"BEZEQ" THE ISRAEL TELECOMMUNICATION CORP. LIMITED

FINANCIAL STATEMENTS

DECEMBER 31, 2002

Contents

	Page
Auditors' Report	2
Financial Statements –	
Balance Sheets	3
Statements of Operation	4
Statements of Changes in Shareholders' Equity	5
Statements of Cash Flows	6
Notes to the Financial Statements	9
Appendix A – List of Group Companies	90
Appendix B – Financial Statements of DBS Satellite Services (1998) Ltd.	

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, 2002 and 2001, 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, 2002. 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% and approximately 17% of the total consolidated assets as at December 31, 2002 and 2001, respectively, and whose revenues constitute approximately 34%, 28%, and 9% of the total consolidated revenues for the years ended December 31, 2002, 2001, and 2000, respectively. The financial statements of those subsidiaries were audited by other auditors whose reports thereon were furnished to us. Our opinion, insofar as it relates to amounts emanating from the financial statements of such subsidiaries, is based solely on the said reports of the other auditors. Furthermore, the data included in the financial statements relating to the net asset value of the Company's investments in affiliates and to its equity in their operating results is based on the financial statements of such affiliates, some of which were audited by 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 provide a reasonable basis for our opinion.

In our opinion, based on our audits and on the reports of the abovementioned 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, 2002 and 2001 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, 2002, 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 anticipated 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).

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

4. The financial condition of an affiliated company and the financing agreement between the affiliated company and banking corporations. As described in Note 8E the activity of the affiliated company is dependent upon the continued execution of the financing agreement, including the formulation of the Addition to the Financing Agreement as detailed in the aforementioned note, and receipt of additional loans from shareholders.

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

March 6, 2003

Balance Sheets

In terms of shekels of December 2002

		Consolidated		Company	
		December 31 2002	December 31 2001	December 31 2002	December 31 2001
	Note	NIS thousands	NIS thousands	NIS thousands	NIS thousands
Current assets					
Cash and cash equivalents	3	**992,454**	1,387,644	**917,365**	1,352,890
Short-term investments	4	**1,180,081**	469,279	**1,179,989**	452,206
Trade receivables	5	**1,751,988**	1,795,814*	**1,126,358**	1,219,959
Other receivables and debit balances	6	**514,756**	308,678*	**476,795**	269,157
Inventory		**167,381**	123,570	**–**	–
		4,606,660	4,084,985	**3,700,507**	3,294,212
Materials and spare parts		**122,188**	161,667	**122,188**	161,667
Investments and long-term payables					
Investments, deposits and debit balances	7	**768,811**	1,788,166*	**675,684**	1,725,152
Investments in investee companies	8	**390,074**	491,018	**1,742,474**	1,704,081
		1,158,885	2,279,184	**2,418,158**	3,429,233
Fixed assets	9				
Cost		**29,956,427**	29,995,478	**24,987,523**	25,534,628
Less – accumulated depreciation		**19,986,463**	19,092,610	**16,946,977**	16,427,787
		9,969,964	10,902,868	**8,040,546**	9,106,841
Other assets					
Deferred charges and other assets	10	**282,798**	362,512	**15,414**	18,086
Deferred taxes	11	**402,076**	477,037*	**236,979**	346,331
		684,874	839,549	**252,393**	364,417
		16,542,571	18,268,253	**14,533,792**	16,356,370

		Consolidated		Company	
		December 31 2002	December 31 2001	December 31 2002	December 31 2001
	Note	NIS thousands	NIS thousands	NIS thousands	NIS thousands
Current liabilities					
Bank credit	12	**528,825**	451,081	**–**	–
Current maturities of:					
Long-term bank loans	13	**545,063**	593,104	**373,184**	390,866
Other debentures	14	**210,294**	198,851	**210,294**	198,851
Trade payables	15	**1,153,363**	1,084,858	**676,213**	607,589
Employee severance benefits	16	**212,631**	280,028	**212,631**	280,028
Other current liabilities	17	**1,118,102**	1,227,173*	**883,240**	1,015,843
		3,768,278	3,835,095	**2,355,562**	2,493,177
Long-term liabilities					
Long-term loans	13	**2,103,365**	2,677,226	**1,510,434**	2,101,737
Other debentures	14	**2,769,127**	2,688,244	**2,769,127**	2,688,244
Employee severance benefits	16				
Prepaid income	18	**1,139,820**	1,358,795	**1,128,812**	1,347,258
		44,639	61,804	**53,090**	78,865
		6,056,951	6,786,069	**5,461,463**	6,216,104
Minority rights		**575**	–	**–**	–
Contingent liabilities	19				
Shareholders' equity	20	**6,716,767**	7,647,089	**6,716,767**	7,647,089
		16,542,571	18,268,253	**14,533,792**	16,356,370

* Reclassified

Adv. Miriam (Miki) Mazar	Ilan Biran	Danny Oz
Chairperson of the Board	CEO	Deputy Chief Financial Officer

Date of approval of the financial statements: March 6, 2003

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

Statements of Operation for the Year Ended December 31

In terms of shekels of December 2002

		Consolidated			Company		
	Note	2002 NIS thousands	2001 NIS thousands	2000 NIS thousands	2002 NIS thousands	2001 NIS thousands	2000 NIS thousands
Revenues from telecommunications services	21	**8,234,543**	8,681,397	9,074,166	**5,567,854**	6,277,572	6,752,258
Costs and expenses							
Operating and general expenses	22	**4,624,490**	4,757,761	4,626,413	**2,461,929**	2,680,870	2,738,998
Depreciation	9	**2,318,357**	2,765,209	2,916,227	**1,924,816**	2,290,770	2,425,936
Royalties to the State of Israel		**254,955**	287,952	339,711	**182,469**	201,612	216,938
		7,197,802	7,810,922	7,882,351	**4,569,214**	5,173,252	5,381,872
Operating income		**1,036,741**	870,475	1,191,815	**998,640**	1,104,320	1,370,386
Financing expenses, net	23	**168,494**	153,435	370,680	**119,386**	77,481	317,877
Earnings after financing expenses		**868,247**	717,040	821,135	**879,254**	1,026,839	1,052,509
Other expenses, net	24	**1,243,243**	115,257*	1,374,430	**1,230,389**	2,665	1,331,449
Earnings (loss) before income tax		**(374,996)**	601,783	(553,295)	**(351,135)**	1,024,174	(278,940)
Income tax (tax benefit)	11	**211,319**	245,571	(165,584)	**234,056**	369,283	(149,891)
Earnings (loss) after income tax		**(586,315)**	356,212	(387,711)	**(585,191)**	654,891	(129,049)
Equity in losses of investee companies	8	**347,072**	233,847*	210,766	**345,131**	525,902	464,144
Minority share in losses of consolidated company		**(3,065)**	(6,624)	(5,284)	**–**	–	–
Net earnings (loss)		**(930,322)**	128,989	(593,193)	**(930,322)**	128,989	(593,193)
Earnings (loss) per share							
Primary and diluted earnings (loss) per NIS 1 par value of common shares (in NIS)	25	**(0.386)**	0.053	(0.244)	**(0.386)**	0.053	(0.244)

* Reclassified

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

Statements of Changes in Shareholders' Equity

In terms of shekels of December 2002

	Share capital	Capital reserve for distribution of bonus shares	Capital reserve – share premium	Capital reserve in respect of transactions between the Company and a controlling shareholder	Dividend offered after the balance sheet date	Retained earnings	Total
Balance as at January 1, 2000	4,463,375	–	703,987	38,500	–	2,632,550	7,838,412
Changes in 2000 –							
Erosion of dividend proposed in a previous year and paid this year	–	–	–	–	–	(1,535)	(1,535)
Net loss	–	–	–	–	–	(593,193)	(593,193)
Tax benefit in respect of shares to employees	–	–	23,500	–	–	–	23,500
Conversion of convertible debentures (1)	15,826	–	161,528	–	–	–	177,354
Capitalization of undesignated earnings to a reserve fund for the distribution of bonus shares	–	1,726,332	–	–	–	(1,726,332)	–
Balance as at December 31, 2000	4,479,201	1,726,332	889,015	38,500	–	311,490	7,444,538
Changes in 2001 –							
Net earnings	–	–	–	–	–	128,989	128,989
Conversion of convertible debentures (2)	6,408	–	67,154	–	–	–	73,562
Distribution of bonus shares	1,748,350	(1,726,332)	–	–	–	(22,018)	–
Balance as at December 31, 2001	6,233,959	–	956,169	38,500	–	418,461	7,647,089
Changes in 2002–							
Net loss	**–**	**–**	**–**	**–**	**–**	**(930,322)**	**(930,322)**
Dividend proposed subsequent to balance sheet date	**–**	**–**	**–**	**–**	**190,000**	**(190,000)**	**–**
Balance as at December 31, 2002	**6,233,959**	**–**	**956,169**	**38,500**	**190,000**	**(701,861)**	**6,716,767**

(1) 147,652,429 par value convertible debentures were converted into 14,590,161 ordinary shares with a par value of NIS 1 each.

(2) 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 2002

	Consolidated			Company		
	2002	2001	2000	2002	2001	2000
	NIS thousands			NIS thousands		
Cash flows from operating activities						
Net earnings (loss)	**(930,322)**	128,989	(593,193)	**(930,322)**	128,989	(593,193)
Adjustments to reconcile net earnings (loss) to net cash flows generated by operating activities (see A below)	**3,744,985**	3,296,047	4,119,535	**3,286,813**	2,880,406	3,812,823
Net cash flows provided by operating activities	**2,814,663**	3,425,036	3,526,342	**2,356,491**	3,009,395	3,219,630
Cash flows from investing activities						
Investment in fixed assets	**(1,379,944)**	(1,346,056)	(1,863,641)	**(892,879)**	(954,329)	(1,192,543)
Proceeds from disposal of fixed assets	**25,165**	87,324	37,361	**13,143**	66,823	31,491
Proceeds from disposal of investment in affiliated companies	**119,062**	31,656	184,805	**97,973**	31,656	184,805
Investment in long-term deposits and investments	**(221,848)**	(1,174,162)	(64,610)	**(179,346)**	(1,151,533)	(27,527)
Proceeds from long-term deposits and investments	**162,816**	38,952	64,819	**187,745**	32,916	25,428
Decrease (increase) in short-term investments, net	**(768,812)**	(255,375)	124,956	**(784,359)**	(260,899)	138,443
Decrease in materials and spare parts	**23,207**	52,076	62,594	**23,207**	52,076	62,594
Acquisition of a partnership consolidated for the first time (see "B" below)	**(3,935)**	–	–	–	–	–
Investment in investee companies	**(366,428)**	(557,831)	(350,688)	**(481,496)**	(835,204)	(289,216)
Investments in other assets	**(128,757)**	(208,585)	(284,034)	**(8,993)**	(5,952)	–
Net cash used in investment activities	**(2,539,474)**	(3,332,001)	(2,088,438)	**(2,025,005)**	(3,024,446)	(1,066,525)
Cash flows from financing activities						
Repayment of debenture issued to the State of Israel	–	–	(509,334)	–	–	(509,334)
Issuance of other debentures (after deduction of issuance expenses)	**109,043**	543,719	1,181,315	**109,043**	543,719	1,181,315
Repayment of other debentures	**(225,642)**	(240,991)	(244,348)	**(225,642)**	(240,991)	(244,348)
Receipt of long-term loans	**211,318**	781,806	867,148	–	461,703	637,026
Repayment of long-term loans	**(842,496)**	(1,102,540)	(1,968,612)	**(650,412)**	(1,040,033)	(1,772,046)
Receipt (repayment) of short-term bank credit	**77,398**	(342,850)	501,252	–	–	–
Dividend paid	–	–	(327,216)	–	–	(327,216)
Net cash used in financing activities	**(670,379)**	(360,856)	(499,795)	**(767,011)**	(275,602)	(1,034,603)
Increase (decrease) in cash and cash equivalents	**(395,190)**	(267,821)	938,109	**(435,525)**	(290,653)	1,118,502
Cash and cash equivalents at beginning of year	**1,387,644**	1,655,465	717,356	**1,352,890**	1,643,543	525,041
Cash and cash equivalents at end of year	**992,454**	1,387,644	1,655,465	**917,365**	1,352,890	1,643,543

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 2002

	Consolidated			Company		
	2002	2001	2000	2002	2001	2000
	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	**2,318,357**	2,765,209	2,916,227	**1,924,816**	2,290,770	2,425,936
Provision for impairment of fixed assets	**–**	108,654	11,893	**–**	–	–
Deferred taxes	**30,729**	(124,521)	(332,840)	**65,056**	(2,207)	(309,890)
Company's equity in losses of investee companies, net	**347,072**	233,847*	210,766	**345,131**	525,902	464,144
Minority share in net losses of a consolidated company	**(3,065)**	(6,624)	(5,284)	**–**	–	–
Increase (decrease) in employee severance benefits, net	**(286,372)**	(91,524)	1,276,903*	**(291,772)**	(98,445)	1,264,381*
Loss (gain) on disposal of fixed assets	**(12,984)**	(9,270)	(1,448)	**(12,490)**	2,665	(2,869)
Loss (gain) on disposal of investment in an affiliate	**–**	3,706	(149,831)	**–**	–	(149,831)
Provision for decrease in value of investments	**1,256,352**	8,173*	–	**1,243,012**	–	–
Erosion (appreciation) of and interest on long-term deposits and investments	**(302,365)**	(211,169)	16,658	**(39,707)**	(211,169)	16,658
Erosion (appreciation) of short-term investments, net	**58,010**	(10,471)	(3,166)	**56,576**	(9,465)	(2,279)
Appreciation (erosion) of long-term liabilities:						
Debenture issued to the State of Israel	**–**	–	718	**–**	–	718
Other debentures	**208,926**	17,640	29,094	**208,926**	17,640	29,094
Long-term loans	**(13,637)**	136,743	(79,689)	**14,219**	139,385	(77,600)
Depreciation of deferred expenses and other adjustments	**224,175**	261,484	162,493	**11,664**	4,529	1,173
Changes in asset and liability items:						
Decrease (increase) in trade receivables	**59,540**	(429,574)	269,732*	**99,513**	(442,929)	302,172
Decrease (increase) in other receivables and debit balances	**4,979**	339,427	(89,190)	**(298,939)**	305,872	(95,226)
Decrease (increase) in inventory	**(45,664)**	23,666	(15,890)	**–**	–	–
Increase (decrease) in trade payables	**52,039**	85,135	(200,124)*	**112,689**	182,649	(115,648)
Increase (decrease) in other current liabilities	**(133,942)**	209,095	112,211*	**(126,106)**	197,320	80,126*
Decrease in prepaid income	**(17,165)**	(13,579)	(9,698)	**(25,775)**	(22,111)	(18,236)
	3,744,985	3,296,047	4,119,535	**3,286,813**	2,880,406	3,812,823

* 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 2002

	Consolidated 2002 NIS Thousands
B – Affiliated partnership consolidated for the first time	
Working capital (excluding cash and cash equivalents)	**6,629**
Fixed assets	**(6,134)**
Long-term liabilities	**809**
Minority rights as at the acquisition date	**737**
Investment in an affiliated company	**1,087**
Goodwill	**(7,063)**
	(3,935)

	Consolidated			Company		
	2002	2001	2000	2002	2001	2000
		NIS thousands			NIS thousands	
C – Non–cash transactions						
Acquisition of fixed assets, other assets, materials and spare parts on credit	**212,256**	174,410	325,106	**128,912**	116,826	196,215
Sale of fixed assets on credit	**5,912**	–	9,567	**5,912**	–	9,567
Transfer of fixed assets against an investment in a consolidated company	**–**	–	–	**–**	12,786	–

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

NOTE 1 – GENERAL

A. "Bezeq" The Israel Telecommunication Corp. Limited (hereinafter – the Company) is controlled by the State of Israel and as such, is subject to the provisions of the Government Companies Law, 5735 – 1975. The Company operates under a general license awarded under the Telecommunications Law (Telecommunications and Broadcasting), 5742 – 1982 (the Telecommunications Law), which authorizes it to engage in the telecommunication business and provide telecommunication services. The Company's license, which was granted on March 1, 1994, (and which replaced an earlier license which was subsequently amended on various dates), sets out the terms under which the Company shall operate, and provides, *inter alia*, that the Company shall continue to provide telephone and related services, infrastructure services and shall operate through subsidiaries which will engage in providing services in areas which were opened to competition. Under the license, the management of the subsidiaries is to be separate from the management of the Company, and the provision of new services by the Company is contingent upon receipt of a license from the Ministry of Communications. Additionally, limits were also imposed on the extent of the Company's financial exposure in projects undertaken outside Israel.

In March 2002 the Company received a draft amendment to its general license from the Ministry of Communications. The draft includes the imposition of new provisions and limitations on the Company (some of which are reflected in the Telecommunications Law and/or the Telecommunications Order and/or in other laws and some of which are new), as well as expansion of existing provisions and restrictions on various matters. The Company submitted its objections and remarks to the Ministry of Communications and several meetings have been held on the matter.

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.

The Company's tariffs are updated according to the recommendations of the committee for arrangement of the Company's tariffs, which were adopted by the Minister of Communications and Minister of Finance with certain amendments. Those recommendations set the efficiency factor of the Company's tariffs ("the efficiency factor"), which averaged 6% in 1999 and 7% in 2000. Commencing 2001, this factor is 3.5% per year.

The Company's tariffs were most recently changed on May 14, 2002, with these changes updating tariffs for various services, among them the call tariffs, installation fees and additional services. The change in the call tariffs included a change in peak and off-peak hours and unification of local and long distance calls at all hours of the day.

In March 2002 a new committee was appointed to examine the structure and method of updating Company’s tariffs and included a mandate to examine and recommend a new tariff arrangement for the Company which will be suited to the changing environment of the communications sector. The committee has not yet completed its work.

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 the royalty percentage, until a uniform rate is attained for all communications operators.

	For the year ended December 31		
	2002	**2001**	**2000**
	%	**%**	**%**
Fixed-line domestic telecommunications services	**4.0**	4.0	5.0
Cellular services	**4.5**	5.0	8.0
Bezeq International services	**4.0**	4.5	5.0
DBS Satellite services	**4.0**	1.5	1.5

NOTE 1 – GENERAL (CONTD.)

In 2003 the percentage of royalties in respect of cellular services will decrease to 4%. IN 2004 the percentage of royalties in respect of all communications operators will decrease to 3.5%.

D. In June 1995, the Commissioner of the Anti–Trust 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 Anti–Trust Commissioner declared the Company a monopoly in the field of telecommunications infrastructure for providing high–speed Internet access services by means of Internet providers.

Two appeals filed by the Company are pending in the Anti–Trust 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.

In April 2001 the Anti–Trust Commissioner cancelled the notice naming Bezeq International Ltd. a monopoly in the provision of international telephone services.

E. Below are the significant changes which have occurred in recent years regarding Company exclusivity in providing communications services in Israel:

(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 only the amounts it actually collected in respect of airtime, less a collection fee, to the Operators (in contrast to the previous arrangement, which was based on customer charges without deduction of a collection fee). The Company came to agreements with Pelephone and with MIRS Communications Ltd. (hereinafter – "MIRS") regarding the period from March 1, 2000 to December 31, 2002.

Following the objections of some of the Operators to the change in the arrangement (one of them even filed a legal claim in court, which was dismissed, and an appeal on the dismissal is pending in the Supreme Court) the Minister of Communications intervened and in November 2001 he determined that until the dispute between the Company and cellular operators Cellcom and Partner is settled, the Company must pay those Operators according to the actual volume of traffic minutes, irrespective of collection, less an amount agreed upon by the parties and in the absence of such agreement – as the Minister will decide, for the period from October 2, 2000 to January 1, 2003. In accordance with the Minister's directive, the Company transferred an immediate interim payment to the Operators, relating to traffic from October 2000, with a 2.5% deduction. The Company's financial statements for 2001 included an expense of NIS 83 million deriving from the above.

In December 2002 the Minister of Communications announced that he is considering setting a reduced deduction rate of 1.1% for the above period, while for the period from January 1, 2003 the Company will pay the Operators in full, irrespective of collection and that the matter will be reflected, to the extent required in the regulation of the Company's tariffs. In February 2003, the Minister subsequently announced that in the light of the allegations made, he is allowing the parties to complete the submission of information before making a final decision on the matter of the percentage of deduction. The Minister also defined an interim arrangement for four months (from January 1, 2003) during which the percentage would be 1.1%, since the committee charged with setting the Company's tariffs has not completed its work (such decision is not meant to influence the final decision on the matter). The Minister further clarified that his decisions apply to all the cellular Operators (i.e. including Pelephone and MIRS, with whom the Company had reached an arrangement).

NOTE 1 – GENERAL (CONTD.)

The Company will decide on which steps it will take on the matter when the final determinations are received. As a result of the aforementioned , the Company recorded an additional expense of approximately NIS 56 million in the financial statements.

Commencing on March 1, 2000, the revenues and expenses of the Company from cellular services do not include airtime. The airtime included in its revenues and expenses in 2000 were approximately NIS 313 million.

(2) International communication services

At the beginning of July 1997, two new companies commenced provision of international communication services. As a result, international call tariffs were significantly lowered, including those of the consolidated company Bezeq International Ltd. At that time, regulations were promulgated to obligate the international operators to pay the Company a fee for "interconnect services". In addition, the general license awarded to the international operators obligates them to pay a fee to the Company for "access services" until December 31, 2001.

Pursuant to the decision of the Minister of Communications, the period of exclusivity of the international communications operators will be extended to January 1, 2004 (the Minister gave notice that he is considering a further extension until August 2004), subject to the international call tariffs not rising in real terms during the term of the extension.

(3) Domestic communication services

In February 1999, Section 50 of the Telecommunications Law was cancelled. Section 50 had granted the Company exclusivity in providing telecommunications services in a nationwide telephone network under the general license.

In July 2001 the Telecommunications Law was amended. The amendment regulates, i*nter alia*, the opening of the domestic communications market and cable broadcasting to competition by means of granting licenses for providing communications services. The amendment covers a large number of matters which affect the Company and the Group companies. The law enables the cable companies to transfer from a regime of franchises to one of licenses, so that they or companies with an interest in them will be able to obtain a general license for providing telecommunications services.

In March 2002 the Ministry of Communications commenced granting domestic operator licenses to the cable companies. At this stage, the licenses are valid for providing broadband internet services on the cable infrastructure and for data and transmission services, with certain restrictions. During 2002 the cable companies started to provide these services. The application of the cable companies to merge was approved by the Anti-Trust Commissioner and by all the regulatory bodies. The matter is currently pending in the Anti-Trust Tribunal, as part of an appeal filed by D.B.S. Satellite Services (1998) Ltd.

After the adoption of the recommendations of the committee appointed to examine the rules and policy of opening fixed-line communications to competition, the Ministry of Communications announced that it had broadened the special licenses of Cellcom and MED-1 so as to permit them to provide high-speed data communication and transmission services to business customers.

A cellular company filed a petition in the High Court of Justice against the Company and the Minister of Communications, seeking cancellation of the directive it received to disconnect direct connections that bypass the Company's network, which it makes for business customers. On February 11, 2002, the High Court of Justice issued an interlocutory injunction retaining the *status quo*. As a result of that injunction, on February 27, 2002, the Ministry of Communications issued instructions to all the cellular companies not to make any additional direct connections. On December 19, 2002 the High Court of Justice issued an interim order and granted the respondents 60 days to respond. In

NOTE 1 – GENERAL (CONTD.)

the Company's opinion, relying on the legal adviser who is handling the claim on its behalf, the chances that the petition will be allowed, cannot be estimated.

On August 8, 2002 the committee formulating policy and rules for opening the domestic fixed-line communications market to competition submitted its recommendations to the Minister of Communications. The recommendations set out the proposed policy, the principles of opening the market to competition and recommendations for the removal of barriers against the entry of new operators. The Company submitted its comments regarding the committee recommendations to the Minister of Communications. The Company expressed its position that adoption of the committee's recommendations on the matters of, *inter alia,* structural separation, universal service, splitting transmission, data communication and infrastructure and the immediate permit for the selective provision of such services as well as the supervision of the Company's tariffs, would be extremely harmful to the Company, consumers and the economy. The Minister adopted the recommendations of the committee with certain changes which are mainly related to the postponement of the date of granting internet providers a permit for access services, to a date when a permit will be granted for services to the general public and keeping in place the duty of corporate separation for a domestic operator. The Company filed a petition in the High Court of Justice against the Minster's decision insofar as it relates to the separation of data communications and transmission from telephony (which the Company believes is impracticable) and to the immediate selective granting of a permit for providing data and transmission services without a universal obligation, in which it alleged, *inter alia*, that the decision of the Minister is unreasonable and was issued without authority. The Company consented to retract the petition following a statement in court by the legal representative of the Ministry of Communications that the Ministry of Communications would enforce the terms of the licenses already granted and that will be granted and that the Ministry of Communications does not intend to expand the use of those special licenses beyond the appropriate objectives for which the law was passed and that the Ministry of Communications intends to initiate an amendment of the regulations so that the Company will also be exempted from payment of royalties in respect of some of the data and transmission services, starting from January 1, 2004.

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. A further deterioration which cannot be estimated at this stage is expected to continue with the opening of fixed–line domestic communication services to full competition.

F. On August 27, 2000, the Ministerial Committee for Privatization decided to sell the State's holdings in the Company by way of a private sale which would be accompanied by a raising capital for the Company. The sale will include shares comprising at least 50.01% of the Company's share capital. The Government Companies Authority was authorized to take the actions necessary for implementing the decision, including those actions set out in the decision.

Thereafter, the Ministerial Committee for Privatization reached a number of decisions designed to advance implementation of the above resolution. In addition, the Company's license, Articles and the Telecommunications Order were amended. On November 13, 2001, the Government of Israel published a notice stating that it was considering the sale of the State's holdings, comprising 50.01% of the share capital of the Company by way of a private sale.

Following the notice, several entities expressed their interest in participating in the sale process. To the best of the Company's knowledge, some of those entities have since given notice of their withdrawal from the process.

On January 13, 2002, a framework agreement was signed between the State and the Company, concerning the raising of up to NIS 890 million in capital for the Company in accordance with the decision of the Ministerial Committee for Privatization, while concurrently, the Company will allot shares to the State in the same amount as those sold by the State. The process of raising capital has not yet commenced as the conditions required for its implementation do not exist .(see Note 20B).

NOTE 2 – SIGNIFICANT ACCOUNTING PRINCIPLES AND REPORTING POLICIES

A. DEFINITIONS

In these financial statements –

(1) Subsidiaries – Companies whose financial statements are fully consolidated, directly or indirectly, with the financial statements of the Corporation.

(2) Proportionately consolidated companies – Companies whose financial statements are partially (proportionately) consolidated, directly or indirectly, with the financial statements of the Corporation.

(3) 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.

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

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

(6) Interested parties – As defined as the definition of "interested party" in the Securities Law, Section 1 Paragraph (1)

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

(8) 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 terms "cost" as used in the adjusted reports 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. 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.

D. CLASSIFICATION OF STATEMENT OF OPERATIONS ITEMS

The items of the statements of operations have been reclassified and are presented in the order arising from the nature of the Company's business as a communications company.

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

E. PRINCIPLES OF ADJUSTMENT

(1) Balance sheet

Non–monetary items (mainly fixed assets, materials and spare parts, investments stated at cost) 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.

(2) Statement of operations

Statement of operation items were adjusted on the basis of 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 operation 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 balance sheet month.

(c) The Company's equity in operating results of investee companies was included on the basis of the adjusted financial statements of those companies.

(d) The financing item reflects interest 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 is comprised of 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.
See Notes 2O and 11D relating to deferred taxes.

(3) Statement of changes in shareholders' equity

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 in the reporting year but had not been distributed by the balance sheet date is stated unadjusted.

F. CONSOLIDATION OF THE FINANCIAL STATEMENTS

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

(2) Lists of the subsidiaries, the affiliates and the other companies and percentage holding in them are included in an appendix to the financial statements.

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

F. 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 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.

c. Excess adjusted equity value over the cost of the investment was deducted initially from intangible assets. The negative excess cost remaining after the attribution to intangible assets was deducted from non-monetary assets proportionally to the fair value of those assets according to the Company's share. The balance of the negative excess cost, after attribution as aforesaid, is stated in the consolidated balance sheet as deferred revenues and will be amortized at equal annual installments over 10 yearsAny amortized balances of goodwill and negative goodwill should be offset from those in the balance sheet for presentation purposes only.

(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) Inter-company balances and transactions between subsidiaries and earnings from inter-company sales not yet realized outside the Group, were eliminated.

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

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

c. Earnings from the sales of the proportionally 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.

G. 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.

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

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

The Company periodically checks whether a change of a non–temporary nature has occurred in its 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, ongoing losses in the investee, the sector in which the investee operates, the goodwill value included in the investment 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.

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

I. 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.

Marketable securities held as a permanent investment are stated at cost (regarding debentures - including the accumulated interest) unless they are subject to a reduction in value of a non-temporary nature (see also paragraph I(3) below).
The changes in the values of securities are charged to the statement of operations in full.

(2) Non-marketable securities

Non-marketable securities are presented at the cost which, in the opinion of management, does not exceed the realization value (see also paragraph I(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 in other companies. 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.

J. 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 period of arrears in clearing their debt. Doubtful debts which Management believes cannot be collected are written off in the Company's books following a Management decision. The financial statements also contain a general provision in respect of doubtful debts.

K. 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.

As part of its current operations, a proportionately consolidated company 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 the company for the repair of user equipment in the framework of the repair service it provides for its customers.

L. 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.

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

M. 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 value to the business.

(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 accordingly recorded in respect of the decrease in value.

(5) Commencing January 1, 2000, real financing expense for loans and credit used for financing the construction or purchase of fixed assets is attributed to the cost of those assets in accordance with Accounting Standard No. 3 – Capitalization of Credit Costs. See Note 9A.

(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	5–10	10
Transmission and power equipment	10–20	20
Network equipment	5–25	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.

(7) Changes of estimates – see Note 9B.

N. DEFERRED EXPENSES 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 Communications Ltd. (a proportionately consolidated company) 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.

(3) Frequencies
For Pelephone Communications Ltd.'s (a proportionately consolidated company) investment in cellular communication frequencies in third generation technology and its amortization, see Note 8D(6).

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

N. DEFERRED EXPENSES AND OTHER ASSETS (CONTD.)

(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) Customer recruitment expenses
Customer recruitment expenses incurred by a consolidated company in connection with recruiting customers from whom revenues are received over a period exceeding one year are amortized by the straight line method over the period of the contract with the customer (usually three years).

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

(7) Acquisition of operations (resources)

a. The components of an operation acquired by a consolidated company from Nortel Networks Israel (Sales & Marketing) Ltd. (see Note 19C(3)), are stated at cost and in accordance with the present value of the future payments to a long-term supplier.

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.

d. The consolidated company 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.

O. 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. Such allocation of taxes is made for differences relating to assets whose consumption or depreciation is deductible for tax purposes. Deferred tax balances (asset or liability) are calculated according to the liability approach using the tax rates which will be in effect at the time of utilization of the deferred taxes, or upon realization of tax benefits, as they are known close to the date of approval of the financial statements.

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

(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 losses carried forward and timing differences, where the likelihood of realizing the benefit is in doubt.

P. INCOME RECOGNITION

Income is attributed to the statement of operations upon being generated on the accrual basis. Income from the sales of user equipment, exchanges and business systems are included upon delivery of the goods to the customer. Income from sales of subscriber equipment by installments are recorded at their present value upon delivery to the customer.

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

Q. CAPITALIZATION OF CREDIT COSTS

The Company capitalizes credit costs in accordance with 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 it for its intended use have been completed. See Note 9A.

R. DERIVATIVE FINANCIAL INSTRUMENTS

(1) Forward currency contracts intended to hedge foreign currency exposure of assets and liabilities are included in the financing item in the statement of operations, in parallel with the accounting treatment of the hedged item.

(2) Derivative financial instruments not designated for hedging are presented in the balance sheet at their fair value. Changes in the fair value are attributed to the statement of operations in the period in which they occurred.
The fair value of derivative financial instruments is determined according to their market prices and in the absence of a market price, according to a valuation model.

S. 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.

Details of the CPI and the U.S. dollar exchange rates are as follows:

	December 31 2002	December 31 2001	% of change 2002	% of change 2001	% of change 2000
CPI – in points	**108.2**	101.6	**6.496**	1.397	0.00
US dollar exchange rate $ 1 – in NIS	**4.737**	4.416	**7.269**	9.279	(2.69)
Euro exchange rate 1 Euro - in NIS	**4.969**	3.907	**27.182**	3.827	(9.87)

T. EARNINGS PER SHARE

Earnings per share is calculated in accordance with Opinion No. 55 of the ICPAI. Fully diluted earnings per share are not presented as the effect of dilution is not significant.

U. REPORTING BY SECTOR

Reporting by sector is presented in accordance with Accounting Standard No. 11, which requires the inclusion of information about business sectors and geographical sectors, and also gives detailed instructions for the identification of business and geographical sectors. See also Note 26.

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

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

(1) In July 2001 the Israeli Accounting Standards Board ("IASB") published two new standards:

(a) Accounting Standard No. 12 – Discontinuance of Adjustment of Financial Statements. This standard provides for the discontinuance of the adjustment for the effects of the purchasing power of the shekel in financial statements, 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.

(b) Accounting Standard No. 13 – Effects 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, and supersedes the provisions of Clarifications 8 and 9 to Opinion No. 36, which will become null and void when Accounting Standard No. 12, described above, takes effect.

(2) In August 2002 the IASB published Standard No 14 – Financial Reporting for Interim Periods, setting the minimum content of financial reports for interim periods, including the disclosure required in the notes and the accounting principles for the recognition and measurement to be applied in financial reports for interim periods. This standard will apply to financial statements for periods starting on January 1, 2003 or thereafter. Restatement of comparative data for interim periods prior to that date is not required under the standard. However, if financial statements include comparative data for interim periods prior to that date, not in accordance with the provisions of the standard, the notes to the financial statements must include a description of the main differences between the requirements laid down in this standard and the requirements under which the comparative data were prepared. The Company believes that the effects of the new standard on the results of its operations, financial position and cash flows will not be material.

(3) In February 2003 the IASB published Standard No. 15 – Impairment of Assets. The standard prescribes sets out procedures which a corporation must follow in order to ensure that its assets in the consolidated balance sheet are not stated in an amount exceeding their fair value which is the higher of the net selling price and the present value of the estimated future cash flows expected to be derived from the use and disposal of the asset. The standard also lays down the rules of presentation and disclosure for assets whose value has decreased. Through December 31, 2002, the Company assessed the requirement for a provision in respect of impairment of assets according to international accounting principles similar to the provisions of Standard 15 and therefore the application of this standard is not expected to affect its financial statements.

Bezeq International Ltd., a consolidated company, is examining the effects of Standard 15, but at this stage is unable to estimate its implications, if any, on its financial position and the results of its operations.

A proportionately consolidated company is preparing to apply the standard, commencing from its first statements in 2003 and is assessing the implications, if any, that can be expected for its financial statements.

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

W. FIRST-TIME CONSOLIDATION OF A PARTNERSHIP

(1) During the reporting year the financial statements of Goldnet Communications Services – a registered partnership, in which the Company's holding increased from 49% to 54% were consolidated for the first time (through the reporting year, the investment in this partnership was stated at equity value). See Note 8H.

(2) Following are the data of the partnership in the consolidated financial statements:

	At the date of acquisition of control	On December 31, 2002 and for the period from the acquisition to the above date
	NIS thousands	NIS thousands
Balance Sheet		
Cash and cash equivalents	**3,935**	**1,216**
Working capital (excluding cash and cash equivalents)	**(6,629)**	**(4,526)**
Fixed assets, after deduction of accumulated depreciation	**6,134**	**4,989**
Goodwill created upon acquisition	**–**	**7,063**
Minority rights at the date of acquisition	**737**	**575**
Long-term liabilities (less current liabilities)	**809**	**837**
Statement of Operations		
Revenues	**31,444**	**41,289**
Net loss	**(1,693)**	**(2,037)**
Group's equity in the loss	**(779)**	**(937)**

(3) The value of goodwill created following acquisition of an investment in the partnership, consolidated for the first time, amounts to approximately NIS 7,063,000.

NOTE 3 – CASH AND CASH EQUIVALENTS

	Consolidated		Company	
	December 31 2002	December 31 2001	December 31 2002	December 31 2001
	NIS thousands	NIS thousands	NIS thousands	NIS thousands
Israeli currency	**963,851**	1,343,338	**913,273**	1,332,587
Foreign currency	**28,603**	44,306	**4,092**	20,303
	992,454	1,387,644	**917,365**	1,352,890

Cash equivalents include bank deposits with an original maturity at the time of making the investment that did not exceed three months.

NOTE 4 – SHORT-TERM INVESTMENTS

	Consolidated		Company	
	December 31 2002	December 31 2001	December 31 2002	December 31 2001
	NIS thousands	NIS thousands	NIS thousands	NIS thousands
Marketable securities:				
Government debentures				
Linked to the CPI	**715,743**	135,627	**715,743**	132,055
Linked to the U.S. dollar exchange rate	**17,944**	17,860	**17,944**	16,086
Unlinked	**115,203**	54,219	**115,203**	49,068
Convertible debentures	**17,700**	16,822	**17,700**	16,628
Other debentures	**187,544**	59,945	**187,544**	59,945
Mutual fund participation certificates	**110,855**	180,952	**110,855**	178,424
	1,164,989	465,425	**1,164,989**	452,206
Short-term bank deposits:				
Linked to the CPI	**–**	3,672	**–**	–
Unlinked	**15,092**	182	**15,000**	–
	1,180,081	469,279	**1,179,989**	452,206

NOTE 5 – TRADE RECEIVABLES

	Consolidated		Company	
	December 31 2002	December 31 2001	December 31 2002	December 31 2001
	NIS thousands	NIS thousands	NIS thousands	NIS thousands
For domestic services:				
On open account	**1,520,282**	1,642,308*	**966,591**	1,080,105
Income receivable	**317,364**	336,259	**246,750**	267,681
Credit cards and checks receivable	**243,589**	181,518	**128,530**	95,879
Investee companies	**4,168**	1,277	**4,168**	1,277
For international services	**32,351**	40,466	**10,354**	8,617
	2,117,754	2,201,828	**1,356,393**	1,453,559
Less provision for doubtful debts	**365,766**	406,014	**230,035**	233,600
	1,751,988	1,795,814	**1,126,358**	1,219,959

* Reclassified

NOTE 6 – OTHER RECEIVABLES AND DEBIT BALANCES

	Consolidated		Company	
	December 31 2002	December 31 2001	December 31 2002	December 31 2001
	NIS thousands	NIS thousands	NIS thousands	NIS thousands
Deferred tax receivable (see Note 11D)	**202,832**	158,600*	**200,744**	156,448
Income tax refundable	**91,192**	5,335	**84,471**	–
Prepaid expenses	**39,381**	37,260	**24,857**	21,024
Forward exchange contracts	**155,766**	86,485	**155,766**	83,346
Other receivables and debit balances	**25,585**	20,998	**10,957**	8,339
	514,756	308,678	**476,795**	269,157

* Reclassified

NOTE 7 – INVESTMENTS, DEPOSITS AND DEBIT BALANCES

	Consolidated		Company	
	December 31 2002	December 31 2001	December 31 2002	December 31 2001
	NIS thousands	NIS thousands	NIS thousands	NIS thousands
Investment in companies that are not investee companies:				
Investment in convertible debentures (1)	–	1,178,774	–	1,178,774
Investments in shares	**57,430**	62,189	**57,430**	62,189
Other investments (2)	**243,761**	–	**243,761**	–
Bank deposit for granting loans to employees (3)	**215,937**	237,948	**215,937**	237,948
Investment in venture capital funds	**26,654**	23,342	**26,654**	23,342
Income tax refundable	**100,000**	214,507	**100,000**	214,507
Forward exchange contracts	**31,902**	8,392	**31,902**	8,392
Long term trade receivables(4)	**93,127**	63,014*	–	–
	768,811	1,788,166	**675,684**	1,725,152

* Reclassified

(1) See Note 8D(2).

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

(2) Other investments

a. Linkage and interest terms

	Interest rate	Consolidated and Company December 31, 2002
	%	NIS thousands
Long-term deposits	Libor 6 months + 3.4	33,159
Linked to the dollar	Libor 3 months + 1.65	33,159
	Libor 3 months + 1.75	33,159
Unlinked	Variable 10.3	20,000
CPI-linked		
Galil*	4	79,136
Matrix ET Ltd. **	4.95	45,148
		243,761

* In May 2002 the Company purchased corporate convertible debentures in a total amount of approximately NIS 77.4 million. The debentures are payable in a 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 of Matrix. The debentures are payable 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 : 8 (commencing August 5, 2003, at a conversion rate of 1 : 9).

b. Repayment dates

	NIS thousands
2004	33,159
2005	65,148
2006	–
2007	66,318
2008 and thereafter	79,136
	243,761

(3) 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.

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

(4) Long-term receivable

a. Linkage and interest terms

		Consolidated	
	Interest rate	December 31 2002	December 31 2001
	%	NIS thousands	
CPI linked	5.5 - 9.4	**13,543**	12,982
Unlinked	7	**79,584**	50,032
		93,127	63,014

b. Repayment dates

	NIS thousands
2004	60,217
2005	28,691
2006	2,318
2007and thereafter	1,901
	93,127

The balance of long-term receivables constitutes the difference between the amount of the original debt and its present value on the day of recognition of the revenue, less the revenue from deferred interest.

NOTE 8 – INVESTMENTS IN INVESTEE COMPANIES

A. Composition:

	Consolidated		Company	
	December 31 2002	December 31 2001	December 31 2002	December 31 2001
	NIS thousands	NIS thousands	NIS thousands	NIS thousands
Affiliated companies				
Investment in shares –				
Cost	**49,936**	132,545*	**(22,089)**	83,027*
Post–acquisition losses	**(763,878)**	(411,965)*	**(708,086)**	(396,077)
Increase in the rate of holding – partnership consolidated for the first time	**(1,087)**	–	**(1,087)**	–
Provision for a decrease in value in respect of an affiliated company	**(21,513)**	(8,173)*	–	–
Amortization of goodwill	**(22,462)**	(27,303)	**(22,279)**	(1,183)
	(759,004)	(314,896)	**(753,541)**	(314,233)
Other investments –				
Long-term loans (1)	**1,149,078**	805,914*	**1,133,041**	801,431*
	390,074	491,018	**379,500**	487,198
Consolidated companies				
Shares –				
Cost			**415,103**	407,960
Loans			**171,569**	169,085
Increase in the rate of holding – a partnership consolidated for the first time			**1,087**	–
Post–acquisition losses			**(168,770)**	(229,198)
Amortization of goodwill			**(161)**	–
			418,828	347,847
Proportionally consolidated company				
Shares –				
Cost			**513,489**	366,086
Post-acquisition earnings			**390,760**	463,053
Amortization of surplus equity over cost attributed to fixed assets			**39,897**	39,897
			944,146	869,036
			1,742,474	1,704,081

* Reclassified

(1) Loan balances of approximately NIS 110 million linked to the CPI ("known"), bearing 5.5% annual interest and for which no repayment date has been set (preferred loans – see also Section E below).

Loan balances of approximately NIS 30 million linked to the CPI ("known"), bearing annual interest of approximately 7%, and repayable by 2012.

Loan balances of a proportionately consolidated company amounting to approximately NIS 4.5 million, bearing annual interest at Prime less 0.3% and for which no repayment date has been set.

The loan balances are linked to the CPI ("known"), bear no interest and no repayment date has been set.

NOTE 8 – INVESTMENTS IN INVESTEE COMPANIES (CONTD.)

A. COMPOSITION (CONTD.):

The market and book values of an affiliated company listed on the stock exchange as at December 31, 2002, are approximately NIS 4.8 million.

	Consolidated		Company	
	December 31 2002	December 31 2001	December 31 2002	December 31 2001
	NIS thousands	NIS thousands	NIS thousands	NIS thousands
Balance of goodwill not yet amortized	**260,977**	15,949	**260,977**	4,573

A list of the companies in the Group appears in a schedule attached to the financial statements.

B. INVESTMENT ACTIVITY IN 2002 AS FOLLOWS (NOT INCLUDING LONG-TERM LOANS):

	Consolidated	Company
	NIS thousands	NIS thousands
Balance as at the beginning of the year	**(314,896)**	**733,565**
Activity during the year:		
Investment in shares	**28,223**	**160,711**
Increase in percentage of holding – a partnership consolidated for the first time	**7,143**	**7,143**
Realization of investment	**(119,062)**	**(118,424)**
Provision for a decrease in value in respect of an affiliated company	**(13,340)**	**–**
Equity in losses	**(347,072)**	**(345,131)**
Balance as at the end of the year	**(759,004)**	**437,864**

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

	December 31 2002	December 31 2001
	NIS thousands	NIS thousands
Current assets	**613,896**	554,980
Other assets	**1,924,705**	1,796,930
Current liabilities	**975,136**	977,909
Long-term liabilities	**554,172**	548,863

	For the year ended December 31		
	2002	2001	2000
	NIS thousands	NIS thousands	NIS thousands
Revenues	**1,858,317**	1,894,147	1,793,642
Costs and expenses	**1,921,538**	1,943,869	1,898,723

NOTE 8 – INVESTMENTS IN AFFILIATED COMPANIES (CONTD.)

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 Anti–Trust Commissioner the transaction was competed. 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 paid 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. These debentures are presented in the balance sheet under the Investments, deposits and long-term debit balances item.

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 ("the Options"). 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"). As at the date of the financial statements the Company had not exercised the Short Option and it expired.

d. The exercise price of the Long Option is the higher of the return of the nominal investment or a market valuation of the 20% of the Corporation's shares.

(2) Following various indications of a decrease in the value of Pelephone Communications Ltd. (hereinafter – Pelephone) in which the Company owns 50% and the other 50% are held by Pelephone Holdings L.L.C. of the Shamrock Holdings of California, Inc, Group (hereinafter – Shamrock) the Company commissioned a valuation of Pelephone (for its financial statements as at September 30, 2002). According to the valuation, the estimated value of Pelephone was between U.S.$ 1.0 billion and U.S.$ 1.2 billion.

As described in sub-section (1) above, the consideration for the purchase of Shamrock's share in Pelephone was partially financed by a loan of $ 240 million extended by the Company to Shamrock, in exchange for which the Company received debentures convertible during a period of four years (commencing February 27, 2001), for 80% of Shamrock's shares (and since Shamrock holds 50% of Pelephone's shares, conversion of the debentures means purchase of 40% of the shares in Pelephone).

Part of the financing for purchase of the Pelephone shares by Shamrock and other investments made by Shamrock in Pelephone after purchasing the shares, were made by means of bank loans, the balance of which on December 31, 2002, was approximately $ 380 million (including interest), and against which a first ranking lien was imposed on Shamrock's shares and the shares it holds in

NOTE 8 – INVESTMENTS IN AFFILIATED COMPANIES (CONTD.)

D. PELEPHONE (CONTD.)

Pelephone. The lien has priority over a lien given to the Company against the above debt, of which the balance is approximately $ 254 million (including interest).

In view of the valuation the value of Shamrock's holding in Pelephone as at September 30, 2002, was approximately $ 550 million (based on the mid-range of the valuation). Since the amount of the bank loans is secured under a first ranking lien, the available balance remaining for repayment of the debt as at September 30, 2002, was only approximately $ 175 million. In other words, there was doubt as to collection of the $ 80 million balance of the debentures (approximately NIS 390 million). This being the case, the Company recorded a provision of approximately NIS 353 million in its financial statements as at September 30, 2002 for impairment of assets (after deduction of the tax saving of NIS 36 million) in respect of its holdings in the debentures.

Subsequently, and following additional indications of a further decrease in the value of Pelephone, the Company commissioned an updated valuation, which it received on March 4, 2003, and which assessed the value of Pelephone at between $ 650 million and $ 850 million.

In view of this update, the value of Shamrock's holding in Pelephone was approximately $ 375 million (based on the mid-range of this latest valuation). Since the bank loan extended to Shamrock for purchasing the Pelephone shares (approximately $ 380 million, including interest) is secured as aforesaid under a first ranking lien, no available balance remained for payment of the debentures issued to the Company by Shamrock. This being the case, the financial statements include a provision for impairment of assets (in addition to the provision made in the financial statements as at September 30, 2002) of approximately NIS 844 million, thereby writing off, in practical terms, the balance of the investment in the debentures.

All these reductions were included together under the item Other expenses, net for 2002 (see Note 24). Consequently, net earnings for 2002 were reduced by approximately NIS 1,197 million.

(3) During the year, the Company and Shamrock invested approximately NIS 148 million each against a premium on Pelephone shares issued in the past (in 2001 they each invested approximately NIS 92 million).

(4) On March 16, 2000, Pelephone signed an agreement for the establishment of GoNext Ltd. ("GoNext"). The operations of GoNext focus mainly on the setting up and operation of the portal with a link to cellular communication. On December 31, 2001, Pelephone held 51% of the shares of GoNext.

On October 29, 2002, Pelephone signed an agreement with Suny.Com Ltd. ("Suny"), for the purchase of all Suny's shares in GoNext (49% of the share capital), in consideration of their par value. Suny also assigned to Pelephone its rights in all the loans it had extended or which were extended on its behalf, amounting to approximately NIS 42 million, which were transferred to Suny by Pelephone on the date of closing the transaction. The consolidated financial statements for the years 2002 and 2001 include consolidation of the financial statements of GoNext, in which Pelephone holds the controlling interest.

(5) Until October 2000 Pelephone held 51% of the shares of Safe Com Car Communication Ltd. ("Safe Com"). The financial statements of Safe Com, were not consolidated as part of the consolidated financial statements as Pelephone held neither control nor joint control of Safe Com, pursuant to that company's founding agreement whereby which significant resolutions would be adopted by a 75% majority.

In October 2000 an agreement was signed between Pelephone and the other shareholders of Safe Com and Eden Telecom Ltd. ("Eden") and its shareholders, whereby the operation of Safe Com was merged with the operation of Eden by way of a transfer of net assets from Safe Com to Eden.

NOTE 8 – INVESTMENTS IN AFFILIATED COMPANIES (CONTD.)

D. PELEPHONE (CONTD.)

Subsequent to the merger, Pelephone holds 22.95% of Eden. Eden's operations focus on locating and identifying vehicles, similar to the operations of Safe Com.

(6) On December 18, 2001, the Minister of Communications notified Pelephone that it had won a tender for an additional band of frequencies which it would use for cellular communications in third generation technology. Following the win, Pelephone's existing license will be amended so as to extend its term to run (concurrently with the license for the use of the new frequencies) until 2017. The granting of the frequencies and the changes in Pelephone's license was made contingent upon preconditions that include, *inter alia*, payment of NIS 225 million (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). The payment determined at the win is to be paid in six installments on various dates through 2006. To date, Pelephone has paid approximately NIS 110 million on account of the frequencies (proportionally consolidated – NIS 56 million).

As a result of the changes in Pelephone's license as described above, the cost of the license frequencies will be amortized from the date Pelephone begins to use them until the end of 2017, , subject to the period of use.

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%. As a result, an excess cost of NIS 269 million was generated to the Company. Another allotment of shares in DBS is currently under way, which is expected to increase the Company's holdings to approximately 49.9% and which will generate a further surplus cost to the Company. For depreciation of the surplus cost, see Note 2F.

In January 1999 DBS received a license from the Ministry of Communications in respect of satellite television broadcasts and commenced provision of services in July 2000. DBS suffers from considerable losses and negative cash flows. Its loss for 2002 amounts to approximately NIS 723 million and its negative operating cash flows from current activities amounts to approximately NIS 70 million. As a result of these losses the capital deficit and working capital deficit of DBS amount to approximately NIS 2,294 million and NIS 1,627 million respectively. The working capital deficit includes bank credit amounting to NIS 1,126 million.

The Company's investment in DBS (mainly shareholder's loans) as at the balance sheet date was approximately NIS 1,101 million. The Company's share in the accumulated losses of DBS is approximately NIS 762 million of which approximately NIS 290 million was recorded in the account year. The balance of DBS's current debt to the Company and its consolidated companies amounts to approximately NIS 56 million.

On May 23, 2002, 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 the suspending conditions, cumulative milestones and various financial requirements (hereinafter - the Conditions). A financial assessment made by the Banks at the beginning of 2002 determined that in order to finance the operations of DBS further financing would be required in significant amounts greater than those requirements defined in the Financing Agreement.

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 is subject, *inter alia*, to DBS meeting the financial and operative conditions prescribed in the financing agreement.

NOTE 8 – INVESTMENTS IN AFFILIATED COMPANIES (CONTD.)

E. DBS (CONTD.)

As at the date of approval of these financial statements, the shareholders and the Banks had transferred to DBS approximately $ 30 million and $ 20 million respectively, on account of the Interim Credit Line. As at the date of approval of these financial statements, some of the conditions laid down in the Financing Agreement and the Interim Credit Line had not been met. The credit from the Banks was classified accordingly under Current liabilities.

In addition, discussions were held by the parties on increasing the Interim Credit Line (hereinafter – Addition to the Financing Agreement). The main shareholders of DBS notified the Banks of their intention to invest, at the same time as the Banks, their proportional share in the Addition to the Financing Agreement. As at the date of approval of these financial statements, the Banks had not yet decided on the Addition to the Financing Agreement.

Under the interim Financing Agreement, it was determined that if by March 31, 2003 –

1) it is not proved to the Banks that the total financing needs of DBS do not exceed the Interim Credit Line plus the Addition to the Financing Agreement (including the proportional part of the shareholders), and additionally

2) DBS, the shareholders and the Banks have not signed the Addition to the Financing Agreement,

then the Banks will be entitled to take the necessary steps, at their exclusive discretion, to collect all the amounts payable to them and to act in accordance with their rights under the Financing Agreement upon the occurrence of a violation as defined in that agreement.

The granting of additional loans by the Company to DBS requires the approval, *inter alia*, of the Ministerial Committee for Privatization (hereinafter – the Committee). 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 covers the proportional part of the Company in the Interim framework plus its proportional part in the Addition to the Financing Agreement.

The continued operation of DBS is contingent upon the ongoing implementation of the Financing Agreement and the Interim Credit Line, together with the Addition to the Financing Agreement as aforesaid and the receipt of additional loans from the shareholders in accordance with those agreements.

The management of DBS believes there is a good chance that the discussions between DBS, the shareholders and the Banks will lead to the implementation of the Addition to the Financing Agreement and the arrangement of the financial resources that DBS requires 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 at 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 their financing). The new Shareholders' Loans are linked to the CPI ("known") and bear interest at 5.5%. In addition, under the same agreement, the shareholders who contribute to 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. A change in the interest rate is subject to the consent of all the shareholders.

The Company has signed a perpetual guarantee for 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

NOTE 8 – INVESTMENTS IN AFFILIATED COMPANIES (CONTD.)

E. DBS (CONTD.)

value of DBS as derives from disposal of the pledged shares of the remaining shareholders. If the Company joins the sale under the framework of disposing 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.

F. WALLA! COMMUNICATIONS LTD.

Bezeq International Ltd. invested in Walla Communications Ltd. (hereinafter "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, 2002, Bezeq International held 36.74% of the rights in Walla. During 2000, Bezeq International purchased approximately 38.5% of the rights in Walla in consideration of NIS 52,515,000.

On December 31, 2000, Walla entered into a 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 3,706,000, which was 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 11,186,000 in exercise of the rights and approximately NIS 3,293,000 in the acquisition and exercise of additional rights from the public. After acquisition and exercise of the rights 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.

In accordance with the investment agreement of Bezeq International Ltd. in Walla and pursuant to the prospectus for an rights issue of Walla, Bezeq International undertook to invest a total of $ 6 million in Walla, either directly or through a strategic investor. Through December 31, 2002, Bezeq International had invested NIS 74.3 million in Walla by way of an investment in shares and extending loans. These investments, on the dates they were made, constitute the total investment approved by the Government of Israel for Bezeq International to invest in Walla. On December 31, 2002, the balance of the prospectus and contractual undertaking of the Company amounts to approximately $ 0.6 million.

As part of its investment in Walla as described above, Bezeq International extended CPI-linked, interest-free loans to Walla during 2002 amounting to approximately NIS 11,485,000. Repayment of the loans will be on a date soon after the date on which Bezeq International invests in Walla's capital.

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 and amortized NIS 8,173 thousand in 2001, in accordance with the valuation ratios and other components relating to the investment. The amortization was included under Other expenses, net for 2001.

During 2002, Bezeq International wrote down its investment in Walla by NIS 13,340,000. In the opinion of the management of Bezeq International, the balance of its investment after that write-down, plus its additional investments by way of loans reflect the fair economic value of Walla to Bezeq International.

NOTE 8 – INVESTMENTS IN AFFILIATED COMPANIES (CONTD.)

G. ADANET FOR BUSINESS GROUP LTD. ("ADANET")

The Company invested approximately NIS 48 million in Adanet Business Group Ltd. (hereinafter "Adanet"), of which approximately NIS 17 million in exchange for 50% of Adanet's capital and NIS 31 million as a shareholders' loan. Upon fulfillment of certain conditions, the Company, Clal Information Technologies Ltd. and the managers of Adanet have a call and put option respectively for the remaining 50% of Adanet's shares, subject to the approvals required by law.

Adanet is a private company which installs and services networks and computer equipment.

H. GOLDNET COMMUNICATIONS SERVICES – A REGISTERED PARTNERSHIP

On June 14, 2000 the Company signed an agreement with AT&T Middle East Ltd. ("AT&T"), whereby, *inter alia*, AT&T was granted a put option to sell the balance of its holdings in a partnership (a 5% holding at December 31, 2001 and 2000) to the Company.

On September 19, 2002, AT&T gave notice of exercise of the put option. Following this change, the Company's holdings in the partnership on December 30, 2002, increased to 54% and AT&T ceased to be a partner in the partnership.

On September 26, 2000 an agreement was signed between the Company and Malam Systems Ltd. ("Malam"), whereby, *inter alia*, Malam was granted a put option to sell up to 20.9% of its share in the partnership and Malam granted the Company a call option to purchase up to 20.9% of Malam's share in the partnership.

The holdings of the partners as at December 31, 2002, are as follows:

"Bezeq" The Israel Telecommunication Corp Ltd.	54%
Malam Systems Ltd.	46%

The option is valid until March 31, 2003. Subsequent to the balance sheet date, Malam gave notice of its wish to exercise the option, and as a result, the holdings of the Company in the partnership are expected to increase to 74.9% (subject to the approvals required by law).

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, 2002	2,276,156	13,803,295	11,751,696	686,500	301,697	1,176,134	29,995,478
Additions	**31,761**	**812,514**	**180,722**	**81,089**	**10,296**	**277,671**	**1,394,053**
Cost additions in respect of a company consolidated for the first time	**1,387**	**–**	**–**	**–**	**948**	**44,855**	**47,190**
Disposals (1)	**18,006**	**1,151,940**	**9,084**	**106,911**	**76,797**	**117,556**	**1,480,294**
Balance as at December 31, 2002	**2,291,298**	**13,463,869**	**11,923,334**	**660,678**	**236,144**	**1,381,104**	**29,956,427**
Accumulated depreciation–							
Balance as at January 1, 2002	1,263,621	8,358,644	8,298,633	406,235	170,120	595,357	19,092,610
Depreciation charge	**100,393**	**1,436,620**	**402,256**	**117,211**	**36,113**	**221,264**	**2,313,857**
Accumulated depreciation in respect of a company consolidated for the first time (2)	**1,349**	**–**	**–**	**–**	**520**	**39,187**	**41,056**
Cancellation in respect of disposals (1)	**14,813**	**1,149,646**	**9,084**	**105,745**	**66,078**	**115,694**	**1,461,060**
Balance as at December 31, 2002	**1,350,550**	**8,645,618**	**8,691,805**	**417,701**	**140,675**	**740,114**	**19,986,463**
Net book value –							
As at December 31, 2002	**940,748**	**4,818,251**	**3,231,529**	**242,977**	**95,469**	**640,990**	**9,969,964**
As at December 31, 2001	1,012,535	5,444,651	3,453,063	280,265	131,577	580,777	10,902,868

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, 2002	2,196,461	10,058,416	11,751,696	660,332	246,273	621,450	25,534,628
Additions	**27,331**	**386,373**	**180,722**	**78,608**	**1,551**	**196,413**	**870,998**
Disposals (2)	**17,581**	**1,137,446**	**9,084**	**98,205**	**69,866**	**85,921**	**1,418,103**
Balance as at December 31, 2002	**2,206,211**	**9,307,343**	**11,923,334**	**640,735**	**177,958**	**731,942**	**24,987,523**
Accumulated depreciation–							
Balance as at January 1, 2002	1,235,571	6,005,015	8,298,633	394,988	148,457	345,123	16,427,787
Depreciation charge	**92,358**	**1,162,363**	**402,256**	**109,859**	**27,545**	**130,435**	**1,924,816**
Cancellation in respect of disposals (1)	**13,684**	**1,137,446**	**9,084**	**98,205**	**61,286**	**85,921**	**1,405,626**
Balance as at December 31, 2002	**1,314,245**	**6,029,932**	**8,691,805**	**406,642**	**114,716**	**389,637**	**16,946,977**
Net book value –							
As at December 31, 2002	**891,966**	**3,277,411**	**3,231,529**	**234,093**	**63,242**	**342,305**	**8,040,546**
As at December 31, 2001	960,890	4,053,401	3,453,063	265,344	97,816	276,327	9,106,841

(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 2002, fully depreciated fixed assets at a cost of approximately NIS 1,331 million (2001 – NIS 2,445 million) were written off the books.

(2) The cost includes the amount of NIS 2,092,000 in the Company and NIS 6,883,000 consolidated, which constitute real financing expenses in respect of loans and credit during the foundation period, calculated at a real interest rate of approximately 2.9% per annum (prior year – 4%).

NOTE 9 – FIXED ASSETS (CONTD.)

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

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

The aforementioned changes reduced the depreciation charge and increased the Company's net earnings by approximately NIS 259 million and NIS 166 million, respectively, for the year ended December 31, 2002. In addition, earnings per share in the year ended December 31, 2002 increased by approximately NIS 0.069 per NIS 1 par value.

Had the new depreciation rates been applied in 2001, the depreciation charges in that year would have been reduced by approximately NIS 228 million and the balance of the fixed assets would have increased by the same amounts.

In addition, net earnings in 2001 would have increased by approximately NIS 146 million and earnings per share would have increased by NIS 0.061 par value.

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.

As at the time of the preparation of the financial statements, the Company's rights in a considerable part of its real estate assets are not registered at the Lands Registry Office.

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 the relocation expenses. Company 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 described 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" rights in those assets which are rented for renewable two–year periods. Regarding 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.

NOTE 9 – FIXED ASSETS (CONTD.)

The State does not agree with these claims of the Company, and asserts, *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 and continues to harm the State's ability to make financially 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. Regarding 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) (all referred to below as "the State").

The claim sues for declaratory relief, whereby the interpretation of the “Asset Transfer Agreement” signed between the State and the Company in connection with the transfer of real estate assets (""the Real Estate") to the Company before it commenced operations in 1984 and the of "umbrella contract" signed in 1993 in connection with some of those assets, requires, *inter alia*, the following conclusions:

1. 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.

2. At most, the Company has a right to use the Real Estate which is limited by conditions and by objectives defined in the aforementioned agreements, and if it fails to comply with those conditions and objectives – then all the Real estate should revert to the State immediately and unconditionally.

3. The State is entitled to immediately deny the Company the right of use of the Real Estate leased to it in bi-annual contracts referred to in the Asset transfer Agreement, even where the Company is using the Real Estate for the purpose for which it was transferred, as long as the State believes that there is another preferable use for the Real Estate and as long as alternative real estate is made available to the Company so that it can continue to provide services as defined in the agreements and to the extent that the Company proves that it is in need of such real estate.

4. The Company must restore to the State immediately, certain assets in the Rishpon region (480 dunams), in the Sakia region (1,300 dunams), and parts of parcels in the Givat Mordechai and Ramat Beit Hakerem neighborhoods in Jerusalem.

In the opinion of the Company, relying on its legal advisers, it has meritorious arguments in support of its position. The Company filed a statement of defense in which it alleged, *inter alia*, that the claim or part of it should be stricken *in limine*, or it should be clarified and amended, and that in any case the claim should also be dismissed on its merits. At this stage, the Company is unable, based on the opinion of its legal advisers, to assess the chances and implications of the claim.

It is noted that concurrently with the above legal action, negotiations are in progress for settlement of the Real Estate dispute between the Company and the State and Israel Lands Administration. The main points of the agreement being formulated were approved by the relevant bodies in the State and by the Board of Directors of the Company and according to which a number of assets defined as "Renewable Lease Assets" from the Real Estate assets held by the Company will be returned to the State, while the rest of the assets will remain in the Company's possession on capitalized lease terms and the restrictions imposed on their use and utilization will be lifted. The final agreement will be subject to the approvals required by law.

NOTE 9 – FIXED ASSETS (CONTD.)

D. In April 2002, Pelephone Communications Ltd., a proportionally consolidated company, signed an agreement for the purchase and installation of a cellular communications system in CDMA 1X technology for $ 147 million. The new system will significantly increase the capacity of the existing network, will add sites to improve coverage and communications quality and will enable it to provide customers with advanced services, including value added services such as downloading games, transmitting pictures and animations and the like. Deployment of the network commenced during the third quarter of 2002 and commercial operation was planned for gradual introduction and commenced in October 2002. The terms of payment are according to delivery of the equipment, acceptance tests and commercial operation.

In addition, the company supplying the new system undertook to buy the old equipment for approximately $ 32 million. As at December 31, 2002, Pelephone had paid the system supplier approximately $ 60 million out of the above total (proportionally consolidated – approximately $ 30 million).

E. As at the balance sheet date, there are commitments to purchase fixed assets (mainly switching equipment) amounting to approximately NIS 766 million (consolidated) and NIS 477 million (Company).

F. In 2001, a proportionally consolidated company depreciated assets which it will not use in providing its services. The net book value of the assets in the books of the proportionally consolidated company, was approximately NIS 217 million (proportionally consolidated – approximately NIS 109 million). The depreciation of the assets was included under the Other expenses, net item.

NOTE 10 – DEFERRED AND OTHER EXPENSES

Consolidated

	Cost	Accumulated depreciation	Depreciable balance December 31 2002	Depreciable balance December 31 2001
	NIS thousands	NIS thousands	NIS thousands	NIS thousands
Capitalized subscriber acquisition costs	393,848	230,885	**162,963**	327,220
Rights in channels	5,583	2,290	**3,293**	3,969
Representation rights in a communications corporation	3,839	2,210	**1,629**	2,013
Acquisition of operations (1)	26,082	3,532	**22,550**	–
Frequencies (2)	56,824	–	**56,824**	–
	486,176	238,917	**247,259**	333,202
Expenses for issuance of debentures, raising loans and others			**15,414**	18,086
Goodwill not yet fully depreciated in consolidated companies (3)			**20,125**	–
Minority rights from a proportionally consolidated company			**–**	11,224
			282,798	362,512

Company

	Depreciable balance December 31 2002	Depreciable balance December 31 2001
	NIS thousands	NIS thousands
Deferred expenses		
Expenses for issuance of debentures and raising loans	**15,414**	18,086

(1) A consolidated company acquired an operation – the acquisition of resources, from Nortel Networks Israel (Sales and Marketing) Ltd. (see Note 19C(3)), to obtain independent capability for the provision of maintenance, support and installation services to customers of the consolidated company.

(2) On the amortization of the investment in cellular frequency ranges in third generation technology of a proportionally consolidated company, see Note 8D(6).

(3) On the amortization of goodwill, see Note 2F(6).

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 with the inflation adjustments prescribed for financial reporting purposes by opinions of the Institute of Certified Public Accountants in Israel. As a result, differences arise between the inflation–adjusted profit in the financial statements and adjusted taxable income.

The asset component demanded by the Company as an expense for tax purposes, is allocated directly to shareholders' equity.

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

B. INCOME TAX (TAX BENEFIT) INCLUDED IN THE STATEMENTS OF OPERATIONS

Consolidated

	For the year ended December 31		
	2002	**2001**	**2000**
	NIS thousands	**NIS thousands**	**NIS thousands**
Current taxes	**220,348**	361,914	189,881
Deferred taxes	**10,994**	(129,278)	(348,640)
Taxes for prior years, net	**(20,023)**	12,935	(6,825)
	211,319	245,571	(165,584)

Company

	For the year ended December 31		
	2002	**2001**	**2000**
	NIS thousands	**NIS thousands**	**NIS thousands**
Current taxes	**218,177**	358,583	182,787
Deferred taxes	**45,321**	(2,206)	(325,691)
Taxes for prior years, net	**(29,442)**	12,906	(6,987)
	234,056	369,283	(149,891)

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

Consolidated

	For the year ended December 31		
	2002	2001*	2000*
	NIS thousands	NIS thousands	NIS thousands
Tax computed at the regular tax rate	**(134,999)**	216,642	(199,186)
Increase (savings) in tax liability in respect of:			
Inflationary erosion of advance tax payments	**1,317**	403	(72)
Exempt income and capital gains	**(39,144)**	(37,340)	(46,052)
Non–deductible expenses	**6,962**	32,380	14,048
Timing differentials for which no tax benefit was created	**448,524**	2,942	–
Losses in respect of which a deferred tax asset was not created	**(35,427)**	17,968	63,835
Differences in the definition of equity and non-monetary assets for tax purposes	**(15,962)**	264	6,812
Taxes in respect of prior years, net	**(20,023)**	12,935	(6,825)
Others	**71**	(623)	1,856
	211,319	245,571	(165,584)

* Reclassified

Company

	For the year ended December 31		
	2002	2001*	2000*
	NIS thousands	NIS thousands	NIS thousands
Tax computed at the regular tax rate	**(126,409)**	368,702	(100,418)
Increase (decrease) in tax liability in respect of:			
Inflationary erosion of advance tax payments	**1,254**	403	(70)
Exempt income and capital gains	**(39,144)**	(36,460)	(46,031)
Non–deductible expenses	**3,330**	29,689	10,356
Timing differentials for which no tax benefit was created	**443,722**	–	–
Taxes in respect of prior years, net	**(29,442)**	12,906	(6,988)
Differences in the definition of equity and non-monetary assets for tax purposes	**(17,862)**	(5,487)	(5,800)
Others	**(1,393)**	(470)	(940)
	234,056	369,283	(149,891)

* Reclassified

NOTE 11 – TAXES ON INCOME (CONTD.)

D. DEFERRED TAXES

	Consolidated		Company	
	December 31 2002	December 31 2001	December 31 2002	December 31 2001
	NIS thousands	NIS thousands	NIS thousands	NIS thousands
Activity–				
Balance at beginning of year	**635,637**	869,458	**502,779**	858,914
Charged to statement of operations for the year	**(10,994)**	129,278	**(45,321)**	2,207
Charged to income tax refundable in respect of prior years	**–**	(358,342)	**–**	(358,342)
Charged to statement of operations in respect of prior years	**(19,735)**	(4,757)	**(19,735)**	–
Balance as at end of year	**604,908**	635,637	**437,723**	502,779
Composition of deferred taxes –				
Difference between the adjusted value of fixed assets and their value for income tax purposes	**(628,909)**	(578,872)	**(457,438)**	(502,465)
Adjustment of materials and spare parts	**(522)**	(370)	**(239)**	(217)
Deferred tax due to losses	**308,524**	281,833	**–**	–
Differences in the recognition of expenses relating to employee rights, doubtful debts and other	**925,815**	933,046	**895,400**	1,005,461
Total	**604,908**	635,637	**437,723**	502,779
Stated as follows:				
As part of current assets	**202,832**	158,600*	**200,744**	156,448
As part of other assets	**402,076**	477,037*	**236,979**	346,331
Total	**604,908**	635,637	**437,723**	502,779

* Reclassified

The deferred taxes are computed at the tax rate expected to be in effect at the time (36%). Realization of the tax benefit is contingent upon the existence of adequate taxable income at appropriate levels in the future. The tax benefit is included in the financial statements since, according to the Company's business plans, its realization is anticipated. The tax benefit in respect of a loss accumulated at 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.

Losses of consolidated companies for tax purposes of which are carried forward to the coming years amounted to approximately NIS 1,023,011,000(2001 – NIS 1,072,540,000). The balance of the losses and deduction carry–forwards for which no deferred tax benefit was included because of the uncertainty of their realization, is approximately NIS 22,223,000 (2001 – NIS 315,643,000).

NOTE 11 – TAXES ON INCOME (CONTD.)

E. FINAL TAX ASSESSMENTS

(1) In June 2001 an agreement was signed between the Company and the Income Tax Authorities in respect of final assessments for the years 1994 – 1998 inclusive. Under the agreement, the Company's claim to increase the depreciation rate of switching and subscriber equipment was recognized and several other matters were also agreed upon, principally postponement of the dates for recognition of certain expenses. As a result of the above, the Company recorded tax expenses in the 2001 financial statements in respect of preceding years, amounting to approximately NIS 12 million, as well as financing income of approximately NIS 79 million (tax exempt) deriving from the rebate payable to the Company.

(2) Under an assessment agreement signed on January 30, 2003, between consolidated company Bezeq International Ltd. and the assessment officer, concerning final tax assessments issued to Bezeq International for the years 1996 - 1999, Bezeq International Ltd. undertook to pay approximately NIS 14 million, of which approximately NIS 3 million represented interest and linkage differentials.

(3) A proportionally consolidated company has received final assessments up to and including 1994,and a final assessment was determined up to 1998 by prescription. BezeqCall Communications Ltd. has received final assessments up to and including 1998.

(4) Pelephone Communications Ltd. ("Pelephone"), a proportionally consolidated company, received deduction assessments for the years 1998 – 2000., which are in dispute and concerning which Pelephone will be submitting objections. Pelephone included in its books a provision in an amount which, based on the opinion of its legal advisers, it believes to be adequate in the event that its position is not accepted.

F. VALUE ADDED TAX

(1) The Company files a consolidated tax return with its subsidiaries for Value Added Tax purposes.

(2) The Company is in dispute with the Value Added Tax Authorities regarding the Company's right to reimbursement of Value Added Tax it paid which was not collected from customers in that it was a bad debt and its right to receive that reimbursement plus interest and linkage differentials from the date on which the debt was generated. An objection filed by the Company was dismissed by the VAT Authorities, and the Company intends to submit the matter for a decision in the appropriate proceedings.

G. On January 1, 2003, the tax reform took effect. Company Management estimates that the amendment is not expected to have a material effect on the business results of the Company.

NOTE 12 – BANK CREDIT

		Consolidated	
	Interest rate	December 31, 2002	December 31, 2001
	%	NIS thousands	NIS thousands
Unlinked loans	9.4-10.15	**368,123**	413,264
CPI-linked loans	6.5-6.65	**125,185**	–
Dollar-linked loans	2.69-2.94	**35,517**	37,817
		528,825	451,081

NOTE 13 – LONG-TERM LOANS

A. COMPOSITION

	Consolidated		Company	
	December 31 2002	**December 31 2001**	**December 31 2002**	**December 31 2001**
	NIS thousands	**NIS thousands**	**NIS thousands**	**NIS thousands**
Banking institutions	**2,583,794**	3,180,009	**1,832,629**	2,420,677
Pension fund	**72,054**	90,391	**72,054**	90,391
Others	**907**	17,614	**–**	–
Suppliers credit	**17,575**	1,498	**–**	–
	2,674,330	3,289,512	**1,904,683**	2,511,068
Less –				
Current maturities from banks	**545,063**	593,104	**373,184**	390,866
Other current maturities	**25,902**	19,182	**21,065**	18,465
	2,103,365	2,677,226	**1,510,434**	2,101,737

B. LINKAGE TERMS AND INTEREST

		Consolidated		Company	
	Interest rate	**December 31 2002**	**December 31 2001**	**December 31 2002**	**December 31 2001**
	%	**NIS thousands**	**NIS thousands**	**NIS thousands**	**NIS thousands**
Loans in foreign currency					
US dollar (*)	2.2-3	**1,580,702**	1,921,120	**1,563,818**	1,921,120
Euro		**–**	1,455	**–**	1,455
		1,580,702	1,922,575	**1,563,818**	1,922,575
Loans linked to the CPI	3.6-8.2	**781,574**	864,896	**268,811**	498,102
	6.1	**72,054**	90,391	**72,054**	90,391
		853,628	955,287	**340,865**	588,493
Unlinked loans	6.85-8.2	**240,000**	411,650	**–**	–
		2,674,330	3,289,512	**1,904,683**	2,511,068

(*) 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.

NOTE 13 – LONG-TERM LOANS (Contd.)

C. REPAYMENT SCHEDULE

December 31	Consolidated NIS thousands	Company NIS thousands
2004	585,895	380,694
2005	747,270	547,432
2006	681,273	546,780
2007	64,887	35,528
2008 and thereafter	24,040	–
	2,103,365	1,510,434

D. SECURITY

(1) Long-term loan agreements of the Company, aggregating NIS 1,673,608,000 include certain conditions upon the occurrence of which the lender may demand early repayment of the loans, including:

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

– In respect of loans aggregating NIS 868,318,000, a decrease in the State's voting rights in the Company to 26% or less, of which in respect of a balance of approximately NIS 532,913,000 upon the occurrence of an event which also allows other loans of the Company to be made available for early repayment.

– In respect of the remaining loan balance of NIS 805,290,000, upon the occurrence of an event which allows early repayment of other loans of the Company and of material subsidiaries to be demanded, 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) 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.

– 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) A proportionally consolidated company provided a negative pledge and undertook to meet certain financial conditions in respect of bank loans it received, the proportionally consolidated balance of which, as at the balance sheet date, is NIS 696,153,000. As at the balance sheet date, that company is complying with those financial conditions.

(3) A subsidiary 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 55 million.

NOTE 13 – LONG-TERM LOANS (CONTD.)

E. LOAN–PROCUREMENT EXPENSES

Deferred expenses for raising loans as at December 31, 2002, and December 31, 2001, amounted to NIS 9,280,000 and NIS 11,161,000 respectively. The expenses are presented after deduction of accumulated amortization amounting to NIS 3,937,000 and NIS 4,064,000, respectively.

NOTE 14 – OTHER DEBENTURES

A. COMPOSITION AND TERMS

		Consolidated and Company	
	Interest Rates	December 31 2002	December 31 2001
	%	NIS thousands	NIS thousands
CPI-linked debentures issued to the public:			
Debentures Series 1 (1)	4.5	**141,957**	212,555
Debentures issued to the public:			
Linked to the euro (2)	4.3 - 6.5	**1,476,805**	1,241,855
Debentures issued:			
Unlinked (3)	4.9 - 8.5	**500,241**	532,597
Debentures issued to financial institutions and others:			
CPI-linked	4.99	**860,418**	900,088
		2,979,421	2,887,095
Less – current maturities		**210,294**	198,851
		2,769,127	2,688,244

(1) The outstanding balance of the debentures is NIS 39,900,581 par value (2001 – NIS 59,850,864 par value).

(2) The outstanding balance of the debentures is 300,000,000 euro par value.

(3) The outstanding balance of the debentures is NIS 500,656 par value.

B. REPAYMENT SCHEDULE

	NIS thousands
2004	603 ,699
2005	214,281
2006	174,636
2007	78,724
2008 and thereafter	1,697,787
	2,769,127

NOTE 14 – OTHER DEBENTURES (CONTD.)

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, 2002 amounts to approximately NIS 725,179,000, 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 1,456,093,000 of debentures which were issued to the public and are linked to the euro, upon the occurrence of an event enabling demand for immediate 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 euro-linked debentures issued to the public.

D. ISSUANCE EXPENSES

Deferred expenses with respect to the issuance of the debentures amounted to NIS 34,494,000 (2001 – NIS 31,873,000) and are stated net of amortization of NIS 25,729,000 (2001 – NIS 22,405,000).

NOTE 15 – TRADE PAYABLES

	Consolidated		**Company**	
	December 31 2002	**December 31 2001**	**December 31 2002**	**December 31 2001**
	NIS thousands	**NIS thousands**	**NIS thousands**	**NIS thousands**
Suppliers of goods and services	**1,148,526**	1,084,141	**676,213**	607,589
Current maturities of long-term supplier credit	**4,837**	717	**–**	–
	1,153,363	1,084,858	**676,213**	607,589
Including subsidiaries	**–**	–	**37,223**	8,918
Including a proportionally consolidated company	**50,711**	37,586	**101,422**	75,172

NOTE 16 – LIABILITY FOR EMPLOYEE SEVERANCE BENEFITS

A. COMPOSITION

	Consolidated		Company	
	December 31 2002	December 31 2001	December 31 2002	December 31 2001
	NIS thousands	NIS thousands	NIS thousands	NIS thousands
Provision for early retirement, (see D below)	**1,268,711**	1,544,370	**1,268,711**	1,544,370
Compensation for unutilized sick leave (see E below)	**57,306**	66,647	**57,306**	66,647
	1,326,017	1,611,017	**1,326,017**	1,611,017
Provision for severance pay (see C below)	**72,239**	66,477	**15,426**	16,269
Less – reserve in compensation fund	**(45,805)**	(38,671)	**–**	–
	26,434	27,806	**15,426**	16,269
	1,352,451	1,638,823	**1,341,443**	1,627,286
Stated as follows:				
In current liabilities	**212,631**	280,028	**212,631**	280,028
In long-term liabilities	**1,139,820**	1,358,795	**1,128,812**	1,347,258
	1,352,451	1,638,823	**1,341,443**	1,627,286

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 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, up to January 31, 1985, are covered by a pension fund ("Keren Makefet") 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 paid by the Company, and the amounts accumulated with Keren Makefet with respect to this period are held in the 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 on the employee severance pay fund.

The Group's liability 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.)

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

(1) Under a special collective agreement for retirement, signed on November 23, 1997 between the Company and the workers' representatives, approximately 2,050 employees retired from the Company up to December 31, 1999.

(2) As part of the plan for organizational change in the Company, which was approved by the Board of Directors in March 2000, approximately 530 employees retired from the Company between December 31, 1999 and December 31, 2001.

(3) a. The Company reached agreement with the workers' representatives in September 2000, to extend the collective early retirement agreement from 1997. 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.

Furthermore, pursuant to the agreement, the Company's management 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 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, 2002, is approximately 355.

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

E. 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 2002	**December 31 2001**	**December 31 2002**	**December 31 2001**
	NIS thousands	**NIS thousands**	**NIS thousands**	**NIS thousands**
The Government of Israel in respect of royalties, interest and other fees	**198,588**	209,705	**158,447**	158,502
Wages and salaries [1]	**308,041**	257,953	**242,881**	210,745
Provision for vacation pay	**91,492**	101,730	**86,420**	97,685
Income tax payable	**–**	102,021	**–**	97,183
Governmental institutions	**69,669**	108,620	**49,918**	92,008
Accumulated interest	**109,731**	110,031	**100,692**	104,112
Forward exchange contracts	**19,435**	14,187	**18,930**	14,187
Other accumulated expenses	**161,880**	157,891	**80,636**	90,445
Current maturities in respect of prepaid Prepaid income	**40,651**	46,420*	**26,701**	32,361
Provision for claims in respect of salary and pension components	**118,615**	118,615	**118,615**	118,615
	1,118,102	1,227,173	**883,240**	1,015,843
[1] Including current maturities of a long-term loan from a pension fund	**21,065**	18,465	**21,065**	18,465

* Reclassified

NOTE 18 – PREPAID INCOME

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 proportionally consolidated company.

NOTE 19 - CONTINGENT LIABILITIES

A. CLAIMS

Following are details of the status of the contingent liabilities of the Company and investee companies as at December 31, 2002, in which the maximum possible exposure is significant.

(1) In August 1996 a claim and an application by way of motion for approval of the claim as a class action were filed against the Company in the District Court. The plaintiff alleges that the Company is misleading the public in that the prices of direct-dial international calls are calculated and collected on the basis of meter pulses rather than call time units as promised in its advertisements. The damage claimed relates to overcharging deriving from rounding-up of fractions of meter pulses to a whole meter pulse. The value of the claim as a class action is approximately NIS 133 million, and it related to the seven years preceding the filing of the action. In February 1997 the court approved the action as a declaratory class action with regard to the deception only, and held that the extent of the damage of the members of the group should not be fixed, whether as a whole or as individuals. If the class action is allowed and a declaration made that the advertising was misleading, a subscriber who believes that he sustained damages as a result of the deception will be able to file a personal claim against the Company, in which he will attempt to prove his losses. The plaintiff filed an appeal against that part of the court's decision that rejected the application to recognize the action as a

NOTE 19 - CONTINGENT LIABILITIES (CONTD.)

A. CLAIMS (CONTD.)

monetary class action. The Company filed a cross-appeal of the decision to recognize the action a declaratory class action. In March 1998 the application of the plaintiff to conjoin Bezeq International Ltd. as an additional defendant in the class action was allowed. Bezeq International filed an appeal against this decision in May 1998 in the Supreme Court. On the same occasion, Bezeq International Ltd. requested that it be conjoined as an additional appellant in the Company's appeal. On July 2, 2001 the Supreme Court denied the appeal of the plaintiff and allowed the appeal of the Company and of Bezeq International. On July 17, 2001 the plaintiff filed an application for an additional hearing of the case against the Company only, and therefore Bezeq International Ltd. is no longer a party to this case. On September 29, 2002 the Supreme Court allowed the plaintiff's application for an additional hearing, and ruled that the additional hearing would be before a panel of seven justices. On October 17, 2002 the Supreme Court allowed the application of the Israeli Consumer Council to be added as a party to the additional hearing. If in the additional hearing, the ruling in the Company's appeal is reversed, the main hearing in the District Court will be resumed. In the Company's opinion, relying on the legal adviser who is handling the claim on its behalf, it is not possible, at this stage, to estimate the chances of the claim. Accordingly, no provision was included in the financial statements in respect of this claim.

(2) In June 1997 a group of approximately 130 employees filed a claim, through the Histadrut, in the Regional Labor Court, for declaratory relief in respect of the pension rights of those employees of the group who were transferred from the Ministry of Communications, serving as departmental managers and employed under personal contracts. According to the plaintiffs, they are entitled to pension terms identical to those of all Company employees to whom a collective agreement applies. In September 1997 the Attorney General gave notice of his appearance in the proceeding. In May 1998 the Company filed an actuarial opinion in the Regional Labor Court, stating that the cost of the plaintiffs' demand would be approximately NIS 155 million. In November 1999 a decision was issued rejecting almost all the causes of the action. This decision has been appealed. The arguments stage in the case has been completed and now awaits the decision of the National Court on the appeal. Negotiations are in progress between the Company and the workers' representatives, with the aim of reaching an arrangement which will end the dispute. A provision was made in the financial statements based on an arrangement proposed by the Company's management. As at the date of approval of the financial statements, the arrangement had not been approved by the Wages and Employment Agreements Division at the Ministry of Finance, but the Company still has the possibility of appealing the Ministry's decision.

(3) On September 16, 2001 a revised statement of claim and an application for recognition as a class action were filed against Bezeq International Ltd. and the State of Israel under Section 46A of the Anti Trust Law. 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 Ltd. as a monopoly, against a background of lowering prices as the international calls market was opening up to competition. On February 18, 2002 Bezeq International Ltd, filed its response to the court, in which it rejected the allegations of the Plaintiff and alleged that conditions did not exist for allowing the claim as a class action. The Court allowed the application of the Applicant to study the financial statements of Bezeq International Ltd. for the relevant period, and the minutes of the meetings of its board of directors from the same period. The legal advisers of Bezeq International Ltd. estimate that if the claim is allowed as a class action, the amount of the action is liable to reach hundreds of millions of shekels. The legal advisers of Bezeq International Ltd. are unable, at this stage, to estimate the chances of the claim, and therefore no provisions were made for this claim in the financial statements.

(4) In September 1997 a claim was filed against the Company and the State in the Regional Labor Court. The claim was filed on behalf of 128 senior employees who are employed under personal contracts. The nature of the claim is the plaintiffs' allegation that commencing October 1, 1996, they are entitled to a wage increment of 33%, corresponding to the increment which was given at that

NOTE 19 - CONTINGENT LIABILITIES (CONTD.)

A. CLAIMS (CONTD.)

time to Members of the Knesset and to senior civil servants whose salaries are linked to those of Members of the Knesset. The total amount of the claim in respect of salary differences is approximately NIS 12 million. Withholding differences are also claimed in respect of these amounts. The Company alleged that it pays the salaries of the plaintiffs in accordance with the directives of the Government Companies Authority. In the Company's opinion, relying on the legal adviser who is handling the claim on its behalf, it is not possible, at this stage, to estimate the outcome of this claim. No provision was made in the financial statements in respect of this claim.

The State joined as a party to the proceeding and filed a final opinion of the Attorney General, which supports the position of the Companies Authority that there is no obligation to pay senior employees the wage increment demanded. In the hearing held on January 27, 1998, the State's representative announced that the Attorney General had made his decision, which was that the Companies Authority has no obligation to issue an instruction to raise the senior employees' salaries by 33%, and that the Companies Authority had exercised its discretion reasonably on this question in deciding not to accede to the claim.

(5) In November 1997 a claim was filed in the District Court, together with an application to recognize a 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 Anti-Trust 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 53 million. In December 1997, the Company was stricken 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 and ruled that the appeal would be heard on its merits. On October 30, 2002 the plaintiffs requested to lower 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. The legal advisers of Bezeq International are unable, at this stage, to estimate the chances of the appeal filed in the Supreme Court, and therefore no provision was included in the financial statements in respect of this claim.

(6) In December 1998 the Anti-Trust Commissioner published notice that the Investigations Department of the Anti-Trust Authority ("the Authority") had completed an investigation which had been carried out over the past year, regarding *prima facie* suspicion of binding agreements between Koor Industries, Telrad, Tadiran, the Company and BezeqCall Communications Ltd., 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 recommend that concerning some of the suspicions investigated, indictments be filed against some of those who were investigated. The Legal Department at the Anti-Trust Commission will now examine the investigation material and the recommendations of the investigators, in order to determine whether offenses against the Anti-Trust Law were indeed perpetrated, and whether there is sufficient evidentiary basis for trial.

NOTE 19 - CONTINGENT LIABILITIES (CONTD.)

A. CLAIMS (CONTD.)

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 was 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.

The second area of suspicion which was 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 Anti-Trust 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 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 Bezeq Call Communications, Telrad and Tadiran. Among other things, 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 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 a demand that the Company take legal action against the suppliers, stating that in his opinion the Company had suffered a loss of approximately NIS 400 million due to the binding agreement. In his demand, 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 investigative material from the Anti-Trust Authority, and that it would formulate its stance in accordance with the decision of the Authority and its findings, if any. In November 2001 a similar approach was made by another

NOTE 19 - CONTINGENT LIABILITIES (CONTD.)

A. CLAIMS (CONTD.)

shareholder, to which the Company replied that it was still awaiting the decision of the Anti-Trust Authority.

On March 3, 2002 the Company was summonsed to a hearing by the Anti-Trust 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 Anti-Trust law, 5748-1988 ("the Anti-Trust 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 hat 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 the years 1997-2000.

The Anti-Trust 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 a tort and is a possible basis for proceedings against a party to the arrangement and for a class action.

The Company, relying on its legal advisers, is unable at this stage to estimate the significance of the decision of the Anti-Trust Authority or what the final decisions of the Authority will be after the Company's hearing and their implications for the Company, including the ability of its shareholders or its customers or any other third party to sue it, or its own ability to sue others.

(7) 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 who 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 permanent transferred employees, graduates of Bezeq College and Ministry of Communications pensioners. 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 may now rule whether it will approve the withdrawal of consent.

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 as long as the court does not approve the plaintiffs' withdrawal of consent. The Company, relying on its legal advisers, is unable, at this stage, to estimate the chances of the action, and accordingly, no provision was made in the financial statements in respect of this claim.

(8) 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 good administration, with negligence and while exploiting the status of the Company as a monopoly or monopsony. 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 was made in the financial statements in respect of this claim.

NOTE 19 - CONTINGENT LIABILITIES (CONTD.)

A. CLAIMS (CONTD.)

(9) On February 23, 2000, two former employees of the Company filed a financial claim in the Jerusalem District Court against the State of Israel and against the Company. An application was attached to the claim, requesting approval as a class action in the names of additional employees and pensioners of the Company. The amount of the personal claim of the two representative plaintiffs is approximately NIS 6,500. The amount of the claim of all the plaintiffs for whom representation is requested, is not stated in the claim. The groups for whom approval of representation is applied for in the action comprise a total of 8,272 employees.

In their statement of claim, the plaintiffs allege, *inter alia*, that the defendants violated various undertakings toward them which were included in the prospectus of the Company published in 1991, including undertakings to allot Company shares, to pay dividends and to make preferential loans available to the plaintiffs. The plaintiffs allege that the allotment of shares to employees in accordance with the Company's prospectus which was published in 1998 constitutes only partial and inadequate fulfillment of those undertakings. (For example, they allege that the number of shares allotted was insufficient, that inadequate sums were paid in dividends, that no preferential loans were granted, etc.) The plaintiffs further allege that the 1998 prospectus contained misleading details and representations, and material documents which ought to have been attached were not attached.

On May 8, 2001 the District Court dismissed the claim, in part for prescription and in part due to absence of cause. The plaintiffs appealed this decision in the Supreme Court. On December 16, 2002 the Supreme Court dismissed the plaintiffs' appeal.

(10) In October 1999, a class action was filed against Pelephone Communications Ltd. ("Pelephone") in the District Court, under the Consumer Protection Law, 5741-1981 and the Anti-Trust 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 amount of the claim (NIS 12.3 billion). On November 14, 2002 an application was filed to appeal the decision of the Tel Aviv District Court dated October 1, 2002, dismissing 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.

(11) In July 2000 an action and application for its approval as a class action were filed against the Company. According to the plaintiffs, the Company collected money unlawfully from its subscribers for certain services which it provides. The claim is for approximately NIS 974 million. Following the court's decision to dismiss the application for approval as a class action, the plaintiffs filed an application for leave to appeal in the Supreme Court. On October 22, 2002 the Supreme Court decided to convert the application for leave to appeal into an appeal, since the plaintiffs were entitled to appeal the decision from the outset. In the opinion of the legal advisers of the Company, the Company has meritorious arguments against the application and against the claim. Nevertheless, they are unable to estimate the chances of the application for approval being allowed, and accordingly, no provisions were included in the financial statements in respect of this claim.

(12) In August 2000, an action and application for its approval as a class action were filed against the Company. The amount of the class action is approximately NIS 65 million including VAT. According to the plaintiff, the Company collected from its subscribers, unlawfully, payment differentials for the fixed monthly fee for using the telephone line. The requested reliefs are two – declaratory, whereby the Court is requested to declare that the Company collected the payment differentials unlawfully, and "operative – financial", for reimbursement of said amounts. The Company rejects the plaintiff's allegations and alleges that its method of charging meets the criteria of the law, reasonableness and

NOTE 19 - CONTINGENT LIABILITIES (CONTD.)

A. CLAIMS (CONTD.)

justice. On November 20, 2001 the Company filed an application for dismissal *in limine* of the application for approval, since there is no legal authority for filing the class action. On December 17, 2001 it was determined that the hearing of the case would be delayed for the time being, until the decision of the Supreme Court (in another case, to which the Company is not a party) on the question of whether the regulation which was relied upon in filing the claim, constitutes a source of legal authority for filing class actions. In the Company's opinion, relying on its legal advisers, the chances of the claim's success cannot be estimated at this stage. Accordingly, no provision was made in the financial statements in respect of this claim.

(13) In September 2000, a declaratory claim was filed against the Company in the Jerusalem Labor Court, by 2,423 pensioners of the Company, former employees 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 normal pay for work which should be seen as part of their regular wage for calculating their pension and for the payments made to them upon retirement. The plaintiffs are also seeking declaratory relief which will determine that their last determining salary for the pension should be calculated according to the last salary which was 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*, a response to that application was filed, and no defense has yet been filed. 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.

(14) In September 2000, a class action and an application for approval as a class action were filed against the Company, in the amount which is estimated at approximately NIS 111 million. According to the plaintiff, the Company unlawfully collected "collection expenses" from its subscribers for Company bills which were not promptly paid, before it had started any collection actions in connection with the plaintiff. The reliefs requested by the plaintiff are mainly two – 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. In January 2001 the Company filed its response to the application for approval of the class action, in which it alleges that the claim does not meet the criteria of the law and states that it rejects the plaintiff's interpretation of the collection regulations, claiming to have acted lawfully. The plaintiff filed his reply to the Company's response. On May 30, 2001 the Court approved an agreement reached between the parties regarding the continuation of the hearing. On February 20, 2003 the Court approved the action as a class action. The Company intends to file an application for leave to appeal that decision. In the opinion of the Company, relying on the legal adviser who is handling the case on its behalf, an application for leave to appeal and the appeal itself have a reasonable chance of success.

On October 18, 2001 another class action was filed on the same matter, in respect of unlawful charging of collection fees on Company bills which were not promptly paid, before it had started any collection actions. The plaintiff alleges that this action constitutes exploitation of the distress of the consumer, in contravention of the Consumer Protection Law, as well as unjust enrichment. The plaintiff estimates amount of this class action at approximately NIS 21 million. On December 16, 2001 the Court approved a continuance until after a decision on the application for approval of the claim described at the beginning of this sub-section as a class action, due to the similarity in the causes of action in the two cases.

In view of the assessment given above, no provision was included in the financial statements in respect of these claims.

NOTE 19 - CONTINGENT LIABILITIES (CONTD.)

A. CLAIMS (CONTD.)

(15) In September 2000 a class action and application for approval as a class action was filed against the Company in an amount estimated at more than NIS 810 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 the telephones were given in a "lease" agreement unlimited in time, 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 revalued amount 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 a class action with an application for approval as a class action. The amount of this claim is estimated at approximately NIS 259 million. It is noted that the action makes allegations which are similar or identical to those in the above action from September 2000.

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 were made in the amended statement of claim, *inter alia,* concerning unlawful charging of "maintenance fees". The amount of the two claims together is now estimated at more than one billion shekels. The Company filed an application for dismissal *in limine* of the amended application for approval as a class action. No decision has yet been made.

The Company, relying on its legal advisers, is unable, at this stage, to estimate the chances of the claim. Accordingly, no provision was made in the financial statements in respect of this claim.

(16) On May 10, 2001 a claim was served to an affiliate in which the plaintiff alleges that the affiliate is misleading consumers in its advertisements in connection with the possibility for the consumer to purchase certain channels only, and with regard to the number of channels offered. It is also alleged that the affiliate required its subscribers to consume a maximum channel package even if they did not choose that package. The plaintiff filed the claim as the representative of the subscribers of the affiliate, and together with the claim also filed an application for recognition of the claim as a class action under the Consumer Protection Law. The personal losses of the plaintiff, as alleged by the plaintiff, are negligible, and the sum stated as accumulated loss for all members of the class is approximately NIS 177 million.

On March 18, 2002 the parties signed a settlement agreement whereby an application will be filed in court to dismiss the claim and the application for its approval as a class action. In exchange, the affiliate will compensate the plaintiff in an amount which is not material.

(17) 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. The total amount of the claim, according to the action, cannot be calculated accurately, and is estimated by the plaintiffs at "millions of shekels per year".

NOTE 19 - CONTINGENT LIABILITIES (CONTD.)

A. CLAIMS (CONTD.)

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 allege 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.

The reliefs requested by the plaintiffs are mainly two – 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 damage caused to the members of the group in the aforesaid amounts. 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 the hearing on February 28, 2002, the plaintiffs' legal representative 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. The legal advisers of the Company and of the consolidated company are unable, at this stage, to estimate the chances of the claim. Accordingly, no provision was made in the financial statements in respect of this claim.

(18) In December 2000 a claim was filed by the State of Israel in the District Court against Pelephone Communications Ltd. ("Pelephone"), 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 outside 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 was heard in court, the parties agreed to transfer the matter for clarification through mediation.

It should be noted that the claim includes sums in respect of the period January – October 1994, for which the Company also received a demand to pay royalties, even though in the Company's opinion the royalties for that period were already paid by the Company as part of a compromise arrangement with the State in November 1995.

(19) In February 2001 a class action and application for its approval as a class action were filed against the Company, as well as an application for an interlocutory injunction. The amount of the claim is not stated, but according to the action, the accumulated loss for the entire group in whose name the plaintiff has filed suit, is estimated at "millions of shekels".

NOTE 19 - CONTINGENT LIABILITIES (CONTD.)

A. CLAIMS (CONTD.)

According to the plaintiff, the "Light Net" track, which is one of the tracks in the alternative basket of payments introduced on May 1, 2000, is actually a "default" from the aspect of the customer, since it is an offer which contains nothing but acquisition of the customer.

The plaintiff alleges that since from May 1, 2000, when the new tariffs took effect, until the end of June, the Company charged the calls to the network of subscribers who did not select one of the tracks, at the Light Net tariff as if it were the "regular" tariff for connecting to the network, then from July 1, 2000 also the Company should have continued to apply the Light Net tariff to all subscribers who did not choose another track. The plaintiff alleges that the charge in the months May – June 2000 constitutes deception, as does the representation of the Company, on the basis of which the subscriber's situation changed for the worse, and therefore, according to the plaintiff, the Company is precluded from renouncing that representation. In so doing, according to the plaintiff, the Company violated the provisions of Section 2(a) of the Consumer Protection Law, 5741-1981. On October 24, 2001 the District Court denied the plaintiff's application for recognition of the claim as a class action pursuant to the Consumer Protection Law. The plaintiff appealed the decision in the Supreme Court. On December 17, 2002 the Supreme Court heard the appeal and the appellant agreed to withdraw it.

(20) In March 2001 a petition was filed in the Supreme Court against the Minister of Communications, the Company and three cellular operators, in which the petitioner requests, *inter alia*, that the court direct the Minister of Communications and the Company to provide a blocking service for every Company subscriber against outgoing calls to cellular phone area codes, as a positive default. The court forwarded the petition to the defendants for their response. The Company gave notice that it does not oppose providing such a service, but emphasized that it would require the approval of the Ministry of Communications. Pelephone Communications Ltd. objected to the provision of the blocking service. The Company filed an application to expedite the hearing of the petition. On November 6, 2002, following the recommendation of the Supreme Court, the petitioners withdrew their petition and it was stricken.

(21) In September 2001, an application was filed for approval of a class action against the Company. The plaintiffs allege that in view of the amendments to the Telecommunications Regulations, the maximum payment that could be collected from a Bezeq subscriber who calls a Pelephone subscriber was lower than the amount actually collected. The applicants estimate the amount of the claim at approximately NIS 45 million. The Company filed a response to the application for approval. On May 12, 2002 the Company's request to conjoin Pelephone as a party to the proceeding was allowed. Based on the opinion of the legal adviser who is handling the case on its behalf, the Company is unable, at this early stage of the proceeding, to estimate the chances of the plaintiff in the above proceedings. Accordingly, no provision was made in the financial statements in respect of this claim.

(22) In July 2001 a claim was filed in the District Court against Pelephone Communications Ltd. ("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 chances and the implications of the claim.

(23) In August 2001 an application for approval of a class action was filed against Pelephone in the Tel Aviv District Court. The applicant, through his attorney, alleges that Pelephone collected from its customers surplus amounts in respect of interconnect fees, in contravention of the regulations applicable thereto

NOTE 19 - CONTINGENT LIABILITIES (CONTD.)

A. CLAIMS (CONTD.)

and/or of its license. The amount of the claim, if recognized as class action, would have exceeded NIS 32.6 million. The parties arrived at a settlement agreement that took effect on May 2, 2002, in which the

District Court gave partial approval for the claim as a class action and simultaneously validated the settlement agreement as a decision. The amount of the settlement derived from that agreement is approximately NIS 6.6 million. The financial statements include a provision that the management of Pelephone deems appropriate.

(24) In September 2001 a claim was filed in the Ramallah District Court by the General Public Palestinian Communications Co. Ltd., against Pelephone Communications Ltd. ("Pelephone") and another company. The plaintiff alleges that its license grants it, inter alia, the right 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 casing 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 action for NIS 676 million from Pelephone alone.

As at the date of signing these financial statements, 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.

(25) In October 2001 the Company received a letter of demand in the name of the Moshav Porath Committee in the Sharon region, which contains allegations in connection with direct and indirect damages which 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, refuting the allegations and the demand. In the Company's opinion, relying on its legal advisers, the chances of the Company's defense cannot be estimated if a claim is actually filed against it in this matter. Accordingly, no provision was made in respect of this matter in the financial statements.

(26) A number of private claims of current and former employees are pending against the Company, mainly concerning the recognition of various wage components as pension components, which could have a wide-ranging effect. It is noted that a precedent ruled in another case (to which the Company is not a party) changed the Company's position for the worse as regards a particular wage component. However, the Company's management believes, relying on the opinion of the legal advisers who are handling the claims on its behalf, that the amount of money involved cannot be estimated, nor the chances of the claims and the implications for the Company. Accordingly, no provision was made in respect of these claims in the financial statements.

(27) In 1995 the Company, together with others through a joint company, submitted bids in tenders of the Government of India for the development of a basic communications system in India. Letters of intent and draft franchise agreements for development of the basic telephone system in the four regions for which the joint company won the tender, were submitted to the joint company. However, the joint company did not sign the letters and drafts because, *inter alia*, in its opinion the drafts do not correspond to the terms of the tender. At the time of the tender, the joint company gave the Indian Ministry of Communications bank guarantees, in which the Company's part was 273 million rupees (approximately NIS 27 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

NOTE 19 - CONTINGENT LIABILITIES (CONTD.)

A. CLAIMS (CONTD.)

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. The Company's management and legal advisers are unable to estimate the chances of the appeal in those proceedings. Accordingly, no provision was made in the financial statements in respect of this matter.

(28) In January 2002 the Company received a claim for payment of financial compensation of approximately NIS 56 million and for writs of mandamus, 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 customer allocation process 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 customer allocation process, in respect of diverting those being allocated to Bezeq International by unlawfully including them in the main file and removing them from the customer allocation process, and in respect of losses it suffered 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 forced 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. The Company, Bezeq International and their legal advisers are unable, at this stage, to estimate the chances and the implications of the claim. Accordingly, no provision was made in the financial statements in respect of this claim.

(29) In October 2000 , Bezeq International Ltd., a consolidated company, received a report from the Ministry of Communications expressing doubt as to the credibility of one of the main files which was forwarded to the Ministry of Communications in the customer allocation process. Bezeq International submitted its objections to the report to the Ministry of Communications. Following the report, one of the competing operators approached the Ministry of Communications, demanding that it direct that the dial code "00" be blocked to all telephone lines which were in the aforementioned file. On April 23, 2001, an agreement was signed between Bezeq International and the competing international operators, with the approval of the Ministry of Communications, whereby the allocation process will be redone for the group of customers called "new customers" in the main file, and Bezeq International would pay financial compensation in respect of the period which had elapsed from the date of allocation of the main file to the date of the renewed allocation for that group, where the compensation formula is two thirds of the contribution generated to Bezeq International in respect of the traffic of those customers in that period. On May 21, 2001 the competing operators sent a letter to the Ministry of Communications giving notice of cancellation of the agreement. On June 7, 2001 the Ministry of Communications gave notice of transfer of the file to the operators for performance of the agreement. Despite this, the competing operators reneged on the matters which had been agreed and accordingly, Bezeq International notified them, on July 15, 2001, that if within seven days they do not give their explicit consent to performance of the agreement, Bezeq International will deem the agreement to have been breached. On July 16 and 18, 2001, the competing operators notified the Ministry of Communications that they do not intend to rescind their decision, and subsequently Bezeq International gave notice, on July 29, 2001, that it considers the agreement to have been breached.

On October 28, 2001 the Minister of Communications notified the Company and the international operators that a supplementary referendum would be held for all the subscribers included in the "main file", except for those allocated to an international operator in an allocation form, and he requested their response to this proceeding by November 6, 2001. On that date, Bezeq International submitted to the Ministry of Communications its objections to the supplementary referendum

NOTE 19 - CONTINGENT LIABILITIES (CONTD.)

A. CLAIMS (CONTD.)

proceeding. Following the objections of the Company, Bezeq International and the competing operators, the Ministry of Communications proposed another format for the, supplementary referendum on December 11, 2001, and after receiving yet more objections from the Company Bezeq International and the competing international operators, on February 14, 2002 the Ministry proposed a final text and details for carrying out the supplementary referendum, which would start on February 21, 2002 and end during July 2002. On March 12, 2002 Bezeq International petitioned the Supreme Court, sitting as the High Court of Justice, to direct the Ministry of Communications to refrain from passing its customer file to the competing international operators before the removal of the particulars of those customers who had requested allocation to Bezeq International on the form, and that a supplementary referendum be carried out also for the customers of the competing operators who have no allocation form. Bezeq International also requested an interlocutory injunction concerning transfer of the customer file to the competing companies. On March 14, 2002 the Supreme Court decided to grant an interlocutory injunction for non-transfer of the customer file to the competing companies. In the hearing on June 26, 2002, Bezeq International withdrew the petition as recommended by the court. The customer allocation process and the supplementary referendum commenced on July 1, 2002, and after postponements, ended in February 2003. The management of Bezeq International is unable, at this stage, to assess the results of the above process and its implications for its financial condition and the results of its operations.

(30) 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 approximately NIS 32 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. 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 if a claim is filed against it in this matter. Accordingly, no provisions were made in the financial statements in respect of this matter.

(31) 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 approximately NIS 15 million as at the date of filing the claim. A pre-trial hearing was scheduled for May 13, 2002. No response and/or defense has yet been filed. 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 were made in the financial statements in respect of this claim.

(32) On February 24, 2002 the Company received a "Notice of a party to a collective dispute" ("the Notice"), 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 on call duty benefits component and clothing allowances which were and are paid to Company employees, are normal wages constituting part of the employee's regular pay, and that various payments and provisions should be made in respect thereof, including for pension purposes. The Notice states that the requested reliefs are for all Company employees, including those whom were transferred from government service to the Company who are currently Company employees and also for former employees.

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 dismissed. A judgment given by the National Labor Court in another case (to which the Company is not a party), could change the Company's position on this matter for the worse. To the best of the Company's knowledge, an appeal will be filed in a higher court against the court which gave that decision. In the opinion of the Company, relying on its legal advisers, the claim is material, regarding at least part of

NOTE 19 - CONTINGENT LIABILITIES (CONTD.)

A. CLAIMS (CONTD.)

which there are considerable risks. However, it is not possible, at this stage, to assess the risks in the claim, and therefore, no additional provision was made in the financial statements beyond that made on the basis of the assessments of the management prior to the date of the aforementioned judgment.

(33) On January 3, 2002 the Company received a class action together with an application for its recognition as a class action, which were filed in the Tel Aviv District Court against the Company and against two cellular companies.

The amount of the class action against the two cellular companies is estimated at approximately NIS 94 million. No mention was made in the claim of the amount claimed (if any) from the Company, although the plaintiff alleges that the Company must repay customers the costs of disconnected calls which were collected through it to the coffers of the defendants. The plaintiff, who claims to be a subscriber of the Company and of the two cellular companies, alleges that the defendants collect payments in respect of calls in the cellular network which were disconnected due to a malfunction in the cellular network rather than on the initiative of the caller or the call recipient. The plaintiff alleges that such collection for a product which was not supplied is unlawful, constitutes a violation of the provisions of the Consumer Protection Law and the Contracts Law, and even constitutes unjust enrichment. On December 31, 2002 the Company was stricken from the action.

(34) On May 21, 2002 a statement of claim together with an application for its recognition as a class action were received at the Company's offices. The claim and application were filed in the Tel Aviv District Court against all the cellular companies in Israel, among them Pelephone (a proportionally consolidated company) and against the Company as a formal defendant. The plaintiffs, who contend that they are subscribers of the Company and of one of the defendant cellular companies, allege in their claim that the defendant cellular companies collected and collect, unlawfully, payments for what are ostensibly cellular calls but which in fact are fixed-line calls in every respect. The reference is to calls initiated by Company subscribers to commercial entities that provide entertainment and information services and which contracted with the cellular companies. Even though these calls do not "consume airtime", the cellular companies collected payment for them, in contravention of their licenses and of the law.

The amount of the class action against the cellular companies is estimated at approximately NIS 613 million. The Company has filed its response to the application for recognition of the claim as a class action. It is noted that the Company approached the Ministry of Communications on this matter, requesting its intervention. The Company, relying on its legal advisers, is unable at this stage to estimate the chances and implications of the claim, and accordingly, no provision was made in the financial statements in respect of this claim.

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

NOTE 19 - CONTINGENT LIABILITIES (CONTD.)

A. CLAIMS (CONTD.)

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

(37) In September 2002 an application was filed in the Tel Aviv District Court for approval of a class action against Pelephone Communications Ltd. ("Pelephone"), in a total amount of NIS 20 million. The applicant, through his lawyers, alleges that Pelephone compels its customers to subscribe to the "GoNext" service and connects them without their prior consent and without giving them a clear explanation of the nature of the service. Pelephone has filed an application to strike the application *in limine* due to the absence of the legally-required affidavit. In the hearing held on February 23, 2003, the claim and the application were stricken with no order for costs.

(38) On November 11, 2002 a petition was filed in the High Court of Justice by Ganei Tikva Local Council, against the Minister of Communications, the Company and Golden Channels Co. The petition is for the relocation of the cable network in the Council's jurisdiction, which the Company maintains for Golden Channels, to an underground infrastructure (instead of above-ground). The petitioners are requesting that the High Court of Justice direct the Minister of Communications to instruct the Company and Golden Channels to relocate the network immediately and at their own expense, since the network, in its condition today, constitutes a safety hazard. The Company and the cable companies are embroiled in a long-standing dispute on the question of who should bear the costs of relocating the infrastructure, which derives from conflicting interpretations of the contract between the parties. In the Company's opinion, based on consultations with its legal advisers, the chances and the implications of the petition cannot be estimated at this stage. Accordingly, no provision was made in the financial statements in respect of this action.

(39) 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 public, regarding calls to 1-800 or 177 numbers, into thinking that such numbers are free calls, whereas in fact, the consumer who calls such a number from a cellular telephone is charged by the cellular companies. 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 have consequently sustained losses.
The estimated amount of the claim is approximately NIS 700 million, which includes compensation for financial loss, non-financial damages and punitive damages. The court is also requested to give interlocutory 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. The Company is studying the claim and consulting with its legal advisers. At this stage, the Company is unable to estimate the chances and the implications of the claim, and therefore no provisions were made in the financial statements in respect thereof.

NOTE 19 - CONTINGENT LIABILITIES (CONTD.)

A. CLAIMS (CONTD.)

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

The applicants, through their legal representatives, base their claim on the following allegations:

a. Every cellular operator is a monopoly in the incoming call service to its network. Pelephone and the additional cellular company 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 this service is 25 agorot per minute, and not as collected in the past by Pelephone and the other company nor as stipulated today in the Telecommunications Regulations (Payments for interconnect), 5760-2000.

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

Pelephone and its legal advisers are studying the claim, and are unable, at this stage, to estimate its chances.

(41) On December 3, 2002 an application was filed for recognition of a claim as a class action against an affiliate, 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 the affiliate for deception, violation of fiduciary duty and good faith in a contracted agreement, fundamental breach of the contract between the affiliate and its customers and unjust enrichment, estimate the amount of the claim at approximately NIS 126 million up to the date of its filing, plus NIS 10.5 million for each month from the date of filing the claim to the date on which the decision will be given. The affiliate has filed a response to the application, requesting that it be stricken *in limine*, or alternatively – its dismissal on its merits or strengths. In the opinion of the legal advisers of the affiliate, 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, and therefore no provisions were made in the financial statements in respect thereof.

(42) On March 3, 2003 a consolidated company received a claim filed against it for approximately NIS 18.5 million. The plaintiff alleges that the consolidated company unlawfully canceled an agreement to supply and install a customer care and billing system, and is suing for enforcement of the agreement on the consolidated company, and compensation for the loses deriving from the delay in the project, and alternatively – if the claim for enforcement is not allowed – compensation in respect of all the loses it sustained as a result of breach of the contract. The management of the consolidated company and its legal advisers are unable to estimate the chances of the claim.

(43) In the matter of the notice of the Accountant General at the Ministry of Finance on the subject of the end of the period of two-year renewable rental of assets, see Note 9C.

(44) For the income tax and value added tax assessments, see note 11.

(45) For possible demand for early repayment of bank loans, see Notes 13D(1) and 14C.

(46) 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

NOTE 19 - CONTINGENT LIABILITIES (CONTD.)

A. CLAIMS (CONTD.)

claims will not cause the Company significant financial losses beyond the amounts included in the financial statements.

The amounts of the claims referred to above are adjusted (without interest) in terms of shekels of December 31, 2002.

B. FORWARD EXCHANGE CONTRACTS

Consolidated

1. Hedging Transactions

	Currency purchased	Currency payable	Final repayment date	Amounts receivable	Amounts payable
				NIS millions	
Contracts at predetermined interest rates					
	Dollar	Linked NIS	April 2004	889	916
	Euro	Linked NIS	February 2005	1,177	1,030
Forward exchange contracts at predetermined currency rates (excluding premium/discounts)					
	Dollar	NIS	December 2003	286	296
	Euro	NIS	December 2003	323	296
	Linked NIS	NIS	June 2003	27	26
	NIS	Dollars	January 2003	86	85
Call options purchased	Dollar	NIS	March 2003	39	41

2. Non-Hedging Transactions

	Currency purchased	Currency payable	Final repayment date	Fair value	Scope of contract
				NIS millions	
Call options purchased	Dollar	NIS	December 2003	1	24
Call options written	Linked NIS	NIS	August 2003	–	20
Forward exchange contracts at predetermined currency rates	Dollar	NIS	December 2003	(2)	71

NOTE 19 – CONTINGENT LIABILITIES (CONTD.)

B. FORWARD EXCHANGE CONTRACTS (CONTD.)

Company

1. Hedging Transactions

	Currency purchased	Currency payable	Final repayment date	Amounts receivable	Amounts payable
				NIS millions	
Contracts at predetermined interest rates					
	Dollar	Linked NIS	April 2004	889	916
	Euro	Linked NIS	February 2005	1,177	1,030
Forward exchange contracts at predetermined currency rates (excluding premium/discounts)					
	Dollar	NIS	December 2003	175	184
	Euro	NIS	December 2003	323	296
	Linked NIS	NIS	June 2003	27	26
	NIS	Dollar	January 2003	86	85

2. Non-Hedging Transactions

	Currency purchased	Currency payable	Final repayment date	Fair value	Scope of contract
				NIS millions	
Call options written	Linked NIS	NIS	August 2003	–	20

C. COMMITMENTS

(1) Lease Contract Commitments

For the year ended December 31	Consolidated NIS thousands	Company NIS thousands
2003	162,818	70,243
2004	175,473	60,224
2005	153,282	52,665
2006	136,948	51,965
2007	129,502	51,827
2008 and thereafter	413,477	304,771
	1,171,500	591,695

An affiliated company is committed to two main operating lease contracts in respect of buildings it uses. One agreement will expire in 2003 with an option for extension for an additional three years with the other expiring in 2009 with an option for extension for an additional 10 years. The rent is linked to the U.S. dollar ("dollar"). In addition, the same company is bound by several other operating lease agreements for various periods.

NOTE 19 – CONTINGENT LIABILITIES (CONTD.)

C. COMMITMENTS (CONTD.)

The annual rent in the next five years, calculated according to the rent in effect as at December 31, 2002, amounts to approximately NIS 10 million as adjusted.

(2) A consolidated company has commitments to provide maintenance services in the network end point field amounting to approximately NIS 63 million.

(3) On June 27, 2002, a consolidated company and Nortel Networks Israel (Sales and Marketing) Ltd. ("Nortel") signed three agreements intended to provide the consolidated company 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 the consolidated company was granted, on a non-exclusive basis, resources, manpower, abilities and licenses for maintaining an independent ability to provide maintenance, support and installation services in 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 to Nortel on the closing date of the transaction (July 31 ,2002)
- $ 4 million spread over16 quarterly installments.

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

c. A services agreement whereby Nortel undertook to supply the consolidated company 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.

(4) In August 2002 the Company signed an agreement for hiring consultation services in various Company projects, in consideration of approximately $ 2.8 million. The consultation services are provided in respect of the Company's main future technological projects.

(5) An affiliated company entered into an agreement as at December 31, 2002, to purchase broadcasting rights, for an inclusive amount of approximately NIS 216 million.

(6) An affiliated company entered into an agreement to lease space segments on 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, the same affiliated company entered into an agreement on May 16, 2001, to lease space segments of the Amos 2 satellite, which has not yet been launched into space. 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 launch is expected during 2003.

(7) An affiliated company is committed to several operating lease agreements for a period of four years in respect of motor vehicles in its service. The annual forecasted lease fees, calculated according to the fees in effect at December 31, 2002, amount to approximately NIS 12 million.

(8) A proportionally consolidated company has commitments to purchase stocks of subscriber equipment in the amount of approximately NIS 354 million and to purchase services in the amount of approximately NIS 19 million.

NOTE 19 – CONTINGENT LIABILITIES (CONTD.)

D. SECURITIES AND LIENS

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

E. GUARANTEES

(1) The Company has provided guarantees to third parties in the amount of approximately NIS 540,000.

(2) A proportionally consolidated company has given a guarantee to third parties amounting to approximately NIS 123 million of which approximately NIS 95 million is in connection with the tender for third generation frequencies in respect of cellular telephones.

(3) Subsidiaries have provided guarantees to third parties for approximately NIS 11 million.

(4) In February 2002, in accordance with a requirement of the Ministry of Communications, a subsidiary, Bezeq International Ltd., gave a bank guarantee of $ 2 million in respect of fulfillment of the terms of its license for the provision of international telecommunications services.

(5) An affiliated company provided guarantees to third parties for approximately NIS 67 million.

Regarding guarantees to related parties, see Note 27C.

NOTE 20 – SHARE CAPITAL

A. The share capital consists of ordinary shares of a par value of NIS 1 each. The registered capital is 2,565,000,000 shares (which will be reduced by 130,000,000 shares – see paragraph B below). The issued and paid up capital is 2,411,657,538 shares (2001 – 2,411,657,538 shares – subsequent to an issue of bonus shares). All the shares are listed on the Tel Aviv Stock Exchange.

The General Meeting which convened on November 23, 2000, passed a resolution to approve the recommendation of the Board of Directors of the Company to increase the registered capital of the Company by 1.6 billion ordinary shares and to distribute bonus shares in the amount of 1.6 billion shares, so that in respect of each share of par value of NIS 1, two bonus shares of a par value of NIS 1 each will be distributed. In January 2001 the Ministerial Committee for Privatization approved the increase of the registered capital for the purpose of allotment of the bonus shares. The increase and the allotment were implemented during February 2001.

B. On January 13, 2002, a framework agreement was signed between the State and the Company, whereby capital would be raised by way of a private placement. The proceeds from raising the capital was designated for financing the costs involved in the retirement of Company employees.

The price at which the State will sell the shares will be not less than NIS 6 net per share. Pursuant to the resolution of the General Meeting of the Shareholders of the Company, the registered share capital which is not allotted in the capital raising by February 28, 2003, or by another date on which the State will hold 51.02% of the Company's share capital (at full dilution), whichever is the earlier, will be cancelled. Since no capital was raised by February 28, 2003, registered capital of 130,000,000 shares was cancelled.

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 which are recorded in the Register of Shareholders at the end of the business day on February 5, 2003. The X-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 7.8784 agorot per share and 7.8784% of the issued and paid up capital of the Company as at the date of distribution.

NOTE 21 – REVENUES FROM TELECOMMUNICATION SERVICES

Consolidated

	For the year ended December 31		
	2002	2001	2000*
	NIS thousands	NIS thousands	NIS thousands
Revenues from communications services –			
Domestic fixed–line communications	**2,306,801**	2,556,153	2,727,680
Fixed fees	**2,147,448**	2,208,685	2,147,684
Cellular telephone (1)	**2,134,548**	2,206,421	2,317,118
International communications and internet services	**675,508**	835,377	914,055
Installation and sale of equipment to subscribers	**536,717**	453,180	535,954
Other	**111,378**	126,904	151,616
	7,912,400	8,386,720	8,794,107
Other revenues	**322,143**	294,677	280,059
	8,234,543	8,681,397	9,074,166

Company

	For the year ended December 31		
	2002	2001	2000
	NIS thousands	NIS thousands	NIS thousands
Revenues from communications services –			
Domestic fixed–line communications	**2,329,567**	2,585,298	2,750,270
Fixed fees	**2,016,760**	2,090,029	2,032,896
International communications and internet services	**138,404**	348,852	419,533
Cellular telephone (1)	**556,629**	711,624	909,866
Installation and sale of equipment to subscribers	**155,138**	148,867	228,180
Other	**117,053**	134,217	155,646
	5,313,551	6,018,887	6,496,391
Other revenues	**254,303**	258,685	255,867
	5,567,854	6,277,572	6,752,258

(1) See Note 1E(1).

NOTE 22 – OPERATING AND GENERAL EXPENSES

Consolidated

	For the year ended December 31		
	2002	**2001**	**2000***
	NIS thousands	**NIS thousands**	**NIS thousands**
Salaries and related expenses	**2,019,868**	2,042,429	1,810,226
General expenses	**746,336**	872,772*	1,061,780*
Materials and spare parts	**606,743**	541,498	451,537
Cellular telephone expenses (1)	**482,237**	373,021*	223,436*
Building maintenance	**358,444**	406,436	419,741
Services and maintenance by sub–contractors	**272,177**	344,411	429,941
International communications expenses	**155,110**	212,875	271,142
Vehicle maintenance expenses	**98,471**	88,709	78,405
Collection fees	**35,488**	39,025	42,127
	4,774,874	4,921,176	4,788,335
Less – salaries charged to investment in fixed assets	**150,384**	163,415	161,922
	4,624,490	4,757,761	4,626,413

Company

	For the year ended December 31		
	2002	**2001**	**2000**
	NIS thousands	**NIS thousands**	**NIS thousands**
Salaries and related expenses	**1,553,908**	1,616,353	1,417,633
General expenses	**310,527**	394,985*	579,390*
Materials and spare parts	**66,987**	67,098	52,074*
Building maintenance	**330,260**	355,761	371,392
Services and maintenance by sub–contractors	**225,755**	287,286	358,029*
International communications expenses	**5,038**	10,323	13,116
Vehicle maintenance expenses	**84,435**	73,809	67,402
Collection fees	**35,403**	38,670	41,884
	2,612,313	2,844,285	2,900,920
Less – salaries charged to investment in fixed assets	**150,384**	163,415	161,922
	2,461,929	2,680,870	2,738,998

* Reclassified

(1) See Note 1E(1)

NOTE 23 – FINANCING EXPENSES, NET

Consolidated

	For the year ended December 31		
	2002	**2001**	**2000**
	NIS thousands	**NIS thousands**	**NIS thousands**
Financing expenses in respect of a debenture issued to the State of Israel	**–**	–	5,272
Expenses in respect of long-term liabilities *			
Debentures	**403,265**	198,330	128,264
Loans	**124,766**	322,372	186,204
	528,031	520,702	319,740
Income in respect of deposits and investments	**(22,012)**	(198,200)	(71,278)
Expenses (income) in respect of forward currency transactions	**(337,873)**	(123,977)	110,398
Short-term bank credit	**7,659**	35,837	38,629
Interest income from income tax	**(5,979)**	(83,635)	(7,187)
Other expenses (income), net	**(1,332)**	2,708	(19,622)
	168,494	153,435	370,680
(*) Including appreciation (net of erosion) in respect of liabilities in foreign currency	**256,779**	168,499	(54,005)

Company

	For the year ended December 31		
	2002	**2001**	**2000**
	NIS thousands	**NIS thousands**	**NIS thousands**
Financing expenses in respect of a debenture issued to the State of Israel	**–**	–	5,272
Expenses in respect of long-term liabilities *			
Debentures	**403,265**	198,330	128,264
Loans	**93,885**	283,416	165,821
	497,150	481,746	299,357
Income in respect of deposits and investments	**(23,446)**	(196,589)	(71,278)
Expenses (income) in respect of forward currency transactions	**(331,773)**	(117,699)	110,398
Interest income from income tax	**(8,979)**	(83,635)	(7,187)
Other expenses, net	**(13,566)**	(6,342)	(13,413)
	119,386	77,481	317,877
(*) Including appreciation (net of erosion) of liabilities in foreign currency	**256,779**	168,499	(50,765)

NOTE 24 – OTHER EXPENSES, NET

Consolidated

	For the year ended December 31		
	2002	2001	2000
	NIS thousands	NIS thousands	NIS thousands
Provision for employee severance benefits upon early retirement (Note 16D)	**–**	–	1,562,136
Provision for erosion of investment in convertible debentures (1)	**1,232,560**	–	–
Compensation in respect of the billing system	**–**	–	(107,058)
Provision for claims in respect of salary and pension components	**–**	–	53,999
Provision and decrease in value of fixed assets	**–**	108,654	11,893
Direct expenses for the customer allocation process	**–**	1,574	29,904
Capital gains, net	**(12,984)**	(9,270)	(1,448)
Capital gain from sale of an affiliated company (2)	**–**	–	(149,831)
Cancellation of provision for a guarantee for an affiliated company	**–**	–	(25,169)
Loss in respect of decrease in holding in an affiliated company	**–**	3,706	–
Provision for a decrease in value of investments in other companies	**23,792**	8,173*	–
Others	**(125)**	2,420	4
	1,243,243	115,257	1,374,430

Company

	For the year ended December 31		
	2002	2001	2000
	NIS thousands	NIS thousands	NIS thousands
Provision for employee severance benefits upon early retirement (Note 16D)	**–**	–	1,562,136
Provision for erosion of investment in convertible debentures (1)	**1,232,560**	–	–
Compensation for the billing system	**–**	–	(107,058)
Provision for claims in respect of salary and pension components	**–**	–	53,999
Capital gains (losses), net	**(12,490)**	2,665	(2,869)
Capital gain from sale of an affiliated company (2)	**–**	–	(149,831)
Cancellation of provision for a guarantee for an affiliated company	**–**	–	(25,169)
Provision for a decrease in value of investments in other companies	**10,452**	–	–
Others	**(133)**	–	241
	1,230,389	2,665	1,331,449

* Reclassified

(1) See Note 8D(2)

(2) In 2000, the Company signed an agreement for the sale and transfer of the Company's holdings in an affiliated company. By December 31, 2001, the Company had received the full consideration for the sale of its holdings.

NOTE 25 – EARNINGS PER SHARE (CONSOLIDATED AND COMPANY)

	For the year ended December 31		
	2002	**2001**	**2000**
	NIS thousands	**NIS thousands**	**NIS thousands**
Primary and diluted earnings (loss)	**(930,322)**	129,182	(587,857)
Weighted number of shares in primary earnings and diluted earnings	**2,411,658**	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, 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	**5,358,071**	**1,996,234**	**683,338**	**196,900**	**–**	**8,234,543**
Inter–segment revenues	**209,782**	**7,789**	**8,431**	**30,010**	**(256,012)**	**–**
Total revenues	**5,567,853**	**2,004,023**	**691,769**	**226,910**	**(256,012)**	**8,234,543**
Segment results	**998,643**	**(63,877)**	**110,100**	**(8,781)**	**656**	**1,036,741**
Financing expenses						**168,494**
Earnings after financing expenses						**868,247**
Other expenses, net						**1,243,243**
Losses before income tax						**(374,996)**
Income tax						**211,319**
Losses after income tax						**(586,315)**
Equity in losses of affiliated companies	**2,559**			**344,513**		**347,072**
Minority equity in losses of a consolidated company	**(3,065)**					**(3,065)**
Net loss						**(930,322)**
Identified assets	**10,255,007**	**2,302,111**	**698,315**	**186,651**	**(123,160)**	**13,318,924**
Investment by equity method	**14,983**			**375,091**		**390,074**
General assets						**2,833,573**
Total consolidated assets						**16,542,571**
Segment liabilities	**1,549,268**	**875,211**	**333,814**	**97,272**	**(119,016)**	**2,736,549**
General liabilities						**7,089,255**
Total consolidated liabilities						**9,825,804**
Capital investments	**870,939**	**480,669**	**139,011**	**6,269**		
Depreciation and amortization	**1,925,472**	**515,257**	**84,842**	**4,992**		

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	5,917,943	1,894,147	700,410	168,897	–	8,681,397
Inter–segment revenues	359,630	6,444	11,870	23,067	(401,011)	–
Total revenues	6,277,573	1,900,591	712,280	191,964	(401,011)	8,681,397
Segment results	1,104,319	(193,092)	(42,738)	1,329	657	870,475
Financing expenses						153,435
Earnings after financing expenses						717,040
Other expenses, net						*115,257
Earnings before income tax						601,783
Income tax						245,571
Earnings after income tax						356,212
Equity in losses of affiliated companies	(30,307)			264,154*		233,847
Minority equity in losses of a consolidated company	(6,624)					(6,624)
Net earnings						128,989
Identified assets	11,868,258	2,217,920	618,705	128,370*	(60,898)	14,772,355
Investment by equity method	135,033			355,985		491,018
General assets						3,004,880
Total consolidated assets						18,268,253
Segment liabilities	1,551,950	791,066	311,031	53,988*	(60,145)	2,647,890
General liabilities						7,973,274
Total consolidated liabilities						10,621,164
Capital investments	849,579	517,164	125,961	8,766		
Depreciation and amortization	2,290,770	753,147	80,760	5,431		

* Reclassified

NOTE 26 – BUSINESS SEGMENTS (CONTD.)

Consolidated

	For the year ended December 31, 2000					
	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	6,384,724	1,801,198	720,614	167,630	–	9,074,166
Inter–segment revenues	367,534	57,504	4,789	33,303	(463,130)	–
Total revenues	6,752,258	1,858,702	725,403	200,933	(463,130)	9,074,166
Segment results	1,370,386	(31,224)	(160,792)	13,268	177	1,191,815
Financing expenses						370,680
Earnings after financing expenses						821,135
Other expenses, net						1,374,430
Loss before income tax						(553,295)
Tax benefit						(165,584)
Loss after income tax						(387,711)
Equity in losses of affiliated companies	13,062			197,704		210,766
Minority equity in losses of a consolidated company	(5,284)					(5,284)
Net loss						(593,193)
Identified assets	13,282,694	2,477,532	579,310*	96,297	(59,871)	16,375,962
Investment by equity method	108,501			77,984		186,485
General assets						1,658,604
Total consolidated assets						18,221,051
Segment liabilities	2,647,989	998,677	434,665*	53,339	(57,884)	4,076,786
General liabilities						6,626,188
Total consolidated liabilities						10,702,974
Capital investments	1,091,526	881,632	140,241	8,809		
Depreciation and amortization	2,372,688	572,348	80,358	4,801		

* Reclassified

NOTE 27 – TRANSACTIONS WITH INTERESTED AND RELATED PARTIES

A. The Company is a government company which transacts a significant volume of business in the regular course of its operations with government ministries, agencies and government 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, (exemption for the year 2002 is dated February 24, 2003), exempted the Company from detailing its transactions with interested parties, other than extraordinary transactions.

B. The Company provides services to the Israeli Defense and Security Forces in accordance with terms agreed upon in prior years and which provided, *inter alia*, that the Ministry of Defense will fund the Company's infrastructure investments in consideration for discounts which the Company will grant in respect of current services.

Due to controversies which arose between the Company and the Ministry of Defense in connection with the terms of the services which the Company provides to the Israeli Defense Forces, a professional committee was established to examine the differences of opinion. In May 1996, the committee submitted recommendations for the resolution of the differences of opinion.

Since the recommendations were not adopted by the Ministers of Defense and Communications, the arrangements which were hitherto in effect between the Company and the Israeli Defense Forces, and which were the subject of the committee's discussions, continued to govern. In July 2002 the Company and the Ministry of Defense (in the name of the State of Israel) reached an agreement for the provision of telecommunications 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 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 base 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 a non-material amount).

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

C. GUARANTEES

The Company has provided guarantees to banks in connection with credit granted to subsidiary companies of up to NIS 70 million.

Regarding guarantees given by the Company in respect of its investments in India, see Note 19A (27).

The Company gave a guarantee for an affiliated company in the amount of approximately NIS 10 million in respect of a bank guarantee of approximately NIS 33 million which the affiliate made available in favor of the State of Israel. The guarantee is valid until December 31, 2010.

In connection with an additional guarantee in respect of the Company's investments in the affiliated company, see Note 8E.

D. TRANSACTIONS WITH INVESTEE COMPANIES (COMPANY)

	For the year ended December 31		
	2002	**2001**	**2000**
	NIS thousands	**NIS thousands**	**NIS thousands**
Revenues –			
Interconnect and access fees	**173,799**	292,588	321,519
Services, royalties and commissions	**142,896**	338,939	217,044
Rent, and fixed fees for use of buildings and equipment	**24,955**	43,464	10,564
Interest	**–**	6,955	–
Expenses –			
Purchase of services	**41,125**	36,470	154,290
Interest	**6**	–	–
Total losses from fixed asset transactions	**–**	–	(479)
Total transaction turnover	**–**	–	613

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

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

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

E. BENEFITS FOR DIRECTORS AND CEO

	For the year ended December 31		
	2002	**2001**	**2000**
	NIS thousands	**NIS thousands**	**NIS thousands**
Total cost of compensation of the CEO and the Chairman of the Board *	**1,680**	1,537	1,266
Number of employees	**2**	2	2
Compensation of members of the Board of Directors who are not Company employees**	**1,584**	1,431	1,492
Number of directors receiving compensation	**19**	19	17

* The total cost includes payment of severance pay to the Chairman of the Board in the amount of approximately NIS 100,000.

** 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 director and 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.

NOTE 28 – FINANCIAL INSTRUMENTS

A. FINANCIAL DERIVATIVES

The Group has an excess of liabilities over assets in or linked to foreign currency in the amount of approximately NIS 3,014 million of which the excess of current liabilities over current assets was approximately NIS 320 million. The excess of current liabilities is partially covered by forward exchange contracts, as described in Note 19B. The Group has revenues in foreign currency from international communications.

As at December 31, 2002, the excess of CPI-linked monetary liabilities over CPI-linked monetary assets amounted to approximately NIS 965 million of which the excess of current liabilities over current assets was approximately NIS 164 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 increase in the CPI, net of an efficiency factor.

The Company has limited commitments in financial derivatives which are intended solely for purposes of hedging. Regarding the Company's commitments to execute forward exchange contracts as at December 31, 2002 – see Note 19B.

B. CREDIT RISKS

At December 31, 2002, 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 debentures and bank deposits, while a small part is invested in debentures of companies trading on the stock exchange in Israel. Accordingly, Management does not expect significant losses deriving from credit risks.

NOTE 28 – FINANCIAL INSTRUMENTS (CONTD.)

B. CREDIT RISKS (CONTD.)

The Group's revenues derive from a large number of customers. Management reviews customer balances on a current basis and the financial statements include provisions which, in Management's opinion, are adequate for doubtful debts. The exposure to credit risk in connection with customers is limited considering the large number of customers of the Company.

C. 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.

Regarding several items, there is a difference between the amount recorded in the books and their estimated fair value, as detailed below.

	December 31, 2002	
	Book value	Fair value
	NIS thousands	NIS thousands
Debentures:		
Issued to the public		
CPI-linked	**141,957**	**193,536**
Euro-linked	**1,476,805**	**1,422,289**
Unlinked	**500,241**	**490,560**
Issued to others	**860,418**	**761,368**
CPI-linked loans	**781,574**	**716,179**
Unlinked loans	**240,000**	**207,462**
Foreign currency loans	**1,568,252**	**1,154,363**

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, 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	26,919	1,614	–	–	963,921	992,454
Short-term investments	165,752	–	–	739,068	275,261*	1,180,081
Trade receivables	19,619	–	–	6,683	1,725,686	1,751,988
Other receivables and debit balances	7,552	149,075	–	92,537	23,379	272,543
Long-term investments, deposits and debit balances	99,477	31,902	–	237,827	315,522	684,728
	319,319	182,591	–	1,076,115	3,303,769	4,881,794
Liabilities						
Short-term bank credit	35,517			125,185	368,123	528,825
Current maturities of long-term liabilities	227,376		–	468,190	59,791	755,357
Trade payables	358,135	1,334	1,662	500	791,732	1,153,363
Other current liabilities	27,039	39,102	–	80,488	944,771	1,091,400
Long-term loans	1,348,489	–	–	574,668	180,208	2,103,365
Other long-term debentures	–	1,476,805	–	792,080	500,242	2,769,127
Employee severance benefits	–	–	–	–	1,352,451	1,352,451
	1,996,556	1,517,241	1,662	2,041,111	4,197,318	9,753,888

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	2,478	1,614	–	–	913,273	917,365
Short-term investments	165,752	–	–	739,068	275,169*	1,179,989
Trade receivables	5,510	–	–	–	1,120,848	1,126,358
Other receivables and debit balances	5,720	149,075	–	85,816	10,583	251,194
Long-term investments, deposits and debit balances	99,477	31,902	–	224,284	235,938	591,601
	278,937	182,591	–	1,049,168	2,555,811	4,066,507
Liabilities						
Current maturities of long-term liabilities	227,376	–	–	356,102	–	583,478
Trade payables	5,478	1,334	1,662	–	667,739	676,213
Other current liabilities	26,409	39,102	–	46,714	744,314	856,539
Long-term loans	1,336,442	–	–	173,992	–	1,510,434
Other long-term debentures	–	1,476,805	–	792,080	500,242	2,769,127
Employee severance benefits	–	–	–	–	1,341,443	1,341,443
	1,595,705	1,517,241	1,662	1,368,888	3,253,738	7,737,234

* Including mutual fund participation certificates of approximately NIS 111 million consolidated and for the Company.

For details of forward exchange contracts for covering exposure to foreign currency, see Note 19B.

NOTE 29 – LINKAGE TERMS OF MONETARY BALANCES AS AT DECEMBER 31, 2001

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	43,219	1,086	–	109	1,343,230	1,387,644
Short-term investments	18,086	–	–	161,352	289,841**	469,279
Trade receivables	32,291	–	–	4,634*	1,758,889	1,795,814
Other receivables and debit balances	61,651	24,005	–	5,736	19,852	111,244
Long-term investments, deposits and debit balances	1,178,774	8,392	–	227,489*	287,980	1,702,635
	1,334,021	33,483	–	399,320	3,699,792	5,466,616
Liabilities						
Short-term bank credit	37,817	–	–		413,264	451,081
Current maturities of long-term liabilities	211,629	–	–	441,881	138,445	791,955
Trade payables	298,117	448	6,784	–	779,509	1,084,858
Other current liabilities	18,775	38,166	–	193,937	929,875	1,180,753
Long-term loans	1,709,492	1,455	–	692,861	273,418	2,677,226
Other long-term debentures	–	1,241,855	–	913,792	532,597	2,688,244
Employee severance benefits	–	–	–	–	1,638,823	1,638,823
	2,275,830	1,281,924	6,784	2,242,471	4,705,931	10,512,940

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	19,217	1,086	–	–	1,332,587	1,352,890
Short-term investments	16,312	–	–	157,779	278,115**	452,206
Trade receivables	5,765	–	–	–	1,214,194	1,219,959
Other receivables and debit balances	58,511	24,005	–	1,544	6,049	90,109
Long-term investments, deposits and debit balances	1,178,774	8,392	–	214,507	237,948	1,639,621
	1,278,579	33,483	–	373,830	3,068,893	4,754,785
Liabilities						
Current maturities of long-term liabilities	211,629	–	–	378,088	–	589,717
Trade payables	19,753	448	6,784	–	580,604	607,589
Other current liabilities	18,776	38,166	–	146,479	780,061	983,482
Long-term loans	1,709,492	1,455	–	390,790	–	2,101,737
Other long-term debentures	–	1,241,855	–	913,792	532,597	2,688,244
Employee severance benefits	–	–	–	–	1,627,286	1,627,286
	1,959,650	1,281,924	6,784	1,829,149	3,520,548	8,598,055

* Reclassified

** Including mutual fund participation certificates of approximately NIS 181 million, consolidated and approximately NIS 178 million, Company.

For details of forward exchange contracts for covering exposure to foreign currency, see Note 19B.

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

A. BALANCE SHEETS

	December 31 2002	December 31 2001
	NIS thousands	NIS thousands
Assets		
Current assets	**3,700,531**	3,093,366
Materials and spare parts	**121,427**	151,239
Long-term investments, deposits and debit balances	**670,610**	1,619,378
Investments in investee companies	**1,460,901**	1,481,849
Fixed assets	**5,866,740**	6,374,488
Other assets	**867,487**	992,328*
	12,687,696	13,712,648
Liabilities		
Current	**2,355,562**	2,341,098
Long-term	**5,458,668**	5,833,124
	7,814,230	8,174,222
Shareholders' equity	**4,873,466**	5,538,426*
	12,687,696	13,712,648

* Restated

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

B. STATEMENTS OF OPERATIONS

	For the year ended December 31		
	2002	**2001**	**2000**
	NIS thousands	**NIS thousands**	**NIS thousands**
Revenues from telecommunications services	**5,538,991**	5,875,892	6,237,202
Costs and expenses			
Operating and general expenses	**2,456,935**	2,503,376	2,531,190
Depreciation	**1,362,889**	1,466,867	1,482,947
Royalties to the Government of Israel	**187,596**	188,853	204,058
	4,007,420	4,159,096	4,218,195
Operating income	**1,531,571**	1,716,796	2,019,007
Financing expenses, net	**173,769**	117,455	289,522
Earnings after financing expenses	**1,357,802**	1,599,341	1,729,485
Other expenses, net	**1,317,364**	18,193	1,227,500
Earnings before income tax	**40,438**	1,581,148	501,985
Income tax	**(236,439)**	(494,736)*	(118,751)*
Earnings (loss) after income tax	**(196,001)**	1,086,412	383,234
Equity in losses of investee companies	**468,959**	447,964	364,188
Net earnings (loss)	**(664,960)**	638,448	19,046

* 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 (loss)	Total
			NIS thousands		
Balance as at January 1, 2000	783,391	3,200,518	–	644,052	4,627,961
Net earnings	–	–	–	19,046*	19,046
Tax benefit in respect of shares to employees	–	21,841	–	–	21,841
Capitalization of undesignated earnings to a reserve fund for the distribution of bonus shares	–	1,600,000	–	(1,600,000)	–
Conversion of convertible debentures	14,590	148,757	–	–	163,347
Balance as at December 31, 2000	797,981	4,971,116	–	(936,902)	4,832,195
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
Net loss	**–**	**–**	**–**	**(664,960)**	**(664,960)**
Dividend proposed subsequent to the balance sheet date	**–**	**–**	**190,000**	**(190,000)**	**–**
Balance as at December 31, 2002	**2,411,658**	**3,432,994**	**190,000**	**(1,161,186)**	**4,873,466**

* 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 recording of deferred taxes in respect of fixed assets.

(1) Effect on net earnings:

	For the year ended December 31	
	2001	2000
	NIS thousands	NIS thousands
Net earnings as previously reported	555,753	60,379
Effect of restatement:		
Increase in income tax	82,695	(41,333)
	638,448	19,046

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

1. BEZEQ INTERNATIONAL LTD.

A. BALANCE SHEETS

	December 31 2002	December 31 2001
	NIS thousands	NIS thousands
Current assets	**197,319**	174,368
Investments	**10,899**	9,113
Fixed assets	**493,484**	432,063
Other assets	**8,592**	16,549
	710,294	632,093
Current liabilities	**378,818**	345,107
Long-term liabilities	**174,037**	205,902
Quasi–capital receipt	**–**	171,150
Shareholders' equity (deficit)	**157,439**	(90,066)
	710,294	632,093

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

1. BEZEQ INTERNATIONAL LTD.

B. STATEMENTS OF OPERATIONS

	For the year ended December 31		
	2002	2001	2000
	NIS thousands	NIS thousands	NIS thousands
Revenues from international communications services	**691,769**	712,271	725,414
Operating expenses	**387,407**	526,391*	601,650*
Gross profit	**304,362**	185,880	123,764
Marketing expenses	**133,909**	129,764	178,617
General and administrative expenses:			
In respect of the reporting period	**67,894**	98,854	105,942*
In respect of cost differences in telecommunication services in previous periods	**(7,541)**	–	–
	194,262	228,618	284,559
Operating income (loss)	**110,100**	(42,738)	(160,795)
Financing income (expenses), net	**1,613**	(11,554)	(3,432)
Earnings (loss) after financing	**111,713**	(54,292)	(164,227)
Other income (expenses), net	**35**	4,243	(42,893)
Earnings (loss) before income tax	**111,748**	(50,049)	(207,120)
Income tax	**(10,741)**	(3,214)	(1,750)
Earnings (loss) after income tax	**101,007**	(53,263)	(208,870)
Company's equity in losses of investee company	**(24,652)**	(28,401)	(11,295)
Net earnings (loss)	**76,355**	(81,664)	(220,165)

* Reclassified

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

2. PELEPHONE COMMUNICATIONS LTD. AND ITS SUBSIDIARY

A. BALANCE SHEETS

	Consolidated December 31 2002	Consolidated December 31 2001
	NIS thousands	NIS thousands
Current assets	**1,339,340**	1,101,575*
Long-term trade receivables	**159,168**	100,064
Deferred taxes	**335,863**	260,402*
Fixed assets	**2,793,852**	2,686,839
Other assets, net	**459,667**	633,304
	5,087,890	4,782,184
Current liabilities	**2,080,516**	1,961,988
Provision for losses of investee company	**4,499**	3,967
Long-term liabilities	**1,125,245**	1,075,276
Shareholders' equity	**1,877,630**	1,740,953
	5,087,890	4,782,184

B. STATEMENTS OF OPERATIONS FOR THE YEAR ENDED DECEMBER 31

	Consolidated		
	2002	2001	2000
	NIS thousands	NIS thousands	NIS thousands
Revenues from Pelephone services, sales and services	**4,008,045**	3,801,182	3,717,403
Cost of Pelephone services, sales and services	**3,521,563**	3,497,027*	3,106,350
Gross profit	**486,482**	304,155	611,053
Sales and marketing expenses	**475,012**	491,280*	484,242
General and administrative expenses	**156,814**	172,143*	216,130
	631,826	663,423	700,372
Operating loss	**(145,344)**	(359,268)	(89,319)
Financing expenses, net	**(94,680)**	(131,196)	(105,838)
Other income (expenses), net	**1,496**	(216,943)	1,852
Loss before income tax	**(238,528)**	(707,407)	(193,305)
Tax benefit	**75,461**	242,848	55,555
Loss after income tax	**(163,067)**	(464,559)	(137,750)
Minority equity in losses of a consolidated company	**5,814**	13,248	10,573
Company equity in losses of investee companies	**(667)**	(8,155)	(11,797)
Net loss	**(157,920)**	(459,466)	(138,974)

* Reclassified

	Percent of control and ownership as at December 31 2002 %	December 31 2001 %
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)	**54**	49
Proportionally Consolidated Companies		
Pelephone Communications Ltd.	**50**	50
GoNext Ltd. (5)	**50**	26
Affiliated Companies		
Stage One Venture Capital Fund (Israel) L.P. (An Israeli Limited Partnership) (hereinafter – the Fund) (6)	**100**	100
Stage One Capital Investments L.P. (An Israeli Limited Partnership) (hereinafter – SOCI) (6)	**27**	27
The International Company for Underwater Cables Ltd. (7)	**50**	50
Aphrodite B.V. Amsterdam (8)	**67**	67
D.B.S. Satellite Services (1998) Ltd. (9)	**44.9**	30
Infogate Online Ltd. (10)	**26.2**	29
Eden Telecom Ltd. (11)	**23**	23
Walla! Communications Ltd.(12)	**36.74**	25
Adanet Business Group Ltd.(13)	**50**	50
Companies that are not investee companies		
Comfynet Ltd.	**17**	17
Xpert Integrated Systems Ltd. (14)	**16**	16
Personeta Inc.	**4**	4
Exent Ltd.	**6**	6
Atrica Inc.	**1**	1
Venture Capital Funds that are not affiliates		
Eurofund 2000 L.P	**14**	14
B.R.M. Capital Fund L.P	**3**	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 the company appointed a liquidator.

(3) The company was founded in December 2000 and commenced operations in 2001.

(4) See Note 8H.

(5) See Note 8D (4).

(6) 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 NIS 27 million was invested by the end of 2002.

(7) 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.

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

(9) See Note 8E.

(10) 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.

(11) See Note 8D (5)

(12) See Note 8F.

(13) See Note 8G.

(14) 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 an Israeli company involved mainly in the construction and integration of IP networks.