Chapter B of the Periodic Report

Directors Report on the State of the Company's Affairs
For the six months ending June 30, 2007

We respectfully present the Directors' Report on the state of the affairs of "Bezeq" – The Israel Telecommunication Corp. Limited (hereinafter: the "Company") and the consolidated Group companies (the Company and the consolidated companies hereinafter collectively referred to as the "Group"), for the six-month period ending June 30, 2007 (hereinafter: "the Directors' Report").

The Directors' Report contains a review, in condensed form, of the matters dealt with by the board of directors, and is drafted taking into account the fact that the reader of the Report is also equipped with a copy of the Directors' Report for the year ended December 31, 2006.

The Group operates in four areas which are reported as business segments in the Company's consolidated reports, as follows:

1) **Domestic fixed-line communications.**
2) **Cellular.**
3) **International communications, internet services and NEP.**
4) **Multi-channel television.**

The Company has an additional area of operations which is not substantial to the Group's operations, and which has been included in the financial statements for June 30, 2007 as a business sector, which mainly includes customer call center services and investment in a venture capital fund.

The financial statements are drafted in accordance with the International Financial Reporting Standards (IFRS). The financial statements for the first half of 2006 have been redrafted in accordance with IFRS. The effect of the transition to reporting in accordance with international standards, on the Company's financial situation and on the results of its operations and cash flows are set out in Note 14 to the financial statements. In order to properly reflect the financial situation of the Group under Israeli accepted accounting rules prior to the transition to IFRS, the Financial Statements of the Group were adjusted by way of restatement as set out in Note 14L to the financial statements.

1. Financial Position

A. The Group's assets, as at June 30, 2007, amount to approximately NIS 16.58 billion, compared with approximately NIS 18.05 billion as at June 30, 2006. Of these, approximately NIS 6.21 billion (approximately 37%) are property, plant and equipment, compared with approximately NIS 6.83 billion (approximately 38%) as at June 30, 2006.

Most of the decrease stems from the fixed-line domestic communications segment. There was a decline in total assets in this segment compared with the previous year, in the sum of approximately NIS 1.61 billion, mainly due to the realization of commercially held financial assets which were mainly used for the distribution of dividends. In addition, there was a decrease in the depreciated cost of property, plant and equipment resulting from the difference between depreciation expenses and the investment made in the reporting period. The decrease was set off mainly due to an increase in cash balances.

In the cellular segment, the segment's assets decreased from approximately NIS 4.34 billion as at June 30, 2006 to the sum of approximately NIS 4.13 billion as at June 30, 2007. The decrease stemmed mainly from realization of a tax asset recorded in the past for losses. In addition, financial assets held for trade and used in the payment of dividends and of liabilities were also realized, and there was a drop in the amortized cost of property plant and equipment. This reduction was set off by an increase in cash balances.

In the international communications, internet and NEP services segment, there was an increase in total assets compared with June 30, 2006, mainly due to the merger with BezeqCall which commenced in January 2007.

In the multi-channel television segment, there was a decrease in total assets compared with June 30, 2006, which stemmed mainly from a decrease in the balance of net investments in property, plant and equipment.

B. The shareholders' equity ascribed to the shareholders of the Company as at June 30, 2007 amounted to approximately NIS 4.72 billion, comprising approximately 28% of the total balance sheet, compared with approximately NIS 5.96 billion as at June 30, 2006, which comprised approximately 33% of the total balance sheet. The decrease in shareholders' equity stemmed from a dividend paid in the sum of NIS 2.5 billion. The decrease was partially offset by the Group's net profit and share-based payments to Company employees.

C. The Group's total debt amounted to approximately NIS 8.65 billion as at June 30, 2007, compared with approximately NIS 9.04 billion as at June 30, 2006. The Group's debt to financial institutions and debenture holders as at June 30, 2007 amounted to approximately NIS 8.06 billion, compared with approximately NIS 8.5 billion as at June 30, 2006. The decrease stemmed from payment of liabilities in the cellular segment which was set off in part against sale of debentures to institutional investors in the domestic fixed line communications segment.

The Company's auditors continue to draw attention to the financial position of DBS, as set out in Note 7A of the financial statements, including the assessment made by management of DBS that the consideration from the placement of debentures raised by DBS in July 2007 enables the financial sources required for it for the coming year to be put in order.

D. The Group's cash and other current investment balances as at June 30, 2007 amounted to the sum of approximately NIS 3.07 billion compared with approximately NIS 3.74 billion as at June 30, 2006. The decrease stemmed mainly from the realization of commercially held securities in the domestic fixed-line communications segment and in the cellular segment, which were used in the payment of a dividend in the sum of NIS 2.5 billion, and for payment of liabilities. The decrease was partially offset due to cash flow from current operations in the principal segments of the Group's operations.

2. Results of Operations

A. Principal Results

Net earnings ascribed to shareholders of the Company for the first half of 2007 amounted to approximately NIS 760 million as opposed to net earnings of approximately NIS 603 million for the corresponding period. The increase in net earnings stemmed mainly from an increase in operating profit and a decrease in financing costs.

The following are details of changes in the results of the various segments, compared with the corresponding period:

Segment	**For the six months ending June 30, 2007 NIS millions profit (loss)**	**For the six months ending June 30, 2006 NIS millions profit (loss)**
Fixed-line domestic communications	612	588
Cellular	453	364
International communications, internet services and NEP	104	70
Multi-channel television	56	10
Others	2	-

Basic and diluted earnings per share for the first half of 2007 amounted to NIS 0.29 per NIS 1.00 par value compared with a profit of NIS 0.23 per share for the corresponding quarter.

B. Revenues

The Group’s revenues in the first half of 2007 amounted to approximately NIS 6.14 billion compared with approximately NIS 6.03 billion in the corresponding period.

Revenues from fixed-line domestic communications decreased from approximately NIS 2.89 billion in the first half of 2006 to approximately NIS 2.84 billion in the reporting period (a decrease of approximately 2%). The decrease in the segment’s revenues stemmed from a reduction of tariffs as of July 2006 and June 2007, and from a reduction in call traffic. The decrease in revenues was offset primarily by ongoing growth in the number of customers who subscribe to high-speed internet service (ADSL). The Company's auditors continue to draw attention to the continued opening up of the communications sector to competition and the effects of regulation.

Revenues in the cellular segment increased from the sum of approximately NIS 2.19 billion in the first half of 2006 to approximately NIS 2.30 billion in the reporting period. The increase stemmed from an increase in revenues from sale of terminal equipment, stemming mainly from an increase in the quantity of handsets sold and upgraded during the first half of 2007. In addition, there was an increase in revenues from cellular services, following an increase in content revenues and an increase in the number of subscribers, which was set off mainly by price erosion.

Revenues in the international communications, internet and NEP services segment increased from the sum of approximately NIS 641 million in the first half of 2006 to approximately NIS 644 million in the reporting period. The increase stemmed from an increase in internet revenues due to sale of capacity and from an increase in revenues from outgoing calls, alongside a decrease in operations relating to transfer of calls between communications carriers around the world.

Revenues from the multi-channel television segment increased from the sum of approximately NIS 670 million in the first half of 2006 to approximately NIS 708 million in the reporting period, as a result of an increase in the number of subscribers and an increase in average revenue per customer.

C. Depreciation and amortization

The Group’s depreciation and amortization expenses decreased from the sum of approximately NIS 932 million in the first half of 2006 to the sum of approximately NIS 877 million in the reporting period, mainly as a result of a decrease in depreciation expenses due to the end of depreciation of property, plant & equipment and a decrease in investments in new property in the principal segments in which the Company operates.

D. Salaries

The Group’s salary expenses increased from the sum of approximately NIS 1,139 million in the first half of 2006 to the sum of approximately NIS 1,160 million in the report period, due mainly to an increase in salary expenses in the cellular segment and in the international communications, internet and NEP services segment.

In the domestic fixed-line communications segment, there was no change compared with the corresponding period. A reduction in salary expenses on account of retiring employees and a reduction in the number of jobs was set off against salary increases under labor agreements.

E. General and Operating Expenses

The Group’s general and operating expenses for the first half of 2007 amounted to approximately NIS 2.83 billion compared with approximately NIS 2.86 billion during the corresponding period.

Revenues in the domestic fixed-line communications segment decreased from the sum of approximately NIS 1,091 million in the first half of 2006 to approximately NIS 1,067 million in the reporting period. The decrease stemmed mainly from a decrease in cellular expenses, services and maintenance by sub-contractors and materials, and spare parts, which was set off by an increase in royalty expenses and general expenses.

In the cellular segment, general and operating expenses increased from the sum of approximately NIS 1,287 million in the first half of 2006 to the sum of approximately NIS 1,320 million in the reporting period, mainly as a result of an increase in costs of terminal equipment due to an increase in the quantity of handsets sold.

In the international communications, internet and NEP services segment, there was a decrease in general and operating expenses from the sum of NIS 404 million in the first half of 2006 to the sum of approximately NIS 374 million in the report period. The decrease stemmed mainly from a reduction in operations relating to call transfers between communications carriers around the world.

Revenues in the multi-channel television segment decreased from the sum of approximately NIS 440 million in the first half of 2006 to approximately NIS 433 million in the reporting period, as a result of a decrease in content expenses and in royalty expenses.

F. Other operating expenses (income), net

The Group's net other operating expenses is mainly in the domestic fixed line communications segment. These expenses decreased from the sum of approximately NIS 71 million in the first half of 2006 to approximately NIS 44 million in the reported period, due mainly to higher provisions made for contingent liabilities recorded in the first half of 2006.

G. Operating income

The Group's operating income during the first half of 2007 amounted to approximately NIS 1,228 million, compared with approximately NIS 1,032 million in the corresponding period, an increase of approximately NIS 196 million. The increase in operating income stems from changes in the results of the segments as described above under the revenue and expense items. These changes brought about an increase in operating income in all of the main segments in which the Group operates.

H. Financing expenses, net

The Group's net financing expenses in the first half of 2007 amounted to approximately NIS 131 million compared with approximately NIS 192 million in the corresponding period, a reduction of approximately NIS 61 million.

This decrease arises out of a decrease in financing expenses in the cellular segment and the multi-channel television segment, stemming from an erosion of CPI-linked loans. In addition, in the cellular segment, there was a reduction in debt.

In the domestic fixed line communications segment, total net financing expenses were similar to expenses during the corresponding period. On the one hand, there was a reduction in financing expenses, which stemmed from erosion of CPI linked and Euro-linked liabilities. And on the other hand, during the corresponding period, revenue had been received from a dividend from a venture capital fund and the provision for termination of past disputes with the Ministry of Communications had been cancelled.

3. Liquidity and sources of financing

The consolidated cash flows from current operations for the first half of 2007 amounted to approximately NIS 1,548 million, compared with approximately NIS 1,724 million in the corresponding period, a decrease of approximately NIS 176 million. The decrease in cash flows from current operations is due mainly to revenues and expenses which do not involve cash flows, and changes in asset and liability items which were partly offset by an increase in net earnings and by an increase in tax expenses less tax payments.

Cash flows generated by operating activities are one of the sources of financing of the Group's investments, which during the reported period included, *inter alia*, approximately NIS 410 million in the development of communications infrastructure, compared with an investment in the sum of approximately NIS 511 million in the corresponding period. During the reported period, the Group realized investments in net financial assets in the sum of approximately NIS 41 million compared with a net investment in the sum of approximately NIS 93 million during the corresponding period.

During the reporting period, the Group repaid debts and paid interest in the total sum of approximately NIS 467 million, of which, approximately NIS 97 million in debentures, approximately NIS 149 million in loans, approximately NIS 23 million in short-term credit, and approximately NIS 198 million in interest payments. During the report period, the Group raised new debt in a total sum of approximately NIS 807 million by taking loans in the sum of approximately NIS 50 million and sale of debentures to institutional investors in the sum of approximately NIS 757 million, compared with payment of net debt and interest payments in the sum of approximately NIS 747 million in the corresponding period. In the reporting period, cash dividends in the sum of NIS 2.1 billion were paid, with the sum of NIS 1.2 billion in the corresponding period.

The monthly average short-term credit average from banks in the first half of 2007 amounted to approximately NIS 100 million. The monthly average of long-term liabilities to financial institutions and debenture holders in the first half of 2007 amounted to approximately NIS 7,554 million.

The working capital as at June 30, 2007 was negative, and amounted to approximately NIS 1,666 million, compared with positive operating capital as at June 30, 2006, which amounted to approximately NIS 366 million. The decrease stems from the domestic fixed-line communications segment, as a result of an increase in current debenture maturities and exercise of commercially held financial assets, which was set off by an increase in cash balances in the segment. The decrease was moderated to some extent by an increase in the working capital of the other principal Group companies.

4. Comparison of the results of the second quarter of 2007 with the results of the corresponding quarter.

Segment	**For the three months ending June 30, 2007 NIS millions profit (loss)**	**For the three months ending June 30, 2006 NIS millions profit (loss)**
Fixed-line domestic communications	243	281
Cellular	240	190
International communications and internet services	54	34
Multi-channel television	32	11
Other	2	-

Revenues during the second quarter of 2007 increased by approximately NIS 34 million compared with the corresponding quarter in the prior year.

Total costs and expenses decreased by approximately NIS 21 million compared with the corresponding quarter last year.

Net financing expenses decreased by approximately NIS 37 million compared with the corresponding quarter.

The results of the quarter, compared with the corresponding quarter, were affected by a decreased in expenses for royalties and financial expenses recorded in the corresponding quarter in the domestic fixed line communications segment, due to an agreement with the Ministry of Communications to terminate past disputes up to and including 2002.

The behavior of the various income and expense items, and the causes of the differences between the quarters are similar to the explanations set out in the half-yearly results. The changes described above in the profit and loss statements brought about a net profit ascribed to shareholders of the Company of approximately NIS 361 million in the second quarter, compared with a net profit of approximately NIS 289 million in the corresponding quarter.

5. Group involvement in the community and donations

The Group is active in the community through its involvement in social institutions and organizations such as the education system in underprivileged areas and the confrontation line. In addition, employees of the Group volunteer for a variety of other communal activities.

During the report period, the Company donated approximately NIS 143,000.

In the project “Children and Parents Study Computer and Internet”, which has been ongoing for some six years, the Company's employees voluntarily mentor underprivileged parents and children on selected subjects in the field of computers and the internet.
The Company’s employees and retirees have set up a charitable association called Halav. The association works together with local councils to locate families in distress, with the aim of providing them with basic food products.

Pelephone has no binding policy regarding donations and its management discusses each case on an individual basis. During the reporting period, Pelephone donated approximately NIS 28,000 to various associations.

Bezeq International is involved in ongoing operations on behalf of underprivileged communities in Petach Tikva, it adopted “lone” soldiers, adopted a fighting division and participated in projects for special needs children. During the reporting period, Bezeq International's expenses amounted to approximately NIS 250,000.

6. Details Concerning Exposure to and Management of Market Risks

A. Further to the statements made in the Directors’ Report for 2006, hedging transactions against the market risks involved in exposure to exchange rate fluctuations substantially reduced this exposure.

B. The report on positions on derivatives for June 30, 2007 is not significantly ifferent from the report as at December 31, 2006.

C. Analyses of sensitivity to fair value and the affect of the change in market prices on the fair value of the balance-sheet and off-balance-sheet surpluses in respect of which there are strong contracts as at June 30, 2007, are not significantly different from the report as at December 31, 2006. This is except for an analysis of sensitivity to fluctuations in the rates of index-linked securities due to the sale of debentures to institutional investors during the report period, as follows:

Analysis of sensitivity to fluctuations in index-linked securities

	Profit (Loss) due to CPI increase		**Fair Value**	**Profit (Loss) due to CPI decrease**	
	2%	1%		-1%	-2%
CPI linked debentures	10,792	5,396	539,621	(5,396)	(10,792)
Debenture 4	(25,934)	(12,967)	(1,296,720)	12,967	25,934
Debenture 5	(24,895)	(12,447)	(1,244,736)	12,447	24,895
Total	(40,037)	(20,018)	(2,001,835)	20,018	40,037

D. The report on linkage bases for June 30, 2007 is not significantly different from the report as at December 31, 2006.

The Group's surplus monetary liabilities over monetary assets denominated in or linked to foreign currency as at June 30, 2007 amounted to approximately NIS 1.76 billion. As a result of forward currency transactions as at June 30, 2007, the net balance of foreign currency liabilities not hedged by such forward transactions amounted to approximately NIS 269 million.

Surplus monetary liabilities over monetary assets linked to the CPI as at June 30, 2007 amounted to approximately NIS 5.78 billion in the Group.

The Group's main segments have hedging policies which reduce CPI exposures caused by tax expenses being calculated on real profit.

7. <u>Disclosure regarding internal auditor at the Company</u>

A. The internal auditor's procedures were updated and approved by the audit committee of the board of directors on January 4, 2005.

B. During the course of 2006, the internal auditor's term of office at the Company terminated and an acting replacement was appointed. Later on, in June 2007, the acting internal auditor was appointed as internal auditor of the Company. During 2007, in the framework of the Company's reorganization and streamlining measures, the unit was reduced by another six audit employees.

C. The audit plan approved for 2007 is for 10,000 work hours (compared with the work plan of 12,000 hours in 2006).

D. During the course of 2007, CEO discussions were held on twelve audit reports (some dating to 2006). The Audit Committee discussed three audit reports.

E. As of May 15, 2007, the external director Eyal Yaniv has been acting as chairman of the audit committee.

8. <u>Disclosure regarding process of approval of financial statements at the Company</u>

The organ responsible for overseeing at the Company is the Board of Directors. The Board of Directors of the Company appointed a balance sheet committee, whose composition and functions are as follows:

A. Most of the members of the committee are to have accounting and finance qualifications, and at least one of them is to be an external director.

B. The balance sheet committee is to discuss the financial statements prior to discussion of them on the board of directors, and is to make recommendations to the board regarding approval of them. The committee is to invite the auditors to participate in these discussions. The balance sheet committee is to discuss and make recommendations to the board of directors with respect to the following matters: prescription of accounting policy and setting down procedures relating to financial reporting and recording.

C. The balance sheet committee is to follow-up changes in accounting rules and to discuss the effect of such on the Company, is to discuss matters that might arise during financial audits and is to discuss changes in internal reporting mechanisms.

D. The balance sheet committee is to follow up and supervise implementation of the prescribed accounting policy and implementation of the procedures prescribed for financial reporting and recording.

E. The balance sheet committee is to provide its opinion on the above issues and on other financial and accounting issues, when it discusses the financial statements and whenever a specific issue of a substantial size arises in any of these areas.

F. The balance sheet committee is to advise the board of directors on the scope of work done by the auditors, and on their fees.

G. The balance sheet committee is to be responsible for contact between the board of directors and the auditors, with respect to their work.

The financial statements were discussed during two meetings of the balance sheet committee and presented to the board of directors for approval. The following office bearers took part in the discussions of the board of directors Dov Weissglas, Menachem Inbar, Ran Gottfried, David Blumberg, Eyal Yaniv, Zehavit Cohen, Yoav Rubinstein, Michael Grabiner, Key Kiarie, Rami Nomkin, and Yehuda Porat. In addition, the following office bearers also participated: Avi Gabbay – Acting CEO, Ran Oz – Deputy CEO and CFO, and Bosmat Chelouche – General Counsel. Representatives of the Company's accountants, Somekh Chaikin, also participated in the discussions.

9. Critical Accounting Estimates

The preparation of the financial statements according to international accounting principles obligates the management to make estimates and assessments that influence the reported values of assets and liabilities, income and expenses, and disclosure relating to contingent assets and liabilities. Management bases its estimates and assessments on past experience and on estimating values and opinions and additional factors which it believes are relevant, taking into account the circumstances. The actual results can differ from those assessments based on various assumptions and conditions. The main issues of uncertainty regarding critical estimates and considerations involved in implementing accounting policy are similar to those that were implemented in the annual statements (see Note 4 to the Financial Statements). We are of the opinion that these estimates and assessments are critical because any change in the estimates and presumptions has the potential of substantially affecting the financial statements.

10. Miscellaneous

Event subsequent to the date of the financial statements

Following a query by the Securities Authority, it was resolved to appoint an external examiner to examine the issues arising out of the immediate reports of the Company of March 20, 2007 regarding approval of the option scheme for employees and directors, the immediate report of the Company of March 26, 2007 regarding approval of grants to office bearers, and the immediate report of the Company of March 26, 2007 regarding restatement, pursuant to the provisions of the letters of the Securities Authority to the Company dated March 25, 2007 and March 28, 2007. The external examiner's findings and the subsequent resolutions of the board of directors, including approval of the notice of Mr. Yacov Gelbard regarding termination of office as CEO of the Company, and commencement of office of Mr. Avi Gabbay in the post of Acting CEO, are set out in Note 16 to the financial statements and in section 2.20 of the Periodic Report, and in the Company's immediate reports published since then.

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

Dov Weisglass	**Avi Gabbay**
Chairman of the Board of Directors	**Acting CEO**