	696,905
Current liabilities	**276,061**	371,676
Long-term liabilities	**180,881**	170,757
Shareholders' equity	**83,925**	154,472
	540,867	696,905

B. STATEMENTS OF OPERATIONS

	For the year ended December 31		
	2003	2002	2001
	NIS thousands	NIS thousands	NIS thousands
Revenues from international communications services	**703,336**	678,729	698,846
Operating expenses	**431,066**	380,106	516,471
Gross profit	**272,270**	298,623	182,375
Marketing, general and administrative expenses:	**188,299**	190,599	224,307
Operating income (loss)	**83,971**	108,024	(41,932)
Financing income (expenses), net	**21,830**	(1,583)	11,336
Earnings (loss) after financing	**62,141**	109,607	(53,268)
Other income (expenses), net	**128,580**	(34)	(4,163)
Earnings (loss) before income tax	**(66,439)**	109,641	(49,105)
Income tax	**3,489**	10,539	3,153
Earnings (loss) after income tax	**(69,928)**	99,102	(52,258)
Company's equity in losses of an affiliate	**619**	24,187	27,866
Net earnings (loss)	**(70,547)**	74,915	(80,124)

NOTE 31 – CONDENSED FINANCIAL STATEMENTS OF BEZEQ INTERNATIONAL LTD. AND PELEPHONE COMMUNICATIONS LTD. (CONTD.)

2. PELEPHONE COMMUNICATIONS LTD.

A. BALANCE SHEET

	Consolidated December 31 2003 NIS thousands	Consolidated December 31 2002 NIS thousands
Current assets	**1,264,002**	1,314,078
Long-term trade receivables	**199,136**	156,166
Investment in investee companies	**2,253**	–
Deferred income taxes	**238,367**	329,528
Fixed assets	**2,977,528**	2,741,156
Other assets, net	**339,506**	450,997
	5,020,792	4,991,925
Current liabilities	**1,761,626**	2,041,272
Provision for losses of investee company	**5,372**	4,414
Long-term liabilities	**1,386,774**	1,104,022
Shareholders' equity	**1,867,020**	1,842,217
	5,020,792	4,991,925

B. STATEMENTS OF OPERATIONS

	For the year ended December 31,		
	2003	2002	2001
	NIS thousands	NIS thousands	NIS thousands
Revenues from Pelephone services, sales and services	**4,054,749**	3,932,448	3,729,487
Cost of Pelephone services, sales and services	**3,238,098**	3,455,141	3,431,068
Gross profit	**816,651**	477,307	298,419
Sales and marketing expenses	**470,935**	466,053	482,014
General and administrative expenses	**152,447**	153,856	168,896
	623,382	619,909	650,910
Operating profit (loss)	**193,269**	(142,602)	(352,491)
Financing expenses, net	**143,786**	92,895	128,721
Other income (expenses), net	**167**	(1,468)	212,851
Earnings (loss) before income tax	**49,316**	(234,029)	(694,063)
Income tax (tax benefit)	**18,289**	(74,038)	(238,268)
Loss after income tax	**31,027**	(159,991)	(455,795)
Minority share in losses of a consolidated company	**–**	(5,704)	(12,998)
Company equity in losses of investee companies	**6,224**	654	8,001
Net earnings (loss)	**24,803**	(154,941)	(450,798)

Appendix A – List of group Companies

	Rate of control and ownership as at	
	December 31 2003	December 31 2002
	%	%
Subsidiaries		
Bezeq International Ltd.	**100**	100
BezeqCall Communications Ltd. (formerly Bezeq Bit 1995 Ltd.) (1)	**100**	100
BezeqCall Ltd. (1)	**100**	100
Bezeq Globe Ltd. (2)	**100**	100
Bezeq On Line Ltd. (3)	**100**	100
GoldNet Communication Services – registered partnership (4)	**74.9**	54
B-One General Partnership (5)	**67.5**	–
Proportionally Consolidated Companies		
Pelephone Communications Ltd.	**50**	50
GoNext Ltd. (6)	**50**	50
Affiliated Companies		
Stage One Venture Capital Fund (Israel) L.P. (an Israeli Limited Partnership) (hereinafter – the Fund) (7)	**100**	100
Stage One Capital Investments L.P. (an Israeli Limited Partnership) (hereinafter – SOCI) (7)	**27**	27
The International Company for Undersea Cables Ltd. (8)	**50**	50
Aphrodite B.V. Amsterdam (9)	**67**	67
D.B.S. Satellite Services (1998) Ltd. (10)	**49.8**	44.9
Infogate Online Ltd. (11)	**22.9**	26.2
Pointer Ltd (formerly Eden Telecom Ltd.) (12)	**11.5**	11.5
Walla! Communications Ltd.(13)	**36.7**	36.7
Adanet for Business Group Ltd.(14)	**50**	50
Companies that are not investees		
Ambez Ltd. (formerly Comfinet Ltd.)	**17**	17
Xpert Integrated Systems Ltd. (15)	**16**	16
Personeta Inc.	**2**	4
Exent Ltd.	**6.2**	6.2
Atrica Inc.	**0.85**	0.85
Venture Capital Funds that are not included		
Eurofund 2002 L.P	**14.4**	14.4
B.R.M. Capital Fund L.P	**2.8**	3

(1) Commencing July 1, 1997, the operations of both companies were merged and BezeqCall Ltd. ceased operations.

(2) The company ceased to operate on July 1, 1998. In 2000 the company decided on voluntary liquidation. The liquidation was approved by the Ministerial Committee for Privatization and a liquidator was appointed for the company.

(3) The company was founded in December 2000 and commenced operations in 2001. The company provides call center outsourcing services.

(4) See Note 8H.

(5) See Note 8I.

(6) On March 16, 2000 Pelephone signed an agreement for the establishment of GoNext Ltd. ("GoNext"). The principal operations of GoNext are the set-up and operation of the portal with a link to cellular mediation. The consolidated financial statements include consolidation of the statements of GoNext, which is controlled by Pelephone. On December 31 Pelephone, together with GoNext, filed an application for a merger commencing on January 1, 2004, for which the authorities have not yet given their approval. If approval is obtained, GoNext will transfer all of its business, assets, property and rights, as well as its debts and liabilities of any kind, to Pelephone.

(7) The Fund is a venture capital fund managed by SOCI. The Company undertook to invest the sum of $20 million in the fund, of which approximately $9 million was invested by the end of 2003.

(8) The Company maintained an underwater cable which it laid. The Company's share of the cost and maintenance of the equipment is charged to fixed assets and maintenance expenses. In February 1997 use of the cable ceased. In January 1999 the Board of Directors resolved upon voluntary liquidation as of March 31, 1999.

(9) Following the sale of Aphrodite's investment in Emitel and the transfer of the earnings as a dividend to the Company, Aphrodite ceased operations

(10) See Note 8E.

(11) The Company is developing and supplying data communication services under the ASP concept, in which computers are linked in a broadband network to a central server from which various services are received.

(12) Until October 2000, Pelephone held 51% of the shares of Safe Com Car Communication Ltd (“Safe Com”). In October 2000 an agreement was signed between Pelephone, other shareholders of Safe Com and Pointer Ltd (formerly Eden Telecom) and its shareholders pursuant to which the activities of Safe Com were merged with the activities of Pointer by means of the transfer of assets from Safe Com to Pointer. The main activities of Pointer, similar to those of Safe Com are focused on the identification of motor vehicles and locating them.

(13) See Note 8F.

(14) See Note 8G.

(15) In 2001, the Company invested approximately NIS 40 million in Xpert Integrated Systems Ltd. ("Xpert"), in consideration of 16.26% (at full dilution) of the capital of that company, as well as options which will enable it to increase its holdings to 20.33% (15.98% at full dilution). Xpert is involved mainly in the construction and integration in the communications field (mainly IP networks) and data protection.