# "BEZEQ" THE ISRAEL TELECOMMUNICATION CORP. LIMITED

## FINANCIAL STATEMENTS

## DECEMBER 31, 2004

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**Auditor's Report to the Shareholders of**
**"Bezeq" The Israel Telecommunication Corp. Limited**

We have audited the accompanying balance sheets of "Bezeq" The Israel Telecommunication Corp. Limited (the Company) as at December 31, 2004 and 2003, 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 on December 31, 2004. 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, (and in respect of 2003 and 2002 those consolidated by the proportionate method) whose assets included in the consolidation constitute approximately 36% and approximately 20% of the total consolidated assets as at December 31, 2004 and 2003 and whose revenues included in the consolidation constitute approximately 49%, 37% and 34% of the total consolidated revenues for the years ended December 31, 2004, 2003, and 2002, respectively. Furthermore, we did not audit the financial statements of affiliates in which the investment was approximately NIS 70 million and approximately NIS 241 million as at December 31, 2004 and 2003, respectively, and the Group's equity in their operating losses is approximately NIS 135 million, approximately NIS 341 million and approximately NIS 349 million for the years ended December 31, 2004, 2003 and 2002 respectively. The financial statements of those companies were audited by other auditors whose reports thereon were furnished to us and our opinion, insofar as it relates to amounts emanating from the financial statements of such companies, is based solely on the said reports of the other auditors.

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

In our opinion, based on our audits and on the reports of the other auditors, the financial statements referred to above present fairly, in all material respects, the financial position of the Company and the consolidated financial position of the Company and its subsidiaries as at December 31, 2004 and 2003 and the results of their operations, the changes in shareholders' equity and their cash flows for each of the three years the last of which ended December 31, 2004, 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.

Somekh Chaikin, a partnership registered under the Israeli Partnership Ordinance, is the Israeli member firm of KPMG International, a Swiss cooperative.

As explained in Note 2B, the financial statements for dates and reporting periods subsequent to December 31, 2003 are stated in reported amounts, in accordance with the accounting standards of the Israel Accounting Standards Board. The financial statements for dates and reporting periods that ended through the aforementioned date are stated in values that were adjusted to that date according to the changes in the general purchasing power of the Israeli currency, in accordance with opinions of the Institute of Certified Public Accountants in Israel.

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

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

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

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

4. The financial position of a consolidated company including:

   (a) Restrictions imposed by the Ministry of Communications on the Company with respect to additional cash transfers to the consolidated company.
   (b) Resolution of the Board of Directors of the Company dated February 17, 2005 whereby it stands behind its resolution dated March 30, 2004 to continue to invest in the consolidated company according to the work plan which was approved, together with the other shareholders and financial institutions, despite the aforementioned restrictions.

   As mentioned in Note 8E, the continuation of the operations of the consolidated company is conditional upon the continued receipt of shareholders' loans, including loans from the Company, pursuant to the consolidated company's work plan.

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

March 3, 2005

## Balance Sheets

| | Note | Consolidated | | Company | |
|---|---|---|---|---|---|
| | | December 31 2004 | December 31 2003 | December 31 2004 | December 31 2003 |
| | | Reported amounts* | Adjusted for the effects of inflation in shekels of December 2003 | Reported amounts* | Adjusted for the effects of inflation in shekels of December 2003 |
| | | NIS thousands | NIS thousands | NIS thousands | NIS thousands |
| **Current assets** | | | | | |
| Cash and cash equivalents | 3 | **1,457,107** | 1,954,350 | **1,327,731** | 1,896,518 |
| Short-term investments | 4 | **1,287,809** | 1,340,341 | **1,285,920** | 1,340,248 |
| Trade receivables | 5 | **2,115,070** | 1,667,623 | **970,766** | 1,021,267 |
| Other receivables and debit balances | 6 | **416,113** | 415,372 | **370,284** | 363,959 |
| Inventory | | **314,549** | 83,995 | **–** | – |
| | | **5,590,648** | 5,461,681 | **3,954,701** | 4,621,992 |
| **Materials and spare parts** | | **130,922** | 151,911 | **130,922** | 151,911 |
| **Broadcasting rights** | | | | | |
| Cost | | **234,757** | – | **–** | – |
| Less – rights utilized | | **94,261** | – | **–** | – |
| | | **140,496** | – | **–** | – |
| **Investments and long-term receivables** | | | | | |
| Investments, deposits and debit balances | 7 | **872,575** | 765,971 | **570,541** | 654,400 |
| Investments in investee companies | 8 | **70,308** | 240,667 | **6,484,476** | 1,509,101 |
| | | **942,883** | 1,006,638 | **7,055,017** | 2,163,501 |
| **Fixed assets** | 9 | | | | |
| Cost | | **34,311,281** | 28,385,188 | **22,124,083** | 23,184,549 |
| Less – accumulated depreciation | | **23,570,947** | 19,686,070 | **15,993,634** | 16,401,414 |
| | | **10,740,334** | 8,699,118 | **6,130,449** | 6,783,135 |
| **Other assets** | | | | | |
| Goodwill | | **1,792,658** | 18,628 | **–** | – |
| Deferred charges and other assets | 10 | **387,904** | 190,049 | **13,434** | 11,016 |
| Deferred taxes | 11 | **446,136** | 560,739 | **339,280** | 441,420 |
| | | **2,626,698** | 769,416 | **352,714** | 452,436 |
| | | **20,171,981** | 16,088,764 | **17,623,803** | 14,172,975 |

| | | Consolidated | | Company | |
|---|---|---|---|---|---|
| | | December 31 2004 | December 31 2003 | December 31 2004 | December 31 2003 |
| | | Reported amounts* | Adjusted for the effects of inflation in shekels of December 2003 | Reported amounts* | Adjusted for the effects of inflation in shekels of December 2003 |
| | Note | NIS thousands | NIS thousands | NIS thousands | NIS thousands |
| **Current liabilities** | | | | | |
| Bank credit | 12 | **88,102** | 144,714 | **–** | – |
| Current maturities of: | | | | | |
| Long-term bank loans | 13 | **1,304,916** | 685,883 | **473,578** | 324,827 |
| Debentures | 14 | **240,481** | 598,153 | **210,481** | 598,153 |
| Trade payables | 15 | **1,675,569** | 1,130,716 | **648,218** | 686,517 |
| Employee severance benefits, net | 16 | **592,474** | 602,520 | **592,474** | 602,520 |
| Other current liabilities | 17 | **1,402,140** | 1,188,200 | **909,194** | 949,835 |
| | | **5,303,682** | 4,350,186 | **2,833,945** | 3,161,852 |
| **Long-term liabilities:** | | | | | |
| Long-term loans | 13 | **2,860,934** | 1,754,293 | **529,734** | 1,046,212 |
| Debentures | 14 | **3,824,539** | 2,324,582 | **6,114,628** | 2,324,582 |
| Employee severance benefits, net | 16 | **680,096** | 770,909 | **658,355** | 761,283 |
| Other long-term liabilities | 18 | **47,375** | 43,764 | **21,374** | 34,104 |
| Loans extended by the minority in a consolidated company: | | | | | |
| Loans | | **1,057,988** | – | **–** | – |
| Less – minority share in deficit of a consolidated company | | **(1,057,988)** | – | **–** | – |
| | | **7,412,944** | 4,893,548 | **7,324,091** | 4,166,181 |
| **Minority rights** | | **(10,412)** | 88 | **–** | – |
| **Contingent liabilities** | 19 | | | | |
| **Shareholders' equity** | 20 | **7,465,767** | 6,844,942 | **7,465,767** | 6,844,942 |
| | | **20,171,981** | 16,088,764 | **17,623,803** | 14,172,975 |

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

* Concerning termination of adjustment for inflation according to the December 2003 CPI, see Note 2

Date of approval of the financial statements: March 3, 2005
The notes to the financial statements are an integral part thereof.

## Statements of Operations for the Year Ended December 31

| | Note | Consolidated | | | Company | | |
|---|---|---|---|---|---|---|---|
| | | 2004 | 2003 | 2002 | 2004 | 2003 | 2002 |
| | | Reported amounts* | Adjusted for the effects of inflation in shekels of December 2003 | | Reported amounts* | Adjusted for the effects of inflation in shekels of December 2003 | |
| | | NIS thousands | NIS thousands | NIS thousands | NIS thousands | NIS thousands | NIS thousands |
| **Revenues** | 21 | **9,269,804** | 7,981,268 | 8,063,480 | **4,959,691** | 5,230,561 | 5,447,068 |
| **Costs and expenses** | | | | | | | |
| General and operating expenses | 22 | **5,565,090** | 4,485,300 | 4,525,933 | **2,347,448** | 2,366,547 | 2,399,726 |
| Depreciation | 9 | **2,092,475** | 2,160,011 | 2,270,214 | **1,495,909** | 1,776,279 | 1,888,511 |
| Royalties to the State of Israel | | **220,691** | 242,608 | 250,146 | **145,318** | 181,116 | 179,027 |
| | | **7,878,256** | 6,887,919 | 7,046,293 | **3,988,675** | 4,323,942 | 4,467,264 |
| Operating income | | **1,391,548** | 1,093,349 | 1,017,187 | **971,016** | 906,619 | 979,804 |
| **Financing expenses, net** | 23 | **(217,529)** | (157,522) | (165,316) | **(93,216)** | (62,372) | (117,134) |
| Earnings after financing expenses | | **1,174,019** | 935,827 | 851,871 | **877,800** | 844,247 | 862,670 |
| **Other income (expenses), net** | 24 | **79,680** | (983,178) | (1,206,704) | **109,904** | (846,948) | (1,207,182) |
| Earnings (loss) before income tax | | **1,253,699** | (47,351) | (354,833) | **987,704** | (2,701) | (344,512) |
| **Income tax** | 11 | **(497,485)** | (48,013) | (207,333) | **(387,079)** | (33,513) | (229,641) |
| Earnings (loss) after income tax | | **756,214** | (95,364) | (562,166) | **600,625** | (36,214) | (574,153) |
| **Equity in earnings (losses) of investee companies** | 8 | **(134,773)** | (343,334) | (353,616) | **20,200** | (401,622) | (338,622) |
| **Minority share in loss (earnings) of a consolidated company** | | **(616)** | 862 | 3,007 | **–** | – | – |
| Net earnings (loss) for the year | | **620,825** | (437,836) | (912,775) | **620,825** | (437,836) | (912,775) |
| **Primary and diluted earnings (loss) per NIS 1 par value of common shares (in NIS)** | 25 | **0.238** | (0.179) | (0.379) | **0.238** | (0.179) | (0.379) |

* Concerning termination of adjustment for inflation according to the December 2003 CPI, see Note 2

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

## Statements of Changes in Shareholders' Equity

| | Share capital | Capital reserve – share premium | Capital reserve in respect of transactions between the Company and a controlling shareholder | Dividend proposed after the balance sheet date | Retained earnings (deficit) | Total |
|---|---|---|---|---|---|---|
| | Adjusted for the effects of inflation in shekels of December 2003 | | | | | |
| | NIS thousands | | | | | |
| **Balance as at January 1, 2002** | 6,116,378 | 938,134 | 37,775 | – | 410,568 | 7,502,855 |
| **Changes in 2002 –** | | | | | | |
| Net loss | – | – | – | – | (912,775) | (912,775) |
| Dividend proposed subsequent to balance sheet date | – | – | – | 186,416 | (186,416) | – |
| **Balance as at December 31, 2002** | 6,116,378 | 938,134 | 37,775 | 186,416 | (688,623) | 6,590,080 |
| **Changes in 2003 –** | | | | | | |
| Net loss | – | – | – | – | (437,836) | (437,836) |
| Dividend paid | – | – | – | (186,416) | 1,070 | (185,346) |
| Allotment of shares | 192,755 | 685,289 | – | – | – | 878,044 |
| **Balance as at December 31, 2003** | 6,309,133 | 1,623,423 | 37,775 | – | (1,125,389) | 6,844,942 |

| | Share capital | Capital reserve – share premium | Capital reserve in respect of transactions between the Company and a controlling shareholder | Dividend proposed after the balance sheet date | Retained earnings (deficit) | Total |
|---|---|---|---|---|---|---|
| | Reported amounts* | | | | | |
| | NIS thousands | | | | | |
| **Balance as at January 1, 2004** | 6,309,133 | 1,623,423 | 37,775 | – | (1,125,389) | 6,844,942 |
| **Changes in 2004 –** | | | | | | |
| Net earnings | **–** | **–** | **–** | **–** | **620,825** | **620,825** |
| **Balance as at December 31, 2004** | **6,309,133** | **1,623,423** | **37,775** | **–** | **(504,564)** | **7,465,767** |

* Concerning termination of adjustment for inflation according to the December 2003 CPI, see Note 2

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

## Statements of Cash Flows for the Year Ended December 31

| | Consolidated | | | Company | | |
|---|---|---|---|---|---|---|
| | 2004 | 2003 | 2002 | 2004 | 2003 | 2002 |
| | Reported amounts* | Adjusted for the effects of inflation in shekels of December 2003 | | Reported amounts* | Adjusted for the effects of inflation in shekels of December 2003 | |
| | | NIS thousands | | | NIS thousands | |
| **Cash flows from operating activities** | | | | | | |
| Net earnings (loss) | **620,825** | (437,836) | (912,775) | **620,825** | (437,836) | (912,775) |
| Adjustments to reconcile net earnings (loss) to net cash flows generated by operating activities (see A below) | **2,229,157** | 3,129,841 | 3,742,957 | **1,489,789** | 2,553,040 | 3,324,909 |
| Net cash flow generated by operating activities | **2,849,982** | 2,692,005 | 2,830,182 | **2,110,614** | 2,115,204 | 2,412,134 |
| **Cash flows from investing activities** | | | | | | |
| Investment in fixed assets | **(1,650,557)** | (1,413,803) | (1,353,916) | **(842,224)** | (853,166) | (876,038) |
| Proceeds from disposal of fixed assets and sale of operations | **131,576** | 86,492 | 24,690 | **44,897** | 7,742 | 12,895 |
| Proceeds from disposal of investment in affiliated companies | **–** | – | 116,816 | **–** | – | 116,203 |
| Investment in long-term deposits and investments | **(42,064)** | (159,564) | (286,270) | **(42,064)** | (150,808) | (279,930) |
| Realization of long-term deposits and investments | **18,094** | 77,216 | 159,745 | **18,094** | 67,176 | 149,614 |
| Increase in short-term investments, net | **135,602** | (107,137) | (754,311) | **135,509** | (107,137) | (769,565) |
| Decrease (increase) in materials and spare parts | **625** | (260) | 22,769 | **625** | (260) | 22,769 |
| Acquisition of companies consolidated for the first time (see C below) | **(246,935)** | – | (3,861) | **–** | – | – |
| Investment in investee companies | **(142,753)** | (190,037) | (359,517) | **(2,376,699)** | (188,542) | (472,414) |
| Dividend from a subsidiary | **–** | – | – | **18,838** | – | – |
| Investments in other assets | **(130,700)** | (51,124) | (126,328) | **(2,598)** | | (8,824) |
| Net cash outflow used for investment activities | **(1,927,112)** | (1,758,217) | (2,560,183) | **(3,045,622)** | (1,224,995) | (2,105,290) |
| **Cash flows from financing activities** | | | | | | |
| Issue of other debentures (after deduction of issue expenses) | **1,528,092** | – | 106,986 | **1,322,171** | – | 106,986 |
| Repayment of other debentures | **(601,481)** | (207,623) | (221,386) | **(601,481)** | (207,623) | (221,386) |
| Receipt of long-term loans | **314,900** | 493,191 | 207,332 | **–** | – | – |
| Repayment of long-term loans | **(2,605,012)** | (557,302) | (826,605) | **(354,469)** | (378,828) | (619,755) |
| Receipt (repayment) of short-term bank credit, net | **(56,612)** | (374,137) | 75,938 | **–** | – | – |
| Proceeds from allotment of shares | **–** | 878,044 | – | **–** | 878,044 | – |
| Dividend paid | **–** | (185,346) | – | **–** | (185,346) | – |
| Net cash generated by (used for) financing activities | **(1,420,113)** | 46,827 | (657,735) | **366,221** | 106,247 | (734,155) |
| **Increase (decrease) in cash and cash equivalents** | **(497,243)** | 980,615 | (387,736) | **(568,787)** | 996,456 | (427,311) |
| **Cash and cash equivalents at beginning of year** | **1,954,350** | 973,735 | 1,361,471 | **1,896,518** | 900,062 | 1,327,373 |
| **Cash and cash equivalents at end of year** | **1,457,107** | 1,954,350 | 973,735 | **1,327,731** | 1,896,518 | 900,062 |

* Concerning termination of adjustment for inflation according to the December 2003 CPI, see Note 2

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

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

| | Consolidated | | | Company | | |
|---|---|---|---|---|---|---|
| | 2004 | 2003 | 2002 | 2004 | 2003 | 2002 |
| | Reported amounts* | Adjusted for the effects of inflation in shekels of December 2003 | | Reported amounts* | Adjusted for the effects of inflation in shekels of December 2003 | |
| | | 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 | **2,092,475** | 2,160,011 | 2,270,214 | **1,495,909** | 1,776,279 | 1,888,511 |
| Disposal of assets and provision for impairment of fixed assets | **–** | 327,295 | – | **–** | 198,686 | – |
| Deferred taxes | **219,975** | (137,670) | 30,149 | **113,330** | (182,167) | 63,829 |
| Company's equity in (earnings) losses of affiliated companies | **134,773** | 343,334 | 353,616 | **(20,200)** | 401,622 | 338,622 |
| Minority share in (losses) earnings of a consolidated company | **616** | (862) | (3,007) | **–** | – | – |
| Increase (decrease) in employee severance benefits, net | **(110,334)** | 46,488 | (280,971) | **(112,974)** | 47,662 | (286,269) |
| Loss (gain) from disposal of fixed assets | **(7,338)** | (1,634) | (12,739) | **(5,674)** | (1,570) | (12,254) |
| Gain from sale of an operation | **(35,033)** | – | – | **(35,033)** | – | – |
| Provision for decrease in value of investments | **26,000** | 14,603 | 1,219,566 | **26,000** | 14,603 | 1,219,566 |
| Erosion (appreciation) of and interest on long-term deposits and investments | **31,199** | 36,407 | (204,341) | **(6,023)** | 36,407 | (204,341) |
| Erosion (appreciation) of short-term investments, net | **(10,584)** | (75,381) | 56,916 | **(10,555)** | (75,378) | 55,509 |
| Appreciation (erosion) of long-term liabilities: | | | | | | |
| Other debentures | **115,674** | 207,133 | 204,985 | **115,674** | 207,133 | 204,985 |
| Long-term loans and other long-term liabilities | **(17,104)** | (77,647) | (13,380) | **(9,971)** | (82,015) | 13,951 |
| Amortization of other assets and deferred expenses | **110,083** | 127,191 | 229,645 | **6,098** | (8,466) | 11,444 |
| Changes in asset and liability items: | | | | | | |
| Increase in broadcasting rights | **(17,516)** | – | – | **–** | – | – |
| Decrease (increase) in trade receivables | **52,827** | 29,835 | 29,422 | **50,501** | 67,096 | 97,636 |
| Decrease (increase) in other receivables and debit balances | **(8,223)** | 129,706 | 4,885 | **(54,988)** | 163,158 | (27,828) |
| Decrease (increase) in inventory | **(122,824)** | 78,083 | (44,803) | **–** | – | – |
| Increase (decrease) in trade payables | **(102,466)** | (123,852) | 51,057 | **(23,124)** | (30,925) | 110,564 |
| Increase (decrease) in other current liabilities | **(126,652)** | 63,054 | (131,416) | **(26,451)** | 45,460 | (123,727) |
| Decrease in deferred revenues | **3,609** | (16,253) | (16,841) | **(12,730)** | (24,545) | (25,289) |
| | **2,229,157** | 3,129,841 | 3,742,957 | **1,489,789** | 2,553,040 | 3,324,909 |

* Concerning termination of adjustment for inflation according to the December 2003 CPI, see Note 2

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

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

| | Consolidated | | | Company | | |
|---|---|---|---|---|---|---|
| | 2004 | 2003 | 2002 | 2004 | 2003 | 2002 |
| | Reported amounts* | Adjusted for the effects of inflation in shekels of December 2003 | | Reported amounts* | Adjusted for the effects of inflation in shekels of December 2003 | |
| | NIS thousands | | | NIS thousands | | |
| **B – Non–cash transactions** | | | | | | |
| Acquisition of fixed assets, other assets, materials and spare parts on credit | **102,687** | 313,119 | 208,253 | **25,553** | 180,463 | 126,481 |
| Sale of fixed assets on credit | **1,196** | – | 5,800 | **1,196** | – | 5,800 |
| Investment against a loan to a consolidated company | **–** | – | – | **2,560,089** | – | – |
| **C – Company consolidated for the first time and assumption of full control of a proportionally consolidated company (Note 2DD)** | | | | | | |
| Operating capital (excluding cash and cash equivalents) | **2,057,632** | – | 6,504 | – | – | – |
| Fixed assets | **(2,967,819)** | – | (6,018) | – | – | – |
| Long-term liabilities | **2,322,740** | – | 794 | – | – | – |
| Minority loans to a consolidated company | **1,048,637** | – | – | – | – | – |
| Less minority share in the deficit | **(1,048,637)** | – | – | – | – | – |
| Minority rights as of acquisition date | **(16,549)** | – | 723 | – | – | – |
| Investment in an affiliate | **178,339** | – | 1,066 | – | – | – |
| Goodwill | **(1,821,278)** | – | (6,930) | – | – | – |
| | **(246,935)** | – | (3,861) | – | – | – |

* Concerning termination of adjustment for inflation according to the December 2003 CPI, see Note 2

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

## NOTE 1 – GENERAL

**A.** "Bezeq" The Israel Telecommunication Corp. Limited ( “the Company”) is a "mixed company", and as such certain provisions of the Government Companies Law, 5735-1975 apply to it, as well as certain provisions, similar to those in that law, by virtue of its Articles of Association. The Company operates under a general license for implementing telecommunications activities and providing telecommunications services, which was granted pursuant to the Telecommunications Law (Telecommunications and broadcasts), 5742-1982 (“the Telecommunications Law”). The Company, together with the subsidiaries (“the Group”), is a main provider of communications services in Israel.

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

On December 5, 2004 the Minister of Communications notified Pelephone that he and the Minister of Finance intend to act for amendment of the regulations so that from January 1, 2006, the royalties rate paid by the cellular companies will be reduced each year by 0.5%, until reduced to a rate of 1%.

**C.** Pursuant to an agreement reached between the Company and Pelephone, from September 2004, Pelephone ceased certain payments to the Company. Until that date, Pelephone paid the Company 3% of a defined list of revenues from cellular services.

**D.** The Company was declared a monopoly in the principle fields in which it operates. An appeal filed by the Company against the non-revocation of the declaration of the Company as a monopoly in the basic telephony field, is pending in the Antitrust Tribunal.

**E.** All the segments of operation of the Group operate in a competitive environment. The Group's operations are generally subject to administrative regulation and supervision. The principal changes that occurred during the period of the financial statements are described below:

**(1) Domestic fixed-line communication services**

a. Most of the tariffs for the Company's services are set according to Section 15 of the Communications Law and are updated in accordance with the regulations. In the future, tariffs will be updated on the basis of the change in the Consumer Price Index ("CPI") less an efficiency factor ("the Efficiency Factor"), which was set at minus 2.5% as long as the average rate of the Company's growth and output is within the range of minus1% to minus 3% per year (the Efficiency Factor will decrease by one half of one percent with each decrease of one percentage point in the growth rate beyond minus 3%, and will increase by one half of one percent with each rise of one percentage point in the growth rate beyond minus 1%, successively). This tariff arrangement will be in effect until December 31, 2007, with an option to extend it for an additional year. These changes in the Company's tariffs have caused a decrease in revenues and the operating income of the Company. The Company believes, based on its projections, that the mechanism for updating the tariffs as described above will have a materially adverse effect on its revenues and operating income.

b. In November 2003 a partnership owned by the cable companies was granted a general license for providing domestic fixed-line telecommunications services, including telephony, data communications and access to internet providers. The partnership is obligated to gradually provide its services nationwide. In November 2004 the partnership commenced providing services under its license on a commercial basis.

c. In June 2003 the Communications Law was amended so that from September 2004, special general licenses will be able to be granted for providing domestic fixed-line services without an obligation for providing universal service and without an obligation to provide services in a minimum number of areas.

## NOTE 1 – GENERAL (CONTD.)

**E (Contd.)**

**(1) Domestic fixed-line communication services (contd.)**

d. On July 5, 2004, regulations were published relating to procedures and conditions for the receipt of a special general license for the provision of domestic fixed-line communications services with no universal service obligation. Under the regulations, the licensee is to be the owner and operator of the telecommunications network by means of which the services are to be provided to its subscribers, but at the same time, the licensee will be entitled to use the infrastructure of others, provided that it is the owner and operator of the switch via which the services are provided to its subscribers.

e. On November 30, 2004, the Ministry of Communications published a policy paper regarding "Licensing the provision of telephony service by means of broadband access (VOB) of a domestic fixed-line operator". The Company submitted its position against this policy. In the meantime, the Ministry of Communications began to grant licenses to several entities, among them Bezeq International, for a " trial marketing for payment" to provide domestic fixed-line communication services in accordance with the policy paper it published, which allows such trials in certain circumstances.

f. On August 1, 2004, a temporary provision took effect which provided that interconnect fees would not be paid for calls between the Company's network and a domestic operator's network for the earlier of a period of two years or until a difference of up to 1.05 billion traffic minutes is generated between the Company's network and that of the domestic operator (other than a special domestic operator and the Company). Pursuant to a letter received from the Ministry of Communications, the Company will receive compensation for non-payment of these interconnect fees up to the sum of approximately NIS 40 million, by way of amendment of the Royalties Regulations.

The Company expressed its objection to this arrangement because in its opinion, the arrangement harms it and its property, there is no similar precedent anywhere in the world, and it could generate distortions, market failure and abuse. Therefore, on July 29, 2004, the Company filed a petition in the High Court of Justice against the aforesaid temporary provision, claiming *ultra vires*, discrimination and harm to the Company's property. The Company also claimed that whilst the arrangement regarding non-payment of the interconnect fee is supposed to take effect on August 1, 2004, there is no corresponding arrangement in force for the compensation promised to the Company. Following the filing of the petition, a letter was sent on August 4, 2004 from the Minister of Communications and the Minister of Finance, enclosing a draft amendment to the Royalties Regulations and clarifying that they intend to act to amend the Royalties Regulations in such a way as to guarantee the aforesaid compensation to the Company, and that in the event that the amendment of the Royalties Regulations does not come into force, they will act to suspend the temporary provision until such amendment is effected. On September 22, 2004, the Knesset Finance Committee approved insertion of the aforementioned amendment to the Royalties Regulations. To date, the State and the cable companies have filed their responses to the petition and a preliminary hearing has been held, following which the Company filed an amended petition. The case is scheduled for hearing on April 14, 2005.

g. The Economic Policy for 2005 Bill (Legislative amendments), 5765-2004 ("the Economic Policy Amendment Bill"), proposes an amendment to the Communications Law whereby the Minister will prepare a numbering plan for number portability with regard to a general licensee (including a special general licensee) and with regard to a general licensee for the provision of cellular services, and will direct regarding its implementation and operation by February 1, 2006. The Ministers of Communications and Finance will determine the payment structure for this matter in a way that will ensure full transparency and prevent any discrimination. At a meeting of the Knesset Joint Finance and Economics Committee on March 3, 2005, the Ministry of Communications proposed that it be prohibited to collect payment both from a subscriber who transfers with a number to the network of another operator and from the operator to which the subscriber transfers.

**NOTE 1 – GENERAL (CONTD.)**

**E (Contd.)**

**(1) Domestic fixed-line communication services (contd.)**

g. (Contd.)
In the present configuration of the Company's network number portability cannot be implemented, and its modification will require considerable investment in changing software versions and hardware in the Company's switching network. The operation of number portability also involves costs in respect of joint records and management with the relevant operators. These are very significant costs that cannot yet be estimated. Number portability is expected to facilitate customer transfer between competing communications operators. As at the date of publication of the financial statements, the Company is of the opinion that it will be unable to implement number portability within the timeframe proposed in the above bill.

**(2) Cellular services**

a. In July 2003 the Minister of Communications issued a decision stating that the compensation in respect of bad debts that the Company deducts from the amounts it transfers to the cellular companies will be set at 1.1%, in the period from October 2, 2000 to August 31, 2003. The decision also states that from September 1, 2003 onwards, the Company will not make any compensatory deduction from the amounts it transfers to them.

The Company appealed the decision of the Minister in the District Court, arguing that the rate of the deduction stated in the decision, and its cancellation from September 2003, do not reflect the bad debts and the collection expenses incurred by the Company.

On August 9, 2004 the Company received the decision of the Court, which stated that it is not competent to hear the appeal, and therefore the appeal had been stricken. On October 13, 2004 the Company approached the Minister of Communications with a request that he re-examine his decision in the light of the Ministry's position as presented in relation to interconnect fees to the cellular network (see section b. below) and the economic findings that were presented by the Ministry of Communications in support of that position. The Ministry rejected the Company's position.

In the financial statements of the Company as at December 31, 2003 and 2002, expenses of approximately NIS 29 million and NIS 59.6 million, respectively, were recorded in respect of the possible effects of the decision of the Minister of Communications on the rate of the deduction from the volume of traffic for the relevant periods.

b. On December 5, 2004 the Minister of Communications notified Pelephone and the Company that as part of a process for re-examination of interconnect fees to a cellular network, the Ministry of Communications had decided to amend the Communications Regulations (Telecommunications and broadcasts) (Payment for interconnect), 5760-2000 (“the Regulations”) in a way that will reduce the interconnect fees to a cellular network for call completion, SMS messages and the computation of the duration to be charged.

The main amendments are:
(1) Reduction of payments receivable from a domestic operator or a cellular operator for the completion of one traffic minute on a cellular network from 45 agorot per traffic minute to a maximum tariff of 32 agorot, as from March 1, 2005, to a maximum tariff of 29 agorot as from March 1, 2006, to a maximum tariff of 26 agorot as from March 1, 2007 and a maximum tariff of 22 agorot as from March 1, 2008.
(2) Reduction of payments receivable from an international licensee for completion of a traffic minute on a cellular network from 25 agorot per minute to a maximum tariff of 22 agorot per minute, as from March 1, 2008.

**NOTE 1 – GENERAL (CONTD.)**

**E (Contd.)**

**(2) Cellular services (contd.)**

(3) Reduction of payments receivable from a cellular operator for the transfer of an SMS message in a cellular network from 28.5 agorot per traffic minute to a maximum tariff of 5 agorot per minute as from March 1, 2005 and 2.5 agorot per minute as from March 1, 2006.

(4) From March 1, 2006, an annual updating mechanism will be introduced for call completion and SMS tariffs in a cellular network, whereby the tariffs will be updated once a year according to the rate of change in the CPI.

(5) For counting the traffic minutes for computation of the payment for call completion to a cellular network, from January 1, 2009, billing will be according to segments of one second rather than 12 seconds as is customary today.
In addition, the Ministry intends to examine whether there is justification for enabling the cellular operators to collect an initial payment for initiating a call.

In addition, in 2005 a hearing will be held on the intention to introduce changes in the structure of the tariff to the consumer for the cellular calls, so that starting on a reasonable date to be determined, there will be no distinction between the price of a call within a network and a call from one cellular network to another network, and the price will also include the interconnect component. The issue will be examined by a joint team of the Ministry of Communications and the Treasury.

**(3) International communication services**

On April 22, 2004 the Communications Regulations (Telecommunications and broadcasts) (Procedures and conditions for receipt of a general license to provide international telecommunication services), 5764-2004.

The Ministry of Communications granted general licenses to provide international telecommunication services to three additional companies, all of which had commenced operation by the end of 2004. The broadening of competition has led to a further lowering of international call prices, although unlike when competition started in 1997, the volume of international traffic has not increased significantly as a result, since in the period prior to the broadening of the competition, the cost of the calls was not a factor that deterred the public from using the service. In addition, the broadening of the competition had an adverse effect on the results of operations of Bezeq International and its financial position, however, since prices in the market have not yet stabilized, Bezeq International and the Company are unable to estimate, at this stage, the extent of the overall effect of the broadening of competition in the field.

The increasing competition and the entirety of the changes in the communications market as described above, are expected to have an adverse effect on the business results of the Group. That effect cannot be assessed.

**F.** As part of an offer for sale and public offering pursuant to the Company's prospectus published on May 24, 2004, the State (the Government Companies Authority) and the employee representatives of the Company reached an arrangement regarding compensation to Company employees for the public offering pursuant to the prospectus and for the private sale of the State's shares in the Company (future sale of controlling interest). The arrangement includes conditions for compensation by means of an allotment of 4.71% of the shares of the Company held by the State to Company employees, the employees entitled to the compensation, the term of the arrangement, the price at which the shares will be offered to the employees, the agreed rate of the discount, suspending

conditions etc. It Should be noted that the arrangement embodies a benefit to the employees in a material amount.

## NOTE 2 – REPORTING PRINCIPLES AND ACCOUNTING POLICY

### A. DEFINITIONS

In these financial statements –

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

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

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

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

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

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

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

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

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

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

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

(12) Adjusted value – A nominal historical amount adjusted in accordance with the provisions of Opinions 23, 34 and Opinions 36, 37 and 50.

(13) Reported value – An amount adjusted for inflation to the transition date (December 31, 2003), with the addition of amounts in nominal values added after the transition, and less amounts deducted after the transition date.

(14) Adjusted financial reporting – Financial reporting based on the provisions of Opinions 23, 34, 36, 37 and 50.

(15) Nominal financial reporting – Financial reporting based on reported amounts.

## NOTE 2 – REPORTING PRINCIPLES AND ACCOUNTING POLICY (CONTD.)

### B. DISCONTINUANCE OF ADJUSTMENT OF FINANCIAL STATEMENTS

(1) In October 2001, the Israeli Accounting Standards Board ("IASB") published Accounting Standard No. 12 – "Discontinuance of Adjustment of Financial Statements". Pursuant to this Standard, and Accounting Standard No. 17 of December 2002, the adjustment of financial statements will be discontinued from January 1, 2004. Until December 31, 2003, the Company continued to prepare adjusted statements in accordance with Opinion 36 of the ICPAI. From January 1, 2004, the Company is applying the provisions of the Standard and accordingly, adjustment has been discontinued.

(2) In the past, the Company prepared its financial statements on the basis of historical cost adjusted for the CPI. The adjusted values included in the financial statements as at December 31, 2003 served as the starting point for nominal financial reporting which commenced on January 1, 2004. Additions made during the period were included in nominal values.

(3) Values in respect of non–monetary assets do not necessarily represent market value or an up-to-date economic value, but rather, the reported values of those assets.

(4) In the financial statements, "cost" means cost at the reported value.

(5) All comparative data for prior periods are stated adjusted to the CPI of December 2003.

### C. REPORTING PRINCIPLES

(1) Balance sheets
 a. Non-monetary items are stated at reported values.
 b. Monetary items are stated at historical nominal values as at the balance sheet date.

(2) Statements of operations
 a. Revenues and expenses deriving from non-monetary items or from provisions included in the balance sheet are derived from the difference between the reported value opening balance and the reported value closing balance.
 b. The remaining items of the statement of operations are stated at nominal values.

### D. CONSOLIDATION OF FINANCIAL STATEMENTS

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

(2) A list of the companies whose reports are included in the consolidated financial statements, the percentage of the holding in shares which grant voting rights and the percentage of the holding in shares granting a share in profits, is presented in Appendix A to the financial statements. In addition, a list of companies of the Corporation which were not consolidated is also presented in Appendix A to the financial statements. Regarding a company consolidated for the first time and the assumption by the Company of full control of a proportionally consolidated company – see Note 2DD.

(3) For the purpose of the consolidation, the amounts included in the financial statements of the companies that were consolidated were taken into account after the adjustments necessary in order to apply uniform accounting principles used by the Group.

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

## NOTE 2 – REPORTING PRINCIPLES AND ACCOUNTING POLICY (CONTD.)

### D. CONSOLIDATION OF FINANCIAL STATEMENTS (CONTD.)

(4) b. The excess cost allocated to assets and liabilities is recorded under the appropriate items in the balance sheet.

(5) The Company applies Accounting Standard No. 20 concerning the period of amortization of goodwill. Goodwill is stated in the consolidated balance sheet under "Other assets and deferred charges" and is systematically amortized over its useful life. The amortization period reflects the best estimate of the period in which the Company can expect to derive future economic benefits from the goodwill.

The Standard applies to financial statements for periods commencing on or after January 1, 2004. The change in the amortization period of goodwill balances as at January 1, 2004 is treated as a prospective change of estimate ("from now on"). Such balances will be amortized systematically over the balance of the period remaining for completion of the amortization period determined.

During 2004 the Company changed the goodwill amortization period from 10 years to 20 years, following the first-time application of Accounting Standard No. 20. The effect of the change on the consolidated financial statements is as follows:

| | Data before change of estimate | Effect of change of the estimate | Data stated in the financial statements (after change of estimate) |
|---|---|---|---|
| | NIS thousands | NIS thousands | NIS thousands |
| Amortization expenses | 31,617 | (11,006) | 20,611 |
| Earnings before income tax | 1,242,693 | 11,006 | 1,253,699 |
| Net earnings | 609,819 | 11,006 | 620,825 |
| Earnings per share (NIS) | 0.234 | 0.004 | 0.238 |

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

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

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

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

### E. USE OF ESTIMATES

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

## NOTE 2 – REPORTING PRINCIPLES AND ACCOUNTING POLICY (CONTD.)

### F. CASH AND CASH EQUIVALENTS

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

### G. SECURITIES

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

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

(3) Decrease in value of investments
The Company periodically checks to see whether a non-temporary decrease has occurred in the value of its permanent investments. The review is carried out upon the existence of signs indicating that the value of permanent investments has been impaired, including falling market 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 in management's opinion are based on examination of all the relevant aspects and giving them their proper weight, and which are not of a temporary nature, are recorded in the statement of operations.

### H. PROVISION FOR DOUBTFUL DEBTS

The financial statements include specific provisions for doubtful debts which, in the opinion of management, properly reflect the loss inherent in debts, the collection of which is considered doubtful. In determining whether the provisions are appropriate, management considered, 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, the collateral they provided and the accumulated experience of the Company and its external lawyers who handle the collection of past debts. Doubtful debts which management and its legal advisers believe cannot be collected are written off in the Company's books following a management decision. Advance payment transactions with credit companies for transactions made with customers by credit card for payment in installments, where the risk of collection was transferred in full to the credit companies, are removed in full from the books. The financial statements also include a general provision in respect of doubtful debts.

### I. INVENTORY

Inventory of subscriber equipment and user equipment is stated 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, Pelephone upgrades user equipment for its customers. As a result, inventory includes user equipment returned from customers. The value of the returned inventory is stated at the lower of cost or market value. Inventory also includes spare parts which are used by Pelephone, *inter alia*, for the repair of user equipment as part of the repair service it provides for its customers.

## NOTE 2 – REPORTING PRINCIPLES AND ACCOUNTING POLICY (CONTD.)

### J. MATERIALS AND SPARE PARTS

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

### K. INVESTMENTS IN AFFILIATED COMPANIES

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

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

### L. IMPAIRMENT OF INVESTMENTS IN INVESTEE AND NON–INVESTEE COMPANIES

Regarding impairment of investments in investee and non-investee companies, see G(3) above and BB below.

### M. COMPANY INVESTMENT IN VENTURE CAPITAL FUNDS

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

(2) See also G(3) above.

### N. FIXED ASSETS

(1) Fixed assets are stated at cost.

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

(3) Improvements and enhancements are charged 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 the assets to the business, a provision is recorded accordingly. Regarding provision for the impairment of assets, see section BB below.

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

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

## NOTE 2 – REPORTING PRINCIPLES AND ACCOUNTING POLICY (CONTD.)

### N. FIXED ASSETS (CONTD.)

(6) (Contd.)
Annual depreciation rates:

| | % depreciation | % principal depreciation |
|---|---|---|
| Buildings | 4 | 4 |
| Digital switching equipment | 5-20 | 10 |
| Transmission and power equipment | 10-20 | 20 |
| Network equipment | 5-20 | 5 |
| Subscriber equipment and public telephones | 20 | 20 |
| Motor vehicles | 15 | 15 |
| Internet equipment | 25 | 25 |
| 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) On change of estimate, see Note 9(g).

### O. DEFERRED CHARGES AND OTHER ASSETS

(1) Cost of issue of debentures and raising loans
Costs of issue of debentures and raising loans (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 subscriber acquisition
Since 1999, Pelephone has been capitalizing its net direct costs paid to a third party ("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 over the period of the subscribers' undertaking, which is up to 36 months.

(3) Frequencies
Regarding Pelephone's investment in cellular communication frequencies in third generation technology, see Note 8D(3).

(4) Acquisition of operations (resources)
An acquired operation is stated at cost and in accordance with the present value of the future long-term payments. The cost of the acquisition is amortized on the basis of actual realization of the allocated components and on the basis of the estimated useful life of those components.

### P. DEFERRED TAXES

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

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

## NOTE 2 – REPORTING PRINCIPLES AND ACCOUNTING POLICY (CONTD.)

### P. DEFERRED TAXES (CONTD.)

(1) A temporary difference generated at the time of first recognition of goodwill.

(2) A temporary difference generated at the time of initial recognition of an asset or liability in a transaction which is not a business combination and on the date of first recognition, there is no effect on either book earnings or taxable income (loss for tax purposes).

(3) The adjustment amounts for changes in the purchasing power of the shekel which relate mainly to buildings and land, in accordance with the principles laid down by the IASB.

(4) Investments in investee companies, where the Company does not intend to realize these investments.

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

### Q. CLASSIFICATION OF PROFIT AND LOSS ITEMS

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

### R. REVENUE RECOGNITION

(1) Revenues are attributed to the statement of operations upon being generated on the accruals basis.

(2) The Company does not include in the cellular revenues/expenses items the revenues/expenses from interconnect fees from the cellular operators; rather, they are recorded net in accordance with the tests prescribed in EITF 99-19, since the Company's tariffs (including interconnect fees) are set by the State in regulations. In 2004 these interconnect fees amounted to approximately NIS 1.5 billion (2003 – approximately NIS 1.6 billion, 2002 – approximately NIS 1.9 billion). Interconnect fees at Pelephone, using the same tests, are recorded gross.

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

(4) Revenues from leasing of exchanges and other equipment are recorded proportionally over the term of the agreement, starting on the date of operation.

(5) Revenues from the development of communications infrastructure over a period of up to 12 months are charged upon completion of the work.

(6) Revenues from sales of subscriber equipment are charged upon delivery to the end user.

(7) Revenues from sales of subscriber equipment by installments are charged at their present value upon delivery to the customer. Interest income in respect of these transactions is charged to the statement of operations over the period of the installments by the interest method.

(8) Revenues from Pelephone services are charged proportionally over the term of the agreement or on the date of providing the service.

(9) A consolidated company, D.B.S. Satellite Services (1998) Ltd. ("DBS"), leases digital satellite decoders to its customers under operating leases. The revenues from the lease fees are charged proportionally over the term of the lease agreement.

## NOTE 2 – REPORTING PRINCIPLES AND ACCOUNTING POLICY (CONTD.)

### R. REVENUE RECOGNITION (CONTD.)

(10) DBS collects deposits from its customers for the decoders on the customers' premises in an amount not exceeding the cost of the decoders. Upon termination of the agreement with DBS, the customers are entitled, under the agreement, to the proportional part of the deposit remaining. The revenues from amortization of the deposits is charged to the statement of operations in accordance with the terms of the agreement with the customers over 5 or 10 years.

### S. ADVERTISING EXPENSES

Advertising expenses are charged to the statement of operations as incurred.

### T. SUPPLIER DISCOUNTS

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

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

### U. CAPITALIZATION OF CREDIT COSTS

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

### V. EARNINGS PER SHARE

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

### W. SOFTWARE DEVELOPMENT COSTS

The costs of software development for internal use are treated according to the position paper of the American Institute of Certified Public Accountants – SOP 98-1: Accounting for the Costs of Computer Software Developed or Obtained for Internal Use. The costs of software development for internal use are capitalized after completion of the preliminary design stage, the project is expected to be completed and the software will be used for its designated purpose. The capitalization is halted when the software virtually complete and ready for its designated use. Capitalized software development costs are amortized by the straight-line method according to the estimated useful life of the software. Significant improvements to the software are also capitalized to the cost of the software and current maintenance costs are recorded in the statement of operations.

### X. FOREIGN CURRENCY AND LINKAGE

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

## NOTE 2 – REPORTING PRINCIPLES AND ACCOUNTING POLICY (CONTD.)

### X. FOREIGN CURRENCY AND LINKAGE (CONTD.)

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

| | Consumer Price Index | Exchange rate of the US dollar | Exchange rate of the euro | Consumer Price Index | Exchange rate of the US dollar | Exchange rate of the euro |
|---|---|---|---|---|---|---|
| | | | | % | % | % |
| Year ended December 31, 2004 | **100.6** | **4.308** | **5.877** | **1.207** | **(1.621)** | **6.217** |
| Year ended December 31, 2003 | 99.4 | 4.379 | 5.533 | (1.848) | (7.557) | 11.350 |
| Year ended December 31, 2002 | 101.3 | 4.737 | 4.969 | 6.496 | 7.269 | 27.182 |

### Y. DERIVATIVES

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

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

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

### Z. BROADCASTING RIGHTS

Broadcasting rights in a consolidated company are stated at cost. Costs of broadcasting rights acquired for the screening of films and television programs include the amounts of contracts with suppliers of the rights, with the addition of direct costs incurred in order to adapt said films and programs for screening in Israel. Broadcasting rights are amortized in accordance with their acquisition agreement, based on actual screening (the portion not amortized by the end of the term of the agreement being fully amortized upon termination), or in accordance with the term of the rights agreement. The costs of independent productions which, in the opinion of the consolidated company, can be broadcast a number of times or sold, are charged to the broadcasting rights and amortized on the basis of the estimated duration of their utilization.

### AA. SEGMENTAL REPORTING

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

### BB. IMPAIRMENT OF ASSETS

The Group companies apply Accounting Standard No. 15 – Impairment of assets ( “the Standard”), which defines procedures which the Company must apply in order to ensure that its assets in the consolidated balance sheet are not stated in an amount exceeding their recoverable amount, which is the higher of net selling prices and usage value (the present value of the estimated future cash flows expected to derive from the use and disposal of the asset).

## NOTE 2 – REPORTING PRINCIPLES AND ACCOUNTING POLICY (CONTD.)

### BB. IMPAIRMENT OF ASSETS (CONTD.)

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

In September 2003 the IASB published Clarification No. 1 concerning the accounting treatment of an impairment of an investment in an investee company which is not a subsidiary ("the Clarification"). The Clarification states that in the reporting periods subsequent to the period in which the provision for impairment was first created in respect of an investee company which is not a subsidiary, the investment in the investee company should be stated according to the lower of the recoverable amount and the investment account according to the equity method, where the recoverable amount is calculated in each reporting period in which there are indications that a change has occurred in the recoverable amount. Losses from the impairment of an investment in an investee company that is not a subsidiary, which were recognized or cancelled during the period, are included in the Company's equity in the earnings (losses) of investee companies item.

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

### CC. DISCLOSURE OF THE EFFECT OF NEW ACCOUNTING STANDARDS IN THE PERIOD PRIOR TO THEIR APPLICATION

In July 2004, the IASB published Accounting Standard No. 19 – "Income Taxes". The Standard prescribes that deferred tax liabilities should be recognized for all temporary differences liable to tax, with a small number of exceptions. Similarly, deferred tax assets for all deductible temporary differences, losses for tax purposes and unutilized tax benefits should be recognized where it is anticipated that there will be taxable income against which these may be utilized, with a small number of exceptions. The new standard will apply to financial statements for periods commencing January 1, 2005. The Standard requires that it is to be adopted by way of a cumulative effect of a change in accounting policy. The effect of the transition to Standard No. 19 is not expected to be material.

### DD. COMPANY CONSOLIDATED FOR THE FIRST TIME AND ASSUMPTION OF FULL CONTROL IN A PROPORTIONALLY CONSOLIDATED COMPANY

1. **D.B.S. Satellite Services (1998) Ltd.**

(a) A number of gradual, substantial changes have taken place over recent years in the Company's investment in D.B.S. Satellite Services (1998) Ltd. ("DBS"), principal among them being the percentage of holding, changes in undertakings to invest in and finance DBS, and changes in actual investments. These developments gradually made the Company the dominant interested party in DBS until, upon implementing the resolution of the Board of Directors to inject NIS 440 million into DBS on the terms set out in the resolution, the Company became, for the first time, the sole shareholder financing DBS's operations. The Company therefore gave notice of its intention to consolidate DBS's financial statements from that date. On July 1, 2004, the Board of Directors of the Company resolved to approve that management act to exercise the warrants and on July 19, 2004, the Company applied for regulatory consents, including the approval of the Antitrust Commissioner, to increase its holdings in DBS to more than 50% ("Merger") (see Note 8E).

## NOTE 2 – REPORTING PRINCIPLES AND ACCOUNTING POLICY (CONTD.)

### DD. COMPANY CONSOLIDATED FOR THE FIRST TIME AND ASSUMPTION OF FULL CONTROL IN A PROPORTIONALLY CONSOLIDATED COMPANY (CONTD.)

1. **D.B.S. Satellite Services (1998) Ltd. (Contd.)**

Due to initial comments of the Antitrust Authority prior to submission of notice of the Merger and which indicated a possible difficulty in approving the Merger due to the structure of the communications market, the Company applied to the Securities Authority, requesting its position on the possibility of postponing the date of full consolidation of DBS until it became completely certain that the regulatory approvals could be obtained for the increase in the Company's holdings in DBS to more than 50%. The plenum of the Securities Authority discussed the Company's request on August 17, 2004 and notified the Company that it must commence consolidation of the financial statements of DBS in the Company's financial statements as at June 30, 2004. On June 21, 2004 the Company began to inject funds on account of the aforementioned NIS 440 million, and from that date the financial statements of DBS have been consolidated with those of the Company. From that date the Company has been fully recording its share of the financial results of DBS in its financial statements. In view of the developments described in Note 8E, the Company approached the Securities Authority for its position on the continued need for the consolidation of DBS, and was informed that those developments do not justify halting the consolidation.

(b) Below are the DBS data as included in the consolidated financial statements as a result of the increase in the percentage of the Company's holding:

| | On the date of acquisition of control | December 31, 2004 |
|---|---|---|
| | NIS thousands | NIS thousands |
| **Balance sheet** | | |
| Operating capital (excluding cash and cash equivalents) | **(1,795,696)** | **(488,290)** |
| Fixed assets and broadcasting rights, net | **1,204,051** | **1,242,562** |
| Long-term liabilities | **(20,862)** | **(1,288,726)** |
| Minority loans to a consolidated company | **(1,048,637)** | **(1,049,534)** |
| Less minority share in deficit | **1,048,637** | **1,049,534** |
| Minority rights | **16,549** | **10,412** |
| Goodwill | **776,511** | **759,809** |
| **Statement of Operations** | | |
| Revenue | | **542,122** |
| Net loss | | **(160,396)** |
| Group’s equity in the loss | | **(160,396)** |

(c) The total of goodwill generated following consolidation of DBS’s financial statements for the first time amounts to approximately NIS 452,000. The goodwill derives from non-participation of the minority in the capital deficit in which the minority is not a guarantor and in respect of which it extended no loans.

2. **Pelephone Communications Ltd.**

(a) On August 26, 2004 the exercise of the option to purchase the remaining 50% of the shares of Pelephone from the Shamrock Group transaction was finally completed (increase of the Company's holding from 50% to 100%). With completion of the transaction, all the shares of Pelephone are now fully owned by the Company (see Note 8D(2)).

## NOTE 2 – REPORTING PRINCIPLES AND ACCOUNTING POLICY (CONTD.)

### DD. COMPANY CONSOLIDATED FOR THE FIRST TIME AND ASSUMPTION OF FULL CONTROL IN A PROPORTIONALLY CONSOLIDATED COMPANY (CONTD.)

2. **Pelephone Communications Ltd. (Contd.)**

(b) Below are the Company data included in the consolidated financial statements as a result of the increase in the percentage of holding:

| | On the date of acquisition of control | December 31, 2004 |
|---|---|---|
| | NIS thousands | NIS thousands |
| **Balance sheet** | | |
| Operating capital (excluding cash and cash equivalents) | **(171,938)** | **(422,447)** |
| Cash | **25,465** | **43,344** |
| Fixed assets, net | **1,527,962** | **3,093,675** |
| Long-term liabilities | **(2,391,877)** | **(3,071,711)** |
| Other assets | **235,806** | **440,531** |
| Goodwill | **1,044,767** | **1,026,698** |
| Investment in an affiliated company | **2,215** | **519** |
| **Statement of Operations** | | |
| Revenue | | **1,324,164** |
| Net earnings | | **(124,334)** |
| Group's equity in the earnings | | **(124,334)** |

(c) The total of goodwill generated following the first-time consolidation of Pelephone's financial statements amounts to approximately NIS 1,045 million.

3. **Goldnet Communication Services – Registered Partnership**

In 2002 the financial statements of Goldnet Communication Services – Registered Partnership were consolidated for the first time, when the Company's holding increased from 49% to 54%. See also Appendix A(4).

## NOTE 3 – CASH AND CASH EQUIVALENTS

| | Consolidated | | Company | |
|---|---|---|---|---|
| | December 31 2004 | December 31 2003 | December 31 2004 | December 31 2003 |
| | Reported amounts | Adjusted for the effects of inflation in shekels of December 2003 | Reported amounts | Adjusted for the effects of inflation in shekels of December 2003 |
| | NIS thousands | NIS thousands | NIS thousands | NIS thousands |
| Israeli currency | **1,425,433** | 1,913,373 | **1,322,168** | 1,891,995 |
| Foreign currency | **31,674** | 40,977 | **5,563** | 4,523 |
| | **1,457,107** | 1,954,350 | **1,327,731** | 1,896,518 |

## NOTE 4 – SHORT-TERM INVESTMENTS

| | Consolidated | | Company | |
|---|---|---|---|---|
| | December 31 2004 | December 31 2003 | December 31 2004 | December 31 2003 |
| | Reported amounts | Adjusted for the effects of inflation in shekels of December 2003 | Reported amounts | Adjusted for the effects of inflation in shekels of December 2003 |
| | NIS thousands | NIS thousands | NIS thousands | NIS thousands |
| Marketable securities: | | | | |
| Government bonds | | | | |
| Linked to the CPI | **309,701** | 599,819 | **309,701** | 599,819 |
| Unlinked | **465,187** | 167,498 | **465,187** | 167,498 |
| Linked to the U.S. dollar exchange rate | **1,346** | 23,605 | **1,346** | 23,605 |
| Securities tradable abroad | **139,035** | 136,769 | **139,035** | 136,769 |
| Corporate bonds | **127,111** | 24,208 | **127,111** | 24,208 |
| Short-term loan | **41,006** | 14,653 | **41,006** | 14,653 |
| Shares and options | **43,354** | 50,736 | **43,354** | 50,736 |
| Mutual fund participation certificates | **137,585** | 147,195 | **137,585** | 147,195 |
| Debentures convertible to shares | **1,595** | 28,514 | **1,595** | 28,514 |
| | **1,265,920** | 1,192,997 | **1,265,920** | 1,192,997 |
| Short-term bank deposits: | | | | |
| Linked to the CPI | **–** | 130,850 | **–** | 130,850 |
| Unlinked | **21,889** | 16,494 | **20,000** | 16,401 |
| | **1,287,809** | 1,340,341 | **1,285,920** | 1,340,248 |

For a discussion of the management of capital funds raised to finance employee retirement costs, see Note 16D.

## NOTE 5 – TRADE RECEIVABLES

| | Consolidated | | Company | |
|---|---|---|---|---|
| | December 31 2004 | December 31 2003 | December 31 2004 | December 31 2003 |
| | Reported amounts | Adjusted for the effects of inflation in shekels of December 2003 | Reported amounts | Adjusted for the effects of inflation in shekels of December 2003 |
| | NIS thousands | NIS thousands | NIS thousands | NIS thousands |
| On open account | **1,550,725** | 1,306,088 | **732,669** | 844,170 |
| Income receivable | **240,912** | 273,101 | **225,579** | 205,767 |
| Credit cards and checks receivable | **458,456** | 273,289 | **175,696** | 154,286 |
| Investee companies | **–** | 75,886 | **33,125** | 31,629 |
| Current maturities of long-term trade receivables | **293,261** | 97,330 | **–** | – |
| | **2,543,354** | 2,025,694 | **1,167,069** | 1,235,852 |
| Less provision for doubtful accounts | **428,284** | 358,071 | **196,303** | 214,585 |
| | **2,115,070** | 1,667,623 | **970,766** | 1,021,267 |

## NOTE 6 – OTHER RECEIVABLES AND DEBIT BALANCES

| | Consolidated | | Company | |
|---|---|---|---|---|
| | December 31 2004 | December 31 2003 | December 31 2004 | December 31 2003 |
| | Reported amounts | Adjusted for the effects of inflation in shekels of December 2003 | Reported amounts | Adjusted for the effects of inflation in shekels of December 2003 |
| | NIS thousands | NIS thousands | NIS thousands | NIS thousands |
| Deferred tax asset (see Note 11D) | **237,319** | 208,797 | **159,023** | 170,213 |
| Income tax refundable | **7,660** | 13,254 | **5,570** | 14,561 |
| Prepaid expenses | **86,082** | 49,091 | **22,081** | 28,866 |
| Receivables in respect of derivatives | **76,627** | 114,372 | **76,394** | 113,867 |
| Other receivables and debit balances | **8,425** | 29,858 | **107,216** | 36,452 |
| | **416,113** | 415,372 | **370,284** | 363,959 |
| Including consolidated companies | **–** | – | **99,486** | – |

## NOTE 7 – INVESTMENTS, DEPOSITS AND DEBIT BALANCES

| | Consolidated | | Company | |
|---|---|---|---|---|
| | December 31 2004 | December 31 2003 | December 31 2004 | December 31 2003 |
| | Reported amounts | Adjusted for the effects of inflation in shekels of December 2003 | Reported amounts | Adjusted for the effects of inflation in shekels of December 2003 |
| | NIS thousands | NIS thousands | NIS thousands | NIS thousands |
| Investment in shares – companies that are not investee companies | **25,954** | 48,389 | **22,389** | 48,389 |
| Other investments (1) | **301,437** | 352,011 | **301,437** | 352,011 |
| Bank deposit for granting loans to employees (2) | **203,196** | 211,078 | **203,196** | 211,078 |
| Investment in venture capital funds | **19,769** | 19,769 | **19,769** | 19,769 |
| Long-term loan receivable (CPI + 6.25%) | **23,750** | – | **23,750** | – |
| Receivables in respect of derivatives | **–** | 23,153 | **–** | 23,153 |
| Long-term trade receivables(3) | **298,469** | 111,571 | **–** | – |
| | **872,575** | 765,971 | **570,541** | 654,400 |

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

(1) Other investments

a. Linkage and interest terms

| | | Consolidated and Company | |
|---|---|---|---|
| | | December 31 2004 | December 31 2003 |
| | | Reported amounts | Adjusted for the effects of inflation in shekels of December 2003 |
| | Interest rate | NIS thousands | NIS thousands |
| Convertible corporate bonds linked to the U.S. dollar | 6 month LIBOR + 3.4 | **30,156** | 30,653 |
| | 3 month LIBOR + 1.65 | **30,156** | 30,653 |
| Investments in fund – euro investments* | – | **35,261** | 33,199 |
| CPI-linked investments: | | | |
| Capital notes: | 5.8 - 5.9 | **125,988** | 109,860 |
| Galil convertible bonds ** | 4 | **79,876** | 78,368 |
| Convertible corporate bonds | 4.95 | **-** | 49,278 |
| Unlinked deposit | Variable 14.5 | **-** | 20,000 |
| | | **301,437** | 352,011 |

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

(•) As part of its financial activities, the Company is in need of various banking services which are provided by Deutsche Bank ("the Bank"), among others. These banking services include, *inter alia*, trading in securities, in foreign currency, in debentures and in derivatives, and the management of financial assets. The services are provided to the Company by the Global Markets division of the Bank, which is completely separate – internally, structurally, personnel-wise and managerially, from the Global Corporate Finance division which prepared, among other items, valuations for the Company as part of a framework agreement for the provision of financial advice services between the Company and the Bank. In 2002, 2003 and 2004 the Company paid Deutsche Bank for financial advisory services, approximately $1.2 million, $1.1 million and $0.74 million, respectively. In addition, Pelephone Holdings paid the Bank approximately $3 million in 2001. During 2004 the Company terminated the receipt of the financial advisory services from Deutsche Bank.

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

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

(1) Other investments (Contd.)

b. Repayment dates

| | NIS thousands |
|---|---|
| 2006 | **–** |
| 2007 | **60,312** |
| 2008 | **–** |
| 2009 | **–** |
| 2010 and thereafter | **241,125** |
| | **301,437** |

(2) The deposit is unlinked and the average weighted monthly interest rate is approximately 0.33%. The Company is responsible for the loans to the employees. The deposit serves as collateral for the bank to extend loans to Company employees.

(3) Long-term receivables

a. Linkage and interest terms

| | | Consolidated | |
|---|---|---|---|
| | | December 31 2004 | December 31 2003 |
| | Interest rate | Reported amounts | Adjusted for the effects of inflation in shekels of December 2003 |
| | | NIS thousands | |
| Linked to the CPI | 7.5 | **20,252** | 17,983 |
| Unlinked | 7.1 | **562,743** | 190,918 |
| Linked to the U.S. dollar | | **8,735** | - |
| | | **591,730** | 208,901 |
| Less current maturity | | **293,261** | 97,330 |
| | | **298,469** | 111,571 |

b. Repayment dates

| | NIS thousands |
|---|---|
| 2005 | **293,261** |
| 2006 | **216,474** |
| 2007 | **79,284** |
| 2008 | **1,892** |
| 2009 and thereafter | **819** |
| | **591,730** |

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

c. The balance of long-term receivables is presented net of deferred interest income which constitutes the difference between the amount of the original debt and its present value on the day of recognition of the revenue and after deducting a provision for doubtful debts in the amount of NIS 50,167,000 (for December 31, 2003 – NIS 34,700,000, constituting NIS 17,350,000 in proportional consolidation).

d. In 2004, Pelephone made transactions with credit companies for the final clearance of current debts amounting to NIS 276 million (2003 – NIS 170 million, which is NIS 85 million in proportional consolidation.

## NOTE 8 – INVESTMENTS IN INVESTEE COMPANIES

### A. Composition:

| | Consolidated | | Company | |
|---|---|---|---|---|
| | December 31 2004 | December 31 2003 | December 31 2004 | December 31 2003 |
| | Reported amounts | Adjusted for the effects of inflation in shekels of December 2003 | Reported amounts | Adjusted for the effects of inflation in shekels of December 2003 |
| | NIS thousands | NIS thousands | NIS thousands | NIS thousands |
| **Affiliated companies** | | | | |
| Shares – cost | **164,006** | 137,170 | **90,921** | 64,085 |
| Long-term loans (1) | **1,386,504** | 1,270,587 | **1,357,861** | 1,248,544 |
| Post–acquisition losses | **(1,168,064)** | (1,052,937) | **(1,100,760)** | (990,673) |
| Increase in holding percentage – company consolidated for the first time | **(178,339)** | – | **(180,555)** | – |
| Provision for impairment in respect of an affiliated company – see Section G below | **(59,196)** | (59,196) | **(38,078)** | (38,078) |
| Amortization of goodwill | **(74,603)** | (54,957) | **(74,259)** | (54,690) |
| | **70,308** | 240,667 | **55,130** | 229,188 |
| **Consolidated subsidiaries** | | | | |
| Shares – cost | | | **703,046** | 430,646 |
| Loans | | | **4,733,726** | 168,262 |
| Increase in holding percentage – company consolidated for the first time and assumption of full control of a proportionally consolidated company | | | **1,194,844** | – |
| Post–acquisition losses | | | **(161,345)** | (251,480) |
| Provision for impairment | | | **(4,716)** | (4,716) |
| Amortization of goodwill | | | **(36,209)** | (1,074) |
| | | | **6,429,346** | 341,638 |
| **Proportionally consolidated company** | | | | |
| Shares – cost | | | **485,065** | 503,903 |
| Post-acquisition earnings | | | **490,080** | 395,228 |
| Increase in holding percentage – acquisition of minority share | | | **(1,014,289)** | – |
| Amortization of surplus equity over cost charged to fixed assets | | | **39,144** | 39,144 |
| | | | **–** | 938,275 |
| | | | **6,484,476** | 1,509,101 |

## NOTE 8 – INVESTMENTS IN INVESTEE COMPANIES (CONTD.)

### A. COMPOSITION (CONTD.):

(1) Loan balances of approximately NIS 177 million linked to the CPI ("known"), bearing 5.5% annual interest and for which no repayment date has yet been set (preferred loans – see E below).
Loan balances of approximately NIS 446 million linked to the CPI ("known"), bearing annual interest of approximately 11%, for which no repayment date has yet been set (preferred loans – see also E. below).
Loan balances of Pelephone amounting to approximately NIS 16.4 million, linked to the CPI and bearing annual interest of 7.5% and for which no repayment date has yet been set.
Loan balances of Bezeq International to Walla Communications Ltd. (a listed affiliate) (hereinafter – "Walla") amounting to approximately NIS 6 million, linked to the CPI and interest-free. The loans will be repaid on a date soon after the date on which Bezeq International invests in Walla.
The loan balances are linked to the CPI ("known"), bear no interest and no repayment date has yet been set.

The market value of Walla, a listed company, as at December 31, 2004, is approximately NIS 44.4 million (book value NIS 14.4 million).

| | Consolidated | | Company | |
|---|---|---|---|---|
| | December 31 2004 | December 31 2003 | December 31 2004 | December 31 2003 |
| | Reported amounts | Adjusted for the effects of inflation in shekels of December 2003 | Reported amounts | Adjusted for the effects of inflation in shekels of December 2003 |
| | NIS thousands | NIS thousands | NIS thousands | NIS thousands |
| Goodwill not yet fully amortized – consolidated in respect of investee companies | **1,797,691** | 347,046 | **1,792,658** | 352,831 |

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

### B. INVESTMENT ACTIVITY IN 2004 IS AS FOLLOWS:

| | Consolidated | Company |
|---|---|---|
| | NIS thousands | NIS thousands |
| Balance as at the beginning of the year | **240,667** | **1,509,101** |
| Movement during the year: | | |
| Investment in shares | **26,836** | **299,236** |
| Increase in holding percentage | **(178,339)** | **–** |
| Dividend from a subsidiary | **–** | **(18,838)** |
| Investment in loans | **115,917** | **4,637,552** |
| Erosion in respect of loans | **–** | **37,225** |
| Equity in losses of affiliates | **(134,773)** | **20,200** |
| Balance as at the end of the year | **70,308** | **6,484,476** |

## NOTE 8 – INVESTMENTS IN INVESTEE COMPANIES (CONTD.)

### C. SUMMARY OF COMPANY EQUITY IN ASSETS, LIABILITIES, REVENUE AND EXPENSES OF A PROPORTIONATELY CONSOLIDATED COMPANY, AS INCLUDED IN THE CONSOLIDATED STATEMENTS (SEE ALSO NOTE 2DD)

| | December 31 2003 |
|---|---|
| | Adjusted for the effects of inflation in shekels of December 2003 |
| | NIS thousands |
| Current assets | 594,577 |
| Other assets | 1,875,712 |
| Current liabilities | 838,626 |
| Long-term liabilities | 693,388 |

| | For the period ended August 26, 2004* | For the year ended December 31 2003 | 2002 |
|---|---|---|---|
| | Reported amounts | Adjusted for the effects of inflation in shekels of December 2003 | |
| | NIS thousands | NIS thousands | NIS thousands |
| Revenues | **1,658,452** | 1,899,709 | 1,823,267 |
| Costs and expenses | **1,438,414** | 1,803,052 | 1,885,295 |

* On August 26, 2004 the transaction for exercise of the option to purchase the remaining 50% of the shares of Pelephone was finally closed. Since that date, Pelephone has been wholly owned by the Company. See Note 2DD(2).

### D. PELEPHONE COMMUNICATIONS LTD.

(1) Following various indications of a decrease in the value of Pelephone and as a result of valuations of Pelephone prepared by Deutsche Bank(•) and received during 2002, according to which the estimated value of Pelephone was between $650 million and $850 million, in 2002 the Company wrote off its investment in debentures convertible to shares in a corporation from the Shamrock Group (hereinafter – Pelephone Holdings). The write-off was effected since the bank financing obtained by Shamrock for purchasing the Pelephone shares (approximately $380 million, including interest) is secured by a first-ranking lien, and no available balance remained for repayment of the debentures issued to the Company by Shamrock. The write-down was included in the "Other expenses, net" item, and as a result, net earnings in 2002 were reduced by approximately NIS 1.2 billion.

(•) See footnote in Note 7(1)a.

## NOTE 8 – INVESTMENTS IN INVESTEE COMPANIES (CONTD.)

### D. PELEPHONE COMMUNICATIONS LTD. (CONTD.)

(2) On August 26, 2004, after receipt of approvals from the Ministerial Committee on Privatization, the Minister of Communications and the Antitrust Commissioner for the merger of Bezeq, Pelephone Holdings and Pelephone, the transaction for exercise of the option was finally closed when the Company exercised an option to purchase the remaining 50% of Pelephone's shares in consideration of an exercise price of US $60 million (approximately NIS 270 million). In addition, immediately prior to closing the option exercise, Pelephone distributed to its shareholders a dividend of approximately US $8.3 million (about NIS 38 million). With the closing of the exercise transaction as aforesaid and conversion of the convertible debentures (of a par value of $240 million, stated in the financial statements at zero value), the Company extended a loan of NIS 1,766 million (US $394 million) to Pelephone Holdings, which was used for actual clearance of the balance of the loans it had taken from the bank to finance part of the cost of purchasing the Pelephone shares. After the closing of the transaction as aforesaid, the Company recorded NIS 1,045 million of goodwill through purchase. The goodwill will be amortized over a period of 20 years, which is the expected period of economic benefit.

It is noted that the approval of the Antitrust Commissioner was made contingent upon a number of conditions which in the opinion of the Company restrict business or commercial cooperation between the Company and Pelephone even more than the restriction relating to structural separation that is written into the Company's general license. It is further noted that on October 10, 2004, the Company was served with an appeal filed in the Antitrust Court by Cellcom, petitioning for revocation of the Merger approval. According to Cellcom, the Antitrust Commissioner erred in deciding to approve the Merger, and the Company should therefore be ordered to sell the recently-purchased Pelephone shares or alternatively, to make the Merger contingent upon additional conditions. In the opinion of the legal advisers of the Company, the chances that the petition will be allowed in a way that will lead to revocation of the transaction are smaller than the chances that the petition will be dismissed, and it is difficult to estimate the chances of the possibility that the court will make the Merger contingent upon additional conditions. However, they do believe that the conditions of the Merger laid down by the Antitrust Commissioner are harsh ones for the Company and for Pelephone.

Towards the end of the year, Pelephone Holdings transferred all its assets (including Pelephone shares) and liabilities to the Company, and as a result, all Pelephone shares are wholly owned by the Company. Pelephone Holdings is currently in voluntary liquidation.

(3) On December 18, 2001, the Minister of Communications notified Pelephone that it had won a tender for an additional band of frequencies which would be used for cellular communications with third generation technology. Following the award of the tender, Pelephone's existing license was amended so as to extend its term until 2022. The grant of the frequencies was made contingent upon preconditions that include, *inter alia*, payment of NIS 225 million (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 to guarantee the terms of the license, which was amended in 2004 to $10 million. The payment determined at the award is to be paid in six installments on various dates through 2006. On the contract for purchase of the frequencies, see also Note 19B(5).

### E. D.B.S. SATELLITE SERVICES (1998) LTD.

In January 1999 DBS received a license from the Ministry of Communications for satellite television broadcasts and commenced provision of services in July 2000. DBS suffers from considerable losses and negative cash flows. Its losses for 2004 amount to approximately NIS 366 million and its negative operating cash flows from current activities amounts to approximately NIS 74 million. As a result of these losses, the capital deficit and working capital deficit of DBS as at December 31, 2004 amount to approximately NIS 3,189 million and NIS 471 million respectively.

## NOTE 8 – INVESTMENTS IN INVESTEE COMPANIES (CONTD.)

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

The Company's investment in DBS (mainly shareholders' loans) as at the balance sheet date was approximately NIS 1,497 million (nominal). The Company's equity in the accumulated losses (from the relevant purchase dates) of DBS is approximately NIS 1,270 million, of which approximately NIS 267 million was recorded during the year of account. The balance of DBS's current debt to the Company and its consolidated companies amounts to approximately NIS 68 million.

At the beginning of May 2002 the Company was allotted additional shares in DBS, thereby increasing its holding to 44.9%. In August 2003 yet more shares were allotted to the Company, brining its holding in DBS to 49.8%. This increase in the Company holdings in DBS created goodwill of approximately NIS 391 million for the Company. On the amortization of the goodwill, see Note 2D(5).

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

On August 6, 2003, an agreement amending the Financing Agreement (hereinafter – the Amendment Agreement) was executed by the Banks and by DBS. Under the Amendment Agreement, the Banks will provide DBS with additional sums to those provided under the Financing Agreement and an additional credit facility approved in December 2002, subject to DBS's meeting the conditions and milestones set out in the Amendment Agreement, including implementation of additional investments by shareholders in amounts of no less than 150% of the amounts to be provided by the Banks. The Amendment Agreement came into force in December 2003. Pursuant to the Amendment Agreement, during 2004 DBS converted short-term credit of a total amount of NIS 1,276 million to long-term loans.

Following the approval for additional investments by the Company in DBS (see below), negotiations were completed in July 2004 between DBS and the Banks, following which a further amendment to the Amendment Agreement was signed, in which it was agreed to amend the conditions that DBS was required to fulfill. As at December 31, 2004, DBS is meeting those amended conditions.

The Company has signed a perpetual guarantee in favor of the Banks for the payment of DBS's debts. The guarantee is up to a maximum amount equal to the percentage of the Company's holdings in DBS multiplied by the value of DBS as derives from disposal of the pledged shares of the remaining shareholders. If the Company joins the sale in the framework of disposing of the pledged shares of remaining shareholders, the amount of the guarantee will not exceed the proceeds that the Company will receive from the disposal of its shares in DBS. The deed of guarantee includes numerous restrictions on the Company with respect to disposing the shares it holds, and details circumstances of violations which, if committed, will enable the Banks to call in the guarantee. The Company also undertook to put its shares up for sale in the event of sale of the pledged shares by the Banks, and agreed that in the event of exercise of the securities given by the other shareholders, the Company will waive repayment of the Shareholders' loans given to DBS, and that its guarantee will apply also, *mutatis mutandis*, to the options and the right to receive them.

The shareholders in DBS, with the exception of one shareholder, made a commitment to the Banks not to object to the sale or other exercise of their charged or guaranteed (by the Company) shares in DBS, in such a way as to enable the Banks to effect the sale and exercise without interference (friendly liquidation).

## NOTE 8 – INVESTMENTS IN INVESTEE COMPANIES (CONTD.)

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

Under an agreement between DBS and its shareholders dated December 30, 2002, it was decided that the loans extended by the shareholders to DBS starting 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 will be entitled to repayment in full by DBS before any distribution of dividends by DBS and/or repayment of the Old Shareholders' Loans extended to DBS by shareholders, this being subject to DBS's cash flow and liabilities under agreements with the Banks (including the priority of repayment of the bank financing). The New Shareholders' Loans are linked to the CPI and bear annual interest of 5.5%. In addition, under the same agreement, the shareholders who invest in the New Shareholders' Loans are permitted to choose between an allotment of shares and options for shares deriving from their investments. On April 25, 2004, the Company received warrants which will enable adjustment of their percentage holding in DBS to the percentage of their investments in it as at March 31, 2004. If the Company's holdings in DBS exceed 50%, exercise of the options by the Company (as opposed to their receipt) will require Government approval, the approval of the Minister of Communications in consultation with the Council for Cable and Satellite Broadcasts and the approval of the Antitrust Commissioner. The warrants are convertible at any time for no additional consideration, and can be transferred as if they were shares, subject to the approvals of the Banks pursuant to the Financing Agreements.

The Old Shareholders' Loans are linked to the ("known") CPI and are interest-free. According to a note of amendment to the aforementioned agreement, the New Shareholders' Loans made in the framework of the Amendment Agreement will be linked to the known CPI plus 11% annual interest. Under the Agreement, any change in the interest rate is subject to the consent of 75% of the shareholders. No date has been set for the repayment of these loans.

Based on a resolution of the Board of Directors of the Company, continued investment in DBS will be effected by way of preferred New Shareholders' Loans, and the Company is to receive warrants for shares in accordance with the existing agreements between DBS and its shareholders. Similarly, the Board of Directors approved the immediate bringing forward of the balance of the investment under the current financing agreement (in the amount of approximately NIS 55 million, provided in full during April-May 2004), against receipt of the aforementioned warrants. Under the present financing agreement of DBS and the level of the Company's investments in DBS, the Company will be entitled to shares, in respect of expected investments in the program, which will bring its holdings to approximately 60%, and/or warrants for shares which, if exercised, will bring its holdings to the same percentage (all presuming that an additional shareholder meets its full obligations under the present financing agreement, and if not, the Company will be entitled to shares bringing its holdings to approximately 61%; the Management of the Company considers that the additional shareholder will meet its obligations). The additional shareholder has, at this stage, provided approximately $ 4.3 million on account of the aforesaid undertaking.

On March 9, 2004, the Board of Directors of DBS approved a multi-year work plan for 2004 and 2005 (hereinafter – the Work Plan), *inter alia*, following a report commissioned by the Company from an external economic consulting firm on the business condition of DBS, which was presented to the Board of Directors of the Company on January 8, 2004. The economic report reveals a negative difference between DBS's financing plan and its actual financing requirements during those years. According to the Work Plan, DBS will need significant additional amounts of outside financing in the aforementioned years, over and above the Amendment Agreement.

## NOTE 8 – INVESTMENTS IN INVESTEE COMPANIES (CONTD.)

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

In view of the requirements of DBS, the difficulty in obtaining additional bank financing and the non-participation of the other shareholders in financing DBS beyond the present Financing Agreement, the Board of Directors of the Company adopted a resolution on March 30, 2004, which was later amended, to approve an additional investment (beyond the present Financing Agreement) of approximately NIS 440 million through the end of 2005, which would be made gradually, according to the requirements of DBS and the Work Plan. According to the resolution, which was amended on May 10, 2004, the investment of NIS 440 million will take into account development of regulatory conditions in the communications market that are to the satisfaction of the Company and subsequent to implementation of the Banks' commitment under the present Financing Agreement. In this regard, from time to time, developments will be examined by the Board of Directors of the Company. Similarly, the resolution provided that its implementation is subject to receipt of the required consents and pursuant to the remarks of the Attorney General. Commencing June 21, 2004, the Company began providing sums on account of the NIS 440 million investment. On the commencement of the provision of these aforementioned funds, the financial statements of DBS were consolidated with those of the Company (see Note 2DD(1)).

In the Company's opinion, relying on its legal advisers, continued investment by the Company in DBS does not, in and of itself, require the approval of the authorities provided that the Company has not exercised the warrants allotted to it. The Government Companies Authority notified the Company that the Deputy Attorney General has confirmed that upon the Company's becoming a mixed company, it will no longer require the consent of the Ministerial Committee on Privatization in order to increase the Company's exposure in DBS. Exercise of the warrants does require the approval of the authorities. Likewise, under the articles of association of DBS, DBS will issue shares or convertible securities after the Banks making loans to DBS confirm that such securities are secured in their favor.

At its meeting on July 1, 2004, the Board of Directors of the Company resolved to approve that the Company's Management should act to exercise some of the warrants for shares in DBS. On July 19, 2004 the Company applied for the required regulatory approvals for exercise of the warrants (the Ministerial Committee on Privatization, the Minister of Communications and the Antitrust Commissioner) which, if exercised, would bring the Company's holdings in DBS to approximately 54.75%.

On January 2, 2005 the Antitrust Commissioner gave notice of his consent to approval of the Merger of the Company with DBS, but limited the injection of funds by the Company so that it would not exceed, in the nine-month period from the date of approval of the Merger, its proportional part in the shares of DBS. Most of the funds will be injected by the other DBS shareholders and institutional investors.

On January 6, 2005, the Board of Directors of the Company resolved that in view of the oppressive conditions upon which the Merger had been made contingent, the Company would delay, at this stage, the exercise of the warrants it holds, so that its holdings in DBS would remain, for the time being, at approximately 49.8%. The Board also resolved that the Management of the Company would file an appeal in the Antitrust Court against the Commissioner's decision.

On August 31, 2004. the Minister of Communications notified the Company that, after a preliminary examination of the Company's request that it exercise the options it holds for shares in DBS, he believes that the process raises significant concern of damage to competition in the field of communications. In light of this, the Minister also informed the Company, in his aforementioned letter, that he does not approve its request to exercise the options, and that the Company is required, meantime, until formulation of his decision, not to implement the additional injection of funds (in the amount of NIS 440 million) of which the Company gave notice in its request and of which part had already been transferred to DBS.

## NOTE 8 – INVESTMENTS IN INVESTEE COMPANIES (CONTD.)

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

As part of a process of consolidation and out of a desire to find a pragmatic solution, the Company agreed to cooperate with the Ministry of Communications and to reach an arrangement on the matter of the funding, without prejudice to its legal position in the matter of the authority of the Minister of Communications concerning the injection already made at the time. Under this arrangement, the Company and DBS submitted to the Ministry of Communications the documents and information they requested.

On October 28, 2004, the Board of Directors of the Company was presented with an external legal opinion stating that the Minister of Communications does not have the authority to prevent the Company from injecting funds into DBS. Nevertheless, and without derogating from that legal opinion, the Board of Directors resolved to authorize the Management of the Company to continue talks with the Ministry of Communications on the continued injection of funds into DBS at the same time as the Ministry carries out its examination.

In a letter dated December 31, 2004, the Minister of Communications notified the Company that based on the findings of the examination it had carried out and after hearing the arguments of the Company and DBS, he is instructing the Company, in the matter of limiting the aforementioned further injection of funds, to the following format:

a. The total amount of the additional injection will be limited to a maximum of NIS 350 million (rather than NIS 440 million).
b. With reference to the NIS 195 million of the additional funding already injected by the Company into DBS, no additional action will be taken.
c. The balance of the sum, a maximum of NIS 155 million, will be transferred once every quarter in equal parts during 2005, on the following principles:
   (1) The Company's share in the aforementioned amount will not exceed 55% (a maximum of NIS 82.25 million).
   (2) The share of the other shareholders in DBS and of the banks or institutional bodies in transfer of the remainder of the balance, will be not less than 45% (a minimum of NIS 69.75 million).

The Minister of Communications also stated in his letter that in order to provide the time to reach financing agreements based on the principles he had laid down, and as an interim step, the Company may inject funds into DBS, out of its share, without a corresponding transfer from the other shareholders, banks or institutional bodies, provided that the required proportions of such a transfer are fully maintained, no later than April 30, 2005, and that the Company may not grant a guarantee to the shareholders in DBS, the banks or financing institutional bodies, or make any other similar commitment, for securing their part in the additional transfer or in credit provided by them to DBS.

In view of the appointment of a new Minister of Communications, the Company postponed taking legal action on the matter and requested that the new Minister re-examine the decision of the outgoing Minister from December 31, 2004.

The new Minister concluded that there was no justification for changing the aforementioned decision. However, taking into consideration the arguments of the Company and DBS in the matter of the need for time to implement the directive, she has seen fit to allow staggered implementation of the outgoing Minister's decision in the following manner:

a. The Company will be able to inject 75% of the maximum amount by the end of June 2005 (i.e. an additional NIS 10 million beyond the amount it has transferred to date out of the maximum amount), provided that up to that date the proportions of the transfer decided upon by the outgoing Minister are fully maintained.

## NOTE 8 – INVESTMENTS IN INVESTEE COMPANIES (CONTD.)

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

b. The Company will be able to inject the remainder of the maximum amount (NIS 21.25 million) during the period July 1, 2005, through the end of 2005, provided that the proportions of the transfer are maintained as set out in the outgoing Minister's directive.

In view of this decision of the new Minister of Communications, the Company filed a legal claim in the Jerusalem District Court for a declaratory decision determining that the decision of the [former] Minister had been made *ultra vires* and was therefore void. On February 23, 2005 DBS filed a claim in the District Court for declaratory relief against the Minister of Communications. The claim filed by DBS requested that the Court give declaratory orders whereby the decision of the Minister of Communications from December 31, 2004, is void, oppressive and invalid, and that the decision of the [new] Minister of Communications from February 14, 2005, not to cancel the decision of the Minister is, for the most part, also null and void. In response to the aforementioned claim, the Ministry of Communications applied to the court, requesting that the proceeding be transferred to a Supreme Court proceeding.

In the opinion of the Company, the instructions contained in the notice of the Minister are significantly damaging to DBS and to the Company as the principal shareholder in DBS.

On February 17, 2005, the Board of Directors of the Company resolved that it stands behind its resolution from March 2004 as amended in May 2004, to invest in DBS according to the approved Work Plan, together with the other shareholders and financial bodies. The Ministry of Communications notified the Company that should it transpire that the Company is taking the law into its own hands and is violating the directive of the Minister, the Ministry of Communications will be compelled to adopt the means of enforcement available to it for ensuring compliance with the terms of the Company's license, including calling in the bank guarantee (see Note 19C(2)).

As at the date of approval of the financial statements, the Company had completed its part in the shareholders' loans in accordance with the Amendment Agreement. The Company injected into DBS, as at December 31, 2004, the sum of NIS 218.5 million on account of the Work Plan. Subsequent to the balance sheet date the Company injected into DBS another NIS 36 million. As at the date of publication of these financial statements, warrants for shares, if exercised, will increase the Company's holdings in DBS to approximately 57.5%.

Without derogating from its arguments and legal steps as described above, the Company approached the other shareholders in DBS, and all in view of the position of the Antitrust Commissioner and the Minister of Communications as explained above. At a meeting of DBS's shareholders on January 16, 2005, the two representatives of the additional shareholders gave notice that they intend to recommend to the appropriate bodies in their companies that they participate in the additional injections in the amounts of NIS 20 million and NIS 10 million into DBS. The recommendations for the additional injections will be in a situation whereby DBS will also have resources from the other shareholders (including the Company) in order that it may fulfill its business plan and without legal proceedings being instituted in which the interim relief which will be sought could halt the process. Since the date of the aforementioned decision through the date of approval of the financial statements, one other shareholder injected NIS 5 million into DBS and another shareholder injected another NIS 2 million.

DBS's continued operations are conditional upon the continued receipt of shareholders' loans, including loans from the Company pursuant to DBS's Work Plan.

Management of DBS and the Company believe, that, in view of the decision of the shareholders to continue investing in DBS according to the Work Plan, the chances of arranging the financial resources that it will require in the coming year are good.

## NOTE 8 – INVESTMENTS IN INVESTEE COMPANIES (CONTD.)

### F. WALLA! COMMUNICATIONS LTD.

Bezeq International invested in Walla! Communications Ltd. (hereinafter – Walla), an Israeli company which is listed on the Tel Aviv Stock Exchange and which provides internet services and operates internet portals. As at December 31, 2004, Bezeq International holds 44.97% of the rights in Walla.

Under the investment agreement between Bezeq International and Walla, Bezeq International undertook to invest a total of $5.9 million in Walla, either directly or through a strategic investor. By December 31, 2004, Bezeq International had invested a total of approximately NIS 80 million through investment in shares in and provision of loans to Walla. These investments, on the dates they were made, constitute the total investment approved by the Government of Israel that Bezeq International may invest in Walla. As at December 31, 2004, Bezeq International had met its entire prospectus and contractual undertaking to invest in Walla.

As part of Bezeq International's aforementioned investments in Walla, Bezeq International extended loans to Walla during 2003 and 2002 which were linked to the CPI and interest-free, and which amounted, as at December 31 2004 and 2003, to NIS 5,755 thousand and NIS 13,945 thousand, respectively. Repayment of the balance of these loans as at December 31, 2004, will be on a date soon after the date of which Bezeq International invests in the share capital of Walla.

In February 2004 Walla published a prospectus for an offering of warrants to its existing shareholders by way of rights. Bezeq International made a prior commitment to exercise options (Series 3) in a total amount equal to the balance of the shareholders' loans that it had provided to Walla as at September 30, 2003 (approximately NIS 14 million). Bezeq International's commitment is subject to the provisions of Section 328 of the Companies Law, i.e., Bezeq International will not exercise warrants in such a way that after exercise it will hold more than 45% of the issued share capital of Walla, except in compliance with the provisions of the law.

In March 2004, Bezeq International purchased 7,073,980 warrants (Series 3) (36.74% of all of the options offered) for a consideration of NIS 1,414,000, which was set off against the aforementioned shareholders' loans. During 2004, Bezeq International exercised 3,786,940 warrants (Series 3) in consideration of NIS 6,816,000, which was offset against the balance of the aforementioned shareholders' loans. Following exercise of the aforementioned warrants, the percentage of Bezeq International's holding in Walla increased from 36.74% on December 31, 2003 to 44.97% as at the date of signing these financial statements (at full dilution, as at December 31, 2004 – 34.2%).

Subsequent to the balance sheet date, Walla issued 231,121 ordinary shares and 192,600 warrants (Series 3) to other shareholders through a private placement. As a result thereof, and following additional exercise of warrants subsequent to the balance sheet date, the percentage of Bezeq International's holding in Walla decreased to 44.52% (at full dilution – 33.88%).

During 2002, Bezeq International reduced the book value of its investment in Walla by NIS 13,089 thousand. The balance of Bezeq International's investment in Walla after that reduction, plus the additional investment it made by way of loans, reflected, in the opinion of Bezeq International's Management, the fair economic value of Walla to Bezeq International at that time.

## NOTE 8 – INVESTMENTS IN INVESTEE COMPANIES (CONTD.)

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

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

In view of the uncertainty regarding the realization of Adanet's business plan as written and regarding the outcome of the discussions with the banks for arranging the financing required by Adanet, there was considerable concern regarding the continued existence of Adanet as a going concern. On November 10, 2003, Adanet filed an application for a stay of proceedings order while formulating a rescheduling and recovery plan for the Adanet group. Later, and in the absence of consensus among the banks, the stay of proceedings order was canceled and temporary liquidation orders were issued against Adanet and its subsidiaries or temporary receivers were appointed for their assets. Due to the financial condition of Adanet and the proceedings described above, in 2003 the Company wrote off the balance of its investment in Adanet.

In February 2004 the Company received a letter from the temporary liquidator of Adanet and some of the Adanet Group companies, in which it is claimed that the Company had made a commitment to provide the financing required for the current operations of the companies through March 31, 2004, as well as additional financing. In the opinion of the Company, in view of Adanet's situation, the basis for the undertaking made by the Company, if and insofar as made, no longer exists, and therefore it rejected the claims of the liquidator and made no provision in its financial statements. In any case, the Company considers that there is no significant exposure arising from from the liquidator's claims.

On March 29, 2004, the Court allowed the application of the temporary liquidator, who had meanwhile been appointed special administrator, to investigate the circumstances that led to the collapse of Adanet. On May 17, 2004, the special administrator sent summonses for questioning to five senior employees of the Company who were involved in Adanet's activities (some of them served as directors in Adanet). In addition, on December 14, 2004, the liquidator filed an application in court for the provision of various documents, and a proceeding is in progress on the matter. It should be made clear that the filing of a claim by the liquidator against a third party (including shareholders), is subject to the approval of the court which is overseeing the liquidation proceeding. The liquidator has not yet filed an application in this matter. In the opinion of the Company, relaying on its legal advisers, it is not possible at this stage to assess the future steps of the liquidator regarding the possibility that he make a request that a claim be filed against the Company, concerning the causes of action that will be claimed and concerning the chances of his claims.

### H. B-ONE GENERAL PARTNERSHIP

In May 2003, Pelephone, Bezeq International and BezeqCall established the general partnership B-ONE (the Partnership). The purpose of the Partnership is the marketing of complete communications services to the customers of the three companies. The Partnership will assist in increasing the sale of the products and services of the parties to the agreement, as a main interface point with customers who purchase products and services through it and which are supplied to them directly by each of the partners.

## NOTE 9 – FIXED ASSETS

### A. COMPOSITION AND ACTIVITY

### Consolidated

| | Land & buildings | Switching, transmission and power equipment | Network equipment | Subscriber equipment | Motor Vehicles | Office equipment and computers | Total |
|---|---|---|---|---|---|---|---|
| | Reported amounts | | | | | | |
| | NIS thousands | | | | | | |
| **Cost –** | | | | | | | |
| Balance as at January 1, 2004 | 2,270,543 | 11,934,296 | 11,837,432 | 633,127 | 202,606 | 1,507,184 | 28,385,188 |
| Additions | **39,880** | **772,909** | **177,021** | **361,948** | **1,450** | **266,556** | **1,619,764** |
| Addition to cost in respect of a company consolidated for the first time | **89,691** | **3,887,623** | **–** | **1,920,469** | **34,613** | **576,132** | **6,508,528** |
| Disposals (1) | **(29,645)** | **(1,833,934)** | **(40,018)** | **(73,844)** | **(47,935)** | **(176,823)** | **(2,202,199)** |
| Balance as at December 31, 2004 | **2,370,469** | **14,760,894** | **11,974,435** | **2,841,700** | **190,734** | **2,173,049** | **34,311,281** |
| **Accumulated depreciation –** | | | | | | | |
| Balance as at January 1, 2004 | 1,418,951 | 7,982,099 | 8,902,804 | 298,298 | 136,740 | 821,854 | 19,560,746 |
| Additions | **103,335** | **1,086,196** | **348,903** | **273,824** | **23,066** | **257,151** | **2,092,475** |
| Accumulated depreciation in respect of a company consolidated for the first time | **52,230** | **2,518,191** | **–** | **944,338** | **18,622** | **366,114** | **3,899,495** |
| Cancellation in respect of disposals (1) | **(26,760)** | **(1,756,123)** | **(40,018)** | **(68,307)** | **(42,826)** | **(173,059)** | **(2,107,093)** |
| | **1,547,756** | **9,830,363** | **9,211,689** | **1,448,153** | **135,602** | **1,272,060** | **23,445,623** |
| **Provision for impairment –** | | | | | | | |
| Balance as at January 1, 2004 | 2,371 | 115,467 | – | – | 66 | 7,420 | 125,324 |
| Balance as at December 31, 2004 | **2,371** | **115,467** | **–** | **–** | **66** | **7,420** | **125,324** |
| **Net book value –** | | | | | | | |
| As at December 31, 2004 | **820,342** | **4,815,064** | **2,762,746** | **1,393,547** | **55,066** | **893,569** | **10,740,334** |
| As at December 31, 2003 | 849,221 | 3,836,730 | 2,934,628 | 334,829 | 65,800 | 677,910 | 8,699,118 |

## NOTE 9 – FIXED ASSETS (CONTD.)

### A. COMPOSITION AND ACTIVITY (CONTD.)

### Company

| | Land & buildings | Switching, transmission and power equipment | Network equipment | Subscriber equipment | Motor Vehicles | Office equipment and computers | Total |
|---|---|---|---|---|---|---|---|
| | Reported amounts | | | | | | |
| | NIS thousands | | | | | | |
| **Cost –** | | | | | | | |
| Balance as at January 1, 2004 | 2,185,096 | 7,606,426 | 11,837,432 | 613,351 | 147,423 | 794,821 | 23,184,549 |
| Additions | **16,125** | **310,274** | **177,021** | **190,544** | **195** | **153,252** | **847,411** |
| Disposals (1) | **(23,935)** | **(1,573,950)** | **(40,018)** | **(65,684)** | **(36,787)** | **(167,503)** | **(1,907,877)** |
| | **2,177,286** | **6,342,750** | **11,974,435** | **738,211** | **110,831** | **780,570** | **22,124,083** |
| **Accumulated depreciation -** | | | | | | | |
| Balance as at January 1, 2004 | 1,374,222 | 5,292,899 | 8,902,804 | 284,194 | 107,414 | 404,399 | 16,365,932 |
| Additions | **89,890** | **750,555** | **348,903** | **146,221** | **14,236** | **146,104** | **1,495,909** |
| Cancellation in respect of disposals (1) | **(23,633)** | **(1,573,950)** | **(40,018)** | **(65,684)** | **(32,901)** | **(167,503)** | **(1,903,689)** |
| | **1,440,479** | **4,469,504** | **9,211,689** | **364,731** | **88,749** | **383,000** | **15,958,152** |
| **Provision for impairment -** | | | | | | | |
| Balance as at January 1, 2004 | – | 35,482 | – | – | – | – | 35,482 |
| Balance as at December 31, 2004 | **–** | **35,482** | **–** | **–** | **–** | **–** | **35,482** |
| **Net book value –** | | | | | | | |
| As at December 31, 2004 | **736,807** | **1,837,764** | **2,762,746** | **373,480** | **22,082** | **397,570** | **6,130,449** |
| As at December 31, 2003 | 810,874 | 2,278,045 | 2,934,628 | 329,157 | 40,009 | 390,422 | 6,783,135 |

(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 2004, fully depreciated fixed assets with a cost of approximately NIS 1,847 million (2003 – NIS 1,769 million) were written off the consolidated and Company books.

(2) The cost includes the amount of NIS 6,658 thousand in the Company and NIS 9,274 thousand consolidated, which constitute real financing expenses in respect loans and credit which were capitalized during the construction period, calculated at an average real interest rate of approximately 6.5% per annum (prior year – 7.4%).

## NOTE 9 – FIXED ASSETS (CONTD.)

**B.** Most of the real estate assets used by the Company were transferred to it by the State under an agreement dated January 31,1984 and for the consideration detailed therein. 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.

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

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

**C.** The Company's holdings in the satellite corporation Intelsat, which was privatized in 2001 when every member of Intelstat became a shareholder proportionate to the percentage of its investment therein, is 0.7405%. In addition, the Company had a holding of 0.8% in a subsidiary spun-off from Intelsat called New Skies Satellites N.V. NSS ("NSS").

On November 17, 2004, the Company received approximately $8 million in respect of its share of the proceeds from the sale of the activity, assets and liabilities of NSS. A capital gain in the full amount of the consideration was recorded during 2004.

In addition, on November 17, 2004, notice was received from Intelsat confirming the intention to sell the corporation for consideration, of which the Company's share amounts to approximately $23 million. The sale transaction was completed on January 28, 2005 at its original price. A capital gain in the full amount of the consideration will be recorded in the first quarter of 2005.

**D.** As at December 31, 2004 Pelephone had a commitment to purchase terminal assets during 2005 in a total amount of NIS 501 million.

**E.** As at the balance sheet date there are agreements to purchase fixed assets amounting to approximately NIS 956 million consolidated and approximately NIS 224 million in the Company (the amounts include the assets referred to in D above).

## NOTE 9 – FIXED ASSETS (CONTD.)

**F.** In September 2003, the Board of Directors of the Company adopted a resolution to close the Inmarsat station (a satellite communications station) and to try to sell the equipment and/or operation. In view of the uncertainty as to the consideration it would receive, if any, a loss of approximately NIS 35 million due to impairment of assets was recorded in the financial statements which was attributed to fixed assets, which was included under the "other expenses" item in the statement of operations. The Ministry of Communications notified the Company that it is not authorized to decide on the closure of the station. Consequently, the Company (with the knowledge of the Ministry of Communications) contacted representatives of the Ministry of Defense and the Israel Defense Forces ("IDF") in an attempt to reach an arrangement for termination of the service. IDF representatives stated unequivocally that the Inmarsat service is an essential service that the IDF cannot forgo. In light of this, the Company is now examining a number of possible actions, including sale of the service (with the consent of the Ministry of Defense, the IDF and the Ministry of Communications), introduction of a strategic partner or continued operation of the service while significantly reducing its costs.

**G. Depreciation policy**

1. Pursuant to the Company's policy of periodically re-examining the useful lives and the values of its assets, a committee was appointed in 2003 to assess the need to update the period of the useful life and value of the assets and to make recommendations to the Management regarding its conclusions. The examination covered only the Company's fixed assets and was based on the balance of its fixed assets as at December 31, 2003. In interim conclusions relating to the value of the assets, the committee found that due to the decline in traffic in the Company's communications network, mainly as a result of the decrease in the number of subscribers and of the decline in dial-up internet traffic, the Company had ceased using equipment having a net book value of approximately NIS 163 million. As a result, in 2003 an expense was recorded in that amount under the "Other expenses" item in the statement of operations. In May 2004, the panel submitted its recommendations to the Management of the Company regarding the estimated useful life of the assets. The panel's recommendations mainly took into consideration the Company's investment plans, technological innovations in fixed-line communications, rates of depreciation used by similar communications companies around the world as well as the regulation and opening of the fixed-line communications market to competition.

   The changes in the estimated useful lives recommended in the report included shortening the life of terminal equipment used for data communications networks from 5 years to 4 years, and shortening the life of new copper cabling from the exchanges to the distribution boxes from 20 years to 15 years. Conversely, it was recommended that the lives of SDH transmission should be extended from 7 years to 8 years, and of the data communications networks (ADSL, ATM) from 5 years to 7 years. The panel also recommended extending the depreciation period of the network in which there was investment until 1991 and which should have been fully depreciated by the end of 2007, through to the end of 2010. Another recommendation was for an estimated useful life for the new transmission systems and data networks which are scheduled for operation in the near future.

   The Company's Management and the Board of Directors adopted the recommendations of the panel and the new depreciation rates have been applied since January 1, 2004. As a result of adoption of the recommendations, the depreciation expense in respect of the Company's existing assets decreased by approximately NIS 77 million in 2004 and in the future will decrease by approximately NIS 74 million in 2005, NIS 62 million in 2006, NIS 75 million in 2007 and will increase by NIS 96 million in 2008.

## NOTE 9 – FIXED ASSETS (CONTD.)

### G. Depreciation policy (Contd.)

2. DBS depreciates its digital satellite decoders ("the Decoders") using the straight-line method, based on the estimated duration of their use. With the accumulation of experience and data during the course of DBS's operations, DBS decided to examine the useful life of the Decoders in June 2004. As part of this examination, DBS received an engineering opinion relating to the useful life of the Decoders. Pursuant to the above opinion, which takes into account, *inter alia*, exposure to technological changes, the useful life of a Decoder is no less than 6 years. Based on the engineering opinion, the depreciation rate for Decoders was changed from 25% to 17%with effect from April 2004. The effect of this change was to decrease the amount of depreciation in 2004 by approximately NIS 59 million. Based on the balance of the cost of the Decoders as at December 31, 2004, the change will reduce the amount of depreciation in 2005 by NIS 37 million.

3. The following shows the effects of the above on the Company's financial statements:

| | Data before change of estimate | Effect of the change of estimate | Data presented in the financial statements (after the change of estimate) |
|---|---|---|---|
| | Reported amounts | | |
| | NIS thousand | NIS thousand | NIS thousand |
| **For the year ended December 31, 2004** | | | |
| Depreciation expenses | 2,218,642 | (126,167) | 2,092,475 |
| Earnings before income tax | 1,127,532 | 126,167 | 1,253,699 |
| Net earnings | 521,608 | 99,217 | 620,825 |
| Earnings per share (NIS) | 0.200 | 0.038 | 0.238 |

### H. BEZEQ INTERNATIONAL – PROVISION FOR IMPAIRMENT, CHANGE OF ESTIMATE AND REMOVAL OF ASSETS IN 2003

As part of the preparation of its financial statements for 2003, Bezeq International conducted a comprehensive review of the book value of all its fixed assets, as required, *inter alia* for the following reasons: the coming into force of Standard No. 15 of the IASB - Impairment of Assets and the resolution of the Board of Directors of Bezeq International to investigate the implications of the Standard; Bezeq International's assessment regarding market trends in the fields in which it operates, arising from economic research and analyses carried out by Bezeq International, including transactions which Bezeq International contracted into at that time; the possible consequences of the decision of the Ministry of Communications to broaden competition in the international communications market (see Note 1E(3)); and the strategic decisions taken by Bezeq International regarding most of the technology equipment it was using at that time, and its plans to replace it in response to the economic and market changes likely to occur, in Bezeq International's estimation, as a result of the factors listed above.

Following the comprehensive review described above, expenses derived from fixed assets in an aggregate amount of NIS 146.8 million were recorded in 2003. Of this amount, NIS 89.8 million included in the "Other expenses, net" item in the statement of operations for 2003, derived from writing down assets, mainly underwater cables (the international communications market (underwater cables) is characterized by the use of both old transmission technology and more advanced transmission technology, both of which are used by Bezeq International. The costs of operating and maintaining the more advanced transmission technology are considerably lower than those for the old generation equipment), which Bezeq International Management believes, based, among other things, on the opinions of external experts, to have an economic value lower than their book value and/or to have ended their economic life; NIS 21.1 million included mainly in the "Operating expenses" item in the statement of operations for 2003, derives from a change in estimate of the remaining useful economic life of part of Bezeq International's assets as described below; and NIS 35.9 million included in the

## NOTE 9 – FIXED ASSETS (CONTD.)

### H. BEZEQ INTERNATIONAL – PROVISION FOR IMPAIRMENT, CHANGE OF ESTIMATE AND REMOVAL OF ASSETS IN 2003 (CONTD.)

“other expenses, net” item in the 2003 statement of operations, are the result of the removal of assets since they are no longer used.

The amount of the deduction according to Standard No. 15 was determined, *inter alia*, on the basis of the assessments of experts as stated below and the assessments of the Management of Bezeq International of the net sale price, as derived from agreements made by Bezeq International at that time, and the usage value of the assets under review. For the purpose of determining usage value, Bezeq International used, where relevant, a discount rate of 10%.

As part of the comprehensive review of the book value of all its fixed assets which Bezeq International carried out while preparing its financial statements for 2003 as aforesaid, the Management of Bezeq International decided to carry out a comprehensive review of the economic life of its assets. Examination of the said remaining economic life was carried out with the assistance of external and internal experts in the field, mainly for switching equipment and systems, transmission equipment (old-generation undersea cables) and internet equipment. Based on the opinions of these experts, the remaining economic life of the assets examined is shorter than the economic life attributed to them by Bezeq International in the past. Based on these opinions, the economic life of switching equipment and systems was shortened by two years (to 10 years, after the opinion of the external expert was submitted to Bezeq International); the economic life of the transmission equipment (underwater cables) that was examined was estimated mostly at 5-15 years (rather than the 10-20 years used prior to submission to Bezeq International of the opinion of the external expert); and the economic life of internet equipment that was examined was assessed at 4 years (rather than 12 years as was used prior to submission to Bezeq International of the opinion of the external expert). Consequently and relying on the aforementioned opinions, starting from the date of the review, Bezeq International is depreciating the balance of the net book value of the assets which were the subject of those opinions, over the stated periods.

The above change of estimate led to an increase of NIS 21.1 million in depreciation expenses for 2003.

The amount of NIS 35.9 million derived from assets removed due to termination of their use, represents their net book value as at the date of their removal in 2003, and includes mainly the net book value of NIS 24.7 million of old-generation undersea cables which Bezeq International decided would no longer be operated, and the net book value of improvements to leased premises which Bezeq International had vacated, amounting to NIS 4.6 million.

## NOTE 10 – DEFERRED CHARGES AND OTHER ASSETS

### Consolidated

| | Cost | Accumulated amortization | Balance for amortization December 31 2004 | Balance for amortization December 31 2003 |
|---|---|---|---|---|
| | | | Reported amounts | Adjusted for the effects of inflation in shekels of December 2003 |
| | NIS thousands | NIS thousands | NIS thousands | NIS thousands |
| Capitalized subscriber acquisition costs | 809,560 | 695,636 | **113,924** | 79,730 |
| Frequencies (1) | 220,104 | – | **220,104** | 77,948 |
| Acquisition of operations (2) | 43,847 | 13,720 | **30,127** | 18,660 |
| Rights in channels | 5,477 | 3,298 | **2,179** | 2,695 |
| Prepaid long-term expenses in respect of a lease agreement | 8,535 | 399 | **8,136** | – |
| | 1,087,523 | 713,053 | **374,470** | 179,033 |
| Expenses for issue of debentures and raising other loans | | | **13,434** | 11,016 |
| | | | **387,904** | 190,049 |

### Company

| | Balance for amortization December 31 2004 | Balance for amortization December 31 2003 |
|---|---|---|
| | Reported amounts | Adjusted for the effects of inflation in shekels of December 2003 |
| | NIS thousands | NIS thousands |
| **Deferred expenses** | | |
| Expenses for issue of debentures and raising loans and others | **13,434** | 11,016 |

(1) Investment in cellular communication frequencies in third generation technology by Pelephone – see Note 8D(3).

(2) Acquisition of operations –

a. BezeqCall Communications acquired an operation from Nortel networks Israel (Sales and Marketing) Ltd., to obtain independent capability for providing maintenance, support and installation services to its customers. In addition, it entered into a transaction for the acquisition of the operations of Newkol Ltd., which provided NEP services for Coral exchanges and value added services for business customers.

b. In December 2003 Bezeq International acquired all the rights in the operations of Infonet, including expansion of the deployment of global communications networks and access to a wider range of advanced and quality communications services.

## NOTE 11 – TAXES ON INCOME

### A. GENERAL

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

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

### B. INCOME TAX INCLUDED IN THE STATEMENTS OF OPERATIONS

**Consolidated**

| | For the year ended December 31 | | |
|---|---|---|---|
| | 2004 | 2003 | 2002 |
| | Reported amounts | Adjusted for the effects of inflation in shekels of December 2003 | |
| | NIS thousands | NIS thousands | NIS thousands |
| Current taxes | **(277,818)** | (220,452) | (216,192) |
| Deferred taxes | **(154,935)** | 169,588 | (10,786) |
| Adjustment of deferred taxes due to changes in tax rates | **(83,881)** | – | – |
| Taxes for prior years, net | **19,149** | 2,851 | 19,645 |
| | **(497,485)** | (48,013) | (207,333) |

**Company**

| | For the year ended December 31 | | |
|---|---|---|---|
| | 2004 | 2003 | 2002 |
| | Reported amounts | Adjusted for the effects of inflation in shekels of December 2003 | |
| | NIS thousands | NIS thousands | NIS thousands |
| Current taxes | **(274,057)** | (216,941) | (214,062) |
| Deferred taxes | **(49,916)** | 178,351 | (44,466) |
| Adjustment of deferred taxes due to changes in tax rates | **(78,713)** | – | – |
| Taxes for prior years, net | **15,607** | 5,077 | 28,887 |
| | **(387,079)** | (33,513) | (229,641) |

## NOTE 11 – TAXES ON INCOME (CONTD.)

### C. RECONCILIATION BETWEEN THE THEORETICAL TAX ON PRE-TAX ADJUSTED EARNINGS AND THE TAX EXPENSE IN THE BOOKS

### Consolidated

| | For the year ended December 31 | | |
|---|---|---|---|
| | 2004 | 2003 | 2002 |
| | Reported amounts | Adjusted for the effects of inflation in shekels of December 2003 | |
| | NIS thousands | NIS thousands | NIS thousands |
| Tax computed at the regular tax rate | **(438,795)** | 17,046 | 127,740 |
| Increase (saving) in tax liability in respect of: | | | |
| Inflationary erosion of advance tax payments | **(1,585)** | 2,227 | (1,292) |
| Exempt income and capital gains | **2,270** | 1,411 | 38,406 |
| Non-deductible expenses | **(9,652)** | (9,737) | (6,831) |
| Utilization of losses and benefits from prior years for which no deferred taxes were recorded | **50,544** | – | – |
| Losses and timing differences for which deferred tax assets were not created | **(63,833)** | (33,926) | (400,592) |
| Taxes for prior years, net | **19,149** | 2,851 | 19,645 |
| Differences in the definition of equity and non-monetary assets for tax purposes | **24,441** | (27,511) | 15,661 |
| Adjustment of deferred taxes for different tax rates | **(83,881)** | – | – |
| Other | **3,857** | (374) | (70) |
| | **(497,485)** | (48,013) | (207,333) |
| Regular tax rate | **35** | 36 | 36 |

### Company

| | For the year ended December 31 | | |
|---|---|---|---|
| | 2004 | 2003 | 2002 |
| | Reported amounts | Adjusted for the effects of inflation in shekels of December 2003 | |
| | NIS thousands | NIS thousands | NIS thousands |
| Tax computed at the regular tax rate | **(345,696)** | 972 | 124,024 |
| Increase (saving) in tax liability in respect of: | | | |
| Inflationary erosion of advance tax payments | **(469)** | 2,051 | (1,230) |
| Exempt income and capital gains | **2,199** | 1,275 | 38,407 |
| Non-deductible expenses | **(9,022)** | (8,726) | (3,267) |
| Utilization of losses and benefits from prior years for which no deferred taxes were recorded | **12,250** | – | – |
| Losses and timing differences for which a deferred tax asset was not created | **(9,100)** | (7,678) | (435,353) |
| Taxes for prior years, net | **15,607** | 5,077 | 28,887 |
| Differences in the definition of equity and non-monetary assets for tax purposes | **22,177** | (25,755) | 17,525 |
| Adjustment of deferred taxes for different tax rates | **(78,713)** | – | – |
| Other | **3,688** | (729) | 1,366 |
| | **(387,079)** | (33,513) | (229,641) |
| Regular tax rate | **35** | 36 | 36 |

## NOTE 11 – TAXES ON INCOME (CONTD.)

### D. DEFERRED TAXES

| | Consolidated | | Company | |
|---|---|---|---|---|
| | December 31 2004 | December 31 2003 | December 31 2004 | December 31 2003 |
| | Reported amounts | Adjusted for the effects of inflation in shekels of December 2003 | Reported amounts | Adjusted for the effects of inflation in shekels of December 2003 |
| | NIS thousands | NIS thousands | NIS thousands | NIS thousands |
| Activity – | | | | |
| Balance at beginning of year | **769,536** | 593,498 | **611,633** | 429,467 |
| Adjustment due to changes in tax rates | **(83,881)** | – | **(78,713)** | – |
| Charged to statement of operations for the year | **(154,935)** | 169,588 | **(49,916)** | 178,351 |
| Allocation of original difference to a tax asset | **21,354** | – | **–** | – |
| Acquisition of minority share in a proportionally consolidated company | **112,540** | – | **–** | – |
| Charged to statement of operations for prior years | **18,841** | 6,450 | **15,299** | 3,815 |
| Balance as at end of year | **683,455** | 769,536 | **498,303** | 611,633 |

| | Consolidated | | Company | |
|---|---|---|---|---|
| | December 31 2004 | December 31 2003 | December 31 2004 | December 31 2003 |
| | Reported amounts | Adjusted for the effects of inflation in shekels of December 2003 | Reported amounts | Adjusted for the effects of inflation in shekels of December 2003 |
| | NIS thousands | NIS thousands | NIS thousands | NIS thousands |
| Composition of deferred taxes – | | | | |
| Difference between the adjusted value of fixed assets and other assets and their value for income tax purposes | **(575,497)** | (566,381) | **(230,732)** | (376,792) |
| Adjustment of materials and spare parts | **–** | 2,784 | **–** | – |
| Deductions and losses carried forward for tax purposes, net | **495,101** | 365,184 | **63,726** | 61,600 |
| Differences in the recognition of expenses relating to employee rights, doubtful debts and other | **763,851** | 967,949 | **665,309** | 926,825 |
| Total | **683,455** | 769,536 | **498,303** | 611,633 |
| Stated as follows: | | | | |
| As part of current assets | **237,319** | 208,797 | **159,023** | 170,213 |
| As part of other assets | **446,136** | 560,739 | **339,280** | 441,420 |
| Total | **683,455** | 769,536 | **498,303** | 611,633 |

Deferred taxes for companies in Israel are computed at the tax rate expected to apply on the date of the reversal of the provision – see Section E below.

## NOTE 11 – TAXES ON INCOME (CONTD.)

### E. AMENDMENTS TO THE INCOME TAX ORDINANCE

On June 29, 2004, the Knesset passed the Income Tax Ordinance Law (Amendment 140 and temporary provision), 5764-2004 (hereinafter – the Amendment). The Amendment provides a gradual reduction in the corporate tax rate from 36% to 30%, in the following manner:
During the 2004 tax year the applicable tax rate will be 35%, in 2005 the applicable tax rate will be 34%, in 2006 the applicable tax rate will be 32%, and from 2007 onwards the applicable tax rate will be 30%.

Current taxes and deferred tax balances as at December 31, 2004 are calculated in accordance with the new tax rates set out in the Amendment. The effect of the change on the consolidated financial statements for the beginning of 2004 is an increase in tax expenses on revenue in the statement of operations and a reduction in deferred taxes in the Company balance sheets in the sum of approximately NIS 79 million, and approximately NIS 84 million in the consolidated balance sheets.

**F.** Realization of the deferred tax asset is contingent upon the existence of adequate taxable income in appropriate amounts in the future. The deferred tax asset is included in the financial statements since, according to the Company's business plans, its realization is anticipated.

(1) The Company recorded a tax asset of approximately NIS 49,626 thousand in respect of an accumulated loss of approximately NIS 162,534 thousand, based on the assessment of Management that there is a high degree of certainty that these losses will be realized in the coming years. The balance of the losses and the deductions carried forward in respect of which no deferred taxes were charged due to the uncertainty regarding the possibility of its realization, is approximately NIS 26,000 thousand (2003 – NIS 21,237 thousand).

(2) As at balance sheet date, losses for tax purposes and capital losses of subsidiaries carried forward to the coming years total the adjusted amount of approximately NIS 3,070 million (2003 – NIS 121,231 thousand). In respect of losses amounting to approximately NIS 3,046 million, no tax asset was created by the subsidiaries.

(3) Pelephone recorded a tax asset of approximately NIS 431 million in respect of losses for tax purposes and a deduction for inflation carried forward to the next year which, as at the balance sheet date, total the adjusted amount of approximately NIS 1,360 million (2003 – NIS 1,686 million, in proportionally consolidated NIS 843 million). The net balance of the tax asset at Pelephone was recorded in accordance with the assessment of Pelephone's Management that there is a high level of certainty that these losses will be realized in the foreseeable future. Realization of the balance of these deferred taxes is contingent upon the existence of adequate taxable income in appropriate amounts in the future.

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

### G. FINAL TAX ASSESSMENTS

(1) The Company has final assessments up to and including 2000.

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

(3) Pelephone has final assessments up to and including 1999. A self-assessment filed by Pelephone for the year ended December 31, 2000 is considered as final.

## NOTE 11 – TAXES ON INCOME (CONTD.)

### G. FINAL TAX ASSESSMENTS (CONTD.)

(4) BezeqCall Communications has final assessments up to and including 2002. BezeqCall Communications has final deduction assessments up to 2002 (income tax and national Insurance).

(5) Self-assessments filed by DBS up to and including 1999 are considered as final.

### H. VALUE ADDED TAX

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

(2) Value Added Tax assessments were issued to the Company and a subsidiary in the amount of approximately NIS 26 million. The assessments have been appealed and are being discussed with the Value Added Tax authority. The financial statements include a provision of an amount which the Company considers appropriate.

## NOTE 12 – BANK CREDIT

| | | Consolidated | |
|---|---|---|---|
| | | December 31 2004 | December 31 2003 |
| | | Reported amounts | Adjusted for the effects of inflation in shekels of December 2003 |
| | Interest rate | NIS thousands | NIS thousands |
| Unlinked loans | 6, Prime + 1.35 | **88,102** | 94,714 |
| CPI-linked loans | 7.25 | **–** | 50,000 |
| | | **88,102** | 144,714 |

## NOTE 13 – LONG-TERM LOANS

### A. Composition

| | Consolidated | | Company | |
|---|---|---|---|---|
| | December 31 2004 | December 31 2003 | December 31 2004 | December 31 2003 |
| | Reported amounts | Adjusted for the effects of inflation in shekels of December 2003 | Reported amounts | Adjusted for the effects of inflation in shekels of December 2003 |
| | NIS thousands | NIS thousands | NIS thousands | NIS thousands |
| Banks | **4,162,573** | 2,406,686 | **1,003,312** | 1,344,520 |
| Pension fund | **26,758** | 49,990 | **26,758** | 49,990 |
| Others | **233** | – | **–** | – |
| Supplier credit | **7,352** | 11,350 | **–** | – |
| | **4,196,916** | 2,468,026 | **1,030,070** | 1,394,510 |
| Less – | | | | |
| Current maturities from banks | **1,304,916** | 685,883 | **473,578** | 324,827 |
| Current maturities from others | **31,066** | 27,850 | **26,758** | 23,471 |
| | **2,860,934** | 1,754,293 | **529,734** | 1,046,212 |

### B. Linkage and interest terms

| | | Consolidated | | Company | |
|---|---|---|---|---|---|
| | | December 31 2004 | December 31 2003 | December 31 2004 | December 31 2003 |
| | | Reported amounts | Adjusted for the effects of inflation in shekels of December 2003 | Reported amounts | Adjusted for the effects of inflation in shekels of December 2003 |
| | Interest rate | NIS thousands | | NIS thousands | |
| Loans in foreign currency | | | | | |
| US dollar (*) | LIBOR+(0.42-0.65) | **1,004,654** | 1,235,280 | **997,302** | 1,223,930 |
| Loans linked to the CPI | 3.9 - 7.3 | **2,122,825** | 893,073 | **6,010** | 120,590 |
| Pension fund | 6.1 | **26,758** | 49,990 | **26,758** | 49,990 |
| | | **2,149,583** | 943,063 | **32,768** | 170,580 |
| Shekel/dollar loans(**) | 2.33 – 3.51 | **215,400** | 109,475 | **–** | – |
| Unlinked loans | 7.13 – 7.31<br>Prime + (1.5-1.35) | **827,279** | 180,208 | **–** | – |
| | | **4,196,916** | 2,468,026 | **1,030,070** | 1,394,510 |

(*) These loans bear interest at LIBOR plus a margin.

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

## NOTE 13 – LONG-TERM LOANS (CONTD.)

### C. Repayment schedule

| December 31 | Consolidated NIS thousands | Company NIS thousands |
|---|---|---|
| 2006 | **1,142,130** | **497,423** |
| 2007 | **220,918** | **32,311** |
| 2008 | **120,827** | **–** |
| 2009 | **76,038** | **–** |
| 2010 and thereafter | **24,060** | **–** |
| | **1,583,973** | **529,734** |
| | **1,276,961(*)** | **–** |
| | **2,860,934** | **529,734** |

(*) Under a financing agreement signed between DBS and certain banks, long-term loans will be repaid in accordance with the loan schedule to be set on December 31, 2005 for a period of 8 years.

### D. Security

(1) Long-term loan agreements of the Company, aggregating NIS 964,540 thousand, include certain conditions upon the occurrence of which the lender may demand immediate repayment of the loans, including:

- A change (without the lender's consent) in the nature of the Company's business, which would have a materially adverse effect on its business, assets or financial condition.
- Non-repayment of a material amount of the loan that has fallen due, or violation of the undertakings or representations made by the Company.
- Abrogation or change of a provision of law that would prevent the Company's operations or the fulfillment of its undertakings.
- The Company ceases to manage its affairs or enters into receivership or bankruptcy proceedings, etc.
- Some or all of the lien-holders realize the liens on the Company's assets.
- A complete or material reduction of the Company's authority to administer its affairs as a result of the intervention of an authority or a change in the Company's tariffs that will have a material effect on the future receipts of the Company (in loans from foreign banks only).
- In respect of loans amounting to NIS 232,180 thousand, upon the occurrence of an event which allows a demand for immediate repayment of other loans of the Company.
- In respect of the remaining balance of NIS 732,360 thousand, upon the occurrence of an event which allows a demand for immediate repayment of other loans of the Company and of material consolidated subsidiaries or the failure of the Company to comply with the following financial covenants relating to the Group:

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

  b. Tangible shareholder's equity (consolidated shareholders' equity of the Company after certain adjustments, primarily deduction of goodwill and other intangible assets) totaling NIS 301,560 thousand must be at least 15% of total tangible assets.

## NOTE 13 – LONG-TERM LOANS (CONTD.)

### D. SECURITY (CONTD.)

(1) (Contd.)

b. (Contd.)

The Company believes that as at the balance sheet date, it is in compliance with these financial covenants.

Regarding the possibility of the realization 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. Bank loans and debentures of Pelephone are secured by an irrevocable undertaking in favor of the banks, whereby Pelephone created a negative pledge in favor of the banks. This undertaking includes, *inter alia*:

(1) That its debts will not exceed three times its shareholders' equity;

(2) That as long as its debts exceed its shareholders' equity by a ratio of 1.5, Pelephone will not distribute dividends and will not pay management fees to the shareholders;

(3) That its total debts will not exceed NIS 3.8 billion (linked to the known CPI in January 2002);

(4) That Pelephone will not encumber in any way, including by way of a floating lien or a fixed lien, of any kind or rank, any or all of its assets (as these may be from time to time), in favor of any third party, without obtaining the prior written consent of those who provided the credit.

As at the date of the financial statements, Pelephone is in compliance with its undertakings to the banks, the balance of which as at the balance sheet date is NIS 2,143 thousand.

b. Under the general license for cellular services, Pelephone may not sell, lease or pledge any of its assets which are used for performance of the license without the consent of the Minister of Communications, except –

(1) Encumbrance of one of the assets of the license in favor of a bank duly operating in Israel, for the purpose of receipt of bank credit, provided that it has notified the Ministry of Communications of the encumbrance it intends to record, whereby the encumbrance agreement includes a clause guaranteeing that in no case, will an exercise of the rights by the bank harm the provision of services under the license in any way;

(2) Sale of items of equipment at the time of an upgrading process, including sale of equipment by the trade-in method.

c. Bezeq International provided a negative pledge in favor of banks, whereby it may not encumber its assets without the bank's consent. As at December 31, 2004, Bezeq International has no obligations towards banks.

d. BezeqCall Communications provided a negative pledge and undertook to meet certain financial conditions in respect of loans from banking institutions, the balance of which as at the balance sheet date is approximately NIS 39 million.

## NOTE 13 – LONG-TERM LOANS (CONTD.)

### D. SECURITY (CONTD.)

(2) (Contd.)

e. The terms of loans received by DBS from banks, the balance of which as at December 31, 2004 is NIS 1,352 million, impose various restrictions, including a demand to comply with the following financial criteria: minimum total income, minimum operating surplus (as defined in the Financing Agreement), minimum operating surplus less investments in decoders (as defined in the Financing Agreement), maximum churn percentage, maximum total financing needs and supplier credit within a stated range. The values for compliance with these criteria vary and are measured every quarter. Failure to comply with the criteria entitles the banks to demand early repayment of the loans received by DBS. As at December 31, 2004, DBS is in compliance with these criteria.

### E. LOAN PROCUREMENT EXPENSES

Deferred expenses for raising loans amounted to NIS 10,855 thousand (2003 – NIS 9,106 thousand). The expenses are stated after deduction of accumulated amortization amounting to NIS 8,457 thousand (2003 – NIS 5,557 thousand).

## NOTE 14 – DEBENTURES

### A. COMPOSITION AND TERMS

| | | Consolidated | | Company | |
|---|---|---|---|---|---|
| | | December 31 2004 | December 31 2003 | December 31 2004 | December 31 2003 |
| | | Reported amounts | Adjusted for the effects of inflation in shekels of December 2003 | Reported amounts | Adjusted for the effects of inflation in shekels of December 2003 |
| | Interest rate | NIS thousands | NIS thousands | NIS thousands | NIS thousands |
| CPI-linked debentures issued to the public | | | | | |
| Debentures Series 1 | 4.5 | **–** | 69,587 | **–** | 69,587 |
| Debentures Series 4 and 5 (1) | 4.8 – 5.3 | **850,847** | – | **3,410,936** | – |
| | | **850,847** | 69,587 | **3,410,936** | 69,587 |
| Debentures issued to the public: In euro (2) | 6.5 | **1,717,622** | 1,615,602 | **1,717,622** | 1,615,602 |
| Debentures issued: Unlinked (3) | Bank of Israel interest + 0.5 | **109,179** | 500,372 | **109,179** | 500,372 |
| Debentures issued to financial institutions and others: | | | | | |
| CPI-linked | 3.9 - 5.95 | **1,355,286** | 706,965 | **1,055,286** | 706,965 |
| Euro-linked | Libor + 0.8 | **32,086** | 30,209 | **32,086** | 30,209 |
| | | **1,387,372** | 737,174 | **1,087,372** | 737,174 |
| | | **4,065,020** | 2,922,735 | **6,325,109** | 2,922,735 |
| Less – current maturities | | **240,481** | 598,153 | **210,481** | 598,153 |
| | | **3,824,539** | 2,324,582 | **6,114,628** | 2,324,582 |

(1) The outstanding balance of the debentures is NIS 3,300,000,000 par value, of which NIS 850,000,000 par value were issued to the public. Regarding sale after the balance sheet date, see section d. below.

a. In a tender offer and public offering pursuant to a prospectus published on May 24, 2004, the Company issued 1,200,000,000 debentures (Series 4) of a par value of NIS 1 each, payable in four equal annual installments in each of the years 2008 through 2011. The interest set for these debentures is 4.8% per annum. Of these debentures, 400 million were allotted to Bezeq Zahav (Holdings) Ltd. ("Bezeq Zahav"), a wholly owned and controlled subsidiary of the Company just prior to the prospectus.

In addition, on May 20, 2004 the Company issued a series of 600 million debentures (Series 5) of NIS 1 par value each, of which 50 million were allotted to institutional investors and the remainder to Bezeq Zahav. These debentures are repayable in 6 equal annual installments in each of the years 2011 through 2016. The interest rate set for these debentures is 5.3% per annum. The debentures were listed for trading under the aforementioned prospectus.

b. On December 9, 2004 the Company issued to Bezeq Zahav 1,500 million debentures (Series 5) of NIS 1 par value each. The debentures are registered by name and are payable in six equal annual installments in each of the years 2011 through 2016, bear annual interest of 5.3% and are not secured by any lien.
The consideration in respect of the debentures was calculated at the market price of the debentures from the same series at the end of trading on December 9, 2004, and is NIS 1,650 million.

## NOTE 14 – DEBENTURES (CONTD.)

### A. COMPOSITION AND TERMS (CONTD.)

The debentures were listed for trading on the stock exchange, and trading in them will be subject to blocking restrictions pursuant to the Securities Law and to restrictions undertaken by Bezeq Zahav not to resell the debentures for any reason during the later of 12 months from the date of the allotment or until within three months from the date of sale of the State's holdings in the Company.

c. Bezeq Zahav financed the purchase of the above debentures by means of a loan granted to it by the Company for that purpose.

d. At the beginning of 2005, Bezeq Zahav sold 300,000,000 par value of debentures (Series 4) of the Company out of the debentures (Series 4) it purchased from the Company. The proceeds from the sale in the amount of NIS 323,750 thousand, was transferred to the Company by Bezeq Zahav as (partial) repayment of a loan extended to it by the Company for purchase of the above debentures (Series 4), in accordance with the loan agreement between the parties.

(2) The outstanding balance of the debentures is € 293,000,000.

(3) The outstanding balance of the debentures is NIS 109,330,000.

### B. REPAYMENT SCHEDULE

| | Consolidated | Company |
|---|---|---|
| | NIS thousands | NIS thousands |
| 2006 | **191,752** | **168,485** |
| 2007 | **1,822,826** | **1,799,559** |
| 2008 | **373,996** | **576,119** |
| 2009 | **309,616** | **511,739** |
| 2010 and thereafter | **1,126,349** | **3,058,726** |
| | **3,824,539** | **6,114,628** |

### 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.

The lenders are entitled to demand the immediate repayment of the debentures in cases where the Company does not repay its loans or violates the terms of the debentures, if a significant attachment is imposed on its assets (and not removed within 60 days), if a receiver is appointed for the Company's assets or a liquidation order is given against the Company, if the Company ceases to manage its business or if another lien-holder realizes the lien it has on the Company's assets. In addition, some of the lenders, the balance of whose loans as at December 31, 2004 is approximately NIS 460,509 thousand, may demand immediate repayment of the debentures if the State's holdings in the share capital of the Company falls below 26%.

In addition, in respect of a balance of NIS 1,717,622 thousand of debentures listed on the Luxembourg bourse which were issued to the public and are linked to the euro, upon the occurrence of an event enabling demand for immediate repayment of other loans of the Company and of material subsidiaries as defined in the terms of the debentures (Pelephone is the only company meeting the definition of a material subsidiary in accordance with these debentures. it should be noted that DBS is not considered a material subsidiary as defined in the debentures), if the Company does not make the payments scheduled in respect of the debentures, if the Company or its material subsidiaries cease to manage their businesses or enter into receivership, liquidation proceedings and the like, and upon the occurrence of a number of additional events of non-compliance with the undertakings of the Company and its material subsidiaries, as set out therein.

## NOTE 14 – DEBENTURES (CONTD.)

### C. SECURITY (CONTD.)

Regarding the Company's application to the tax authorities for receipt of approval for exemption from the deduction of withholding tax from interest paid in respect of the above debentures, the Company reached an agreement with the assessment officer whereby it would be exempt from withholding tax from August 1, 2004 until the final repayment of the debentures. It was also agreed that where the ratio of debt to capital in the Company is greater than 1:1.5 debt to capital, the Company's financing expenses in the tax year would be adjusted for tax purposes but not by more than the amount of the financing expenses in respect of the debentures. This will be checked in the quarterly financial statements of the Company, and applied each quarter. In this regard, "debt" – any obligation bearing interest, linkage differentials or whose value changes as a result of changes in the interest or linkage differentials, except for an undertaking to the employees or former employees.

The Company believes that as at the balance sheet date, it is in compliance with all these conditions.

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

### D. ISSUANCE EXPENSES

The deferred expenses in respect of the issuance of the debentures amounted to NIS 39,266 thousand (2003 – NIS 33,884 thousand) and are stated net of accumulated amortization of NIS 29,520 thousand (2003 – NIS 27,657 thousand).

## NOTE 15 – TRADE PAYABLES

| | Consolidated | | Company | |
|---|---|---|---|---|
| | December 31 2004 | December 31 2003 | December 31 2004 | December 31 2003 |
| | Reported amounts | Adjusted for the effects of inflation in shekels of December 2003 | Reported amounts | Adjusted for the effects of inflation in shekels of December 2003 |
| | NIS thousands | NIS thousands | NIS thousands | NIS thousands |
| Suppliers of goods and services | **1,671,261** | 1,126,337 | **648,218** | 686,517 |
| Current maturities of long-term supplier credit | **4,308** | 4,379 | **–** | – |
| | **1,675,569** | 1,130,716 | **648,218** | 686,517 |
| Including subsidiaries | **–** | – | **99,409** | 24,206 |
| Including a proportionally consolidated company | **–** | 41,233 | **–** | 82,466 |

## NOTE 16 – LIABILITY FOR EMPLOYEE SEVERANCE BENEFITS

### A. COMPOSITION

| | Consolidated | | Company | |
|---|---|---|---|---|
| | December 31 2004 | December 31 2003 | December 31 2004 | December 31 2003 |
| | Reported amounts | Adjusted for the effects of inflation in shekels of December 2003 | Reported amounts | Adjusted for the effects of inflation in shekels of December 2003 |
| | NIS thousands | NIS thousands | NIS thousands | NIS thousands |
| Provision for early retirement (see D below) | **1,190,447** | 1,300,493 | **1,190,447** | 1,300,493 |
| Compensation for unutilized sick leave (see F below) | **47,196** | 50,682 | **47,196** | 50,682 |
| | **1,237,643** | 1,351,175 | **1,237,643** | 1,351,175 |
| Provision for severance pay (see B below) | **76,629** | 53,634 | **13,186** | 12,628 |
| Less – reserve in compensation fund | **41,702** | 31,380 | **–** | – |
| | **34,927** | 22,254 | **13,186** | 12,628 |
| | **1,272,570** | 1,373,429 | **1,250,829** | 1,363,803 |
| Stated as follows: | | | | |
| In current liabilities | **592,474** | 602,520 | **592,474** | 602,520 |
| In long-term liabilities | **680,096** | 770,909 | **658,355** | 761,283 |
| | **1,272,570** | 1,373,429 | **1,250,829** | 1,363,803 |

### 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 by the above liabilities. The accumulated amounts in the funds mentioned above are not under the management or control of the companies and therefore, are not reflected in the balance sheet.

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

### C. EMPLOYEE RIGHTS BEFORE RETIREMENT AGE

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

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

### C. EMPLOYEE RIGHTS BEFORE RETIREMENT AGE (CONTD.)

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

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

Employees who transferred to the Company from government service ("transferred employees") and whose employment in the Company is ceased before reaching retirement age, are entitled, in certain conditions, if they so choose and under the provisions of the Civil Service Law (Retirees), 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. In recent years, most Company employees have retired under agreed early retirement plans, and accordingly the chances of realization of the above liability are slight. Accordingly, no provision has been made for it in the financial statements, other than a provision for the early retirement plan described below.

### D. EARLY RETIREMENT PLANS

In September 2000, the Company reached an agreement with workers' representatives to extend the 1997 collective agreement on early retirement (the "Retirement Agreement"). Under the Retirement Agreement, 1,770 additional employees, of whom up to 300 are not transferred employees, were to take early retirement between April 1, 2001 and December 31, 2006 (with the option of extending the final date of retirement for certain employees through December 31, 2008). Similarly, in accordance with the provisions of the agreement, the Company may terminate the employment of employees on the severance pay track in excess of the aforementioned quota. According to the agreement between the Company and workers' representatives, the funds raised by the Company (See Note 20B.) will be used to finance the costs of retirement of employees under the Retirement Agreement. Therefore, it was agreed that the funds raised would be held, managed and invested by the Company as part of its total monetary balances, and that shortly before the Government ceases to hold control of the Company, the Company will transfer the retirement funds to an external body which would manage and invest the retirement monies. The financing round completed in 2003.

Under the retirement Agreement, 1,222 employees had retired from the Company through December 31, 2004.

The Company's Management does not expect any significant costs arising as a result of employees who retire under the severance pay track (if they retire) under the Retirement Agreement, or under any other framework, and therefore no provision has been made in the financial statements

In May 2003, the Knesset approved the Israeli Economic Recovery Plan (Legislative Amendments for Achieving Budgetary Targets and Economic Policy for the 2003 and 2004 Financial Years) Law, 5763-2003. This law includes, *inter alia*, an amendment to the Supervision of Insurance Business Law, 5741-1981, which relates to the old pension funds operating at a deficit, including the Makefet Fund. Under the amendment, the retirement terms of all members of these pension funds were made equal, in accordance with uniform articles which, amended by law, became valid on October 1, 2003, such that the rights of members of those pension funds who were a party to special pension agreements were harmed.

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

**D. EARLY RETIREMENT PLANS (CONTD.)**

On March 18, 2004, an amendment to the Retirement Agreement was signed between the Company), the New General Workers' Trade Union and the workers' representation under which certain amendments to the present Retirement Agreement were agreed upon with the aim of clarifying the uncertainties arising out of the amendment of the Supervision of Insurance Business Law. Amongst others, it was agreed that by September 30, 2004, 400 employees would retire, and it was also agreed that the retirement conditions of all transferred employees who take a pension under the Retirement Agreement as of September 2000, will remain in force despite the amendments to the Pension Law and the Company shall bear any additional costs that might be required. It was agreed that in the event that an alternative pension fund to the Makefet Fund is found, in which the status and rights afforded to the retirees under the Retirement Agreement are retained, then under this agreement the Company shall be entitled to contract with such a fund with the consent of the employees' representatives and receipt of approvals required by law. As at the date of these financial statements the Company is in the process of selecting an alternative body to the Makefet Fund in coordination with the employees' representatives and the Company, and the representatives have come to an appropriate collective agreement. In addition the parties agreed in the amendment to the agreement dated March 18, 2004, that they would enter into negotiations in order to regulate the retirement of the remainder of the employees through 2011 on one hand and the requirements of Management for organizational and other changes, on the other hand. A provision will be recorded in the financial statements if and when the negotiations develop into an agreement. As of the date of these financial statements the negotiations on which an agreement for an amendment to the Retirement Agreement will be based have not commenced..

On May 12, 2004, the Government Companies Authority, with the consent of the Commissioner for Wages, approved the amendment of the Retirement Agreement dated March 18, 2004.

On April 1, 2004, the Commissioner for Capital Markets, Insurance and Savings published a circular regarding "Employer-Financed Early Retirement in Old Pension Funds". According to the circular, the discount rate for capitalizing the cost of early pension was changed from 3.5% to 3% and the management fees were raised to 1.75%. As a result of these and additional updates, the Company recorded an additional provision of approximately NIS 105 million in its financial statements as at December 31, 2004.

**E.** Under the collective agreements applicable to labor relations in the Company and pursuant to the agreements with the Fund, Company employees who are transferred employees retain the option of retiring under one of two retirement tracks. The method of calculating the cost of early retirement of these employees is laid down in the provisions of several agreements and documents drawn up between the Company and Makefet Fund during the years 1990-1996, including a letter of understanding drawn up and signed by them in 1996. The Company contends that the Fund violated the provisions of the agreements in general and those of the letter of understanding in particular, in that when it calculated the costs of early retirement for transferred employees, it determined the data on the basis of the assumption that these employees had chosen the track with the higher cost of purchase, irrespective of the track those employees had actually chosen. According to an actuarial opinion prepared for the Company, the difference between the payments collected by the Fund from the Company according to its calculations and the rate of those costs had they been made, as the Company alleges, on the basis of the retirement track actually chosen by those employees, is a nominal cumulative amount of more than NIS 128 million, the reimbursement of which the Company is suing the Makefet Fund. On November 20, 2003, the Company filed another claim against the Fund for additional amounts of approximately NIS 80 million in respect of other components. The Makefet Fund submitted data on the previous retirees. On the basis of these data, together with the previous file, a revised actuarial opinion was prepared which quantified the total amount of the claim as at the date of its filing at approximately NIS 280 million. The Makefet Fund filed statements of defense in which it rejects the allegations of the Company and alleges that it acted in accordance with the agreements between it and the Company.

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

### F. COMPENSATION FOR UNUTILIZED SICK LEAVE

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

## NOTE 17 – OTHER CURRENT LIABILITIES

| | Consolidated | | Company | |
|---|---|---|---|---|
| | December 31 2004 | December 31 2003 | December 31 2004 | December 31 2003 |
| | Reported amounts | Adjusted for the effects of inflation in shekels of December 2003 | Reported amounts | Adjusted for the effects of inflation in shekels of December 2003 |
| | NIS thousands | NIS thousands | NIS thousands | NIS thousands |
| The Government of Israel in respect of royalties | **244,886** | 204,768 | **145,121** | 153,110 |
| Wages and salaries [1] | **397,666** | 250,739 | **286,360** | 203,358 |
| Provision for vacation pay | **113,144** | 85,299 | **73,370** | 79,308 |
| Governmental agencies | **102,229** | 24,474 | **15,635** | – |
| Accrued interest | **235,352** | 106,647 | **165,124** | 92,959 |
| Payables in respect of derivatives | **57,635** | 65,304 | **47,827** | 65,304 |
| Other accrued expenses | **166,086** | 168,544 | **103,519** | 80,623 |
| Current maturities in respect of prepaid income | **34,547** | 24,830 | **21,643** | 17,578 |
| Provision for claims in respect of salary and pension components | **50,595** | 257,595 | **50,595** | 257,595 |
| | **1,402,140** | 1,188,200 | **909,194** | 949,835 |
| Including subsidairies | **–** | – | **76,308** | – |
| [1] Including current maturities of a long-term loan from a pension fund | **26,758** | 23,471 | **26,758** | 23,471 |

## NOTE 18 – OTHER LONG-TERM LIABILITIES

| | Consolidated | | Company | |
|---|---|---|---|---|
| | December 31 2004 | December 31 2003 | December 31 2004 | December 31 2003 |
| | Reported amounts | Adjusted for the effects of inflation in shekels of December 2003 | Reported amounts | Adjusted for the effects of inflation in shekels of December 2003 |
| | NIS thousands | NIS thousands | NIS thousands | NIS thousands |
| Prepaid income | **25,750** | 27,544 | **20,936** | 27,544 |
| Liabilities in respect of an onerous contract (1) | **9,247** | 9,660 | **–** | – |
| Liabilities in respect of derivatives | **438** | 6,560 | **438** | 6,560 |
| Checks payable | **11,940** | – | **-** | – |
| | **47,375** | 43,764 | **21,374** | 34,104 |

(1) In the course of its business and as part of the setting up of Bezeq International and receipt of assets from the Company, Bezeq International entered into agreements granting it rights to use transmission equipment (old-generation undersea cables) for periods ending between 2016 and 2024. Under those agreements, Bezeq International is obligated to pay fixed monthly amounts, irrespective of the extent of the use it makes of those cables. The management of Bezeq International estimates that the unavoidable costs for compliance with those agreements exceed the anticipated financial benefit that will accrue to it from use of the undersea cables. This assessment, together with the decision of Bezeq International's management not to operate the undersea cables, formed the basis for charging a provision of NIS 9,660 thousand in the financial statements as at December 31, 2003. The balance of the provision as at December 31, 2004, which reflects the capitalized value as at that date of all the unavoidable costs that Bezeq International must pay the owners of the undersea cables until the end of the terms of the agreements is NIS 9,247 thousand.

## NOTE 19 - CONTINGENT LIABILITIES

### A. CLAIMS

Below are details of the status of contingent liabilities of the Company and investee companies as at December 31, 2004, in respect of which the maximum possible exposure is considerable.

(1) In September 1997 a claim was filed against the Company and the State in the Jerusalem Regional Labor Court. The claim was filed on behalf of 128 senior employees employed under personal employment contracts. The essence of the claim is the plaintiffs' allegation that since October 1, 1996 they have been entitled to a 33% salary increase, commensurate with the raise given at that time to Knesset members and senior civil servants whose salaries are linked to those of Knesset members. The total amount of the claim in respect of salary differentials is approximately NIS 12 million. In addition, delay differentials are claimed in respect of these amounts. The Company contended that it pays the plaintiffs' salaries according to the directives of the Government Companies Authority. The State joined as a party to the proceeding and filed a final opinion written by the Attorney General, which supports the position of the Government Companies Authority that there is no obligation to grant the senior employees the salary increment demanded. In a hearing on January 27, 1998 the State's representative stated that the Attorney General had given his decision that the Government Companies Authority had no obligation to order a 33% raise in the salaries of the senior employees, and that the Government Companies Authority had exercised its discretion reasonably on this matter when it decided not to accede to the claim. The claim was dismissed, as was the appeal filed against its dismissal. On May 23, 2004 the plaintiffs filed a petition in the Supreme Court, requesting that the decision of the National Labor Court be annulled. On June 23, 2004 the Company, through its legal advisers, filed a preliminary response to the petition, seeking its dismissal *in limine*.

## NOTE 19 - CONTINGENT LIABILITIES (CONTD.)

### A. CLAIMS (CONTD.)

(10 (Contd.)
A decision on these claims has not yet been made and a hearing is scheduled for March 22, 2005 in the Supreme Court. In the opinion of the Company, relying on the assessment of its external legal advisers, the prospects that the Supreme Court will not hear arguments on the petition itself but will dismiss it *in limine*, are high. Accordingly, no provision has been made in the financial statements in respect of this petition.

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

In the field of Public Switching, the Authority's investigation found, according to the notice, suspected collaboration between Telrad and Tadiran against the Company, and suspected restrictive practices between the Company, Koor, Telrad and Tadiran, which include 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 from the two companies through tenders. It was suspected that these undertakings, or some of them, in the relevant circumstances, constitute violation of the provisions of the Antitrust Law. According to the Commissioner, 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 restricted itself and had the entire market not been blocked to other equipment suppliers by the aforementioned arrangement.

In the NEP field, the findings of the Authority's investigation gave *prima facie* indication of a series of restrictive arrangements and attempted offenses in the NEP field, between BezeqCall Communications, Telrad and Tadiran.

On March 3, 2002 the Company and certain persons who were serving as its officers during the relevant period, were summoned to a hearing by the Antitrust Authority. The summons (which relates to the investigation of the public switching issue only) stated that the Authority was considering committing the Company for trial on the basis of offenses against the Antitrust Law.

The Company's legal advisers recommended that the Company not attend the hearing without all the relevant material having been submitted to them for study. Since not all the requested material was not submitted to the Company, the hearing was not held.

The Authority recently gave notice that it does not intend to file indictments in connection with this affair. However, the Authority also notified the Company that it was considering issuing a determination against the Company, under Section 43 of the Antitrust Law, concerning the public switching field, and that the Company was invited to attend a hearing on the matter. In reply, the Company gave notice that it refuses to attend the hearing, for the same reasons it refused to attend the hearing in connection with the intention to file an indictment against it.

## NOTE 19 - CONTINGENT LIABILITIES (CONTD.)

### A. CLAIMS (CONTD.)

(2) a. (Contd.)
The discussions between the Company and the Authority in an attempt to arrive at an agreed order (which would also preclude issue of the determination), were in vain, due to the Company's refusal to pay money to the State Treasury within the framework of the agreed order, unlike Telrad and Tadiran, which together paid NIS 8 million as part of an agreed order arrived at with the Authority in connection with the same affair. (It should be noted that under the same agreed order, the Commissioner gave notice that notwithstanding the suspicion of restrictive practices in the public switching market, competition in that market had not in fact been restricted, and therefore he had already previously decided not to file an indictment in the matter.)

In these circumstances, the Company filed a petition in the Supreme Court, in which it demanded that the Authority be directed to hold the hearing, to submit the security material to it before holding the hearing, and to refrain from issuing the determination. The Company's petition was dismissed on March 2, 2005, and following that decision the Company approached the Authority and requested that the hearing be held even without all the relevant material, before issue of the determination.

If the determination is issued against the Company following dismissal of its petition, the Company will be entitled to file an appeal in the Antitrust Tribunal. In such a case, the Company’s external legal advisers believe that the Company has worthy and good arguments against the determination. These arguments are based, in part, on the security aspects relating to the purchase of the public switching (combined with the "act of state" doctrine), partly on arguments relating to the management process and to the manner of exercise of management discretion, and partly on other arguments (such as the restrictive application by the courts of everything involved in the application of the Antitrust Law concerning vertical arrangements between customer and supplier, reliance on legal advice, the corporate connection between Telrad and Tadiran, reasons of equitable defense, etc.).

b. On September 21, 2004 a claim and an application for approval as a class action were filed in the Jerusalem District Court against the Company and several other defendants (including Telrad and Tadiran) and against the State of Israel-Ministry of Communications as a formal defendant. The claim was filed by the plaintiff under the Antitrust Law, and Article 29 of the Civil Procedure Regulations, 5744-1984. According to the plaintiff, the defendants unlawfully formed a number of cartels which divided up the communications exchange market in Israel and set the prices of the exchanges, where the Company was part to those agreements as a customer of Telrad and Tadiran. It is alleged that these arrangements gave rise to unnecessary expenses for the Company, resulting in an unjustified rise in the Company's tariffs in a cumulative amount of NIS 1,700 million. Since these proceedings are in their early stages, the external legal advisers of the Company are unable to assess the exposure of the Company arising from the claim, but in their opinion, the Company has good and worthy defense arguments against the claim, and accordingly, no provisions has been made in the financial statements in respect of the claim. If a determination is issued by the Authority, as referred to in section a. above, stating that the Company was party to a cartel in the field of public switching, and as long as that determination remains in place, it will constitute *prima facie* proof of the existence of an arrangement. However, if such a determination is issued, the Company will be able, as part of an appeal to the Antitrust Tribunal, to contest that determination. In the opinion of the Company's external legal advisers, the Company has good arguments in such an appeal.

## NOTE 19 - CONTINGENT LIABILITIES (CONTD.)

### A. CLAIMS (CONTD.)

(2) c. Applications by Company shareholders relating to the filing of claims against suppliers and/or officers:

In November 2000 an application was received from a Company shareholder, demanding that the Company take legal action against the abovementioned suppliers of communications equipment, and gave notice that in his estimation, the Company had suffered a loss of about NIS 392 million as a result of the cartel. In his application, the shareholder reserves the right to file a derivative claim pursuant to Section 194 of the Companies Law. The Company replied that it was monitoring developments in the matter, that it had requested the investigation material from the Authority and that it would formulate its position on the basis of the Authority's decision and any findings there might be. In November 2001 a similar application was made by another shareholder. The Company replied that it was still awaiting the decision of the Authority. On November 2, 2004 another similar application was made by a Company shareholder who believes that the Company should file an action in respect of losses caused by the suppliers. The Company replied that his application did not contain the factual and legal basis required under the Companies Law, and added that to the extent the Company explains, as part of the class action referred to in section b. above, or if information that comes to the Company shows that it has cause of action, it will be ready to institute proceedings to defend its rights.

In addition, on November 29, 2004 an application was received demanding that a claim be filed against whoever served in the Company as directors and/or as senior managers from the end of the 1980s to 2004 (inclusive), in which the officers would be required to compensate the Company in respect of all the excess payments made by the Company to its equipment suppliers and which, due to the omission of those officers, the Company is unable to claim from those equipment suppliers.
On January 30, 2005 the Company replied that is rejects everything stated and alleged in the demand, since the Company was not in a position which would enable it to formulate a reasoned and final stance on the matter of the public switching and that it has no cause of action against any of its officers.

(3) In March 1999 a claim was filed against the Company in the Jerusalem regional Labor Court by a group of employees who had been employed as non-permanent workers at the Ministry of Communications and were transferred to the Company when it commenced operations. The plaintiffs are requesting that the Labor Court determine that they are entitled to all the benefits which were granted to transferred permanent employees, graduates of Bezeq College and retired Ministry of Communications employees. 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. The Labor Court must now rule whether it approves the withdrawal of consent. In a preliminary hearing the parties agreed to split the hearing so that in the first stage the court would hear only the dispute on whether the plaintiffs have the status of "transferred employees". Based on the outcome of this stage, the plaintiff will give notice of continuation of the case proceedings. In the opinion of the Company the plaintiffs are not considered "transferred employees" and collective labor agreements differentiate between transferred employees and other employees regarding pension and other rights.

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

## NOTE 19 - CONTINGENT LIABILITIES (CONTD.)

### A. CLAIMS (CONTD.)

(4) 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 alleged in its claim that the Company violated its undertakings and representations to the plaintiff to purchase large quantities of equipment from it. The plaintiff further alleges that the procedure adopted for selecting the equipment which would be purchased by the Company was unlawfully managed, with infringement of the tenders laws and the rules of proper administration, with negligence and while exploiting the status of the Company as a monopoly or monopsony. With the agreement of the parties, the claim was transferred to an arbitrator, and on November 14, 2004 the arbitrator awarded the plaintiff compensation of approximately NIS 1 million, thereby ending the proceeding.

(5) Several claims are pending against the Company concerning the recognition of various salary components as pensionable components and the recognition of various components of the determining wage for severance pay as detailed below:

a. In September 2000, a claim was filed in the Jerusalem Labor Court against the Company by 2,423 retired employees of the Company, who were transferred from the Ministry of Communications to the Company when it commenced operations. The plaintiffs are requesting from the Labor Court declaratory relief which will determine that the payments they received for grossing up of tax, clothing allowance and incentive pay are regular salary which should be seen as part of their determining wage for the purpose of calculating their pension and for the payments made to them upon retirement, and should be included in the calculation of hour value and the calculation of the percentage increments. The plaintiffs are also seeking declaratory relief which will determine that their last determining salary for pension should be calculated according to the last salary paid to each of them for the last month of work, and not according to the average grade which each of them held. The Company filed a preliminary application for the claim to be dismissed and/or stricken *in limine*. The preliminary allegations made in that application are dismissal for limitation, strike for absence of material details, strike for absence of financial quantification and causal arguments relying on the retirement agreements.

On June 24, 2004 the regional Court gave its decision, in which the claim was stricken *in limine*. The Court ruled that the plaintiffs were not a homogenous group in that each of them has different data relevant to his claim, that the claim cannot be conducted as if it were a class action, it is a monetary claim which was not properly quantified, and it contains no facts and demands enabling it to be quantified. The Court also determined that the pensioners' organization is not a workers' organization as referred to in Section 3 of the Collective Agreements Law, that it is not an action in a collective dispute and that the consent of the organization is not sufficient for filing a claim in the name of each of the 2,423 plaintiffs. On October 10, 2004 this decision was appealed in the National Labor Court. In the appeal filed against the claim being stricken *in limine*, the Court proposed that the parties meet in an attempt to arrive at agreements concerning how an amended statement of claim should be filed. The case is scheduled for hearing.

b. On February 24, 2002 a "notice of a party to a collective dispute" ("the notice"), was received at the Company's offices, which was filed in the Jerusalem Regional Labor Court on February 21, 2002 by the New General Federation of Workers in the name of all Company employees. The applicant alleges that payments for grossing up of tax, the component of administrative call duty benefits and clothing allowances which were and are paid to Company employees are regular pay which form part of the determining salary of every employee, including for the matter of calculation of payments upon retirement, redemption of holidays, grants, acclimatization payments, percentage increments and hour value, and that various payments and provisions should be made in respect thereof, including for pension purposes. On October 20, 2002 the Attorney General gave notice that he would be joining the claim, and he later submitted his position that the application in all its parts should be rejected.

## NOTE 19 - CONTINGENT LIABILITIES (CONTD.)

### A. CLAIMS (CONTD.)

(5) c. A group of employees filed a claim against the Company in the Tel Aviv Regional Labor Court concerning the inclusion of a number of components as part of the determining pay for pension. The Company and the group of employees participated in a mediation proceeding, which was terminated, but the Company's management believes there is a chance that concurrently with the continued conduct of the legal proceedings, further contacts will be made to reach a settlement. The financial statements include a provision which management believes, based on the assessment of its legal advisers, reflects a possible settlement.

d. A number of other, individual claims are pending against the Company, filed by employees and former employees and concerning recognition of various salary components as pensionable components and recognition of various components as part of the determining salary for severance pay.

The wide-ranging effect of these claims is considerable, and could, under certain assumptions, reach an amount of approximately NIS 2.6 billion.

Concerning the risk assessment of the claims described in this section –

On July 14, 2003 the National Labor Court gave its decision on an appeal in another claim which was filed by 7 former employees of the Company, which recognized the component of administrative call duty benefits as a pension component, considering the factual circumstances in that case.

On October 13, 2004 the National Labor Court gave its decision in the appeal of dismissal of a claim filed by a former employee of the Company, the main thrust of which was a claim for the inclusion of the administrative call duty benefits and a jubilee grant as part of the determining salary for making various payments, including for pension purposes. The Court determined in its ruling that the source of the right to administrative call duty benefits is contractual and that the parties to the agreement may determine the terms of granting the right, its scope and its limits, and therefore, full validity should be given to the limits set forth in the Company's procedure, whereby the payment for the administrative call duty benefit is not considered as salary in any way insofar as rights deriving from agreements are concerned. Nevertheless, the decision determined that the administrative call duty benefits should be included in the determining salary for the calculation of rights under law (Hours of Work and Rest Law and the Annual Vacation Law). In the opinion of the Company's external legal advisers, this decision appears to close the door on the claim that the component of administrative call duty benefits should be seen as salary in every respect. In view of the above and in accordance with the resolution of the Board of Directors of the Company of October 28, 2004, the Company has reduced the provision it made in its financial statements in respect of the component of administrative call duty benefits by approximately NIS 145 million.

On January 17, 2005 the Supreme Court gave a decision in a petition (to which the Company is not a party) against a ruling of the National Labor Court that the grossing up of tax component (in respect of the value of use of a vehicle and in respect of reimbursement of telephone expenses) should be recognized as part of the determining salary for pension purposes. The Supreme Court vacated the decision of the National Labor Court and determined that the grossing up of the tax component paid as aforesaid is not part of the determining salary for pension purposes, since that component is secondary to the salary increment in respect of which the tax is grossed up, and it should be treated in the same way as a salary increment is treated. Since this petition refers to increments which are not part of the determining salary for pension purposes, the grossing up of tax component thereon is also not part of the determining salary for pension purposes.

## NOTE 19 - CONTINGENT LIABILITIES (CONTD.)

### A. CLAIMS (CONTD.)

(5) (Contd.)

Following this decision of the Supreme Court and in view of the opinion of the Company's external legal advisers that following the Supreme Court ruling there is a good chance that claims filed against the Company and relating to the grossing up of tax component can be dismissed, and after examining the salary components which are grossed for tax in the Company, it appears that the risk to which the Company is exposed in relation to recognition of the grossing up of tax component as a pensionable component in pending claims against it has been reduced considerably, and accordingly, no provision has been made in the financial statements. In view of the above, the provision of approximately NIS 62 million for the grossing up of tax component which was recorded in the books, has been cancelled.

No provision has been made in the financial statements in respect of other components subject to the above claims, , relying on the opinion of the Company's external legal advisers that the risk in respect thereof, cannot be assessed.

(6) On September 7, 2000, an action and an application for approval as a class action were filed against the Company in the Tel Aviv – Jaffa District Court, based on Article 29 of the Civil Proceedings Regulations, 5744-1984 ("Article 29"). The amount of the claim is estimated at approximately NIS 110 million. According to the plaintiff, the Company unlawfully collected "collection fees" from its subscribers for Company bills which were not promptly paid, before it had started any collection actions in connection with the plaintiffs' debt. According to the plaintiff, Article 2 of the Telecommunications Regulations (Arrearage interest and collection fees), 5747-1987 ("the Collection Regulations") authorizes the Company to collect collection expenses for a bill in arrears only if the collection action against the consumer has been initiated, and therefore the Company exceeded its authority. In addition, the plaintiff alleges that charging collection fees before taking any action is an administrative offense, fraud, under Section 56 of the Torts Ordinance (New Version), false representation, negligence, harm to the proprietary right, violation of legislated duty, unjust enrichment, and fulfillment of a contract in bad faith. There are two main reliefs requested by the plaintiff – declaratory, in which the Court is requested to declare that the collection of "collection expenses" by the Company in the circumstances described in the claim was unlawful and that the Company may not continue to collect such expenses in the future, and an "operative – financial" relief, for reimbursement of said amounts. On January 7, 2001 the Company filed its response to the application for approval of the claim as a class action, to which it attached a financial opinion of an auditor. In its response the Company alleges that Article 29 does not constitute legal grounds for filing class actions and therefore the application for approval should be dismissed *in limine*. Alternatively, the Company alleged that the claim does not meet the criteria of Article 29 for filing a class action. The Company also alleged in its response that it charges the collection expenses only to subscribers who have caused it to incur expenses due to arrears in payment, that the plaintiff's interpretation of the provisions of the Collection Regulations are groundless, and that it acted lawfully. On February 8, 2001 the plaintiff filed his reply to the Company's response.

On October 18, 2001 an additional class action was filed in the Tel Aviv – Jaffa District Court on the same matter as the above claim, unlawful charging of collection fees of Company bills not paid on time, before the Company had started any collection action. The plaintiff alleges that this action constitutes exploitation of the consumer's difficulties, in contravention of the Consumer Protection Law, 5741-1981 ("the Consumer Protection Law"), as well as unjust enrichment. The amount of the class action is estimated by the plaintiff at about NIS 21 million. On December 16, 2001 the court approved a suspension requested by the Company until after giving a decision on the application for approval as a class action of the first claim described in this sub-section, in view of the similarity of the causes of action in the two cases.

## NOTE 19 - CONTINGENT LIABILITIES (CONTD.)

### A. CLAIMS (CONTD.)

(6) (Contd.)
On February 20, 2003 the District Court approved the first action as a class action in the name of whoever was charged collection fees by the Company despite having paid the relevant bill before the Company commenced collection actions as explained in the statement of claim, from March 7, 1997 to the date of filing the claim. In its decision, the court determined that the Company's authority to collect collection expenses depends on the initiation of means of collection involving costs, and that the Company had not presented proof that retrieving the data of payment arrears, before any action is taken against them, involves costs. In addition, the court determined that Article 29, on which the application for approval relies, was suitable grounds for a class action. On March 17, 2003 the District Court suspended the proceedings in the claim until a decision on the application for leave to appeal which will be filed by the Company. On March 20, 2003 the Company filed an application in the Supreme Court for leave to appeal the decision to allow the action as a class action. In its application, the Company claimed, *inter alia*, that that the District Court's interpretation of the Collection Regulations is erroneous and disregards their language and purpose, and that even were its interpretation correct, the plaintiff would still have no cause against the Company since the Company collects the collection expenses by virtue of the Collection Regulations only from subscribers whose arrears require additional handling, which the Company would not have required had the payment been made on time.

The Company further alleged that the District Court erred when it determined that no proof was presented of the Company bearing expenses in relation to a bill that is not promptly paid before the elapse of 14 days arrears, since an affidavit of the Company was presented which described the expenses it incurs due to the fact of arrears, as well as a financial opinion on the same matter, which the court had disregarded in its decision.

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

(7) In September 2000 a claim and application for approval as a class action were filed in the Haifa District Court against the Company. The amount of the action cannot be assessed, and is estimated at more than NIS 795 million. According to the plaintiffs, the Company unlawfully collected from its subscribers a fixed payment for the lease of telephones which the Company made available to them, so they allege, since the telephones were supplied to subscribers without a specific lease agreement being made, without disclosure and proper publication of the fact that this was a "lease" transaction for an unlimited term, and also concerns the amount of the "lease fee" demanded and the continued collection of the "lease fee" even after the date on which the Company's subscribers had paid the "lease fees" in an amount equal to the full value 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.

## NOTE 19 - CONTINGENT LIABILITIES (CONTD.)

### A. CLAIMS (CONTD.)

(7) (Contd.)
In addition, on November 21, 2000 the Company received another class action which was filed in the Haifa District Court together with an application for approval as a class action. The amount of this claim is estimated at approximately NIS 254 million. It should be noted that the additional action makes claims which are similar or identical to those in the above action from September 2000.

On April 25, 2001 the plaintiffs' application for consolidation of the hearings in the two claims, was approved. 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 claim of all the plaintiffs is now estimated at more than one billion shekels. In its response, the Company claimed that the amounts were maintenance fees collected in connection with Company equipment which was made available to subscribers and that the charge and the rate of such charge were prescribed in law and covered the considerable costs to the Company for providing the service.

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

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

(8) On September 28, 2000, three plaintiffs filed a claim and application for approval as a class action in the Tel Aviv District Court against the Company, Bezeq International and the other international communications operators. The plaintiffs estimated the amount of the claim in million of shekels per year.

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 which, according to the plaintiffs, the Company acts as a "collection pipeline" for the international operators to which the payment is due), in contravention of the VAT law and its regulations and in violation of a legislated duty, in a manner that breaches existing telecommunications agreements, while acting in bad faith in the fulfillment of such contracts and with negligent conduct. The plaintiffs make further allegations against the international operators concerning the collection of VAT in respect of calls made from abroad to Israel using phone cards. The plaintiffs estimate the total loss incurred by the group due to the unlawful collection of VAT for all the calls made from abroad to Israel in the relevant period (since October 20, 1998) at millions of shekels per year.

There are two main reliefs requested by the plaintiffs: declaratory, stating that each of the defendants violated its obligations under the contractual agreement between it and the member of the group with which it contracted, and financial, for restitution of said amounts (compensation for the loss incurred by the members of the group which the plaintiffs are requesting to represent, in the aforesaid amounts). The defendants filed their responses and Bezeq International filed an application for dismissal *in limine* of the application for approval as a class action. On June 18, 2001 the Attorney General gave notice that he would appear in this proceeding. On January 6, 2002 the Court decided to conjoin the Director General of the VAT authority as an additional defendant in the action and the application for its approval as a class action, and denied the application of Bezeq International for dismissal *in limine*. At a hearing on February 28, 2002, the plaintiffs' attorney clarified that the plaintiffs are not demanding independent relief from the communications companies, but rather, reimbursement of the VAT which the Director General of the VAT authority will pay them if the claim is successful.

## NOTE 19 - CONTINGENT LIABILITIES (CONTD.)

### A. CLAIMS (CONTD.)

(8) (Contd.)
The plaintiffs' attorney also proposed that the communications companies be considered formal defendants. In view of the A.S.T. Ruling, the Court decided on August 25, 2003 to strike the application for approval of the claim as a class action and therefore also the action itself.

On October 13, 2003 the plaintiffs filed an appeal against this decision in the Supreme Court. On April 18, 2004 the Supreme Court decided to suspend the proceedings in the case until after its decision in the further hearing in the matter of A.S.T. In the opinion of Bezeq International and the Company, relying on their external legal advisers, in the circumstances to date and taking note, *inter alia*, of the status of the Company (and of the other defendant communications companies) as a formal respondent, and noting the statements of the plaintiffs' attorney that there is no claim for independent relief against the communications companies (including, the Company) – no financial exposure of the Company seems likely in connection with this claim, (and if any such exposure exists, then it is minimal). In addition, the Company has credible defense arguments pertinent to the matter itself for refuting the action. Accordingly, no provision has been made in the financial statements in respect of this claim.

(9) In September 2001, an application was filed in the Tel Aviv District Court for approval of a class action against the Company. The plaintiffs allege that in view of certain amendments to the Telecommunications Regulations, the maximum payment that could be collected from a Company subscriber who called a Pelephone subscriber in off-peak hours during the period between October 2000 and December 31, 2000, was lower than the amount actually collected. The applicants estimate the amount of the claim, as at the date of filing the application for approval of a class action, at about NIS 44 million. The Company filed a response to the application for approval, in which it alleged mainly that it simply acts as a non-discretionary collection contractor and that the conditions required for approval of the claim as a class action have not been met. On May 12, 2002 the Company's request to conjoin Pelephone as a party to the proceeding was allowed. On August 29, 2002 Pelephone filed a response to the application for approval as a class action, to which it attached confirmation from the Ministry of Communications that the plaintiffs' interpretation does not reflect the intention of the formulator of the Regulations. The parties filed their summations in the application for approval of the class action. On January 14, 2005 the Court gave its decision denying the application for approval. To the best of the Company's knowledge, the plaintiff intends to appeal.

(10) a. In March 2003 a statement of claim was filed in the Tel Aviv District Court against the Company, the Broadcasting Authority and the State of Israel by various plaintiffs from Moshav Porath in the Sharon region, including the estates of deceased persons, for compensation due to physical harm pursuant to the Torts Ordinance. The statement of claim alleges violation of legislated duties and acts and/or failures allegedly perpetrated by the defendants jointly and/or severally in connection with the operation of the Hillel broadcasting station, which is located near the homes of the plaintiffs. It is also alleged that as a result, the plaintiffs were subjected to illegal radiation from the broadcasting station causing bodily harm, which in the most part, had ended in the death of some of the plaintiffs.

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

## NOTE 19 - CONTINGENT LIABILITIES (CONTD.)

### A. CLAIMS (CONTD.)

(10) a. (Contd.)

The Company filed a statement of defense to which it attached expert opinions in occupational medicine and non-ionizing radiation safety, which state, *inter alia*, that there is no causal connection between the broadcasts of the Hillel station and the alleged cancer of the plaintiffs. The plaintiffs filed a response in which they argue against the Company's experts and their opinions. In the opinion of the Company, relying on its external legal advisers, whose opinion is based on the expert opinions mentioned above, the chances of the claim being dismissed are greater than the chances that the claim against the Company will be allowed. Accordingly, no provision has been included in the financial statements in respect of this claim.

It should be noted that following an application for dismissal *in limine* filed by the Company, a partial decision was given in favor of the Company, denying the claim of five plaintiffs who died before the Company commenced operation of the station.

The Company is reserving its arguments against the other defendants, the State of Israel and the Broadcasting Authority. These arguments relate mainly to the fact that the station was operated by the Company for and on behalf of the other defendants, in accordance with directives and operational requirements of the other defendants or any of them, and that the Company acted in accordance with the provisions of any law and with the directives of the various authorities, including those which were responsible for the broadcasting activity from the station.

b. On June 13, 2004 another claim was filed in the Tel Aviv District Court by 25 plaintiffs from Moshav Porath and Moshav Ein Vered, including 11 heirs of the estates of deceased persons, against the Company, the Broadcasting Authority and the State of Israel, for compensation in respect of bodily harm (18 of the plaintiffs are suing the Company, the Broadcasting Authority and the State, and 7 plaintiffs are suing only the Broadcasting Authority and the State).

The additional claim alleges violation of legislated duties and acts and/or failures allegedly perpetrated by the defendants jointly and/or severally in connection with the operation of the Hillel broadcasting station, which is located near the homes of the plaintiffs. It is alleged that as a result, the plaintiffs were subjected to illegal radiation from the broadcasting station causing bodily harm, which had ended in the death of some of the plaintiffs.

The amount of the compensation demanded in the additional claim has not been estimated (although the claim is in the jurisdiction of the District Court, i.e. more than NIS 2.5 million), and the compensation is based on financial and non-financial damages items which are listed in respect of each plaintiff, together with punitive compensation. The claim also states that the plaintiffs will petition to split the reliefs sought so that they will reserve the right to sue later for other financial damages which are not bodily harm allegedly caused, and that this refers to damage to crops, loss of value of land, deterrence of potential investors and the like. According to the plaintiffs, these damages amount to "in excess of millions of shekels", but have not yet been calculated. The Company filed a statement of defense on October 31, 2004.

At this stage, the legal external advisers of the Company are still unable to assess the chances of the Company's defense against the claim. Nevertheless, since the claim is similar in essence to the first claim mentioned above, the Company's external legal advisers expect (subject to the aforesaid) that the chances that this claim will be dismissed are greater than the chances of it being allowed, and accordingly, no provisions has been included in the financial statements in respect of these claims.

## NOTE 19 - CONTINGENT LIABILITIES (CONTD.)

### A. CLAIMS (CONTD.)

(10) (Contd.)
It should be noted that on December 31, 2003 the Company ceased all broadcasts from the station, as demanded by the State and the Broadcasting Authority, and since that date the site no longer serves as a broadcasting site.

(11) In January 2002 a claim for payment of monetary compensation of approximately NIS 56 million and for writs of mandamus were filed in the Tel Aviv - Jaffa District Court by an international communications operator against the Company and Bezeq International. The claim makes allegations concerning the process of customer allocation to the international communications operators. According to the plaintiff, it is entitled to compensation from the Company and from Bezeq International in respect of postponement of implementation of the allocation process, in respect of diverting those being allocated to Bezeq International by unlawfully including them in the coordinated listing and removing them from the customer allocation process, and in respect of losses it sustained due to the method of the voice announcement of the possibility of dialing from card-operated public telephones. Alternatively, the plaintiff alleges that it is entitled to reimbursement of access fees which it paid to the Company under an interconnect agreement which was allegedly imposed upon it unlawfully. The plaintiff also requests that the court give orders directing investigations and accounts be made in relation to certain actions in the allocation process and for changing the order of the voice announcement in public telephones so as to ensure, in its opinion, equality among the international operators. On April 22, 2002 the Company filed a statement of defense, in which it denied the allegations of the plaintiff. In the statement of defense the Company claimed, *inter alia*, that postponement of the date for completing the allocation process derived, among other things, from objective failures and difficulties.

The Company also alleged that in the subscriber survey its role was purely technical, and involved nothing more than collating the data and preparing a file of those who participated. The Company relied, for this purpose, on data conveyed to it by the three international operators, and was extremely careful in processing the data and even on its own initiative, beyond the call of duty, identified errors that had occurred in them (insofar as these were apparently reasonable to discover, by means of the systems at its disposal).

In addition, the Company filed a third party notice against the Ministry of Communications in the full amount of the claim. In the notice the Company alleges, *inter alia*, (as in the statement of defense) that in all its actions relating to the allocation process, the Company acted as the agent and long arm of the Ministry of Communications and under its instruction, that the Ministry of Communications devised, planned and supervised the allocation process, directed it and dictated the manner of its implementation and the timetables for each stage of its implementation, and to the extent that it was flawed in any way, the Ministry of Communications is exclusively responsible.

Bezeq International also filed a statement of defense and a third party notice.

On July 3, 2002 the plaintiff filed its reply. On October 14, 2002 the Ministry of Communications filed a statement of defense to the third party notice filed against it by the Company and Bezeq International. As at the date of signing the financial statements, the claim had not yet been heard. The Company and Bezeq International, relying on their external legal advisers, are unable, at this stage, to estimate the chances and the implications of the claim. Accordingly, no provision has been made in the financial statements in respect of this claim.

## NOTE 19 - CONTINGENT LIABILITIES (CONTD.)

### A. CLAIMS (CONTD.)

(12) In January 2002 the Company received a letter of demand from a supplier, in which it was alleged that an order issued by the Company to the supplier for a total sum of about NIS 31 million, is valid. According to the Company, the order was contingent upon suspending conditions which were not fulfilled, and therefore the order is not valid. About a year ago the supplier sent the Company a letter to which it attached a draft statement of claim for approximately 2 million Euro and the Company replied to that letter, rejecting the supplier's allegations and repeating its own allegations. In the opinion of the Company, relying on the legal advisers who are handling the demand on its behalf, the chances of the Company's defense should a claim to be filed against it in this matter, cannot be estimated. Accordingly, no provision has been included in the financial statements in respect of this claim.

(13) In February 2002 a claim and application for recognition as a class action were filed against the Company in the Tel Aviv District Court, concerning reimbursement of a commission which the plaintiff alleges was collected unlawfully, for calls in Israel from a public telephone operated by means of a BezeqCard. The amount of the class action is estimated by the plaintiff at about NIS 15 million as at the date of filing the claim. Summations have been filed in the matter of the application for recognition as a class action and the case is awaiting a decision on that application. On February 23, 2004 the Telecommunications Regulations (Payments for telecommunications services listed in the addendum to the Law) (Amendment of the 5759-1999, 5760-2000 and 5761-2001 regulations), 5764-2004 were published, in which the Telecommunications Regulations (Payments for telecommunications services listed in the addendum to the Law) were amended for the years 1999-2001. In the opinion of the legal advisers who are handling the claim for the Company, following the above amendment, the basis for the claim and the application for recognition as a class action has been removed, and accordingly, no provision has been made in the financial statements in respect of this claim.

(14) On July 25, 2002 the Company received a claim for monetary and declaratory relief together with an application for recognition as a class action by virtue of both Article 29 of the Civil Proceedings Regulations and the Antitrust Law 1988 – 5748 ("the Antitrust Law"), which had been filed in the Tel Aviv - Jaffa District Court against the Company. The plaintiffs, who contend that they are Company subscribers or use its services, allege that the Company unlawfully collects interest on arrears, as defined in a directive concerning Accountant General's interest rates, in respect of arrears in payment for services provided by other communications providers, which are included in the invoice which the Company issues to its subscribers. The plaintiffs allege that the Company may collect such interest only in respect of arrears in payment for the telecommunication services provided by the Company itself. They further allege that the Company does not transfer to the other communications providers the full amount of interest on arrears it collects, and that by collecting the additional arrearage interest, the Company enriched itself unlawfully at their expense and perpetrated an administrative offense against them. The plaintiffs are requesting declaratory relief including for the Company's exploitation of its monopolistic status and that the Company be directed to reimburse the interest on arrears that it allegedly 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.

## NOTE 19 - CONTINGENT LIABILITIES (CONTD.)

### A. CLAIMS (CONTD.)

(14) (Contd.)
On February 11, 2003 the Company filed its response to the application. Its arguments are that since it is the one which bears the costs of collecting the bill from the subscribers, there can be no dispute that it is entitled to interest for arrears in payment of the bills both legally by virtue of the Adjudication of Interest and Linkage Law and by virtue of the licenses of the other communications providers, that according to a practical interpretation of the interest regulations it is entitled to collect the additional arrearage interest at the rate prescribed in those regulations. In addition, the Company argued that the basic assumption of the plaintiffs, that the arrearage interest under the interest regulations is necessarily higher than the arrearage interest under the licenses of the communications providers and/or under the Adjudication of Interest and Linkage Law, is unfounded and incorrect. In this context the Company showed that in calculating the damages, the plaintiffs have disregarded several benefits that the Company grants its subscribers, as a result of which some of the plaintiffs suffered no damages and some suffered damages that were much lower than alleged in the claim, and in any case the plaintiffs in the class action suffered no damages and therefore cannot serve as appropriate plaintiffs in a class action, that Article 29 cannot serve as legal grounds for filing a class action, and that the filing of the action is tainted with serious delay which is sufficient for its dismissal.

Following the A.S.T. Ruling, the plaintiffs filed an agreed claim in January 2004 and an amended application for approval from which the parts relating to Article 29, and causes of action the source of which was not the Antitrust Law, had been stricken. The Company filed its amended response on May 3, 2004, and summations have been scheduled for filing. In the opinion of the Company, relying on its external legal advisers, the chances of the claim and the application for approval cannot be estimated at this stage, and therefore no provision has been included in the financial statements in respect of this claim.

(15) On December 22, 2002 a financial claim for grant of a declaratory order and injunction, together with an application for recognition as a class action, were filed in the Tel Aviv-Jaffa District Court against the Company. The plaintiffs, who contend that they are subscribers of cellular communications providers, allege that the Company is misleading the consumer public regarding calls to 1-800 or 1-700 numbers, into thinking that such numbers are toll-free calls, whereas in fact, the consumer who calls such a number from a cellular telephone is charged by the cellular companies for air-time for those calls. According to the plaintiffs, in so doing, the Company is perpetrating torts according to the Consumer Protection Law (deception of the consumers, including deception in advertising, exploitation of the distress of consumers and refraining from disclosure of essential information to consumers), and all the members of the group represented in the action (all the consumers who called 1-800 or 1-700 from a cellular telephone during the seven years prior to the date of filing the claim) 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 temporary and permanent injunctions against the Company, to cease misleading consumers and to refrain in the future from advertising or making any other representation liable to mislead consumers regarding the price of such calls. On March 27, 2003 the Company filed its response to the application for approval, in which it alleged, *inter alia*, that no transaction was made between it and the plaintiffs, that the advertisements did not make representations towards the plaintiffs and that all the representations of the Company were correct. In addition, the Company contended that the claim does not meet even one of the conditions required under the Consumer Protection Law for its approval as a class action.

The case is in preliminary proceedings. In the opinion of the Company, relying on its external legal advisers, the chances and implications of the claim cannot be estimated at this stage, and therefore no provision has been made in the financial statements in respect of this claim.

## NOTE 19 - CONTINGENT LIABILITIES (CONTD.)

### A. CLAIMS (CONTD.)

(16) On April 24, 2003 a statement of claim was filed in the Tel Aviv-Jaffa District Court, titled "Derivative Claim" (a claim filed by a shareholder or director of a company in the name of the company, with the approval of the court). The claim was filed by a shareholder of the Company against 20 directors and certain senior managers who served in the Company during October and November 2000 ("the Officers") and against the Company. The statement of claim alleges as the main cause of the action, the negligent conduct of the officers in the "Pelephone-Shamrock transaction". In that transaction, the shares of Motorola Israel Ltd. in Pelephone Holdings L.L.C., a corporation registered in the U.S.A. ("the Foreign Corporation"),were sold to in consideration of approximately $591 million.

On June 12, 2003 the Company filed an application for the dismissal *in limine* of the claim, citing as its reason that the plaintiff had not filed a preliminary application for approval of his claim as a derivative claim, as required by law. Concurrently, the Company filed an application for extension of the date for filing a statement of defense until a decision was given on the application for dismissal *in limine*. The Company's application to extend the date was allowed. A similar application for dismissal *in limine* was also filed by the officers. On January 8, 2004 the plaintiff filed an application requesting, *inter alia*, leave to file a preliminary independent application for approval of the claim as derivative, and on that basis he requested denial of the applications for dismissal *in limine*. On January 15, 2004 the court determined that the plaintiff may file an independent application for approval of the claim as derivative, and the Company would be required to file its response to that application. The plaintiff was granted an extension for filing the application until April 1, 2004, but by that date he had not done so. On May 17, 2004 the plaintiff filed an application to strike the claim in *limine*, without an order for costs. The claim was stricken, thereby ending the proceeding.

(17) On May 27, 2003, a statement of claim was received at the Company's offices together with an application for recognition as a class action, which were filed against the Company in the Tel Aviv-Jaffa District Court. The plaintiff who describes himself as "a private internet user" alleges in his claim that the Company refuses to install splitters for high speed internet lines of the broadband ADSL/frame relay type used for internet service in condominiums, and does so, allegedly, in order to increase its profits. The plaintiff, who is seeking to represent all the internet users in Israel, further alleges that the Company's refusal to install the splitters causes losses of thousands of shekels each year to every private internet user, since the connection of a number of tenants in a condominium on one telephone line using such splitters would considerably reduce the fees paid to the Company by each consumer. The pretexts for the claim as they appear in the statement of claim, are cited by virtue of the Antitrust Law, the Torts Ordinance and the Unjust Enrichment Law and not by case law. The plaintiff also alleges fraud and material deception under the Consumer Protection Law. The amount of the claim is estimated by the plaintiff at NIS 2.5 billion (NIS 10,000 per consumer), which he alleges is the loss sustained by the plaintiffs. The plaintiff also petitions that the Company be charged, in addition, with special and punitive damages, and for an order for the Company to give accounts for all private internet users in respect of the amounts received from them from the time each user started using the service until the date of the reply. The stage of evidentiary hearings has ended and the case is scheduled for written summations. The main points of the Company's arguments are that there is no basis in law for obligating it to connect a number of users on one "broadband" and that the service and the tariff collected by the Company for it were approved by the Ministry of Communications. In the opinion of its external legal advisers, the Company has credible arguments in its defense. Nevertheless and relying on its legal advisers, the Company is unable, at this stage, to estimate the chances of the claim, and accordingly no provision has been made in respect of the claim in the financial statements.

## NOTE 19 - CONTINGENT LIABILITIES (CONTD.)

### A. CLAIMS (CONTD.)

(18) On June 5, 2003, a statement of claim was received at the Company's offices together with an application for recognition as a class action, which were filed in the Tel Aviv-Jaffa District Court against the Company by two of its subscribers. According to the allegations in the statement of claim, the Company overcharged its subscribers by NIS 0.021 (plus VAT) compared with the charge set in the regulations for calls from Company subscribers to subscribers in the cellular networks of Cellcom and Pelephone, during the period (estimated) from June 1996 to August 31 of that year. The plaintiffs allege that in so doing, the Company violated the ban on misleading consumers as laid down in the Consumer Protection Law, breached duties under the Contracts Law, the Torts Ordinance and the Sale Law as well as unjust enrichment. The group in whose name the claim is filed is defined by the plaintiffs as "a group of Bezeq subscribers in Israel who dialed to subscribers of Cellcom and Pelephone in June, July, August 1996" and estimated by them as numbering more than four million subscribers. (It should be noted that at the relevant time, the Company's subscribers numbered about 2.5 million.) Based on the estimation (which is erroneous, as aforesaid) of the number of subscribers and the average "loss" to the plaintiffs (NIS 7.5), the plaintiffs estimate the amount of their claim at about NIS 30 million and are claiming compensation in respect of that loss. A calculation made by the Company found that the difference between actual collection and collection by the applicants' method amounts to about NIS 6 million. Alternatively, the plaintiffs are requesting that the court recognize the claim as a claim for declaratory relief or as a claim for a mandamus against the Company. Concurrently, and according to the statement of claim, claims for similar causes were filed against Cellcom and Pelephone, where the claim against Pelephone was dismissed by the District Court. An appeal against the dismissal of the application against Pelephone was also dismissed on January 5, 2004. The application for approval as a class action was denied with consent on February 17, 2004, and subsequently the statement of claim accompanying it was stricken, thereby ending the proceeding.

(19) Keren Makefet was instructed by the Capital Markets Division at the Ministry of Finance to fulfill the undertakings it had made in connection with the change in the retirement tracks of about 600 Company retirees, contingent upon the Company paying Keren Makefet NIS 50 million. The Company notified Keren Makefet that it is demanding the continued implementation of the agreement that enabled transfer from one retirement track to another at no additional cost to the Company, since Keren Makefet had undertaken not to impose any additional cost on the Company. Subsequently Keren Makefet stopped allowing Company retirees to transfer from one track to another and also ceased complete or partial performance of the retirement agreement with regard to pensions paid in respect of April 2002. On January 11, 2004, a claim was filed in the Tel Aviv Regional Labor Court by 66 retirees who had retired under the retirement agreement of November 1997, alleging that they had elected to receive their pensions under Track B since the personal agreement signed with them under that track embodied a promise of amendment of the wage that determines their pensions in accordance with the "Yellow Note" agreement (i.e. additional payment of up to NIS 650 per employee).

According to the plaintiffs, that promise had not been kept, and therefore a collective agreement was signed on April 2, 2001, which was intended to enable employees to transfer from Track B to Track A. The plaintiffs contend that the April 2001 agreement was applied to only about 70 employees of the 600 or so who wished to exercise their right under it. The claim is consequently for enforcement of the April 2001 agreement. The claim, which was filed initially by 66 retirees, was broadened when, with the approval of the court, other retirees were added to bring the total to 264 retirees. After a preliminary hearing on December 5, 2004, the Company and Makefet filed applications for dismissal of the claim, and alternatively, for is quantification. The plaintiffs responded to the applications, and the Company is now awaiting the decision of the court. It is the opinion of the Management of the Company, relying on its external legal advisers, that the Company is not at risk of actual legal exposure in respect of the claim, in view of Makefet's undertaking not to impose upon the Company any additional cost for application of the agreement. Accordingly, no provision has been made in respect thereof in the financial statements.

## NOTE 19 - CONTINGENT LIABILITIES (CONTD.)

### A. CLAIMS (CONTD.)

(20) At the beginning of July 2004 an action for declaratory relief against Keren Makefet, the State of Israel and the Company, was filed in the Tel Aviv Regional Labor Court by the Organization of Bezeq Retirees and six of its members. The action alleged that the defendants breached agreements for binding arrangements that were made upon the transfer of the employees from the civil service to the Company. According to the plaintiffs, the uniform code under the Economic Recovery of Israel Law should not be applied to them as retirees, and alternatively, the defendants or any of them must compensate them for application of the uniform code. The Company filed an application for dismissal of the claim *in limine*, citing as its reasons, *inter alia*, that the claim is not quantified, and that in the amendment to the retirement agreement from March 18, 2004, the Company undertook that the rights of employees who retired from the Company commencing from the date of application of the uniform code, would not be harmed. The plaintiffs responded to the application, and the Company is awaiting the decision of the court. In the opinion of the external legal advisers of the Company, there are weighty preliminary arguments for dismissal of the action, and there is only low risk that the action will actually impose a financial cost on the Company. Accordingly, no provision in respect of this claim is included in the financial statements.

(21) During 2004, various claims were filed in the Regional Labor Courts in Tel Aviv and Be'er Sheva, against the Company and/or Makefet, by a number of employees who retired from the Company with a disability pension due to their medical condition. Against a background of the pension reforms, these employees were called for a repeat medial examination and were notified of a reduction to their pension, initially of 50%. In their claim, the employees are demanding payment of a full disability pension. A procedural agreement has been drafted between the parties, in which the applications for temporary reliefs have been consolidated into the main case, and until that main case is decided, Makefet will pay advances to supplement the pension to its full rate and the Company will pay Makafet compensation for insurance of half of the salary. If the claim against Makefet is allowed, this compensation will be returned to the Company. In the opinion of the Company, relying on its external legal advisers, the claim has a reasonable chance of being allowed against Makefet and dismissed against the Company, and therefore no provision has been included in the financial statements.

(22) On October 19, 2004, a claim together with an application for its recognition as a class action was filed in the Tel Aviv District Court. The statement of claim alleges that the Company adds VAT to the arrearage interest it collects from its subscribers in respect of arrears in payment, thereby generating over-collection, in contravention of the law, since the arrearage interest of the Accountant General at the Ministry of Finance, which the Company is entitled to collect, includes the VAT component. The claim is grounded, *inter alia*, on the Antitrust Law - 1988 and the Consumer Protection Law - 1981. The amount of the claim against the Company is estimated by the plaintiffs at approximately NIS 87 million (if it is ruled that the ground for the action is only the Consumer Protection Law - 1981, the amount of the claim is estimated by the plaintiffs at about NIS 56 million). In the opinion of the external legal advisers of the Company, the Company has worthy arguments of defense. Nevertheless, they are unable to assess, at this stage, the chances of the action and therefore, no provision has been included in the financial statements in respect of this claim.

## NOTE 19 - CONTINGENT LIABILITIES (CONTD.)

### A. CLAIMS (CONTD.)

(23) On February 10, 2005, the Company received a claim and an application for its approval as a class action which were filed in the Haifa District Court. The statement of claim alleges that the Company's charges for internet access in the "WOW Extra" and "WOW" campaigns in the summer of 2004 and in its calculations, constituted deception, fraud, unjust enrichment and overcharging. The plaintiff also alleges that the acts and/or failures of the defendant constitute a criminal offense under the Consumer Protection Law - 1981, and a tortuous offense. In addition, the plaintiff requests discovery of facts. The grounds for the action are based on the Consumer Protection Law, and the preliminary estimated amount of the class action is NIS 96 million. The plaintiff reserves the right to amend the amount of the claim and to increase it after receipt of the data it has requested. In the opinion of the Company's external legal advisers, it is not possible to assess the chances of the defense in the case at this stage, and therefore no provision has been included in the financial statements in respect of this claim.

(24) In November 1997 a claim was filed in the Tel Aviv-Jaffa District Court, together with an application to recognize the claim as a class action, against the Company, Bezeq International, the Chairman of the Board of Directors of Bezeq International and the then CEO of Bezeq International. The claim alleges, *inter alia*, that the Antitrust Commissioner had 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 registered as Bezeq International subscribers would enjoy the reduced tariffs. The amount of the class action is estimated by the plaintiffs at approximately NIS 50 million. In December 1997 the Company was struck from the claim. On June 19, 2001, the District Court decided to deny 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*. The parties filed their summations.

(24) (Contd.)
In a hearing in the Supreme Court on July 15, 2003, the Supreme Court explained that the District Court had erred procedurally, since it should have decided only on the application to join another plaintiff to the class action and not on the question of denial of the application for approval of the claim as a class action. Accordingly, the appeal was allowed. The case was returned to the District Court and instead of a hearing, the plaintiff's summations were filed on May 16, 2004, and on January 2, 2005, Bezeq International filed its summations on the question of approval of the claim as a class action and on the question of establishment of the plaintiffs' personal cause of action. The legal advisers of Bezeq International believe that there is a reasonable chance that Bezeq International will be able to argue convincingly for denial of the application for approval of the claim as a class action, and therefore no provision has been included in the financial statements in respect of this claim.

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

## NOTE 19 - CONTINGENT LIABILITIES (CONTD.)

### A. CLAIMS (CONTD.)

(25) (Contd.)
On February 2, 2004, the plaintiff filed its reply to the application, requesting its dismissal *in limine.* On February 2, 2004, the plaintiff filed an appeal in the Supreme Court against the decision of the District Court relating to the cause prescribed in the Unjust Enrichment Law . At the request of the State and Bezeq International, in February 2004 the District Court agreed to delay implementation of its decision on approval of the claim as a class action until the decision of the Supreme Court on the application for leave to appeal filed by Bezeq International (see below). Following applications for leave to appeal filed by the State and Bezeq International in the Supreme Court on this matter, the Supreme Court determined, on March 7, 2004, that their applications must be answered, and accordingly, on May 9, 2004 the plaintiff filed its reply to the applications of Bezeq International and the State for leave to appeal. The hearing of the class action and the two applications for leave to appeal were consolidated into one case, the parties filed their summations, and the Court has scheduled a hearing to complete the arguments orally on March 22, 2005.

The Company believes, based on the assessment of Bezeq International and its legal advisers, that if the action is eventually approved also by the Supreme Court as a class action and if it is allowed, the amount of the action is liable to reach hundreds of millions of shekels. However, the legal advisers of Bezeq International estimate that Bezeq International has good arguments against the decision of the District Court, and Bezeq International therefore decided not to include a provision in respect of this claim in the financial statements.

(26) On March 3, 2003, a claim was filed against Bezeq International by a systems vendor for approximately NIS 18.5 million. According to the vendor, Bezeq International unlawfully canceled an agreement to supply and install a customer care and billing system, and it is suing for enforcement of the agreement with Bezeq International and compensation for the losses deriving from the delay in the project, and alternatively – if the claim for enforcement is not allowed – compensation in respect of all the losses it sustained as a result of breach of the contract. On May 26, 2003, Bezeq International filed a statement of defense and a statement of counter-claim in the amount of NIS 10 million, in which it alleged that the contract was canceled because the vendor violated the undertakings it made in the contract. On September 14, 2003, the vendor filed a reply to the counter-claim, in which it denied the allegations of Bezeq International. At the request of the vendor on January 20, 2004, that a date for the pre-trial hearing be set, the Court recommended that the parties use the time until the per-trial hearing for a mediation proceeding. The parties were in contact in order to decide on the identity of the mediator, but were unable to reach agreement. The pre-trial hearing is scheduled for March 15, 2005. The legal advisers of Bezeq International are unable, at this stage, to estimate the chances of the claim. And accordingly, no provision has been included in its financial statements in respect of this claim.

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

The State's claim is based, *inter alia*, on the following: summary of a meeting between Motorola, the Company and the Ministers of Communications and Finance on March 3, 1993, concerning the provision of cellular services by means of a joint company of Motorola and the Company, commencing on January 1, 1994; the original license of the Company, by virtue of which Pelephone operated from the time of its establishment; the license to provide cellular services that was granted to Pelephone on February 7, 1996 , which was valid from January 1, 1994; the Telecommunications Order (Reduction of the percentage of royalties and imposition of the requirement to pay royalties),-5754-1994 ("the Royalties Order"); the Royalties Regulations; unjust enrichment.

## NOTE 19 - CONTINGENT LIABILITIES (CONTD.)

### A. CLAIMS (CONTD.)

(27) (Contd.)
In March 2001 Pelephone filed a statement of defense in which it argued, *inter alia*, that the Royalties Order was void from the date of its issue since it exceeded authority and was unreasonable, and alternatively it was void from the date on which Cellcom won the tender for a second cellular operator; and there is no reason for payment of royalties for the period preceding receipt of the license, and the license cannot constitute a source for charging royalties, and in any case – not retroactively; the Royalties Order does not apply to monthly subscription fees; Pelephone cannot be liable under the memorandum of understanding of March 3, 1993, which set out a general principle but does not supersede secondary legislation, and in any case, Pelephone was not a party to that understanding. On this administrative matter, arguments cannot be based on contracts laws or unjust enrichment laws.

The statement of defense claimed that the amount should be reduced by the sum paid by Pelephone to the State, as aforementioned, , in 1996an amount paid by the Company to the State in respect of the period from January 1, 1994 to October 10, 1994 as part of a compromise agreement between them (dated November 29, 1995), and additionally, an additional sum claimed by the State in respect of royalties for fixed monthly fees, even though the Royalties Order does not apply to this component, should be deducted from the amount claimed. Accordingly, the true dispute, in the opinion of Pelephone, is over NIS 70 million. Pelephone believes, relying on the opinion of the external lawyers who are handling the claim, that the chances of a good defense are real and that the provision it has made in its financial statements is appropriate.

In a counter-claim filed by Pelephone together with the statement of defense, it claims reimbursement of approximately NIS 66 million (principal, interest and linkage up to March 1, 2001) in respect of the amount it paid to the State in 1996.

Before the hearing of the claim and the counter-claim, the parties agreed to transfer the matter to a mediation proceeding, which commenced in 2002 and during which an outside examiner was appointed to check the revenue components on which royalties are payable for the period of the claim and which affect the amount of the original claim. The results of that examination were submitted in September 2004, and found that the maximum amount of royalties on the revenues of Pelephone from January 1, 1994 to February 7, 1996 is only approximately NIS 118 million, of which approximately NIS 23 million relate to the period January – October 1994.

In the opinion of Pelephone's management, relying on the opinion of its external legal advisers who are handling the claim, Pelephone has a good defense. Pelephone's financial statements include a provision which the management believes is appropriate, and will suffice if indeed Pelephone is required to pay any amount in the claim / mediation proceeding.

On February 16, 2004, the Company provided an undertaking to Pelephone, as approved by the Board of Directors on February 12, 2004, that if the mediation proceeding fails, the Company will pay Pelephone any sum it is ordered to pay to the State, if charged in a peremptory decision in respect of royalties for revenues from the provision of cellular services during the period from January 1, 1994 to October 10, 1994. According to the Company, it paid the State for the period under the settlement agreement of November 29, 1995, between it and the State. The undertaking to indemnify is subject to the presentation of the Company's arguments in the proceeding and the consent of Pelephone for the Company to join the action as a third party should the Company request to do so. The Company estimates that the risk of it being ordered to pay is low, and accordingly, no provision has been made in its financial statements.

## NOTE 19 - CONTINGENT LIABILITIES (CONTD.)

### A. CLAIMS (CONTD.)

(28) In July 2001 a claim was filed in the Tel Aviv-Jaffa District Court against Pelephone. The plaintiffs allege that Pelephone's pre-paid service constitutes infringement of a patent of the plaintiff's company. Among the reliefs claimed are that Pelephone be directed to cease and desist from infringing the patent, be ordered to submit a report on the number of cards, revenues and profits, etc., received in respect of the sale of the cards, and ordered to pay NIS 100,000 in compensation. The proceeding in the District Court has been frozen until a decision in a parallel proceeding before the Registrar of Patents, for a ruling on whether the patent is valid is issued. At this stage, Pelephone is unable to estimate the outcome and the implications of the claim.

(29) In September 2001 a claim was filed in the Ramallah District Court by the General Palestinian Public Communications Co. Ltd. ("Paltel"), against Pelephone and another cellular company.

The plaintiff alleges that its license grants it, *inter alia*, the full right and authority to set up, operate, supply, sell and manage services and stations for telephone communication, both landline and cellular, for the supply of fixed and cellular communications services for an extended period, part of which being granted exclusivity. According to the plaintiff, it commenced providing cellular communications services in September 1999, and despite its requests 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, prejudicing the exclusive rights of the plaintiff and causing it losses and damages. The reliefs requested are a permanent judicial injunction preventing the defendants from providing communications services in the areas of the Palestinian National Authority and a financial action for NIS 676 million from Pelephone alone.

Pelephone denies both the allegations of Paltel and the jurisdiction of any court in Ramallah to hear any such claim. On the issue itself Pelephone's position is that it acted and acts in accordance with the provisions of an interim agreement between the State of Israel and the PLO. Procedurally, Pelephone argues that the Palestinian court in Ramallah has neither territorial nor material jurisdiction to hear a claim of this kind.

Pelephone learned that the Ramallah Court may have given a decision on the aforementioned claim. According to the Order referred to above, enforcement of decisions given by a court of the Palestinian Authority may only be executed if approved by the Commissioner for Legal Aid at the Ministry of Justice. Pelephone considers that such a ruling – if made – was made without jurisdiction, contrary to public order and contrary to the provisions of the interim agreement and the Extension of the Effect of the State of Emergency Regulations Law (Judea, Samaria and Gaza Strip, jurisdiction for offenses and legal aid), -1967. If an attempt is made to submit this ruling for the approval of the Commissioner or to enforce it in any way, Pelephone will act to prevent such approval and/or enforcement of the ruling and/or proceedings for execution or to cancel them for the reasons set out above, which formed the basis of the Commissioner's decision to prevent the claim being served on Pelephone in the first place, and additionally due to the fact that the very hearing of the claim in the Ramallah Court without the process having been served in accordance with the Order and the Agreement, constitutes a breach of the agreement and harm to the sovereignty of the State of Israel, and that any ruling handed down in such a claim has no force. Accordingly, no provision in respect of this claim has been included in the financial statements.

## NOTE 19 - CONTINGENT LIABILITIES (CONTD.)

### A. CLAIMS (CONTD.)

(30) In November 2002 an application was filed for leave to appeal the decision of the Tel Aviv District Court from October 1, 2002, which denied the application of the applicants for approval of their claim against Pelephone as a class action. The statement of claim was based on the applicants' allegation that throughout the years when Pelephone was a monopoly in the cellular telephone market, it abused that status and collected exorbitant prices for all its services. The applicants were therefore seeking to order Pelephone to make restitution to its customers of the excess profits it collected and which allegedly amount to the total of the claim (NIS 12 billion). On February 2, 2003, Pelephone responded to the application for leave to appeal. In the opinion of Pelephone and its legal advisers, Pelephone has good defense arguments, although the chances of the appeal cannot be assessed at this stage, and accordingly, no provision has been made in the financial statements in respect of this claim.

(31) In December 2002 a claim was filed in the Tel Aviv-Jaffa District Court against Pelephone and against another cellular company, together with an application for its approval as a class action, in the amount of approximately NIS 4 billion, of which approximately NIS 2.4 billion is against Pelephone.

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

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

b. Pelephone and the other cellular company violated obligations legislated under the authority of the Telecommunications Law, their licenses and the duty of good faith which require a reasonable price for a telecommunications service for which no price is set.

In July 2003 Pelephone filed its response to the application. Pelephone and its legal advisers believe that Pelephone has a good defense, but are nevertheless 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.

(32) In April 2003 an application was filed in the Tel Aviv-Jaffa District Court for approval of a class action in a total amount of approximately NIS 90 million against all the cellular companies. The applicants allege that the three cellular companies formed a cartel among themselves for the collection of a tariff of 38 agorot plus VAT for SMS messages coming in to the network of each of them. The plaintiffs allege that this is a uniform, coordinated, exaggerated, unreasonable and unfair tariff. The period to which the claim relates is March-June 2002 through the date of filing the claim. Pelephone believes, relying on its legal advisers, that it has good arguments for defense against the claim, however at this stage, its chances cannot be assessed. Accordingly, no provision has been made in the financial statements in respect of this claim.

## NOTE 19 - CONTINGENT LIABILITIES (CONTD.)

### A. CLAIMS (CONTD.)

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

The plaintiffs further allege that Pelephone does not comply with subscribers' requests to disconnect them on the date it is required by its license to do so, and accordingly, they are seeking reimbursement of the monthly subscriber fees starting from the date of the request for disconnection until the date of actual disconnection. It is also alleged that Pelephone makes termination of the service to a subscriber conditional upon payment of a penalty of NIS 1,000 per handset.

Pelephone contends that it meets all the service quality indices referred to in its license (which are not measured per subscriber) and the applicants have not established cause of action since the applicants did not request permanent disconnection from Pelephone's services and made their request to disconnect contingent upon conditions which contradict the cellular agreement. Pelephone argues further that it does not make disconnection from the service conditional upon a payment, but acts in accordance with the contractual agreements with it, and that the payment is not a penalty but is for cellular handsets purchased by the plaintiffs by installments. In addition, Pelephone has filed an application for dismissal *in limine* of the application and the action, since they are based on Article 29 of the Civil Proceedings Regulations, 5744-1984. On the recommendation of the Court, in June 2004 the plaintiffs struck the claim and the application for approval as a class action.

(34) On May 13, 2004, a petition was filed in the Supreme Court by the municipalities and local planning and building committees in Herzliya and Ramat Hasharon against the Government of Israel, the National Planning and Building Council, the Minister of Health, the Interior Ministry, the head of the Noise and Radiation Abatement Department at the Ministry of the Environment, the Attorney General, the Future Generations Commissioner and the cellular companies, among them Pelephone. The petition attacks the provisions of the National Outline Plan for Small Communications Installations, Part A (NOP 36), its legality and the manner of its implementation in the field. The petition was heard on July 5, 2004, at which the Supreme Court of Justice ruled to stay the hearing until a later date and to rule on the continuation of the proceedings in the light of a supplementary notice to be submitted by the State Attorney's office within three to four months.

The notice will relate to the Government's position on legislation on the subject of non-ionizing radiation. No date has been set for a further hearing of the petition. At this stage, Pelephone is unable to assess the chances and the implications of the petition.

(35) On December 3, 2002, an application was filed in the Tel Aviv-Jaffa District Court for recognition of a claim as a class action against DBS, the Council for Cable and Satellite Broadcasts and the Ministry of Communications, in connection with the broadcasts of the Channel 5+ sports channel. According to the applicants, the broadcasts of Channel 5+ contravene the terms laid down in the approval issued by the Council for its broadcasting while stripping Channel 5 of its content, in contravention of the aforementioned approval. The applicants, who wish to sue DBS for deception, violation of fiduciary duty and good faith under a contracted agreement, fundamental breach of the contract between DBS and its customers and unjust enrichment, estimate the amount of the claim at approximately NIS 126 million up to the date of its filing and an additional amount of approximately NIS 10.5 million for each month from the date of filing the claim until the date on which the decision is handed down.

## NOTE 19 - CONTINGENT LIABILITIES (CONTD.)

### A. CLAIMS (CONTD.)

(35) (Contd.)
In the opinion of the legal advisers of DBS, it is difficult, at this stage, to estimate whether the claim will be approved as a class action, and if it is approved, what its chances will be. Accordingly, no provision has been made in respect of this claim.

(36) On February 21, 2005, an application was filed in the Tel Aviv-Jaffa District Court against DBS, concerning payment the plaintiff makes to the electricity consumption of installations used to receive DBS's broadcasts. Together with the claim, an application was filed in the court for its approval as a class action, since it concerns thousands of condominiums in which DBS's equipment is installed and which pay for the consumption of electricity of those installations.

According to the plaintiff, about 200,000 households pay a monthly charge of NIS 1.4, from which he concludes that since the start of its operation (which the plaintiff contends is 6 years), DBS should be ordered to pay approximately NIS 20 million.

In the opinion of the legal advisers of DBS, it is difficult, at this stage, to estimate whether the claim will be approved as a class action, and if it is approved, what its chances will be. Accordingly, no provision has been made in respect of this claim.

(37) In 1995, the Company, together with others and through a joint venture company, submitted bids in tenders of the Government of India for the construction of a basic communications system in India. Letters of intent and draft concession agreements for development of the basic telephone system in four provinces, for which the joint venture company in which the Company has a share won the tender, were submitted to the joint venture company .The joint venture company did not sign the letters and drafts because in its opinion, *inter alia,* these documents did not correspond to the terms of the tender. At the time of the tender the joint venture company gave the Indian Ministry of Communications bank guarantees of which the Company's share was 273 million rupees (approximately NIS 26 million). The Indian Ministry of Communications demanded foreclosure of the guarantees at the end of June 1996. On September 19, 1997, the court in India gave a permanent injunction preventing the Indian Ministry of Communications from foreclosing on the guarantees. At the end of October 1997 the Indian Ministry of Communications appealed the decision preventing the foreclosure. During 2003 the proceeding was stricken "for inaction" and an application was filed to revive the proceeding. In the opinion of the Indian lawyer who is handling the case on behalf of the Company, since the proceeding is still in its preliminary stage, its outcome cannot be reasonably assessed with any accuracy, and therefore no provision has been included in the financial statements. It is noted that the Company has no activities in India at this time.

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

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

The amounts of the claims referred to above are adjusted (without the addition of interest) in terms of shekels of December 31, 2004.

## NOTE 19 - CONTINGENT LIABILITIES (CONTD.)

### B. COMMITMENTS

(1) Lease and Rental Contract Commitments

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

| For the year ended December 31 | Consolidated<br>NIS thousands | Company<br>NIS thousands |
|---|---|---|
| 2005 | **223,409** | **63,524** |
| 2006 | **177,073** | **62,565** |
| 2007 | **143,671** | **61,834** |
| 2008 | **110,047** | **56,653** |
| 2009 and thereafter | **266,989** | **131,780** |
| | **921,189** | **376,356** |

(2) DBS is committed to agreements to purchase broadcasting rights which amount to approximately NIS 87 million as at December 31, 2004 (2003 – approximately NIS 149 million).

(3) DBS entered into an agreement to lease space segments of the Amos 1 satellite. The agreement commenced on April 14, 1999 and ends on the earlier of June 30, 2009 or the end of the life of the satellite. In addition, DBS entered into an agreement on May 16, 2001, to lease space segments on the Amos 2 satellite. The lease period will end on the earlier of twelve years after the date of the satellite's launch or at the end of the satellite's life. The satellite was launched in April 2004. The contractual annual lease fees during the next five years as stated in the aforementioned agreements, amount to NIS 482 million

(4) In March 2004 DBS entered into an outsourcing agreement with Ness A.T. Ltd. (hereinafter – Ness), whereby DBS transferred the management of its information systems and project implementation (hereinafter – the Service) to Ness. In addition, DBS transferred to Ness's ownership certain equipment in respect of which the Service is provided and which will, be returned to DBS's ownership at the end of the agreement. The term of the agreement (subject to early termination rights contingent upon payment) was defined as eight years commencing April 1, 2004, and at the end of the term of the agreement it will be extended automatically for a further five years. During 2004, the payments made by DBS to Ness amounted to approximately NIS 14 million. The contractual consideration for 2005 will be approximately NIS 20 million.

(5) In winning a tender for frequencies, Pelephone committed to paying license fees in the amount of NIS 225 million to the Ministry of Communications in six installments (see Note 8D(3)).

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

a. payment of the remainder of the balance of the license fee in the amount of approximately NIS 99 million, during 2004; and

b. return of the aforementioned frequencies to the State, in order that that Pelephone will not have to pay frequency fees from 2003 onwards. In addition and concurrently, Pelephone was granted a right to a future allocation of these frequencies, at which time Pelephone would complete payment of the reduced amount. plus the frequency fees in respect of the relevant period, and all plus linkage differentials and interest as is customary

## NOTE 19 - CONTINGENT LIABILITIES (CONTD.)

### B. COMMITMENTS (CONTD.)

(5) (Contd.)
Between March and August 2004 Pelephone paid the balance of the license fees – approximately NIS 99 million.

On May 4, 2004, Pelephone received a letter from the Ministry of Communications, advising that according to an amended calculation made by the Ministries of Finance and Communications, the amount that Pelephone will be required to pay at the time of allocation of the frequencies in the future, is NIS 51 million rather than NIS 33 million as agreed in March 2004. Pelephone has not yet submitted its position to the Ministers.

(6) In May 2004 Pelephone signed an agreement for upgrading sites with EVDO technology. The contract value is about $44 million, and the upgrade will be carried out during 2004-2005.

(7) In January 2005 Pelephone won a tender issued by the Accountant General at the Ministry of Finance (hereinafter – the AG), to provide cellular services to the various government ministries for a period of three years, commencing April 2005. The tender includes an option for the AG to extend the agreement for a further three years. Under the agreement, Pelephone will supply cellular subscriber equipment to about 25,000 subscribers. The costs of acquiring the subscribers in the AG transaction, approximately NIS 30 million in respect of the supply of subscriber equipment, will be charged at the time of the agreement to the statement of operations.

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

(9) On September 30, 2004, Bezeq International was notified by the American company Verio of termination of the agreement between the companies and the halting of the provision of the host server management service which had been provided to Bezeq International by Verio. According to Verio, the reason for the termination was Bezeq International's breach of the agreement. On October 7, 2004 Verio ceased the service to Bezeq International and deleted the content of the host servers it had operated. As a result, the site hosting service that Bezeq International had provided to its customers was terminated. Bezeq International commenced immediate action to have the service resumed.

Bezeq International made sweeping compensation in the form of three months' service free of charge for customers of the site hosting service who were subscribers to Verio's service on the date it was terminated. The amount of this compensation is not material.

Through the date of approval of the financial statements, a small number of customers had demanded additional compensation, and two claims were filed against Bezeq International. The total amount of these demands is also not material.

At this stage it is not possible to estimate the extent of additional exposure for Bezeq International in this context.

(10) For commitments to purchase fixed assets, see Note 9F.

## NOTE 19 - CONTINGENT LIABILITIES (CONTD.)

### C. SECURITIES, LIENS AND GUARANTEES

(1) The Company has provided guarantees to third parties in the amount of approximately NIS 777 thousand.

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

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

(4) Regarding guarantees provided by the Company with regard to its investments in India, see Note 19A(37).

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

(6) In February 2002, upon the demand of the Ministry of Communications, Bezeq International provided a bank guarantee of $2 million for fulfillment of all the terms of the license to provide international telecommunications services. In December 2004, again at the demand of the Ministry of Communications, Bezeq International provided a bank guarantee of approximately NIS 320,000 for fulfillment of the terms of a special license granted to Bezeq International for a marketing trial. As at the balance sheet date, Bezeq International provided additional bank guarantees in a total amount of approximately NIS 1,500 thousand.

(7) BezeqCall Communications provided a guarantee of approximately NIS 6 million for third parties

(8) Pelephone gave a guarantee to third parties of approximately NIS 74 million, of which approximately NIS 46 million to the Ministry of Communications in connection with the tender for third generation frequencies for cellular telephones.

(9) To secure its obligations, DBS provided documentary credit and guarantees amounting to approximately NIS 73 million (including a bank guarantee of NIS 33 million in favor of the State of Israel).

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

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

## NOTE 20 – SHAREHOLDERS' EQUITY

### A. SHARE CAPITAL

| | Registered | | Issued and fully paid up | |
|---|---|---|---|---|
| | December 31 2004 | December 31 2003 | December 31 2004 | December 31 2003 |
| | No. of shares | No. of shares | No. of shares | No. of shares |
| Ordinary shares of NIS 1 par value each | **2,625,000,000** | 2,625,000,000 | **2,605,045,611** | 2,605,045,611 |

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

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

Pursuant to the framework agreement, on July 24, 2003 the State approached several institutional bodies and requested offers for the purchase of 86,500,000 ordinary shares of NIS 1 par value each of the State's shares in the Company. Subsequently, on July 29, 2003, the State sold those shares to Gmul Sahar Underwriters Ltd. (which offered the highest price) at a price of NIS 4.338 per share. Accordingly, on July 30, 2003 the Company allotted the entire balance of its un-issued registered capital to the State at that time, a total of 23,342,462 ordinary shares of NIS 1 par value each, in consideration of NIS 101,261,807. On October 23, 2003, the registered capital of the Company was increased by 190,000,000 shares, increasing it to 2,625,000,000 shares (this was subsequent to the cancellation, at the beginning of February 2003, of registered capital of 130,000,000 shares in accordance with a decision of the General Meeting of the Company as this capital was not allotted as part of raising capital on the terms prescribed). Immediately after increasing its registered capital, the Company allotted to the State, on October 30, 2003, the balance of the shares in respect of those sold by the State to Gmul Sahar Underwriters Ltd, as well as additional shares in accordance with the framework agreement (a total of 64,398,076 additional shares). The proceeds from this additional allotment amounted to NIS 279,364,943.

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

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

## NOTE 20 – SHAREHOLDERS' EQUITY (CONTD.)

**A. SHARE CAPITAL (CONTD.)**

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

After completion of the sale of the State's shares and allotment of Company shares to the State, the raising of NIS 890 million of capital (NIS 878 million net of the margin) was completed.

**C.** On June 1, 2004 the State of Israel offered, pursuant to a prospectus of the Company of May 24, 2004, 156,000,000 ordinary shares of NIS 1 par value each of the Company (approximately 5.99% of the Company's issued capital). In the public offering, 70,671,100 ordinary shares of NIS 1 par value each were sold (approximately 2.71% of the Company's issued capital) at a price of NIS 4.921 per share, and the State's holdings in the Company as at December 31, 2004 amount to approximately 46.38%.

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

## NOTE 21 – REVENUES FROM TELECOMMUNICATION SERVICES

### Consolidated

| | For the year ended December 31 | | |
|---|---|---|---|
| | 2004 | 2003 | 2002 |
| | Reported amounts | Adjusted for the effects of inflation in shekels of December 2003 | |
| | NIS thousands | NIS thousands | NIS thousands |
| **Revenues from communications services –** | | | |
| Domestic fixed–line communications - traffic | **1,567,631** | 1,990,649 | 2,263,292 |
| Fixed fees | **2,501,250** | 2,289,868 | 2,106,944 |
| Cellular telephone | **2,699,876** | 1,989,970 | 2,094,288 |
| International communications and internet services | **771,290** | 683,037 | 662,767 |
| Multi-channel television | **529,838** | – | – |
| Installation and sale of equipment to subscribers | **825,390** | 590,866 | 526,594 |
| Other | **89,448** | 74,851 | 93,528 |
| | **8,984,723** | 7,619,241 | 7,747,413 |
| Other revenues | **285,081** | 362,027 | 316,067 |
| | **9,269,804** | 7,981,268 | 8,063,480 |

### Company

| | For the year ended December 31 | | |
|---|---|---|---|
| | 2004 | 2003 | 2002 |
| | Reported amounts | Adjusted for the effects of inflation in shekels of December 2003 | |
| | NIS thousands | NIS thousands | NIS thousands |
| **Revenues from communications services –** | | | |
| Domestic fixed–line communications | | | |
| Traffic | **1,590,671** | 2,006,567 | 2,285,628 |
| Fixed fees | **2,354,700** | 2,184,650 | 1,978,721 |
| Total revenues from fixed-line communications | **3,945,371** | 4,191,217 | 4,264,349 |
| Cellular telephone | **414,740** | 428,149 | 546,130 |
| International communications | **126,856** | 134,212 | 135,794 |
| Installation and sale of equipment to subscribers | **169,508** | 144,338 | 152,212 |
| Other | **97,472** | 80,105 | 99,077 |
| | **4,753,947** | 4,978,021 | 5,197,562 |
| Other revenues | **205,744** | 252,540 | 249,506 |
| | **4,959,691** | 5,230,561 | 5,447,068 |

## NOTE 22 – OPERATING AND GENERAL EXPENSES

### Consolidated

| | For the year ended December 31 | | |
|---|---|---|---|
| | 2004 | 2003 | 2002 |
| | Reported amounts | Adjusted for the effects of inflation in shekels of December 2003 | |
| | NIS thousands | NIS thousands | NIS thousands |
| Salaries and related expenses – | | | |
| Operational | **1,565,471** | 1,648,413 | 1,645,885 |
| General and administrative | **549,869** | 304,465 | 335,885 |
| Total salaries and incidentals | **2,115,340** | 1,952,878 | 1,981,770 |
| General expenses | **996,323** | 733,412 | 728,051 |
| Materials and spare parts | **643,013** | 597,676 | 599,736 |
| Consumption of content from satellite services | **200,469** | – | – |
| Cellular telephone expenses | **700,890** | 480,536 | 473,141 |
| Building maintenance | **352,430** | 352,405 | 351,683 |
| Services and maintenance by sub-contractors | **341,999** | 250,220 | 255,484 |
| International communications expenses | **228,936** | 159,478 | 152,184 |
| Motor vehicle maintenance expenses | **144,630** | 118,050 | 96,613 |
| Collection fees | **39,357** | 36,160 | 34,819 |
| | **5,763,387** | 4,680,815 | 4,673,481 |
| Less – wages charged to investment in fixed assets (1) | **198,297** | 195,515 | 147,548 |
| | **5,565,090** | 4,485,300 | 4,525,933 |

### Company

| | For the year ended December 31 | | |
|---|---|---|---|
| | 2004 | 2003 | 2002 |
| | Reported amounts | Adjusted for the effects of inflation in shekels of December 2003 | |
| | NIS thousands | NIS thousands | NIS thousands |
| Salaries and related expenses | | | |
| Operational | **1,122,381** | 1,206,623 | 1,254,861 |
| General and administrative | **271,310** | 241,206 | 269,738 |
| Total salaries and incidentals | **1,393,691** | 1,447,829 | 1,524,599 |
| General expenses | **341,977** | 342,492 | 304,480 |
| Materials and spare parts | **114,443** | 93,601 | 65,724 |
| Building maintenance | **315,074** | 322,099 | 324,031 |
| Services and maintenance by sub–contractors | **205,192** | 207,843 | 205,919 |
| International communications expenses | **27,105** | 10,685 | 4,943 |
| Motor vehicle maintenance expenses | **111,359** | 101,597 | 82,842 |
| Collection fees | **36,904** | 35,916 | 34,736 |
| | **2,545,745** | 2,562,062 | 2,547,274 |
| Less – wages charged to investment in fixed assets (1) | **198,297** | 195,515 | 147,548 |
| | **2,347,448** | 2,366,547 | 2,399,726 |

(1) Commencing February 2003, following the establishment of a new reporting system in the Company which allows precise measurement of the direct costs of employees in the Engineering Division and the Technology Systems Division, the Company capitalized an additional sum for self-constructed fixed assets. The additional amount for the period ended December 31, 2004 is approximately NIS 50 million (2003 – NIS 46 million).

## NOTE 23 – FINANCING EXPENSES, NET

### Consolidated

| | For the year ended December 31 | | |
|---|---|---|---|
| | 2004 | 2003 | 2002 |
| | Reported amounts | Adjusted for the effects of inflation in shekels of December 2003 | |
| | NIS thousands | NIS thousands | NIS thousands |
| Expenses in respect of long-term liabilities | | | |
| Debentures | **(319,522)** | (395,393) | (395,659) |
| Loans | **(121,329)** | (21,015) | (122,413) |
| | **(440,851)** | (416,408) | (518,072) |
| Income in respect of deposits and investments | **195,243** | 249,677 | 21,597 |
| Income (expenses) in respect of derivatives | **(12,250)** | (806) | 331,500 |
| Short-term bank credit | **(2,699)** | (33,470) | (7,515) |
| Interest income from income tax | **–** | – | 5,866 |
| Other income, net | **43,028** | 43,485 | 1,308 |
| | **(217,529)** | (157,522) | (165,316) |

### Company

| | For the year ended December 31 | | |
|---|---|---|---|
| | 2004 | 2003 | 2002 |
| | Reported amounts | Adjusted for the effects of inflation in shekels of December 2003 | |
| | NIS thousands | NIS thousands | NIS thousands |
| Expenses (income) in respect of long-term liabilities | | | |
| Debentures | **(315,175)** | (395,393) | (395,659) |
| Loans | **(20,774)** | 43,618 | (92,114) |
| | **(335,949)** | (351,775) | (487,773) |
| Income in respect of deposits and investments | **194,761** | 248,629 | 23,004 |
| Income in respect of derivatives | **3,834** | 21,024 | 325,515 |
| Interest income from income tax | **–** | – | 8,810 |
| Other income, net | **44,138** | 19,750 | 13,310 |
| | **(93,216)** | (62,372) | (117,134) |

## NOTE 24 – OTHER INCOME (EXPENSES), NET

### Consolidated

| | For the year ended December 31 | | |
|---|---|---|---|
| | 2004 | 2003 | 2002 |
| | Reported amounts | Adjusted for the effects of inflation in shekels of December 2003 | |
| | NIS thousands | NIS thousands | NIS thousands |
| Provision for claims for salary and pension components (1) | **207,000** | (195,000) | – |
| Provision for employee severance benefits upon early retirement (2) | **(105,000)** | (419,016) | – |
| Write-off and impairment of fixed assets (3) | **–** | (327,295) | – |
| Provision for impairment and other liabilities in respect of investments in other companies | **(26,000)** | (42,908) | (10,143) |
| Provision for decrease in value of investment in convertible debentures (4) | **–** | – | (1,209,312) |
| Amortization of goodwill | **(35,135)** | (1,032) | (111) |
| Capital gain from sale of operation (5) | **35,033** | – | – |
| Capital gains, net | **7,338** | 1,634 | 12,739 |
| Other | **(3,556)** | 439 | 123 |
| | **79,680** | (983,178) | (1,206,704) |

### Company

| | For the year ended December 31 | | |
|---|---|---|---|
| | 2004 | 2003 | 2002 |
| | Reported amounts | Adjusted for the effects of inflation in shekels of December 2003 | |
| | NIS thousands | NIS thousands | NIS thousands |
| Provision for claims for salary and pension components (1) | **207,000** | (195,000) | – |
| Provision for employee severance benefits upon early retirement (2) | **(105,000)** | (419,016) | – |
| Write-off and impairment of fixed assets (3) | **–** | (198,686) | – |
| Provision for impairment and other liabilities in respect of investments in other companies | **(26,000)** | (36,110) | (10,254) |
| Provision for decrease in value of investment in convertible debentures (4) | **–** | – | (1,209,312) |
| Capital gain from sale of operation (5) | **35,033** | – | – |
| Capital gains, net | **5,674** | 1,570 | 12,254 |
| Other | **(6,803)** | 294 | 130 |
| | **109,904** | **(846,948)** | **(1,207,182)** |

(1) See Note 19A(5).
(2) See Note 16D.
(3) See Notes 9F, 9G and 9H.
(4) See Note 8D(1).
(5) See Note 9C.

## NOTE 25 – EARNINGS PER SHARE (CONSOLIDATED AND COMPANY)

| | For the year ended December 31 | | |
|---|---|---|---|
| | 2004 | 2003 | 2002 |
| | Reported amounts | Adjusted for the effects of inflation in shekels of December 2003 | |
| | NIS thousands | NIS thousands | NIS thousands |
| Primary and diluted earnings (loss) | **620,825** | (437,836) | (912,775) |
| Weighted number of shares in primary earnings and diluted earnings | **2,605,046** | 2,444,891 | 2,411,658 |

## NOTE 26 – BUSINESS SEGMENTS

The Company operates in various segments of the communications sector, with each company in the Group operating in a separate business segment.

Each company provides services in the segment in which it operates by means of the fixed assets and the infrastructure it owns. The infrastructure of each company is used for providing its services only. Each of the companies in the Group is exposed to different risks and yield opportunities, primarily in relation to the technology and competition in the sector in which it operates.

Each company in the Bezeq Group is a separable component, since each company's business is the provision of service or group of related services, and each company is exposed to different risks and yield opportunities from those of other components.
Based on the above, the business segments of the Bezeq Group are as follows:

- "Bezeq", The Israel Telecommunication Corp. Ltd.– Domestic fixed-line communications.
- Pelephone Communications Ltd. – Cellular telephone.
- Bezeq International Ltd. – International communications and internet services.
- D.B.S. Satellite Services (1998) Ltd. – Multi-channel television.

The other companies in of the Group are presented in other sections.

## NOTE 26 – BUSINESS SEGMENTS (CONTD.)

### A. Business Segments

### Consolidated

| | For the year ended December 31, 2004 | | | | | | |
|---|---|---|---|---|---|---|---|
| | Domestic fixed–line communications | Cellular telephone | International communications and internet services | Multi-channel television | Others | Adjustments | Consolidated |
| | Reported amounts | | | | | | |
| | NIS thousands | NIS thousands | NIS thousands | NIS thousands | NIS thousands | NIS thousands | NIS thousands |
| **Revenues** | | | | | | | |
| Revenues from external sources | 4,736,756 | 2,966,486 | 797,735 | 529,838 | 238,989 | - | 9,269,804 |
| Inter-segment revenues | 222,935 | 8,493 | 18,704 | 12,304 | 80,387 | (342,823) | - |
| Total revenues | 4,959,691 | 2,974,979 | 816,439 | 542,142 | 319,376 | (342,823) | 9,269,804 |
| **Segment results** | 971,016 | 379,328 | 118,223 | (85,381) | 8,362 | - | 1,391,548 |
| Financing expenses | | | | | | | (217,529) |
| Earnings after financing expenses | | | | | | | 1,174,019 |
| Other income, net | | | | | | | 79,680 |
| Earnings before income tax | | | | | | | 1,253,699 |
| Income tax | | | | | | | (497,485) |
| Earnings after income tax | | | | | | | 756,214 |
| Equity in losses of affiliated companies | | | | (126,630) | (8,143) | | (134,773) |
| Minority share in losses of a consolidated company | | | | | (616) | | (616) |
| **Net earnings** | | | | | | | 620,825 |
| Identified assets | 8,589,680 | 4,775,659 | 598,090 | 1,364,941 | 235,240 | (206,476) | 15,357,134 |
| Investment by equity method | | | | | 70,308 | | 70,308 |
| General assets | | | | | | | 4,744,539 |
| **Total consolidated assets** | | | | | | | 20,171,981 |

## NOTE 26 – BUSINESS SEGMENTS (CONTD.)

### A. Business Segments (contd.)

### Consolidated

| | For the year ended December 31, 2004 | | | | | | |
|---|---|---|---|---|---|---|---|
| | Domestic fixed–line communications | Cellular telephone | International communications and internet services | Multi-channel television | Others | Adjustments | Consolidated |
| | | | Reported amounts | | | | |
| | NIS thousands | NIS thousands | NIS thousands | NIS thousands | NIS thousands | NIS thousands | NIS thousands |
| Segment liabilities | 1,412,990 | 858,943 | 233,113 | 595,229 | 133,360 | (200,811) | 3,032,824 |
| General liabilities | | | | | | | 9,673,390 |
| **Total consolidated liabilities** | | | | | | | 12,706,214 |
| **Capital investments** | 850,005 | 588,002 | 116,938 | 160,134 | 173,353 | | |
| **Depreciation and amortization** | 1,502,354 | 418,925 | 117,316 | 162,029 | 18,978 | | |

## NOTE 26 – BUSINESS SEGMENTS (CONTD.)

### A. Business Segments (contd.)

### Consolidated

| | For the year ended December 31, 2003 | | | | | |
|---|---|---|---|---|---|---|
| | Domestic fixed–line communications | Cellular telephone | International communications and internet services | Others | Adjustments | Consolidated |
| | Adjusted for the effects of inflation in shekels of December 2003 | | | | | |
| | NIS thousands | NIS thousands | NIS thousands | NIS thousands | NIS thousands | NIS thousands |
| **Revenues** | | | | | | |
| Revenues from external sources | 5,023,754 | 2,021,807 | 689,378 | 246,329 | – | 7,981,268 |
| Inter-segment revenues | 206,807 | 5,568 | 13,958 | 40,236 | (266,569) | – |
| Total revenues | 5,230,561 | 2,027,375 | 703,336 | 286,565 | (266,569) | 7,981,268 |
| **Segment results** | 906,619 | 96,013 | 90,001 | 72 | 644 | 1,093,349 |
| Financing expenses | | | | | | (157,522) |
| Earnings after financing expenses | | | | | | 935,827 |
| Other expenses, net | | | | | | (983,178) |
| Earnings before income tax | | | | | | (47,351) |
| Income tax | | | | | | (48,013) |
| Loss after income tax | | | | | | (95,364) |
| Equity in losses of affiliated companies | (2,280) | | | (341,054) | | (343,334) |
| Minority share in losses of a consolidated company | | | | 862 | | 862 |
| **Net loss** | | | | | | (437,836) |
| Identified assets | 9,903,468 | 2,258,000 | 527,565 | 213,574 | (106,196) | 12,796,411 |
| Investment by equity method | | | | 240,667 | | 240,667 |
| General assets | | | | | | 3,051,686 |
| **Total consolidated assets** | | | | | | 16,088,764 |
| Segment liabilities | 1,609,316 | 500,091 | 270,031 | 126,516 | (102,649) | 2,403,305 |
| General liabilities | | | | | | 6,840,517 |
| **Total consolidated liabilities** | | | | | | 9,243,822 |
| **Capital investments** | 815,382 | 524,644 | 114,456 | 201,670 | | |
| **Depreciation and amortization** | 1,776,279 | 394,203 | 99,868 | 7,498 | | |

## NOTE 26 – BUSINESS SEGMENTS (CONTD.)

### A. Business Segments (contd.)

### Consolidated

| | For the year ended December 31, 2002 | | | | | |
|---|---|---|---|---|---|---|
| | Domestic fixed–line communications | Cellular telephone | International communications and internet services | Others | Adjustments | Consolidated |
| | | Adjusted for the effects of inflation in shekels of December 2003 | | | | |
| | NIS thousands | NIS thousands | NIS thousands | NIS thousands | NIS thousands | NIS thousands |
| **Revenues** | | | | | | |
| Revenues from external sources | 5,241,263 | 1,958,582 | 670,449 | 193,186 | – | 8,063,480 |
| Inter-segment revenues | 205,825 | 7,642 | 8,272 | 29,444 | (251,183) | – |
| Total revenues | 5,447,088 | 1,966,224 | 678,721 | 222,630 | (251,183) | 8,063,480 |
| **Segment results** | 979,807 | (62,672) | 108,023 | (8,615) | 644 | 1,017,187 |
| Financing expenses | | | | | | (165,316) |
| Earnings after financing expenses | | | | | | 851,871 |
| Other expenses, net | | | | | | (1,206,704) |
| Loss before income tax | | | | | | (354,833) |
| Income tax | | | | | | (207,333) |
| Loss after income tax | | | | | | (562,166) |
| Equity in losses of affiliated companies | (5,851) | | | (347,765) | | (353,616) |
| Minority share in losses of a consolidated company | | 2,850 | | 157 | | 3,007 |
| **Net loss** | | | | | | (912,775) |
| Identified assets | 10,046,942 | 2,258,690 | 685,059 | 189,419 | (120,838) | 13,059,272 |
| Investment by equity method | | | | 382,717 | | 382,717 |
| General assets | | | | | | 2,788,566 |
| **Total consolidated assets** | | | | | | 16,230,555 |
| Segment liabilities | 1,520,047 | 858,703 | 327,518 | 95,437 | (116,771) | 2,684,934 |
| General liabilities | | | | | | 6,955,541 |
| **Total consolidated liabilities** | | | | | | 9,640,475 |
| **Capital investments** | 854,512 | 471,603 | 136,389 | 286,513 | | |
| **Depreciation and amortization** | 1,925,472 | 505,539 | 83,242 | 4,898 | | |

## NOTE 26 – BUSINESS SEGMENTS (CONTD.)

### B. Distribution of The Group's Revenues

The table below provides additional information about the distribution of revenue in the Group according to customer use. The costs relating to this revenue cannot be allocated since expenses relating directly to them are impossible to identify, nor can they be allocated on a reasonable basis.

| | For the year ended December 31 | | |
|---|---|---|---|
| | **2004** | **2003*** | **2002*** |
| | **Reported amounts** | **Adjusted for the effects of inflation in shekels of December 2003** | |
| | **NIS millions** | **NIS millions** | **NIS millions** |
| Telephony – domestic calls, fixed fees and installations | **3,329** | 3,549 | 3,682 |
| Cellular telephone | **3,128** | 2,199 | 2,188 |
| Internet | **773** | 643 | 543 |
| International communications | **599** | 562 | 582 |
| Transmission services and data communication | **608** | 648 | 730 |
| Fixed line infrastructure and maintenance works | **230** | 298 | 272 |
| Multi-channel television services to subscribers | **530** | – | – |
| Others | **73** | 82 | 66 |
| Total | **9,270** | 7,981 | 8,063 |

* Reclassified

## NOTE 27 – TRANSACTIONS WITH INTERESTED PARTIES AND RELATED PARTIES

**A.** The Company is a "mixed company" under the control of the State of Israel, and transacts a significant volume of business, in the ordinary course of its operations, with government ministries, agencies and companies, banks and their related companies. The business transacted is primarily the provision of telecommunications services and the execution of development work, as well as the receipt of various types of services, and their description involves numerous difficulties in view of the wide range of entities concerned and the large volume of transactions (which are primarily, as noted, the provision of the Company's services). It is not practicable to determine the identity of these interested parties involved in such transactions, nor to make a distinction in the recording thereof. The Securities Authority, pursuant to its authority under the Securities Regulations (Preparation of annual financial statements), 5753-1993, exempted the Company from detailing its transactions with interested parties (exemption for 2004 is dated February 15, 2005), other than extraordinary transactions. The exemption is given for transactions with the State and its agents. In the opinion of the Company, the exemption is not harmful to the affairs of the investor in Company securities.

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

The main points of the agreement, which was approved by all of the Company's authorized bodies as required under the Companies Law for a transaction with a controlling interest, are as follows:

(1) The Company will provide telecommunications services to the IDF at a special discounted rate of approximately 28% for services which the Company provided to the IDF prior to signing the agreement and at 14% for services which did not exist or which the Company did not provide for the IDF prior to signing the agreement. Based on the volume of the services which the Company provided to the IDF prior to the date on which the agreement took 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 at least 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 at the end of the agreement term will remain with the Ministry of Defense and ownership of infrastructures outside the IDF bases will remain with the Company.

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

As at the date of publication of the financial statements, negotiations with the Ministry of Defense for a new agreement for the provision of communications services for the period commencing April 1, 2005, are at an advanced stage.

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

**B (Contd.)**

On December 16, 2003 the Company filed a claim in the Tel Aviv District Court against the Ministry of Defense for payment of approximately NIS 57 million in connection with a dispute in the matter of a discount of 18% deducted by the Ministry, as referred to in item (3) above, and on March 16, 2004 the State filed a statement of defense. On May 17, 2004 the Company filed its response. As proposed by the Court, the parties agreed to refer the case to a mediation proceeding, but eventually decided to try to resolve their differences out of court. As at the date of publication of the financial statements, a settlement is being formulated between the parties, and no provision has been included in the financial statements in respect of this claim.

**C.** Regarding guarantees to related parties, see Note 19C.

**D. TRANSACTIONS WITH INVESTEE COMPANIES (COMPANY)**

| | For the year ended December 31 | | |
|---|---|---|---|
| | **2004** | **2003** | **2002** |
| | **Reported amounts** | **Adjusted for the effects of inflation in shekels of December 2003** | |
| | **NIS thousands** | **NIS thousands** | **NIS thousands** |
| **Consolidated companies** | | | |
| Revenues – | | | |
| Interconnect and access fees | **48,320** | 38,515 | 33,403 |
| Services, royalties and commissions | **92,688** | 52,940 | 34,400 |
| Rent and usage fees for buildings and equipment | **4,034** | 541 | 578 |
| Expenses – | | | |
| Purchase of services | **46,221** | 47,092 | 30,641 |
| Interest | **–** | – | 6 |
| **Proportionally consolidated company** | | | |
| Revenues – | | | |
| Interconnect and access fees | **37,533** | 58,458 | 68,559 |
| Services, royalties and commissions | **103,790** | 41,425 | 47,954 |
| Rent and usage fees for buildings and equipment | **10,341** | 6,818 | 11,953 |
| Interest | **1,240** | – | – |
| Expenses – | | | |
| Purchase of services | **3,901** | 2,481 | 4,854 |
| Interest | **–** | 551 | – |
| **Affiliated companies** | | | |
| Revenues – | | | |
| Services, royalties and commissions | **8,063** | 2,812 | 4,947 |

For balances with investee companies, see the relevant notes.

For loans to investee companies and the terms of those loans, see Note 8 and Note 14A(1).

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

### E. BENEFITS FOR DIRECTORS AND THE CEO

| | For the year ended December 31 | | |
|---|---|---|---|
| | 2004 | 2003 | 2002 |
| | Reported amounts | Adjusted for the effect of inflation in shekels of December 2003 | |
| | NIS thousands | NIS thousands | NIS thousands |
| Total cost of compensation of the CEO and the Chairman of the Board * | **1,574** | 1,678 | 1,648 |
| Number of employees | **2** | 3 | 2 |
| Compensation of members of the Board of Directors who are not Company employees** | **1,663** | 1,695 | 1,554 |
| Number of directors receiving compensation | **13** | 16 | 19 |

* The cost in respect of 2003 includes payment of severance pay to the CEO in the amount of approximately NIS 152,000, and in respect of 2002 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 stated at the proportional share of the Company (50%) for the period in which that company was proportionally consolidated.

The Company holds an insurance policy for the directors and officers of the Company. The maximum insurance is $150 million per event and for the period (of 12 months) and up to an additional 20% for legal expenses. On August 5, 2004 the Audit Committee of the Board of Directors of the Company approved the extension of the insurance policy for 12 months, until July 31, 2005. The extension was approved by the general meeting of the shareholders. In addition, the Company will indemnify officers in an amount not exceeding $50 million per officer for a financial obligation imposed upon them in any matter connected with the Company's prospectus from February 27, 1998, and which is not covered by the insurance policy.

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

On May 13, 2004, the general meeting of shareholders of the Company approved an undertaking to officers on the subject of indemnification and insurance, as follows:

(a) An undertaking by the Company regarding the extension of a loan to officers to finance reasonable litigation expenses in legal proceedings, and an undertaking by the Company to acquire an insurance policy for officers at a reasonable cost.

(b) Grant of notes of indemnity in advance to officers of the Company on the following matters:

1. The claim of a shareholder holding 15% or more of the share capital of the Company. The total extent of the indemnity will not exceed $150 million plus $30 million for legal expenses (a claim of this kind was excluded in the officers insurance policy of the Company).

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

### E. BENEFITS FOR DIRECTORS AND THE CEO (CONTD.)

(b) 2. Any matter relating to the prospectus for an offer for sale of securities of the Company by the State of Israel and an offering by the Company, which was published at the end of May 2004. The total extent of the indemnity (including in respect of the advance undertakings to indemnify which were given up to publication of the prospectus and in respect of advance undertakings to indemnify which are to be given, if at all, immediately prior to transfer of control in the Company by the State) shall not exceed 25% of the Company's shareholders' equity (according to the financial statements for 2003, linked to the CPI of November 2003).

On April 20, 2004, the Board of Directors of the Company resolved that the Company would indemnify the employees of the Group who took part in preparation of the prospectus to be published in May 2004, who are not officers of the Company, in respect of financial liability that would be imposed upon them and in respect of reasonable litigation expenses that they might face, with respect to the prospectus, similar in form to the indemnity given to officers.

## NOTE 28 – FINANCIAL INSTRUMENTS AND RISK MANAGEMENT

### A. DERIVATIVES

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

The Group has an excess of monetary liabilities over monetary assets in or linked to foreign currency in the amount of approximately NIS 3,402 million, of which the excess of current liabilities over current assets is approximately NIS 1,004 million. The excess of current liabilities is covered by forward exchange contracts, as described in section C below. The Group has revenues in foreign currency from international telecommunications.

As at December 31, 2004, the excess of CPI-linked monetary liabilities over CPI-linked monetary assets amounted to approximately NIS 3,743 million, of which the excess of current liabilities over current assets was approximately NIS 553 million. As stated in Note 1B, most of the Company's tariffs are subject to government regulation and are revised annually in accordance with the increase in the CPI, net of an efficiency factor.

The Company has limited commitments in derivatives, which are intended solely for purposes of hedging. Regarding the Company's commitments to execute forward exchange contracts as at December 31, 2004 – see section C below.

### B. CREDIT RISK

At December 31, 2004, most of the cash and cash equivalents, as well as bank deposits, are deposited in large Israeli banks. Short-term investments primarily represent investments in government bonds and bank deposits, while a small part is invested in debentures of companies traded on the stock exchange in Israel. Accordingly, Management does not expect significant losses deriving from credit risks.

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

## NOTE 28 – FINANCIAL INSTRUMENTS AND RISK MANAGEMENT (CONTD.)

### C. CURRENCY RISK

The Company and the consolidated companies manage their exposure to currency risk deriving from fluctuations in foreign currency exchange rates in respect of assets, liabilities and cash flows denominated in foreign currency. The Group acts to minimize the currency exposure by forward transactions in foreign currency and by purchasing currency options. Hereunder the details of the derivatives of the Company and consolidated companies as at December 31, 2004:

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

### C. CURRENCY RISK (CONTD.)

**Consolidated**

(1) Forward currency transactions - hedging transactions

| | Purchased currency | Currency payable | Last repayment date | Amounts receivable | Amounts payable | Fair value | Book value |
|---|---|---|---|---|---|---|---|
| | | | | NIS millions | | NIS millions | |
| **Currency exchange transactions at predetermined interest rates –** | Dollar | CPI-linked shekel | February 2005 | 45 | 53 | (8) | (8) |
| | Euro | CPI-linked shekel | October 2005 | 159 | 131 | 28 | 28 |
| **Forward transactions at predetermined currency exchange rate** (excluding premium/discount) **-** | Dollar | Shekel | December 2005 | 1,168 | 1,236 | (56) | (68) |
| | Euro | Shekel | December 2005 | 1,336 | 1,307 | 45 | 48 |
| | CPI-linked Shekel | Shekel | January 2006 | 654 | 661 | (2) | (0.7) |

(2) Forward currency transactions - non-hedging transactions

| | Purchased currency | Currency payable | Last repayment date | Fair value | Scope of commitment |
|---|---|---|---|---|---|
| | | | | NIS millions | |
| **Options purchased (Call)** | Dollar | Shekel | April 2005 | 0.4 | 122 |
| **Options purchased (Put)** | Dollar | Shekel | April 2005 | (0.25) | (44) |

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

### C. CURRENCY RISK (CONTD.)

**Company**

(1) Forward currency transactions - hedging transactions

| | Purchased currency | Currency payable | Last repayment date | Amounts receivable | Amounts payable | Fair value | Book value |
|---|---|---|---|---|---|---|---|
| | | | | NIS millions | | NIS millions | |
| **Currency exchange transactions at predetermined interest rates –** | Dollar | CPI-linked shekel | February 2005 | 45 | 53 | (8) | (8) |
| | Euro | CPI-linked shekel | October 2005 | 159 | 131 | 28 | 28 |
| **Forward transactions at predetermined currency exchange rate** (excluding premium/discount) **-** | Dollar | Shekel | December 2005 | 817 | 869 | (43) | (39) |
| | Euro | Shekel | December 2005 | 1,336 | 1,307 | 45 | 48 |
| | CPI-linked Shekel | Shekel | January 2006 | 654 | 661 | (2) | (0.7) |

### D. INTEREST RISK

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

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

### E. FAIR VALUE OF FINANCIAL INSTRUMENTS

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

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

| | December 31, 2004 | |
|---|---|---|
| | Book value | Fair value |
| | NIS thousands | NIS thousands |
| Debentures: | | |
| Issued to the public | 850,847 | 903,950 |
| CPI-linked | 1,355,286 | 1,479,089 |
| Euro-linked | 1,717,622 | 1,958,668 |
| Unlinked, issued to others | 109,179 | 109,907 |
| Euro-linked, issued to others | 32,086 | 34,872 |
| CPI-linked loans | 1,458,441 | 1,495,044 |
| Unlinked loans | 214,702 | 221,872 |
| Foreign currency loans | 1,004,645 | 997,882 |

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 to those liabilities.

## NOTE 29 – LINKAGE TERMS OF MONETARY BALANCES AS AT DECEMBER 31, 2004

### Consolidated

| | In or linked to foreign currency | | | | | |
|---|---|---|---|---|---|---|
| | Dollar-linked | Euro-linked | Other | CPI-linked | Unlinked | Total |
| | | | Reported amounts | | | |
| | NIS Thousands | | NIS Thousands | | | |
| **Assets** | | | | | | |
| Cash and cash equivalents | 30,373 | 1,301 | – | – | 1,425,433 | 1,457,107 |
| Short-term investments | 171,029 | 24,757 | – | 476,622 | *615,401 | 1,287,809 |
| Trade receivables | 33,296 | – | – | – | 2,081,774 | 2,115,070 |
| Other receivables and debit balances | 519 | 75,982 | – | 8,038 | 8,173 | 92,712 |
| Investee companies | – | – | – | 16,414 | (12,330) | 4,084 |
| Investments, long-term deposits and debit balances | 69,048 | 35,261 | – | 256,986 | 478,397 | 839,692 |
| | 304,265 | 137,301 | – | 758,060 | 4,596,848 | 5,796,474 |
| **Liabilities** | | | | | | |
| Short-term bank credit | – | – | – | – | 88,102 | 88,102 |
| Current maturities of long-term liabilities | 604,548 | – | – | 868,063 | 72,786 | 1,545,397 |
| Trade payables | 572,048 | 52,795 | 1,182 | – | 1,049,544 | 1,675,569 |
| Other current liabilities | 66,401 | 44,829 | – | 169,147 | 1,087,216 | 1,367,593 |
| Long-term loans | 743,130 | – | – | 1,425,268 | 692,536 | 2,860,934 |
| Other long-term debentures | – | 1,749,709 | – | 2,038,438 | 36,392 | 3,824,539 |
| Employee severance benefits | – | – | – | – | 1,272,570 | 1,272,570 |
| Other long-term liabilities | 9,247 | – | – | 437 | 11,941 | 21,625 |
| | 1,995,374 | 1,847,333 | 1,182 | 4,501,353 | 4,311,087 | 12,656,329 |

### Company

| | In or linked to foreign currency | | | | | |
|---|---|---|---|---|---|---|
| | Dollar-linked | Euro-linked | Other | CPI-linked | Unlinked | Total |
| | | | Reported amounts | | | |
| | NIS Thousands | | NIS Thousands | | | |
| **Assets** | | | | | | |
| Cash and cash equivalents | 4,262 | 1,301 | – | – | 1,322,168 | 1,327,731 |
| Short-term investments | 171,029 | 24,757 | – | 476,622 | *613,512 | 1,285,920 |
| Trade receivables | 11,724 | – | – | – | 959,042 | 970,766 |
| Other receivables and debit balances | 286 | 75,982 | – | 103,215 | 9,697 | 189,180 |
| Investee companies | – | – | – | 2,560,089 | – | 2,560,089 |
| Investments, long-term deposits and debit balances | 60,312 | 35,261 | – | 229,614 | 203,196 | 528,383 |
| | 247,613 | 137,301 | – | 3,369,540 | 3,107,615 | 6,862,069 |
| **Liabilities** | | | | | | |
| Current maturities of long-term liabilities | 469,572 | – | – | 141,701 | 72,786 | 684,059 |
| Trade payables | 1,590 | 52,795 | 1,182 | – | 592,651 | 648,218 |
| Other current liabilities | 48,622 | 44,829 | – | 145,829 | 648,271 | 887,551 |
| Long-term loans | 527,730 | – | – | 2,004 | – | 529,734 |
| Other long-term debentures | – | 1,749,708 | – | 4,328,527 | 36,393 | 6,114,628 |
| Employee severance benefits | – | – | – | – | 1,250,829 | 1,250,829 |
| Other long-term liabilities | – | – | – | 437 | – | 437 |
| | 1,047,514 | 1,847,332 | 1,182 | 4,618,498 | 2,600,930 | 10,115,456 |

* Including mutual fund participation certificates of approximately NIS 138 million consolidated and in the Company.
For details of forward exchange contracts for covering exposure to foreign currency, see Note 28C.

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

### Consolidated

| | In or linked to foreign currency | | | | | |
|---|---|---|---|---|---|---|
| | Dollar-linked | Euro-linked | Other | CPI-linked | Unlinked | Total |
| | Adjusted for the effects of inflation in shekels of December 2003 | | | | | |
| | NIS Thousands | | NIS Thousands | | | |
| **Assets** | | | | | | |
| Cash and cash equivalents | 39,179 | 1,798 | – | – | 1,913,373 | 1,954,350 |
| Short-term investments | 164,190 | 18,319 | – | 887,423 | *270,409 | 1,340,341 |
| Trade receivables | 31,448 | – | – | (3,433) | 1,639,608 | 1,667,623 |
| Other receivables and debit balances | 1,614 | 113,023 | – | 20,387 | 22,460 | 157,484 |
| Investments, long-term deposits and debit balances | 61,306 | 56,352 | – | 249,509 | 330,646 | 697,813 |
| | 297,737 | 189,492 | – | 1,153,886 | 4,176,496 | 5,817,611 |
| **Liabilities** | | | | | | |
| Short-term bank credit | – | – | – | 50,000 | 94,714 | 144,714 |
| Current maturities of long-term liabilities | 210,192 | – | – | 609,661 | 464,183 | 1,284,036 |
| Trade payables | 278,999 | 3,512 | 32 | – | 848,173 | 1,130,716 |
| Other current liabilities | 65,318 | 43,542 | – | 83,833 | 972,417 | 1,165,110 |
| Long-term loans | 1,130,183 | – | – | 516,759 | 107,351 | 1,754,293 |
| Other long-term debentures | – | 1,645,811 | – | 569,725 | 109,046 | 2,324,582 |
| Employee severance benefits | – | – | – | – | 1,373,429 | 1,373,429 |
| Other long-term liabilities | 16,220 | – | – | – | – | 16,220 |
| | 1,700,912 | 1,692,865 | 32 | 1,829,978 | 3,969,313 | 9,193,100 |

### Company

| | In or linked to foreign currency | | | | | |
|---|---|---|---|---|---|---|
| | Dollar-linked | Euro-linked | Other | CPI-linked | Unlinked | Total |
| | Adjusted for the effects of inflation in shekels of December 2003 | | | | | |
| | NIS Thousands | | NIS Thousands | | | |
| **Assets** | | | | | | |
| Cash and cash equivalents | 2,725 | 1,798 | – | – | 1,891,995 | 1,896,518 |
| Short-term investments | 164,190 | 18,319 | – | 887,423 | *270,316 | 1,340,248 |
| Trade receivables | 9,189 | – | – | – | 1,012,078 | 1,021,267 |
| Other receivables and debit balances | 1,057 | 113,023 | – | 21,695 | 29,105 | 164,880 |
| Investments, long-term deposits and debit balances | 61,306 | 56,352 | – | 237,506 | 231,078 | 586,242 |
| | 238,467 | 189,492 | – | 1,146,624 | 3,434,572 | 5,009,155 |
| **Liabilities** | | | | | | |
| Short-term bank credit | | | | | | |
| Current maturities of long-term liabilities | 210,192 | – | – | 321,462 | 391,326 | 922,980 |
| Trade payables | 3,666 | 3,512 | 32 | – | 679,307 | 686,517 |
| Other current liabilities | 65,318 | 43,542 | – | 44,308 | 779,089 | 932,257 |
| Long-term loans | 1,013,737 | – | – | 32,475 | – | 1,046,212 |
| Other long-term debentures | – | 1,645,811 | – | 569,725 | 109,046 | 2,324,582 |
| Employee severance benefits | – | – | – | – | 1,363,803 | 1,363,803 |
| Other long-term liabilities | 6,560 | – | – | – | – | 6,560 |
| | 1,299,473 | 1,692,865 | 32 | 967,970 | 3,322,571 | 7,282,911 |

* Including mutual fund participation certificates of approximately NIS 129 million consolidated and in the Company.
For details of forward exchange contracts for covering exposure to foreign currency, see Note 28C.

## NOTE 30 – CONDENSED FINANCIAL STATEMENTS OF THE COMPANY IN HISTORICAL NOMINAL VALUES FOR TAX PURPOSES

### A. ACCOUNTING PRINCIPLES USED FOR STATING DATA IN HISTORICAL NOMINAL VALUES FOR TAX PURPOSES

1. These financial statements were prepared on the historical cost basis.
2. These financial statements include the data of the Company alone, without presentation of consolidated statements, as required under accepted accounting principles.
3. The Company's investments in investee companies are stated on the basis of their historical cost.

### B. BALANCE SHEETS

| | December 31 2004 | December 31 2003 |
|---|---|---|
| | NIS thousands | NIS thousands |
| **Assets** | | |
| Current assets | **3,954,529** | 4,621,820 |
| Materials and spare parts | **130,922** | 151,911 |
| Investments, long-term deposits and debit balances | **569,800** | 651,798 |
| Investment in investee companies | **6,379,360** | 1,397,803 |
| Fixed assets | **4,899,478** | 5,234,511 |
| Other assets | **631,477** | 917,553 |
| | **16,565,566** | 12,975,396 |
| **Liabilities** | | |
| Current | **2,833,945** | 3,161,852 |
| Long-term | **7,324,091** | 4,166,181 |
| | **10,158,036** | 7,328,033 |
| **Shareholders' equity** | **6,407,530** | 5,647,363 |
| | **16,565,566** | 12,975,396 |

## NOTE 30 – CONDENSED FINANCIAL STATEMENTS OF THE COMPANY IN HISTORICAL NOMINAL VALUES FOR TAX PURPOSES (CONTD.)

### B. Statements of Operations

| | For the year ended December 31 | | |
|---|---|---|---|
| | **2004** | **2003** | **2002** |
| | **NIS thousands** | **NIS thousands** | **NIS thousands** |
| **Revenues from telecommunications services** | **4,959,691** | 5,285,062 | 5,523,013 |
| **Costs and expenses** | | | |
| Operating and general expenses | **2,347,448** | 2,397,800 | 2,440,957 |
| Depreciation | **1,178,829** | 1,334,060 | 1,362,889 |
| Royalties to the Government of Israel | **145,318** | 182,181 | 187,596 |
| | **3,671,595** | 3,914,041 | 3,991,442 |
| Operating income | **1,288,096** | 1,371,021 | 1,531,571 |
| **Financing expenses, net** | **(93,216)** | (45,667) | (173,769) |
| Earnings after financing expenses | **1,194,880** | 1,325,354 | 1,357,802 |
| **Other income (expenses), net** | **112,836** | (806,725) | (1,317,364) |
| Earnings before income tax | **1,307,716** | 518,629 | 40,438 |
| **Income tax** | **(573,572)** | (195,754) | (236,439) |
| Net earnings (loss) after income tax | **734,144** | 322,875 | (196,001) |
| **Equity in earnings (losses) of investee companies** | **26,023** | (285,464) | (423,341) |
| Net earnings (loss) | **760,167** | 37,411 | (619,342) |

## NOTE 30 – CONDENSED FINANCIAL STATEMENTS OF THE COMPANY IN HISTORICAL NOMINAL VALUES FOR TAX PURPOSES (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, 2002** | 2,411,658 | 3,432,994 | – | (306,226) | 5,538,426 |
| **Changes in 2002** | | | | | |
| Net loss | – | – | – | (619,342) | (619,342) |
| Dividend proposed after the balance sheet date | – | – | 190,000 | (190,000) | – |
| **Balance as at December 31, 2002** | 2,411,658 | 3,432,994 | 190,000 | (1,115,568) | 4,919,084 |
| **Changes in 2003** | | | | | |
| Net earnings | – | – | – | 37,411 | 37,411 |
| Dividend paid | – | – | (190,000) | – | (190,000) |
| Allotment of shares | 193,388 | 687,480 | – | – | 880,868 |
| **Balance as at December 31, 2003** | 2,605,046 | 4,120,474 | – | (1,078,157) | 5,647,363 |
| **Changes in 2004** | | | | | |
| Net earnings | **–** | **–** | **–** | **760,167** | **760,167** |
| **Balance as at December 31, 2004** | **2,605,046** | **4,120,474** | **–** | **(317,990)** | **6,407,530** |

## NOTE 32 – CONDENSED FINANCIAL STATEMENTS OF PELEPHONE COMMUNICATIONS LTD., DBS SATELLITE SERVICES (1998) LTD. AND BEZEQ INTERNATIONAL LTD.

### 1. PELEPHONE COMMUNICATIONS LTD.

### A. BALANCE SHEET

| | December 31 2004 | December 31 2003 |
|---|---|---|
| | Reported amounts | Adjusted for the effects of inflation in shekels of December 2003 |
| | NIS thousands | NIS thousands |
| Current assets | **1,413,049** | 1,264,002 |
| Long-term trade receivables | **278,778** | 199,136 |
| Investment in investee companies | **4,084** | 2,253 |
| Deferred income taxes | **106,503** | 238,367 |
| Fixed assets | **3,093,675** | 2,977,528 |
| Other assets, net | **334,028** | 339,506 |
| | **5,230,117** | 5,020,792 |
| Current liabilities | **1,794,413** | 1,761,626 |
| Provision for losses of investee company | **–** | 5,372 |
| Long-term liabilities | **1,305,674** | 1,386,774 |
| Shareholders' equity | **2,130,030** | 1,867,020 |
| | **5,230,117** | 5,020,792 |

## NOTE 32 – CONDENSED FINANCIAL STATEMENTS OF PELEPHONE COMMUNICATIONS LTD., DBS SATELLITE SERVICES (1998) LTD. AND BEZEQ INTERNATIONAL LTD. (CONTD.)

### 1. PELEPHONE COMMUNICATIONS LTD. (CONTD.)

### B. STATEMENTS OF OPERATIONS

| | For the year ended December 31 | | |
|---|---|---|---|
| | 2004 | 2003 | 2002 |
| | Reported amounts | Adjusted for the effects of inflation in shekels of December 2003 | |
| | NIS thousands | NIS thousands | NIS thousands |
| Revenues from Pelephone services, sales and services | **4,412,344** | 4,054,749 | 3,932,448 |
| Cost of Pelephone services, sales and services | **3,238,533** | 3,238,098 | 3,455,141 |
| Gross profit | **1,173,811** | 816,651 | 477,307 |
| Sales and marketing expenses | **469,353** | 470,935 | 466,053 |
| General and administrative expenses | **145,334** | 152,447 | 153,856 |
| | **614,687** | 623,382 | 619,909 |
| Operating profit (loss) | **559,124** | 193,269 | (142,602) |
| Financing expenses, net | **(99,597)** | (143,786) | (92,895) |
| Other income (expenses), net | **3,645** | (167) | 1,468 |
| Earnings (loss) before income tax | **463,172** | 49,316 | (234,029) |
| Tax benefit (income tax) | **(153,400)** | (18,289) | 74,038 |
| Earnings (loss) after income tax | **309,772** | 31,027 | (159,991) |
| Minority share in losses of a consolidated company | **–** | – | 5,704 |
| Company's equity in losses of investee companies | **(9,080)** | (6,224) | (654) |
| Net earnings (loss) | **300,692** | 24,803 | (154,941) |

## NOTE 32 – CONDENSED FINANCIAL STATEMENTS OF PELEPHONE COMMUNICATIONS LTD., DBS SATELLITE SERVICES (1998) LTD. AND BEZEQ INTERNATIONAL LTD. (CONTD.)

### 2. DBS SATELLITE SERVICES (1998) LTD.

### A. BALANCE SHEET

| | December 31 2004 | December 31 2003 |
|---|---|---|
| | Reported amounts | Adjusted for the effects of inflation in shekels of December 2003 |
| | NIS thousands | NIS thousands |
| Current assets | **124,393** | 107,188 |
| Broadcasting rights, net | **140,496** | 128,334 |
| Fixed assets, net | **1,102,066** | 1,124,158 |
| | **1,366,955** | 1,359,680 |
| Current liabilities | **595,229** | 1,862,403 |
| Long-term liabilities | **1,299,138** | 31,858 |
| Loans from shareholders | **2,661,540** | 2,271,283 |
| Capital deficit | **(3,188,952)** | (2,805,864) |
| | **1,366,955** | 1,359,680 |

## NOTE 32 – CONDENSED FINANCIAL STATEMENTS OF PELEPHONE COMMUNICATIONS LTD., DBS SATELLITE SERVICES (1998) LTD. AND BEZEQ INTERNATIONAL LTD. (CONTD.)

### 2. DBS Satellite Services (1998) Ltd. (contd.)

### B. Statements of Operations

| | For the year ended December 31 | | |
|---|---|---|---|
| | 2004 | 2003 | 2002 |
| | Reported amounts | Adjusted for the effects of inflation in shekels of December 2003 | |
| | NIS thousands | NIS thousands | NIS thousands |
| Revenues from DBS services | **1,027,992** | 842,374 | 659,902 |
| DBS operating expenses | **1,013,403** | 1,012,159 | 1,069,204 |
| Operating profit (loss) | **14,589** | (169,785) | (409,302) |
| Sales and marketing expenses | **133,511** | 109,859 | 117,108 |
| General and administrative expenses | **72,240** | 84,691 | 114,825 |
| | **205,751** | 194,550 | 231,933 |
| Loss from ordinary operations | **(191,162)** | (364,335) | (641,235) |
| Financing expenses, net | **(171,522)** | (179,608) | (47,178) |
| Other expenses, net | **(3,200)** | (11,201) | (20,715) |
| Net loss | **(365,884)** | (555,144) | (709,128) |

## NOTE 32 – CONDENSED FINANCIAL STATEMENTS OF PELEPHONE COMMUNICATIONS LTD., DBS SATELLITE SERVICES (1998) LTD. AND BEZEQ INTERNATIONAL LTD. (CONTD.)

### 3. BEZEQ INTERNATIONAL LTD.

### A. BALANCE SHEET

| | December 31 2004 | December 31 2003 |
|---|---|---|
| | Reported amounts | Adjusted for the effects of inflation in shekels of December 2003 |
| | NIS thousands | NIS thousands |
| Current assets | **226,434** | 149,765 |
| Long-term investments and debit balances | **23,552** | 12,704 |
| Fixed assets | **355,439** | 375,703 |
| Other assets | **18,106** | 2,695 |
| | **623,531** | 540,867 |
| Current liabilities | **239,133** | 276,061 |
| Long-term liabilities | **181,982** | 180,881 |
| Shareholders' equity | **202,416** | 83,925 |
| | **623,531** | 540,867 |

## NOTE 32 – CONDENSED FINANCIAL STATEMENTS OF PELEPHONE COMMUNICATIONS LTD., DBS SATELLITE SERVICES (1998) LTD. AND BEZEQ INTERNATIONAL LTD. (CONTD.)

### 3. BEZEQ INTERNATIONAL LTD. (CONTD.)

### B. STATEMENTS OF OPERATIONS

| | For the year ended December 31 | | |
|---|---|---|---|
| | **2004** | **2003** | **2002** |
| | Reported amounts | Adjusted for the effects of inflation in shekels of December 2003 | |
| | **NIS thousands** | **NIS thousands** | **NIS thousands** |
| Revenues from international telecommunication services | **816,439** | 703,336 | 678,729 |
| Operating expenses | **503,379** | 431,066 | 380,106 |
| Gross profit | **313,060** | 272,270 | 298,623 |
| Marketing, general and administrative expenses | **194,837** | 188,299 | 190,599 |
| Operating income | **118,223** | 83,971 | 108,024 |
| Financing income (expenses), net | **(4,301)** | (21,830) | 1,583 |
| Earnings after financing | **113,922** | 62,141 | 109,607 |
| Other income (expenses), net | **4,656** | (128,580) | 34 |
| Earnings (loss) before income tax | **118,578** | (66,439) | 109,641 |
| Tax benefit (income tax) | **822** | (3,489) | (10,539) |
| Earnings (loss) after income tax | **119,400** | (69,928) | 99,102 |
| Company's equity in earnings (losses) of an affiliate | **1,440** | (619) | (24,187) |
| Net earnings (loss) | **120,840** | (70,547) | 74,915 |

**Appendix A – List of Group Companies**

| | Percentage control and ownership as at | |
|---|---|---|
| | **December 31 2004** | **December 31 2003** |
| | **%** | **%** |
| **Consolidated Companies** | | |
| Bezeq International Ltd. | **100** | 100 |
| DBS Satellite Services (1998) Ltd. (1) | **49.8** | – |
| Pelephone Communications Ltd. (2) | **100** | – |
| GoNext Ltd. (3) | **100** | – |
| Bezeq Zahav (Holdings) Ltd.(4) | **100** | – |
| BezeqCall Communications Ltd. (formerly Bezeq Bit 1995 Ltd.) (5) | **100** | 100 |
| BezeqCall Ltd. (5) | **100** | 100 |
| Bezeq Globe Ltd. (6) | **–** | 100 |
| Bezeq On Line Ltd. (7) | **100** | 100 |
| GoldNet Communication Services – registered partnership (8) | **74.9** | 74.9 |
| B-One General Partnership (9) | **100** | 67.5 |
| **Proportionally Consolidated Companies** | | |
| Pelephone Communications Ltd. (2) | **–** | 50 |
| GoNext Ltd. (3) | **–** | 50 |
| **Affiliated Companies** | | |
| Stage One Venture Capital Fund (Israel) L.P. (an Israeli Limited Partnership) (hereinafter – the Fund) (10) | **100** | 100 |
| Stage One Capital Investments L.P. (an Israeli Limited Partnership) (hereinafter – SOCI) (10) | **27** | 27 |
| The International Company for Undersea Cables Ltd. (ISCC) (11) | **50** | 50 |
| Aphrodite B.V. Amsterdam (12) | **67** | 67 |
| D.B.S. Satellite Services (1998) Ltd. (1) | **—** | 49.8 |
| Infogate Online Ltd. (13) | **8.12** | 22.9 |
| Pointer Ltd. (14) | **–** | 11.5 |
| Walla! Communications Ltd.(15) | **44.97** | 36.7 |
| Adanet for Business Group Ltd.(16) | **50** | 50 |
| **Companies that are not investees** | | |
| Ambez Ltd. (formerly Comfinet Ltd.) | **17** | 17 |
| Xpert Integrated Systems Ltd. (17) | **16** | 16 |
| Personeta Inc. | **0.6** | 2 |
| Exent Ltd. | **3.5** | 6.2 |
| Atrica Inc. | **0.34** | 0.85 |
| Num4net (18) | **4.45** | – |
| Nexus Telocation Systems Ltd (14) | **6** | – |
| **Venture Capital Funds that are not affiliated** | | |
| Eurofund 2000 L.P | **14.4** | 14.4 |
| B.R.M. Capital Fund L.P | **–** | 2.8 |

(1) See Note 8E.

(2) See Note 8D.

(3) On March 16, 2000 Pelephone signed an agreement for the establishment of GoNext Ltd. (hereinafter – GoNext). The principal operations of GoNext are the set-up and operation of the portal with a link to cellular mediation. The consolidated financial statements include consolidation of the statements of GoNext, which is controlled by Pelephone. On December 29, 2004 Pelephone and GoNext agreed that Pelephone would waive and pardon the balance of its right in GoNext, in the amount of NIS 64,970 thousand, less a current debt balance between the two companies. As a result of this waiver, a capital gain was generated at GoNext, enabling GoNext, for the first time, to allocate the surplus cost created at the time of purchase of half of the shares in GoNext in 2002, to a deferred tax asset.

**Appendix A – List of Group Companies (Contd.)**

(4) See Note 14A (1).

(5) Commencing July 1, 1997, the operations of the two companies were consolidated and BezeqCall ceased its operations.

(6) The company ceased operation commencing July 1, 1998. In 2000 the company decided on voluntary liquidation. The voluntary liquidation proceedings were completed in January 2005 with the liquidation of all of the company's overseas subsidiaries.

(7) The company was founded in December 2000 and commenced operations in 2001. The company provides Call Center Outsourcing services.

(8) In 2002, following exercise of the Put option with AT&T, the Company's holding in the partnership increased to 54%. In March 2003 Malam Systems Ltd. ("Malam") notified the Company of exercise of a Put option it had towards the Company, to sell 20.9% of its holdings in the partnership. In May 2003, on receipt of the required approvals, for changing the holdings in the partnership and on payment of consideration of approximately NIS 6.4 million by the Company, the Company's holdings in the partnership increased to 74.9%, while the holdings of Malam in the partnership decreased to 25.1%.

(9) See Note 8H. The partnership was not consolidated in the financial statements for lack of materiality.

(10) The Fund is a venture capital fund, all of whose management rights are held by SOCI, and the Company has rights in profits only. SOCI's management is implemented by an investments committee in which the Company has no control. As the Company does not control SOCI (nor its management of the Fund), the investments are stated by the equity method. The Company undertook to invest the sum of $20 million in the Fund, of which approximately $15 million was invested by the end of 2004.

(11) ISCC – The Company maintained an undersea cable that it had laid. The Company's equity in the costs of the equipment and its maintenance is charged to fixed assets and to maintenance expenses. In February 1997 use of the undersea cable was halted. In January 1999 the Board of Directors resolved on the voluntary liquidation commencing March 31, 1999.

(12) With the sale of Aphrodite's investment in Emitel and transfer of the profit as a dividend to the Company, Aphrodite ceased its operations and was sold. The shares were transferred in February 2005.

(13) Infogate develops and supplies ASP concept computer communication services in which computers in a broadband network are connected to a central server and receive various services from that server. In January 2005 an additional dilution decreased the Company's holding in Infogate to 6.49%.

(14) In April 2004 the Company signed a share swap contract with Pointer Ltd ("Pointer"), an affiliated company, and the conversion of the loans and capital notes given to Pointer in exchange for shares and options of Nexus Telocation Systems Ltd. ("Nexus"), which is traded on Nasdaq in the U.S.A. The transaction was closed June 28, 2004. The value of the shares that the Company received is approximately NIS 7 million, which was recorded by Pelephone against a capital gain from realization of holdings in an affiliated company.

(15) See Note 8F.

(16) See Note 8G.

(17) In 2001, the Company invested approximately NIS 40 million in Xpert Integrated Systems Ltd. ("Xpert"), in consideration for 16.26% of the capital of that company, as well as options which will enable it to increase its holdings to 19.53%. Xpert is involved in the construction and provision of integration services in the communications field (primarily IP networks) and data security. In 2004 a provision of NIS 26 million was recorded for impairment, in accordance with Standard 15 of the IASB.

(18) Num4net develops technology for providing interconnect services for information.

PVI Actuarial Ltd. 58 Rambam, Ra'anana 43602
Tel: (09) 743 1932 / Fax: (09) 741 1189 / dengelma@zahav.net.il

27 February, 2005

Bezeq, The Israel Telecommunications Corp. Ltd.
15 Hazvi Street
Jerusalem

Dear Sir,

Re: Reserve in respect of early retirement
for the balance sheet as at the end of 2004

**Actuarial Qualifications**

Name: David Engelmayer, Actuary
Education: Qualified actuary – Fellow of the Society of Actuaries in the USA
Member of the Academy of Actuaries in the U.S.A.
Full member of the Association of Actuaries in Israel
M.Sc. in Applied Mathematics, Columbia University, New York
Consent: The actuary consents to publication of the reserve for early retirement

**General**

As requested, we have prepared a calculation for the liability of Bezeq with regard to future early retirements. Currently there remain 990 employees in the potential group, of whom 493 are transferred workers and 497 are not transferred workers. As directed by you, we used a table of remaining expected early retirement for 548 employees under the early retirement agreement reached with the Workers Committee. Of these 548 retirees, 105 will be non-transferred workers and 443 will be transferred workers.
This calculation does not relate to other types of retirement, such as retirement due to death or disability. The calculation was prepared on the basis of data supplied to us, relying on the data and principles of the calculation in the aforementioned agreement.

The retirement schedule for the 548 employees is:

| Retirement Year | Retirees |
|---|---|
| 2005 | 125 |
| 2006 | 200 |
| 2007 | 105 |
| 2008 | 118 |
| **Total** | 548 |

The retirement of the transferred workers and non-transferred workers is proportional to the total (i.e. about 82% transferred and 18% not transferred), for each calendar year.

The actuarial obligation was calculated using a statistical model which reflects the average expected early retirement costs in each future year.

**Effects of the pension reform**

The pension agreement provides two systems for determining pension rights for retirees among the transferred workers:

Track A – which was determined on the basis of the assessment pension rules in the civil service, i.e. the pension will be determined on the basis of the average of the grades in the last three years prior to the retirement and updated according to the rules for civil servants. The pension in this track is linked to the cost-of-living increments and the wage agreements in the economy.

Track B – was determined on the basis of the Makefet bylaws, i.e. it sets the pension according to a relative salary average called the "averages method", taking into account the best 25 years (hereinafter: "**the Averages Method**"). A pension in this track is linked to the CPI on the dates on which a cost-of-living increment was given in the economy.

In June 2003, as part of the reform of the pension funds, the Knesset passed a law that cancels agreements that benefit the workers and the employers. This included cancellation of the calculation formulae that had applied until the date of the reform between Bezeq and the Makefet Fund, which regulate the accounting in respect of a worker taking early retirement.

In the litigation between Bezeq, the Capital Market, Insurance and Savings Division of the Ministry of Finance and the Makefet Pension Fund, the parties reached consensus that for the population that retired up to 01.10.2003 (exclusive) the same cost calculation method would apply as for those who retired prior to 01.06.2003. Makefet, for its part, agreed to recognize the company's retirees after 1.10.2003 as pensioners of the Fund if the company would pay the costs in accordance with circulars 2000/1 and 2000/6 of the Capital Markets Division.

Starting on 1.10.2003, the standard bylaws apply to members of the Makefet Fund, and the Makefet Fund, for its part, may not grant benefits beyond the standard bylaws. This includes the matter of CPI linkage.

Several principal points from the pension fund reform:

- Cancellation of the Bezeq-Makefet agreement (the alpha formulae).
- The retirement age for men and women will rise gradually to 67 and 64 respectively.
- Contributions will rise gradually, for the worker from 5.5% to 7% and for the employer from 12% to 13.5%.
- The rights of the workers will be calculated by the Averages Method according to the 35 best years only (cancellation of Track A).
- The worker will pay up to 1.75% management fees from any pension, on a graduated scale (this does not affect the cost of early retirement).
- The pension will be inflation adjusted only after a cumulative inflation increase of 4.25% or every two years – whichever is the earlier.

**Calculation assumptions**

- Pension circular 2004/8 for early retirement.
- Retirement age: rising gradually to 67/64
- Discount rate: 3.0%
- Management fees: 1.5% of early retirement cost, and 3.5% in respect of lost contributions as a result of the employee’s early retirement.

- Mortality of active persons and disabled persons: as per circular 2000/1
- Persons who become disabled: as per circular 2000/1
- Marriage percentage: as per circular 2000/1
- Age differences: 4 years
- Orphans and parents: as per circular 2000/1
- Retirement grants according to an agreement between the Workers Committee and Bezeq from 2000
- Salary increases in Track A at 4% per year up to early retirement. Additionally, in keeping with Bezeq's instructions, we have assumed an immediate one-off 1.9% increase in Track A salaries.[1]
- Salary increases in Track B at 1.5% per year up to early retirement
- A worker may take early retirement only if he has accumulated 20 years seniority and he is more than 50 years old.
- The distribution of transferred / non-transferred workers is 443 / 105 (respectively)
- Every year, the retirees retire on 1 July of that year, with the exception of 2005 when the retirements are assumed to occur on 1 October, as per Bezeq's instructions.
- Under the standard bylaws, the average wage in the economy does not continue to increase for the purpose of determining the pension of a "frozen" member of the pension fund.

**Changes in the calculation since the previous valuation**

- The bonus pension payable under Track A is calculated assumed employment of 100%, and not on the basis of the weighted average employment percent as was previously the case. The impact of this alteration is an increase of 1.0 M NIS in the cost of early retirement.
- The non-transferred employees' pension accrual is based on the old tables, according to the relevant table for each employee, and not on the accrual table under the new standard byelaws. The impact of this alteration is an increase of 0.8 M NIS in the early retirement cost.

**Results of the calculation**

The cost of early retirement in respect of 548 retirees who will retire between 2005 and 2008, based on the distribution in the table above, amounts to NIS 820.1 million (NIS 665.3 million for Makefet; NIS 151.8 million for grants; NIS 3.0 million for standard deviation). This compares with 1,191.7 M NIS last year. The reduction arises from the retirement of 370 employees (309 transferred employees and 61 non-transferred employees) who were included in last year's report.

We have added one standard deviation to the assessment in respect of uncertainty of who are the workers who will actually retire and when during the year they will retire. We note that use of an average as a cost estimate is on the conservative side as the approach of Bezeq is to offer early retirement to the longer-serving employees in the potential population. The cost of early retirement for long-serving employees, despite the higher salary, is lower because the time to official retirement is shorter.

Penalty in respect of excess years: pension circular 2004/8 demands that if a worker who takes early retirement would have attained 35 years seniority prior to full retirement, the

[1] The impact of this increase is an increase in the cost of early retirement of 16.2 M NIS.

pension fund should be compensated in an amount equal to the excess of contributions (in respect of those years) over the 35 year grant that the fund would have paid the retiree. This calculation was made on an assumption of full implementation of the reform – retirement ages up to age 67/64, contributions rising to 20.5%. We have assumed that the basis for the contributions is the Track A salary, which is closer to the actual salary of the employee from which the contributions are paid. On the other hand, we have assumed that the 35 year grant is based on the Track B salary, according to the new byelaws. This is a conservative assumption as it raises the level of the future contributions and reduces the value of the grant.[2]

**Miscellaneous – Comparison of quarterly data**

- The salary for Track A rose by an average of 1.1%, which is consistent with the model's assumed 4% p.a.
- It must be noted that Makefet alone calculates the data regarding employees' salary according to the new byelaws. For transferred employees the Track B salary rose by 3.6% on average, while for non-transferred employees there was a decrease of 1.6% on average. It is unclear what is the source of this differential development. The overall average increase is 1.1%, which is significantly higher than the model's assumption of 1.5% p.a. (approximately 0.4% per quarter).
- The employees' seniority increased by a quarter of a year for most employees.
- The salary for Histaglut grant rose by 2.7% on average, whilst for the other grants the salary rose by 5.7% on average.

Yours sincerely,

David Engelmayer, Actuary

[2] A court ruling has recently been published, regarding the claim of Bezeq employees against Makefet Pension Fund, stating that retired employees are entitled to receive the 35 year grant on the basis of their last salary, and not on the basis of the pensionable salary under the new byelaws. It is not clear whether this ruling applies also to the fine for the excess years according to pension circular 2004/8. The conservatism, if any, in the calculation is 4.6 M NIS.

Appendix: Assessment of balance sheet reserve – discount interest 3.0%, circular of the Capital Market Division including a penalty in respect of excess years

**Potential Pool Of Early Retirees** **990**

***Scheduled Leaves:***

| Retire Year | Total Leaves | Senior Management | | | Transferred Employees | | | Non-Transferred Employees | | | Total | | | |
|---|---|---|---|---|---|---|---|---|---|---|---|---|---|---|
| | | Number | Reserve | Grants | Number | Reserve | Grants | Number | Reserve | Grants | Number | Reserve | Grants | Total |
| **2005** | 125 | 0 | 0.0 M | 0.0 M | 1 | 1.2 M | 0.3 M | 0 | 0.0 M | 0.0 M | 1 | 1.2 M | 0.3 M | 1.5 M |
| **2006** | 200 | 0 | 0.0 M | 0.0 M | 0 | 0.0 M | 0.0 M | 0 | 0.0 M | 0.0 M | 0 | 0.0 M | 0.0 M | 0.0 M |
| **2007** | 105 | 0 | 0.0 M | 0.0 M | 0 | 0.0 M | 0.0 M | 0 | 0.0 M | 0.0 M | 0 | 0.0 M | 0.0 M | 0.0 M |
| **2008** | 118 | 0 | 0.0 M | 0.0 M | 0 | 0.0 M | 0.0 M | 0 | 0.0 M | 0.0 M | 0 | 0.0 M | 0.0 M | 0.0 M |
| **2009** | 0 | 0 | 0.0 M | 0.0 M | 0 | 0.0 M | 0.0 M | 0 | 0.0 M | 0.0 M | 0 | 0.0 M | 0.0 M | 0.0 M |
| **2010** | 0 | 0 | 0.0 M | 0.0 M | 0 | 0.0 M | 0.0 M | 0 | 0.0 M | 0.0 M | 0 | 0.0 M | 0.0 M | 0.0 M |
| **Total** | 548 | 0 | 0.0 M | 0.0 M | 1 | 1.2 M | 0.3 M | 0 | 0.0 M | 0.0 M | 1 | 1.2 M | 0.3 M | 1.5 M |

***Other Leaves:***

| Retire Year | Total Leaves | Senior Management | | | Transferred Employees | | | Non-Transferred Employees | | | Total | | | |
|---|---|---|---|---|---|---|---|---|---|---|---|---|---|---|
| | | Number | Reserve | Grants | Number | Reserve | Grants | Number | Reserve | Grants | Number | Reserve | Grants | Total |
| **2005** | 125 | 0 | 0.0 M | 0.0 M | 100 | 139.8 M | 31.5 M | 24 | 10.1 M | 4.5 M | 124 | 149.9 M | 36.1 M | 186.0 M |
| **2006** | 200 | 0 | 0.0 M | 0.0 M | 162 | 224.5 M | 48.8 M | 38 | 15.5 M | 7.1 M | 200 | 240.0 M | 55.8 M | 295.8 M |
| **2007** | 105 | 0 | 0.0 M | 0.0 M | 85 | 120.4 M | 24.4 M | 20 | 8.1 M | 3.8 M | 105 | 128.5 M | 28.1 M | 156.6 M |
| **2008** | 118 | 0 | 0.0 M | 0.0 M | 95 | 136.7 M | 27.3 M | 23 | 9.1 M | 4.3 M | 118 | 145.7 M | 31.6 M | 177.3 M |
| **2009** | 0 | 0 | 0.0 M | 0.0 M | 0 | 0.0 M | 0.0 M | 0 | 0.0 M | 0.0 M | 0 | 0.0 M | 0.0 M | 0.0 M |
| **2010** | 0 | 0 | 0.0 M | 0.0 M | 0 | 0.0 M | 0.0 M | 0 | 0.0 M | 0.0 M | 0 | 0.0 M | 0.0 M | 0.0 M |
| **Total** | 548 | 0 | 0.0 M | 0.0 M | 442 | 621.4 M | 131.9 M | 105 | 42.7 M | 19.6 M | 547 | 664.1 M | 151.6 M | 815.7 M |

***Total Leaves:***

| Retire Year | Total Leaves | Senior Management | | | Transferred Employees | | | Non-Transferred Employees | | | Total | | | |
|---|---|---|---|---|---|---|---|---|---|---|---|---|---|---|
| | | Number | Reserve | Grants | Number | Reserve | Grants | Number | Reserve | Grants | Number | Reserve | Grants | Total |
| **2005** | 125 | 0 | 0.0 M | 0.0 M | 101 | 141.0 M | 31.8 M | 24 | 10.1 M | 4.5 M | **125** | **151.1 M** | **36.3 M** | **187.4 M** |
| **2006** | 200 | 0 | 0.0 M | 0.0 M | 162 | 224.5 M | 48.8 M | 38 | 15.5 M | 7.1 M | **200** | **240.0 M** | **55.8 M** | **295.8 M** |
| **2007** | 105 | 0 | 0.0 M | 0.0 M | 85 | 120.4 M | 24.4 M | 20 | 8.1 M | 3.8 M | **105** | **128.5 M** | **28.1 M** | **156.6 M** |
| **2008** | 118 | 0 | 0.0 M | 0.0 M | 95 | 136.7 M | 27.3 M | 23 | 9.1 M | 4.3 M | **118** | **145.7 M** | **31.6 M** | **177.3 M** |
| **2009** | 0 | 0 | 0.0 M | 0.0 M | 0 | 0.0 M | 0.0 M | 0 | 0.0 M | 0.0 M | **0** | **0.0 M** | **0.0 M** | **0.0 M** |
| **2010** | 0 | 0 | 0.0 M | 0.0 M | 0 | 0.0 M | 0.0 M | 0 | 0.0 M | 0.0 M | **0** | **0.0 M** | **0.0 M** | **0.0 M** |
| **Total** | **548** | **0** | **0.0 M** | **0.0 M** | **443** | **622.6 M** | **132.2 M** | **105** | **42.7 M** | **19.6 M** | **548** | **665.3 M** | **151.8 M** | **817.1 M** |