"BEZEQ" THE ISRAEL TELECOMMUNICATION CORP. LIMITED

INTERIM CONSOLIDATED FINANCIAL STATEMENTS

JUNE 30, 2004

Interim Consolidated Financial Statements as at June 30, 2004 (unaudited)

Contents

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The Board of Directors of
"Bezeq" - The Israel Telecommunications Corp. Limited

Dear Sirs,

Re:Review of the Unaudited Interim Consolidated Financial Statements for the Six-Month Period Ended June 30, 2004

At your request, we have reviewed the interim consolidated balance sheet of "Bezeq" - The Israel Telecommunication Corp. Limited and its subsidiaries as at June 30, 2004, as well as the interim consolidated statement of operations, the interim statement of changes in shareholders' equity and the interim consolidated statement of cash flows for the six-month and three-month periods then ended.

Our review was carried out in accordance with procedures prescribed by the Institute of Certified Public Accountants in Israel. The procedures included, inter alia, reading the said financial statements, reading the minutes of meetings of the shareholders and of the Board of Directors and its committees, as well as making inquiries of persons responsible for financial and accounting matters.

Reports of other auditors were furnished to us which relate to the review of the interim financial statements of subsidiaries, whose assets as at June 30, 2004, constitute approximately 24.6% of the total assets included in the interim consolidated balance sheet and whose revenues constitute approximately 39.8% of the total revenues included in the interim consolidated statement of operations for the six-months then ended. Furthermore, reports of other auditors were furnished to us which relate to investments in affiliated companies in which the Company's investments amount to approximately NIS 60,502 thousand as at June 30, 2004, and the Company's share in the losses in respect thereof amount to approximately NIS 129,330 thousand and NIS 64,446 thousand for the six-month and three-month periods ending on the same date.

As the review is limited in scope and does not constitute an audit in accordance with generally accepted auditing standards, we do not express an opinion on the interim consolidated financial statements.

In the course of our review, including reviewing the reports of other auditors as mentioned above, nothing came to our attention which would indicate the necessity of making material changes to the said interim financial statements in order for them to be in conformity with generally accepted accounting principles and in accordance with the provisions of Section 4 of the Securities Regulations (Periodic and Immediate Reports), 5730-1970.

We draw attention to the uncertainties relating to the following matters, for which the maximum possible exposure is significant:

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

2. A program of early retirement, as described in Note 6.

3. Claims made against the Company and against investee companies, as described in Note 7A.

4. The financial position of a subsidiary company as described in Note 4B. The continuation of the activities of the subsidiary is dependent upon receipt of additional loans from shareholders within the framework of the financing agreements including loans from the Company in accordance with the work plan of the subsidiary.

Somekh Chaikin
Certified Public Accountants (Isr.)
August 19, 2004

Interim Consolidated Balance Sheets

	June 30 2004 (Unaudited)	June 30 2003 (Unaudited)	December 31 2003 (Audited)
	Reported amounts*	Adjusted for the effects of inflation in shekels of December 2003	
	NIS thousands	NIS thousands	NIS thousands
Current assets			
Cash and cash equivalents	**3,199,933**	930,609	1,954,350
Short-term investments	**1,200,490**	1,300,107	1,340,341
Trade receivables	**1,743,501**	1,706,852	1,667,623
Other receivables and debit balances	**374,345**	435,588	415,372
Inventory	**143,027**	115,697	83,995
	6,661,296	4,488,853	5,461,681
Materials and spare parts	**150,736**	165,256	151,911
Broadcasting rights			
Cost	**228,792**	-	-
Less – rights utilized	**105,812**	-	-
	122,980	-	-
Investments and long-term receivables			
Investments, deposits and debit balances	**738,708**	615,114	765,971
Investments in investee companies	**60,502**	320,471	240,667
	799,210	935,585	1,006,638
Fixed assets			
Cost	**31,039,413**	30,099,605	28,385,188
Less - accumulated depreciation	**21,656,097**	20,649,317	19,686,070
	9,383,316	9,450,288	8,699,118
Other assets			
Goodwill	**802,746**	11,304	6,553
Deferred charges and other assets	**213,907**	240,405	202,124
Deferred taxes	**469,469**	377,090	560,739
	1,486,122	628,799	769,416
	18,603,660	15,668,781	16,088,764

	June 30 2004 (Unaudited)	June 30 2003 (Unaudited)	December 31 2003 (Audited)
	Reported amounts*	Adjusted for the effects of inflation in shekels of December 2003	
	NIS thousands	NIS thousands	NIS thousands
Current liabilities			
Bank credit	**1,344,781**	460,989	144,714
Current maturities of:			
Long-term bank loans	**1,072,694**	578,167	685,883
Debentures	**175,612**	593,197	598,153
Trade payables	**1,362,487**	971,730	1,130,716
Employee severance benefits	**658,910**	460,540	602,520
Other current liabilities	**1,470,104**	1,284,388	1,188,200
	6,084,588	4,349,011	4,350,186
Long-term liabilities			
Long-term loans	**1,177,197**	1,808,215	1,754,293
Debentures	**3,530,796**	2,178,086	2,324,582
Employee severance benefits, net	**659,263**	806,421	770,909
Other liabilities	**49,200**	35,354	43,764
Loans provided by the minority in a consolidated company:			
Loans	**1,048,637**	–	–
Less – minority share in deficit of a consolidated Company	**(1,048,637)**	–	–
	5,416,456	4,828,076	4,893,548
Minority rights	**(16,549)**	387	88
Contingent liabilities (Note 7)			
Shareholders' equity	**7,119,165**	6,491,307	6,844,942

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

Date of approval of the financial statements: August 19, 2004

	18,603,660	15,668,781	16,088,764

* 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.

Interim Consolidated Statements of Operations

	For the six-month period ended June 30		For the three-month period ended June 30		For the year ended December 31
	2004 (Unaudited)	2003 (Unaudited)	2004 (Unaudited)	2003 (Unaudited)	2003 (Audited)
	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	Adjusted for the effects of inflation in shekels of December 2003
	NIS thousands		NIS thousands		NIS thousands
Revenues from telecommunications services (Note 9)	**4,020,781**	3,934,582	**2,011,560**	1,956,212	7,981,268
Costs and expenses					
Operating and general expenses (Note 10)	**2,223,980**	2,200,553	**1,133,168**	1,084,077	4,485,300
Depreciation	**938,789**	1,082,498	**466,997**	535,490	2,160,011
Royalties to the Government of Israel	**96,061**	121,257	**48,689**	61,087	242,608
	3,258,830	3,404,308	**1,648,854**	1,680,654	6,887,919
Operating income	**761,951**	530,274	**362,706**	275,558	1,093,349
Financing expenses, net	**68,747**	83,925	**37,998**	52,148	157,522
Earnings after financing expenses	**693,204**	446,349	**324,708**	223,410	935,827
Other expenses (income), net	**23,001**	1,794**	**(7,451)**	1,707**	983,178
Earnings (loss) before income tax	**670,203**	444,555	**332,159**	221,703	(47,351)
Income tax (Note 11)	**266,778**	165,007	**161,464**	79,266	48,013
Earnings (loss) after income tax	**403,425**	279,548	**170,695**	142,437	(95,364)
Equity in losses of affiliates	**129,330**	193,208**	**64,446**	124,189**	343,334
Minority share in losses of a consolidated company	**(128)**	(233)	**(52)**	(803)	(862)
Net earnings (loss)	**274,223**	86,573	**106,301**	19,051	(437,836)
Primary and diluted earnings (loss) per NIS 1 par value of ordinary shares (in NIS)	**0.105**	0.036	**0.041**	0.008	(0.179)

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

** Reclassified

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

Interim Statements of Changes in Shareholders' Equity

	Share capital	Capital reserve for premium on shares	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					
Six months ended June 30, 2004						
Balance as at January 1, 2004 (audited)	**6,309,133**	**1,623,423**	**37,775**	**–**	**(1,125,389)**	**6,844,942**
Net earnings for the period (unaudited)	**–**	**–**	**–**	**–**	**274,223**	**274,223**
Balance as at June 30, 2004 (unaudited)	**6,309,133**	**1,623,423**	**37,775**	**–**	**(851,166)**	**7,119,165**

	Share capital	Capital reserve for premium on shares	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					
Six months ended June 30, 2003						
Balance as at January 1, 2003 (audited)	6,116,378	938,134	37,775	186,416	(688,623)	6,590,080
Net earnings for the period (unaudited)	–	–	–	–	86,573	86,573
Dividend paid (unaudited)	–	–	–	(186,416)	1,070	(185,346)
Balance as at June 30, 2003 (unaudited)	6,116,378	938,134	37,775	–	(600,980)	6,491,307

	Share capital	Capital reserve for premium on shares	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					
Three months ended June 30, 2004						
Balance as at April 1, 2004 (unaudited)	**6,309,133**	**1,623,423**	**37,775**	**–**	**(957,467)**	**7,012,864**
Net earnings for the period (unaudited)	**–**	**–**	**–**	**–**	**106,301**	**106,301**
Balance as at June 30, 2004 (unaudited)	**6,309,133**	**1,623,423**	**37,775**	**–**	**(851,166)**	**7,119,165**

* 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.

Interim Statement of Changes in Shareholders' Equity (Contd.)

	Share capital	Capital reserve for premium on shares	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					
Three months ended June 30, 2003						
Balance as at April 1, 2003 (unaudited)	6,116,378	938,134	37,775	–	(620,031)	6,472,256
Net earnings for the period (unaudited)	–	–	–	–	19,051	19,051
Balance as at June 30, 2003 (unaudited)	6,116,378	938,134	37,775	–	(600,980)	6,491,307

	Share capital	Capital reserve for premium on shares	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					
Year ended December 31, 2003						
Balance as at January 1, 2003 (audited)	6,116,378	938,134	37,775	186,416	(688,623)	6,590,080
Net loss for the year (audited)	–	–	–	–	(437,836)	(437,836)
Dividend paid (audited)	–	–	–	(186,416)	1,070	(185,346)
Issue of shares (audited)	192,755	685,289	–	–	–	878,044
Balance as at December 31, 2003 (audited)	6,309,133	1,623,423	37,775	–	(1,125,389)	6,844,942

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

Interim Consolidated Statements of Cash Flows

	For the six-month period ended June 30		For the three-month period ended June 30		For the year ended December 31
	2004 (Unaudited)	2003 (Unaudited)	2004 (Unaudited)	2003 (Unaudited)	2003 (Audited)
	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	Adjusted for the effects of inflation in shekels of December 2003
	NIS thousands		NIS thousands		NIS thousands
Cash flows from operating activities					
Net earnings (loss)	**274,223**	86,573	**106,301**	19,051	(437,836)
Adjustments to reconcile net earnings (loss) to net cash flows from operating activities (see A below)	**1,194,203**	1,323,439**	**604,235**	714,021**	3,129,841
Net cash derived from operating activities	**1,468,426**	1,410,012**	**710,536**	733,072**	2,692,005
Cash flows for investing activities					
Investment in fixed assets	**(677,703)**	(704,962)**	**(280,460)**	(316,074)**	(1,413,803)
Proceeds from disposal of fixed assets	**42,663**	52,717**	**19,957**	21,994**	86,492
Investment in long-term deposits and investments	**(28,090)**	(4,966)	**(11,917)**	(1,582)	(159,564)
Proceeds from long-term deposits and investments	**35,922**	26,655	**20,478**	2,303	77,216
Decrease (increase) in short-term investments, net	**182,192**	(164,476)	**(77,975)**	(504,771)	(107,137)
Decrease (increase) in materials and spare parts	**(46,401)**	(30,109)	**2,881**	(23,355)	(260)
Investment in investee companies	**(108,129)**	(115,266)	**(61,221)**	(64,450)	(190,037)
Investment in other assets	**(70,424)**	(32,839)	**(24,762)**	(17,612)	(51,124)
Net cash used in investing activities	**(669,970)**	(973,246)**	**(413,019)**	(903,547)**	(1,758,217)
Cash flows from financing activities					
Issue of debentures (after deduction of issue expenses)	**1,320,294**	–	**1,005,294**	–	–
Repayment of other debentures	**(544,281)**	(152,223)	**(28,246)**	(27,728)	(207,623)
Receipt of long-term loans	**139,500**	200,551	**67,474**	48,817	493,191
Repayment of long-term loans	**(371,226)**	(285,013)	**(238,264)**	(169,783)	(557,302)
Receipt (repayment) of short-term bank credit, net	**(97,160)**	(57,861)	**(22,085)**	17,475	(374,137)
Proceeds from allocation of shares	**–**	–	**–**	–	878,044
Dividend paid	**–**	(185,346)	**–**	–	(185,346)
Net cash used in financing activities	**447,127**	(479,892)	**784,173**	(131,219)	46,827
Increase (decrease) in cash and cash equivalents	**1,245,583**	(43,126)	**1,081,690**	(301,694)	980,615
Balance of cash and cash equivalents at the beginning of the period	**1,954,350**	973,735	**2,118,243**	1,232,303	973,735
Balance of cash and cash equivalents at the end of the period	**3,199,933**	930,609	**3,199,933**	930,609	1,954,350

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

** Reclassified

The notes to the financial statements are integral part thereof.

Interim Consolidated Statements of Cash Flows (Contd.)

	For the six-month period ended June 30		For the three-month period ended June 30		For the year ended December 31
	2004 (Unaudited)	2003 (Unaudited)	2004 (Unaudited)	2003 (Unaudited)	2003 (Audited)
	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	Adjusted for the effects of inflation in shekels of December 2003
	NIS thousands		NIS thousands		NIS thousands
A – Adjustments to reconcile net earnings to net cash flows provided by operating activities					
Income and expenses not involving cash flows:					
Depreciation	**938,789**	1,082,498	**466,997**	535,490	2,160,011
Disposal of assets and impairment in value of fixed assets	**–**	–	**–**	–	327,295
Deferred taxes	**1,804**	32,390	**64,818**	13,966	(137,670)
Company's equity in losses of affiliated companies	**129,330**	193,208**	**64,446**	124,189**	343,334
Minority share in losses of a consolidated company	**(128)**	(233)	**(52)**	(803)	(862)
Increase (decrease) in employee severance benefits, net	**(59,784)**	(59,981)	**(9,067)**	(34,997)	46,488
Loss (gain) on disposal of fixed assets	**396**	3,852	**316**	2,577	(1,634)
Provision for decrease in value of investments	**–**	–**	**–**	–**	14,603
Erosion (appreciation) and interest on long-term deposits and investments	**(19,658)**	114,932	**(12,399)**	96,560	25,160
Erosion (appreciation) of short-term investments, net	**10,145**	22,191	**(6,540)**	18,230	(75,381)
Appreciation (erosion) of long-term liabilities:					
Debentures	**1,739**	280	**2,241**	(20,668)	207,133
Long-term loans	**44,925**	(118,726)	**3,546**	(86,017)	(77,647)
Amortization of deferred expenses and other assets	**43,918**	84,180	**20,468**	46,868	138,438
Changes in current assets and liabilities:					
Decrease (increase) in trade receivables	**2,600**	7,168	**101,905**	(18,707)	29,835
Decrease (increase) in receivables and debit balances	**82,129**	110,549	**(1,336)**	25,946	129,706
Decrease (increase) in inventory	**(62,752)**	47,265	**(48,457)**	47,838	78,083
Decrease in trade payables	**(115,863)**	(249,367)**	**(168,985)**	(75,535)**	(123,852)
Increase in other current liabilities	**211,697**	61,677**	**129,346**	49,579**	63,054
Decrease in deferred revenues	**(15,084)**	(8,444)	**(3,012)**	(10,495)	(16,253)
	1,194,203	1,323,439**	**604,235**	714,021**	3,129,841
B - Non-cash transactions					
Acquisition of fixed assets, other assets, materials and spare parts on credit	**58,299**	196,243	**58,299**	196,243	313,119

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

** Reclassified

The notes to the financial statements are integral part thereof.

Interim Consolidated Statements of Cash Flows (Contd.)

	For the six-month period ended June 30		For the three-month period ended June 30		For the year ended December 31
	2004 (Unaudited)	2003 (Unaudited)	2004 (Unaudited)	2003 (Unaudited)	2003 (Audited)
	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	Adjusted for the effects of inflation in shekels of December 2003
	NIS thousands		NIS thousands		NIS thousands
C – Newly consolidated company					
Working capital (excluding cash and cash equivalents)	**1,795,696**	–	**1,795,696**	–	–
Fixed assets	**(1,204,051)**	–	**(1,204,051)**	–	–
Long-term liabilities	**20,862**	–	**20,862**	–	–
Minority loans to a consolidated company	**1,048,637**	–	**1,048,637**	–	–
Less – minority share in deficit	**(1,048,637)**	–	**(1,048,637)**	–	–
Minority rights	**(16,549)**	–	**(16,549)**	–	–
Investment in an affiliated company	**180,553**	–	**180,553**	–	–
Goodwill	**(776,511)**	–	**(776,511)**	–	–
	–	–	**–**	–	–

* 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.

Notes to the Interim Consolidated Financial Statements as at June 30, 2004

NOTE 1 – GENERAL

A. These interim statements were prepared according to generally accepted accounting principles, applicable to the preparation of financial statements for interim financial statements pursuant to Accounting Standard 14 of the Israeli Accounting Standards Board (hereinafter – the IASB) and to the provisions of Chapter D of the Securities Regulations (Periodic and Immediate Reports) 5730-1970.

B. These statements should be read in conjunction with the annual financial statements of the Company and its consolidated companies as at December 31, 2003, and for the year then ended, and the accompanying notes (hereinafter – the Annual Reports).

C. The Company presents in the notes to the interim financial statements only those significant changes in its business and legal environment that occurred from the date of the latest annual financial statements until the date of these interim financial statements. The full and detailed description, including significant changes and developments which occurred in recent years, particularly in the field of cellular telephone services, international communication services, domestic communication services, the opening of these markets to competition and decisions of the Ministerial Committee on Privatization to reduce the State's holdings in the Company, appear in Note 1 to the Company's annual financial statements as at December 31, 2003. The significant changes that occurred from the date of those annual financial statements to the date of these financial statements are as follows:

(1) Further to Note 1A to the financial statements as at December 31, 2003 concerning the Company's license, on March 31, 2004 the Company's license was amended by a comprehensive and extensive revision and consolidated into a format that includes all the amendments made to the license since it was granted in 1994. The license sets out the conditions for the Company's operation and states, *inter alia*, that the Company will provide universal telephony services, associated services and infrastructure services. Under the license, the management of the subsidiaries and the management of the Company are separate, and the introduction of a new service by the Company requires the approval of the Minister of Communications.

According to the Ministry of Communications' notice to the Ministerial Committee on Privatization, the amended license is intended to adapt the general license to the competitive environment in which the Company operates, however the Company believes that certain provisions in the license are expected to restrict the Company's operations and will impede its ability to compete. In addition, on February 5, 2004, the Government, and on March 24, 2004, the Knesset Finance Committee, approved an amendment to the Telecommunications Order that brings it into line, *inter alia*, with an amendment made to the decision on the privatization of the Company and amendments to the Telecommunications Law.

(2) Further to Note 1B to the financial statements as at December 31, 2003, concerning changes in the Company's tariffs and the update thereof, call completion tariffs on the Bezeq network for calls originating on a cellular network, and international interconnect tariffs were lowered on June 1, 2004 by an average rate of 8.2%.

The Company's supervised tariffs were reduced as of June 1, 2004 in accordance with a formula prescribed in regulations, by an average rate of 4.3%. This rate includes an average reduction of approximately 5% in interconnect tariffs paid to the Company.

(3) Further to Note 1E(1) to the financial statements as at December 31, 2003, concerning the Company's appeal to the District Court against the decision of the Minister of Communications regarding interconnect payments between the Company and cellular companies, the ruling of the Court, stating that it had no jurisdiction to hear the appeal, and that therefore the appeal was to be struck out, was received by the Company on August 17, 2004. The Company is currently studying the ruling and will consider its steps accordingly.

NOTE 1 – GENERAL (CONTD.)

(4) Further to Note 1E(2) to the financial statements as at December 31, 2003, concerning the expansion of competition in the international communications market, the Telecommunications Regulations (Telecommunications and Broadcasts) (Processes and Conditions for Receipt of a General License for the Provision of International Telecommunications Service) 5764-2004 were published on March 30, 2004, and were effective on April 22, 2004. Most of the claims of Bezeq International were accepted, and the Regulations provide that a license will not be granted to a corporation in which an interested party is an international operator, nor to a corporation in which a party with considerable influence in it (as defined in the Regulations) is a cellular operator, nor will a license be granted to a corporation that is a domestic carrier or a cellular operator or a significant operator in the international transmission service operations sector (as defined in the Regulations), and a limitation was imposed on an applicant for a license which provides that at least twenty-six percent of all means of control in such applicant must be held by a citizen and resident of Israel. The Regulations also provide that in other situations of cross-ownership, a license will only be granted to a corporation if the Minister is convinced that the grant of the license will promote competition in the field of telecommunications or in the communications operations sector, or is in the public interest. The Minister of Communications may also stipulate restrictions and conditions in the license concerning the relationship between the licensee and companies which hold a right to domestic communications services, a cellular operator or a significant operator as aforesaid, including regarding filling positions in the appointment of officers, information transfer, the existence of separate companies or separate accounting systems for operations, and, in addition, concerning technological or commercial restrictions in setting up an international telecommunications system, in providing services, in implementing interconnect connections and in granting use of the licensee's telecommunications installations.

The shareholders' equity of a corporation applying for a general license pursuant to these Regulations shall not be less than NIS 20 million. The Regulations also stipulate that whoever receives a license will be required to set up an international telecommunications network and to commence provision of international telephone services within six months of the date of grant of the license.

Pursuant to this, the Ministry of Communications granted general licenses for the provision of international telecommunications services to a number of additional operating companies, one of which commenced operations during the course of August 2004. During the coming quarter, the rest of the companies which received general licenses for the provision of international telecommunications services are also expected to commence selling their services.

In the opinion of Bezeq International, the increase in competition will cause a further decrease in international call tariffs, however, as distinct from the commencement of competition in 1997, the extent of international traffic will not significantly increase as a result thereof, as call tariffs today do not prevent the public from using the service. In addition, Bezeq International believes that the aforementioned increase in competition is expected to adversely affect the results of its activities and financial position, and is expected to bring about a further drop in international call tariffs, and to require Bezeq International to respond accordingly. Bezeq International cannot, at this stage, estimate the extent of that effect.

(5) On July 5, 2004, regulations were published relating to processes and conditions for the receipt of a special general license for the provision of domestic fixed-line communications services with no universal service obligation. These Regulations prescribe the manner for filing an application to receive such a license, and the treatment of such application, as well as the conditions and limitations for grant of the license (under the Regulations, the licensee is to be the owner and operator of the telecommunications network via which the services are to be provided to subscribers, but at the same time, the licensee shall 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).

NOTE 1 – GENERAL (CONTD.)

(6) Pursuant to a notice from the Minister of Communications to Pelephone dated July 28, 2004 (which was also sent to the Company on August 8, 2004), following the result of economic work done as part of the process of reviewing interconnect tariffs to cellular networks, the Minister is considering amending the Telecommunications Regulations (Telecommunications and Broadcasts) (Payments for Interconnection), 5760-2000 (the "Regulations") so as to reduce the interconnect tariffs to the cellular network, both in terms of call completion and the transmission of SMS messages.

The main amendments under consideration, according to the Minister's notice, are as follows:

a. Reduction of payments received from a domestic operator or a cellular operator for the completion of one traffic minute on a cellular network from NIS 0.45 per traffic minute to a maximum tariff of NIS 0.27, as of January 1, 2005, and to a maximum tariff of NIS 0.151 as of January 1, 2006.

b. Reduction of payments received from an international licensee for completion of a traffic minute on a cellular network from NIS 0.25 to a maximum tariff of NIS 0.151 as of January 1, 2006.

c. Reduction of payments received from another cellular operator for the transfer of an SMS message from NIS 0.285 to a maximum tariff of NIS 0.058, as of January 1, 2005, and to a maximum tariff of NIS 0.011 as of January 1, 2006.

d. Billing is to be by way of segments of one second (instead of 12 seconds). Likewise, call completion tariffs and SMS tariffs are to be updated each year from January 1, 2007, according to the rate of change in the CPI, and with respect to call completion – using a reduction coefficient of 1%.

The notice to Pelephone and the Company was given as part of a hearing process regarding amendment of the Regulations, and Pelephone and the Company were invited to submit their responses to the Minister's notice. In Pelephone's opinion, if, and to the extent that, the amendments being considered are implemented, it is likely to considerably harm its revenues, and as a result, substantially adversely affect its financial results.

(7) The Company contracts with business customers for defined periods with the aim of encouraging increased use of its services by providing assistance in financing communications equipment or annual financial bonuses by way of discounts which the Company is of the opinion that it is entitled to provide.

Pursuant to a notice from the Ministry of Communications, following an investigation by it, its position is that these contracts contravene the provisions of the law and the Company's general license and therefore it intends to order the Company to rescind the contracts, and if these are not rescinded within the time set out, to order forfeit of a guarantee in the sum of NIS 10 million, and to prohibit the Company from entering into new contracts. The Company has provided the Ministry of Communications with its position in writing, stating that its operations in this regard accord with the provisions of the law and its general license. The Company also objected to the Ministry of Communications' authority to order rescission of agreements that had already been signed, and its authority to forfeit the guarantee under the circumstances. In its estimation, if it is prohibited from entering into this kind of contract, it shall be denied a means that provides it with important and fundamental operations in the field of its operations.

D. 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 gap 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 the said interconnect fee up to the sum of approximately NIS 40 million, by way of amendment of the Royalty Regulations.

NOTE 1 – GENERAL (CONTD.)

The Company expressed its objection to this arrangement because in its opinion, the arrangement harms it and its property, there is no similar precedent to it anywhere in the world, and it could generate distortions, market failure and abuse. Therefore, on July 29, 2004, the Company filed a petition with 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 regarding the compensation promised to the Company. Following submission 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, which clarified that they intended to act to amend the Royalties Regulations in such a way as to ensure that the aforesaid compensation is provided to the Company, and that in the event that the amendment of the Royalties Regulations does not come into force, they shall act to suspend the temporary provision until such amendment is effected.

E. (1) The offer for sale and the offering to the public under the Company's prospectus published on May 24, 2004, contained the following securities:

An offer for sale to the public, by the State of Israel, of approximately 156,000,000 ordinary shares of NIS 1.00 par value each of the Company (comprising approximately 5.99% of the issued share capital of the Company).

An offering by the Company of 1,200,000,000 debentures (Series 4) of NIS 1.00 par value each, payable in four equal annual installments. Out of these debentures, approximately 400,000,000 debentures of NIS 1.00 par value each were issued on the eve of the prospectus to Bezeq Gold (Holdings) Ltd., which is a wholly owned and controlled subsidiary of the Company.

In addition, the Company issued a series of 600,000,000 debentures (Series 5) of NIS 1.00 par value each, on May 20, 2004, out of which it issued 50,000,000 debentures to institutional investors and the remainder to Bezeq Gold (Holdings) Ltd. The interest rate prescribed for these debentures was 5.3% per annum. These debentures were listed for trading under the aforesaid prospectus.

The results of the offer of sale to the public by the State of Israel were the sale of 70,671,100 shares (approximately 2.71% of the issued capital of the Company), at a price of NIS 4.921 per share. The debentures (Series 4) offered by the Company were sold in full. The interest rate set for the debentures was 4.8% per annum.

(2) Just prior to the issue, the State (the Government Companies Authority) and employee representatives of the Company reached an arrangement regarding recompense to employees of the Company for the offer to the public under 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 provision of recompense, including noting those employees who are entitled to recompense, the term of the arrangement, the amount of shares, the price at which the shares are to be offered to the employees, the rate of the discount, preconditions, etc.

NOTE 2 – REPORTING POLICIES AND ACCOUNTING PRINCIPLES

A. General

The significant accounting principles applied in these interim financial statements are consistent with those applied in the preparation of the annual financial statements, except as stated in this Note.

NOTE 2 – REPORTING POLICIES AND ACCOUNTING PRINCIPLES (Contd.)

B. Definitions

In these financial statements –

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

Reported value – an amount adjusted for inflation to the transition date (December 31, 2003), plus amounts in nominal values added after the transition and less amounts deducted after the transition date.

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

Nominal financial reporting – financial reporting based on reported values.

C. Termination of adjustment of financial statements

In October 2001, the IASB published Accounting Standard No. 12 – "Termination of Adjustment of Financial Statements". Under this Standard, and Accounting Standard No. 17, of December 2002, the adjustment of financial statements is to be terminated from January 1, 2004. Until December 31, 2003, the Company continued to prepare adjusted statements in accordance with Opinion 36 of the Institute of Certified Public Accountants in Israel. Commencing January 1, 2004, the Company is applying the provisions of the Standard.

D. Financial statements in reported values

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

(2) 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.

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

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

(5) Balance Sheets:
   a. Non-monetary items are stated at reported values.
   b. Monetary items are stated in the balance sheet at historical nominal values as at the balance sheet date.

   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 in nominal values.

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

E. Broadcasting rights

Broadcasting rights in a consolidated company are reported at cost. Costs of broadcast rights acquired for the screening of films and television programs include the amounts of contracts with suppliers of the rights, plus direct costs incurred in order to adapt the 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 added to the broadcasting rights and amortized on the basis of the estimated duration of their utilization.

F. Initial Application of Accounting Standards

Accounting Standard No. 20, period of amortization of goodwill.

The Company is applying Accounting Standard No. 20 concerning the period of amortization of goodwill (hereinafter – the Standard). The Standard states that goodwill is to be methodically amortized over its useful life using the straight-line method. The amortization period should reflect the best estimate of the period in which future economic benefits can be expected to be derived from the goodwill. The amortization period is not to exceed 20 years from the date of first recognition. The Standard applies to financial statements whose periods commence on January 1, 2004 or thereafter. The change in the amortization period of the balances of goodwill as at January 1, 2004 is treated as a prospective change of estimate (“from now on”). Such balances of goodwill were amortized by the straight-line method during the balance of the period remaining for completion of the amortization period determined. Initial application of the Accounting Standard No. 20 did not have a material effect on the financial position of the Company during the reporting period.

G. Disclosure of effect on new Accounting Standards during the period preceding application of them

In July 2004, the IASB published Accounting Standard No. 19, “Income Taxes”. The Standard prescribes that deferred tax liabilities are to be recognized for all temporary taxable differences, with a small number of exceptions. Similarly, deferred tax assets for all deductible temporary differences, losses for tax purposes and unutilized tax benefits are to 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 is to apply to financial statements for the periods commencing January 1, 2005. The Standard provides that it is to be adopted by way of cumulative effect of the change in accounting principle. In the Company’s estimation, the effect of the Standard on its results of operations, financial position and cash flows is not expected to be material.

H. Newly consolidated company

(1) A number of gradual, substantial changes have taken place over recent years in the Company’s investment in DBS Satellite Services (1998) Ltd. (hereinafter – DBS), the principal changes being the rate of holding, changes in undertakings to invest in DBS and to finance it, and changes in actual investments. These developments have gradually made the Company the dominant interested party in DBS, and upon realizing the resolution of the board of directors to inject NIS 440 million, under the conditions 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 as of that point in time. 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 to receive regulatory consents, including the approval of the Antitrust Commissioner, to increase the rate of the Company’s holdings in DBS to more than 50% (hereinafter – the Merger) (see Note 4B).

Notes to the Interim Consolidated Financial Statements as at June 30, 2004

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

H. Newly consolidated company (Contd.)

Due to initial comments of the Antitrust Authority, given prior to submission of notice of the Merger, which indicated a possible difficulty relating to the Merger due to the structure of the communications market, the Company applied to the Securities Authority to receive its position regarding the possibility of postponing the date of full consolidation of DBS's financial statements, until attaining certainty as to receipt of the regulatory consents for the Company's increased holdings in DBS to more than 50%. The Securities Authority's plenum discussed the Company's application on August 17, 2004, and gave notice to the Company that it must commence consolidation of the financial statements of DBS as of these financial statements. On June 21, 2004, the Company began to inject funds on account of the aforesaid NIS 440 million and as of that date, the financial statements of DBS are consolidated with those of the Company. As of that date, the Company includes all of DBS's financial results in its own financial statements. In these financial statements, the said results of operations are included under the equity method, due to proximity between the date of commencement of consolidation and the date of the financial statements.

(2) The following is information regarding the Company that has been included in the consolidated financial statements.

	As at June 30, 2004
	NIS thousand
Balance Sheet	
Working capital (excluding cash and cash equivalents)	**(1,797,696)**
Fixed assets and broadcasting rights, net	**1,204,051**
Long-term liabilities	**(20,862)**
Minority loans to a consolidated company	**(1,048,637)**
Less – minority share in deficit	**1,048,637**
Minority rights	**16,549**
Goodwill	**776,511**

(3) The sum of goodwill generated following consolidation of DBS's financial statements for the first time amounts to approximately NIS 452,000.

NOTE 3 – RATES OF CHANGES IN THE CONSUMER PRICE INDEX AND FOREIGN CURRENCY EXCHANGE RATES

The changes that occurred in the Consumer Price Index ("CPI") and in the US Dollar and Euro exchange rates are as follows:

	Consumer price index	Exchange rate of the US dollar	Exchange rate of the Euro
	%	%	%
For the six-month period ended:			
June 30, 2004	**1.408**	**2.695**	**(1.218)**
June 30, 2003	(0.005)	(0.089)	(0.008)
For the three-month period ended:			
June 30, 2004	**1.511**	**(0.685)**	**(1.257)**
June 30, 2003	(0.013)	(0.080)	(0.028)
In the year ended December 31, 2003	(1.848)	(7.557)	17.824

NOTE 4 – INVESTMENTS IN INVESTEE COMPANIES

A. Pelephone Communications Company Ltd. ("Pelephone")

Further to Note 8D(3) to the financial statements as at December 31, 2003, concerning the decision of the Board of Directors of the Company dated February 26, 2004 to exercise the option to acquire the remaining 50% of the shares in Pelephone from the Shamrock Group, the approvals of the Ministerial Committee on Privatization and of the Minister of Communications to exercise the option were obtained. The Company also applied to the Antitrust Commissioner for his opinion, before submission of the notice of merger. In response to this application, the Company was informed that the Commissioner's impression is that the transaction does not give rise to competition-related suspicions that would require the Commissioner to object, however, given the Company's status, the Commissioner may impose conditions on the parties. Following that, a notice of merger was submitted to the Antitrust Commissioner on July 27, and his consent has yet to be received.

On August 12, 2004, an agreement was signed with the Shamrock Group to amend the option agreement, providing that the Company was to exercise the option. The Company is to bear the cost of exercise of the option in the sum of US$ 60 million (approximately NIS 270 million), the cost of approximately US$ 390 million (approximately NIS 1,760 million) for amounts that a corporation in the Shamrock Group which holds the shares in Pelephone that are being acquired (hereinafter – "Pelephone Holdings") owes to the bank, and for the conversion of the debentures – waiver of the Company's rights to repayment of the loan. Similarly, Pelephone is expected to pay its shareholders a dividend in the amount of US$ 8.3 million (approximately NIS 38 million) prior to exercise of the option.

Due to the provision made for the reduction in the value of the debentures recorded by the Company, the investment is to be recorded in the Company's books only at the cost of exercise of the option, and the amounts that Pelephone Holdings owes the bank. The cost for the Company's waiver of the right to repayment of the loan given against the debentures is not to be included.

B. DBS 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 has accumulated considerable losses and negative cash flows. The loss for the year 2003 amounted to approximately NIS 555 million and the loss for the six-month period ending June 30, 2004 amounted to approximately NIS 205 million. As a result of these losses, the deficit in shareholders' equity and the working capital deficit of DBS as at June 30, 2004 amounted to approximately NIS 3,034 million and NIS 1,799 million respectively. The working capital deficit includes credit from banking corporations in the amount of NIS 1,297 million.

The Company's investment in DBS (primarily shareholders' loans) as at the balance sheet date amounts to approximately NIS 1,282 million (nominal). The Company's share in the accumulated losses of DBS amounts to approximately NIS 1,178 million, of which approximately NIS 127 million was recorded in the financial year. The balance of the current debt of DBS to the Company and its consolidated companies amounts to approximately NIS 65 million.

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

On December 30, 2002, DBS, the shareholders and the Banks signed an agreement to increase the credit facility provided by the Banks (hereinafter: the "Interim Facility"), which is to be implemented concurrently with additional investments by the shareholders in the sum of no less than 150% of the sum to be provided by the Banks. As at the date of approval of these financial statements, the shareholders and the Banks have transferred their entire share of the Interim Facility to DBS. Concurrent with the signing, as aforesaid, the parties were discussing an increase in the Interim Facility as part of an amendment to the Financing Agreement (hereinafter – the Amending Agreement).

NOTE 4 – INVESTMENTS IN INVESTEE COMPANIES (Contd.)

B. DBS Satellite Services (1998) Ltd. (Contd.)

On August 6, 2003, the Amending Agreement was executed by the Banks and by DBS. Under the Amending Agreement, the Banks are to provide DBS with additional sums to those provided under the Financing Agreement and the Interim Facility, subject to DBS's meeting the conditions and milestones set out in the Amending Agreement, including performance of additional investments by shareholders in amounts of no less than 150% of the amounts to be provided by the Banks. The Amending Agreement came into force in December 2003. Under the Amending Agreement, DBS converted short-term credit to a total amount of NIS 1,225 million for long-term loans in February 2004. As at the date of approval of these financial statements, some of the conditions set out in the Amending Agreement have not been fulfilled and as a result, the Banks did not provide it with the sums that they were supposed to provide it with during the first and second quarters of 2004 pursuant to that Agreement.

Following the approval of 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 Amending Agreement was signed, in which the Banks consented in principle to waive the breach by DBS of conditions of the Amending Agreement and to undertake to provide their share of the funds to DBS for the first and second quarters of 2004.

As part of the additional amendment of the Amending Agreement, it was agreed to amend the conditions that DBS was required to fulfill. As at the date of approval of the financial statements, DBS is in fulfillment of the amended conditions prescribed, with the exception of failure to meet the Banks' requirement for insurance of loss of revenue as a result of satellite failure. Pursuant to execution of this deed of amendment, the Banks provided approximately $ 6.8 million during the month of August. In DBS's financial statements, in light of the aforesaid, the long-term loans were classified as part of DBS's current liabilities.

Grant of additional loans from the Company to DBS was subject (as long as the Company was a government company), *inter alia*, to the approval of the Ministerial Committee on Privatization (hereinafter – the Committee), by virtue of conditions laid down by the Committee for the approval it granted to the Company to invest in DBS. On January 14, 2003, the Committee approved an increase in the Company's investment up to double the percentage of its holdings in DBS shares multiplied by $ 600 million up to an exposure ceiling of $ 300 million.

Under an agreement between DBS and its shareholders dated December 30, 2002, it was decided that the loans extended by the shareholders to DBS on July 10, 2002 (hereinafter – the New Shareholders' Loans) would have priority over the shareholders' loans to DBS which were made earlier (hereinafter – the Old Shareholders' Loans). Under the agreement, the New Shareholders' Loans will be entitled to repayment in full by DBS before any payment of dividends by DBS and/or repayment of the Old Shareholders' Loans to DBS by shareholders, this being subject to DBS's cash flow and liabilities under the 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 the Company 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 options are convertible at any time for no additional consideration and may be transferred as if they were shares, subject to the approvals of the Banks pursuant to the Financing Agreement. The option warrants received by the Company as aforesaid will bring the Company's holdings, if exercised, to approximately 54.02% of DBS. The Old Shareholders' Loans are linked to the ("known") CPI and are interest-free. According to a note of amendment to the aforesaid agreement, the New Shareholders' Loans made under the framework of the Amendment Agreement will be linked to the known CPI plus interest at an annual rate of 11%. 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.

NOTE 4 – INVESTMENTS IN INVESTEE COMPANIES (CONTD.)

B. DBS Satellite Services (1998) Ltd. (contd.)

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 under the framework of disposing 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 held and details of circumstances of violations which, if committed, will enable the Banks to call in the guarantee. Likewise, the Company also undertook to provide its shares 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 shall waive repayment of the Shareholders' Loan given to DBS, and that its guarantee shall apply, *mutatis mutandis*, to the options and the right to receive them as well.

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

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 bringing forward the balance of the investment under the current financing agreement (in the sum of NIS 55 million provided in full during the course of April-May 2004) immediately, as against receipt of such option warrants. Accordingly, on July 19, 2004 the Company received additional warrants which, if exercised, will bring the Company's holdings in DBS to 54.75%. Under the present financing agreement for DBS, and the Company's investments in DBS, the Company shall be entitled, in return for anticipated investments therein, to additional shares which will bring its holdings to approximately 60% and/or option warrants for shares which, if exercised, will bring its holdings to this rate as well (all presuming that another shareholder meets its full obligations under the present financing agreement, and if not, the Company shall be entitled to shares bringing its holdings to a rate of 61% – management of the Company estimates that the additional shareholder will meet its obligations). The additional shareholder has, at this stage, provided approximately $ 2.3 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 in those years. According to the work plan, DBS shall need significant additional amounts of outside financing in the aforementioned years, over and above the Amending Agreement.

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 by the end of 2005, which would be made gradually, according to the requirements of DBS and the Work Plan. 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, developments will be examined by the board of directors from time to time. Similarly, the resolution provided that implementation of it is subject to receipt of the required consents and pursuant to the remarks of the Attorney General. As of June 21, 2004, the Company began providing sums on account of the NIS 440 million investment. As at the date of approval of these financial statements, the Company has provided a total of NIS 105 million. As a result, the Company was granted an additional option warrant, which, if exercised, will increase the Company's holdings in DBS to 56.38%. When the Company started providing these funds as aforesaid, the financial statements of DBS became consolidated with those of the Company (see Note 2H).

NOTE 4 – INVESTMENTS IN INVESTEE COMPANIES (CONTD.)

B. DBS Satellite Services (1998) Ltd. (contd.)

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 options issued 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 is to allot shares or convertible securities after the Banks making loans to DBS confirm that such securities are assured in their favor.

In a meeting held on July 1, 2004, the Board of Directors of the Company resolved to approve that management of the Company act in order to exercise the warrants for shares in DBS. On July 19, 2004, the Company made applications to receive the regulatory approvals required for exercising the warrants (consent of the Ministerial Committee on Privatization, the Minister of Communications and the Antitrust Commissioner). The initial comments made by the Antitrust Authority prior to submission of the notice of merger indicated a possible difficulty in approving the merger, due to the structure of the communications market.

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

Management of DBS believes that there is a good chance of arranging sources for the financial resources required by DBS in the coming year.

C. Walla! Communications Ltd.

In February 2004 Walla! Communications Ltd. (hereinafter – "Walla") published a prospectus for an offering of options 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 options 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 options (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. In March and June 2004, Bezeq International exercised 3,417,940 and 292,000 options (Series 3), respectively, in consideration for a total sum of NIS 6,678,000, offset against the balance of the shareholders' loans as set out above. Following exercise of the options, the percentage of Bezeq International's holding in Walla increased from 36.74% on December 31, 2003 to 44.98% as of the date of these interim financial statements (at full dilution, as at June 30, 2004 – 35.39%).

NOTE 5 – FIXED ASSETS

A. Depreciation Policy

1. Pursuant to the Company's policy of periodically re-examining the useful lives and the values of its assets, a panel was appointed in 2003 to assess the need to revise those periods and to make recommendations to the Management regarding their conclusions. The examination only included the Company's fixed assets and was based on the balance of its fixed assets as at December 31, 2003. In May 2004, the panel submitted its recommendations to Management of the Company on 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 at similar communications companies around the world, and regulation and opening of the fixed-line communications market to competition.

NOTE 5 – FIXED ASSETS (Contd.)

A. Depreciation Policy (Contd.)

The modifications in the estimated useful lives recommended in the report included shortening the life of terminal equipment used for 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 be extended from 7 years to 8 years, and of data communications networks (ADSL, ATM) from 5 years to 7 years. The panel also recommended extending the amortization period of the network, in which there was investment until 1991, and which should have been amortized in full by the end of 2007, through to the end of 2010. The panel also recommended 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 are applicable beginning January 1, 2004. As a result of adoption of the recommendations, the depreciation expense in respect of the Company's existing and future assets will decrease by approximately NIS 77 million in 2004, NIS 74 million in 2005, NIS 62 million in 2006, NIS 75 million in 2007 and will increase by NIS 96 million in 2008.

The following table shows the effects of the aforementioned on the Company's financial statements:

	Data before modification of estimation	Effect of modification of estimation	Data presented in the financial statements (after modification of estimate)
	Reported amounts*		
	NIS thousands		
For the six months ended June 30, 2004 (unaudited)			
Depreciation expenses	977,289	38,500	**938,789**
Earnings before income tax	631,703	(38,500)	**670,203**
Net earnings	249,198	(25,025)	**274,223**
Earnings per share	0.096		**0.105**
For the three months ended June 30, 2004 (unaudited)			
Depreciation expenses	486,247	19,250	**466,997**
Earnings before income tax	312,909	(19,250)	**332,159**
Net earnings	96,596	(12,705)	**106,301**
Earnings per share	0.036		**0.041**

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

2. DBS depreciates its digital satellite decoders (hereinafter – 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 which relates 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 changed in April 2004 from 25% to 17%. The effect of this change was a reduction in depreciation expense for the second quarter of 2004, by the sum of approximately NIS 34 million. The change will also cause a reduction in the sum of amortization for 2004 and 2005 in the sum of NIS 59 million and NIS 37 million respectively.

NOTE 5 – FIXED ASSETS (CONTD.)

A. Depreciation Policy (Contd.)

During the reporting period, DBS's monetary results were recorded using the equity method (see Note 2H). The effect of the aforesaid change on the Group's financial statements is the reduction of the Company's share in the losses of investee companies by NIS 12.2 million.

B. Further to Note 9F to the financial statements as at December 31, 2003, concerning the resolution of the Board of Directors of the Company to close the Inmarsat station, and the notice of the Ministry of Communications to the Company that it is not authorized to resolve on the closure of the station, 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 forego. 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 provision of the service whilst significantly reducing the costs of it.

NOTE 6 – LIABILITY FOR EMPLOYEE SEVERANCE BENEFITS

A. Early retirement plan

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 to 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 (in 2003) will be used to finance the costs of retirement of employees under the 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 shall transfer the retirement funds to an external body which would hold the money for the purpose of employee retirement arrangements. Under this plan, 854 employees had retired by March 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 enacted 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 a uniform constitution which, according to the amendment of the law, took effect on October 1, 2003, so that the rights of members of those pension funds who were a party to special pension agreements, were harmed.

NOTE 6 – LIABILITY FOR EMPLOYEE SEVERANCE BENEFITS (CONTD.)

A. Early retirement plan (contd.)

On March 18, 2004, an amendment to the Retirement Agreement was signed between the Company (after being approved by the Board of Directors of 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 other things, 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 and the current agreement are retained, then the Company shall be entitled to contract with such a fund with the consent of the employees' representation. In addition, the parties agreed that they would enter into negotiations in order to regulate the retirement of the remaining transferred employees by 2011 on the one hand, and the demands 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 result in an agreement. As at the balance sheet date, the negotiations had not yet started.

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

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 the aforementioned and additional updates, the Company recorded an additional provision of approximately NIS 30 million in the financial statements as at March 31, 2004.

B. Makefet Fund

Further to Note 16E to the financial statements as at December 31, 2003, concerning claims filed by the Company against the Makefet Fund, the Makefet Fund has filed statements of defense with the court in which it rejects the Company's allegations and alleges that it acted in accordance with the agreements between it and the Company.

NOTE 7 – CONTINGENT LIABILITIES

A. CLAIMS AND CONTINGENT LIABILITIES

The Company and the investee companies have contingent liabilities in respect of which the maximum possible exposure is considerable. A detailed description of these contingent liabilities appears in Note 19A to the Company's annual financial statements as at December 31, 2003. No significant changes occurred in contingent liabilities up to the date of signing of these financial statements, except for the following:

(1) Further to Note 19A(3) to the financial statements as at December 31, 2003, regarding a claim filed against the Company alleging that the process for selecting the equipment to be purchased by the Company was unlawfully managed, in violation of tender laws and the rules of good administration, with negligence and while exploiting the Company's status as a monopoly or monopsony, it was decided, with the consent of the parties, to refer the dispute to an arbitrator, who is to rule on the amount of compensation to be paid by the Company to the plaintiff, with a floor and ceiling mechanism in amounts that are not material.

NOTE 7 – CONTINGENT LIABILITIES (CONTD.)

A. CLAIMS AND CONTINGENT LIABILITIES (CONTD.)

(2) Further to Note 19A(4) to the financial statements as at December 31, 2003, regarding a declaratory suit filed by 2,423 pensioners of the Company, in a request for recognition of certain wage components as part of their determining wage regarding their pensions, the financial implications of which suit as set out in that Note being material and could reach NIS 1.258 billion under certain assumptions. According to the Company's legal counsel, it is not possible, at this stage, to estimate the chances of success of this suit. In light of heavy claims available to the Company, and the circumstances of the suit, the Company resolved not to make a provision in its financial statements for this suit. On June 24, 2004, the Regional Court handed down a ruling dismissing the suit *in limine*. The Court held that the group of plaintiffs was not homogeneous, each having different data relevant to his suit, that it would not be possible to run the suit as if it were a class action, that the suit is for monetary relief that was not quantified as required by the law, and that the suit failed to contain all of the facts required in order to quantify it. The Court further held that the pensioners' organization did not come within the bounds of the definition of a workers' organization as set out in section 3 of the Collective Agreements Law, that this was not a claim under a collective dispute and that the consent of the organization was not sufficient for the filing of a suit on behalf of all of the 2,423 plaintiffs. Note that the Court stated in this ruling that "the suit should be struck out and counsel for the plaintiffs shall be allowed to file a new suit on behalf of any person who signs a power of attorney, and in which the correct relief is formulated or is quantified properly, without harming the defendant's right to defend such".

(3) Further to Note 19A(7) to the financial statements as at December 31, 2003, concerning an action accompanied by an application for approval of the action as a class action, filed against the Company, Bezeq International and the other international communications operators, alleging unlawful collection of 17% VAT for some collect calls received by Company subscribers in Israel and originating abroad, the Company believes, relying on its legal advisers, that in the circumstances of the matter to date, and noting, *inter alia*, the Company's status (and that of the other defendant communications companies) as formal respondent, and noting the statements made by counsel for the plaintiffs to the effect that the claim is not for independent relief against the communications companies (including the Company), it would appear that the Company is not expected to suffer financial exposure in connection with the claim (and if there is any exposure, it will be minor). On April 18, 2004, the Supreme Court ruled to stay the proceedings in this case until after a ruling is issued by the Supreme Court in another case (to which the Company is not a party).

(4) Further to Note 19A(9) to the financial statements as at December 31, 2003 regarding a letter of demand on behalf of the committee of Moshav Porat in the Sharon Region, containing claims regarding direct and indirect damages caused and which are still being caused, according to members of the Moshav, as a result of the erection of the Hillel Station near the Moshav, and of the station's broadcasts, and regarding a claim filed with the District Court at Tel Aviv against the Company, the Broadcasting Authority and the State of Israel by various plaintiffs from Moshav Porat in the Sharon Region, including deceased estates, on June 13, 2004, an additional claim was filed at the District Court of Tel Aviv by 25 plaintiffs from Moshav Porat and Moshav Ein Vered, including 11 heirs to deceased estates, against the Company, the Broadcasting Authority, and the State of Israel for compensation for bodily harm (18 of the plaintiffs are suing the Company, the Broadcasting Authority and the State, and 7 additional plaintiffs are suing the Broadcasting Authority and the State of Israel only).

The additional claim contains an alleged breach of statutory duties and acts and/or omissions by the defendants jointly and/or severally, as alleged in the statement of claim, in respect of operation of the Hillel broadcast station located near the plaintiffs' homes, and it was further alleged that the plaintiffs suffered bodily harm as a result of prohibited radiation derived from the broadcast station, which, in part, caused the death of some of the plaintiffs.

NOTE 7 – CONTINGENT LIABILITIES (CONTD.)

A. CLAIMS AND CONTINGENT LIABILITIES (CONTD.)

The amount of compensation sued for under the additional claim is not estimated (however, the claim is within the jurisdiction of the District Court, meaning that it is more than NIS 2.5 million), and the compensation is based on items of monetary and non-monetary damage, described for each plaintiff, as well as penal damages. The claim also states that the plaintiffs will petition to split remedies so as to reserve the right to sue for other monetary damages that do not fall within the bounds of the bodily harm that they allegedly suffered later on, and that such damages relate to harm to crops, loss of value of land, fleeing of potential investors, etc. According to the plaintiffs, these damages amount to “millions of Shekels”, but their amount has not yet been formulated.

At present, a statement of defense has not yet been prepared and therefore the Company’s legal advisers are not yet in a position to estimate the chances of the Company’s defense against the suit. Despite this, since the claim is similar in substance to the previous claim referred to above, the Company’s legal counsel anticipate (subject to the aforesaid) that the chances that this suit will be dismissed are greater than the chances that it will be accepted.

(5) Further to Note 19A(12) to the financial statements as at December 31, 2003 regarding a claim accompanied by an application for approval of the claim as a class action claim filed against the Company in the matter of restitution of a commission collected, at the plaintiff’s allegation, unlawfully in respect of calls in Israel from a public telephone operated by means of a Bezeqcard – on February 23, 2004, the Telecommunications Regulations (Payments for the Telecommunications Services listed in the Addendum to the Law) (Amendment to Regulations 5759-1999, 5760-2000, 5761-2001) 5764-2004 were enacted, containing amendments to the Telecommunications Regulations (Payments for The Telecommunications Services listed in the Addendum to the Law) for the years 1999-2001. In the Company’s opinion, following this amendment, there is no longer any basis for the claim and for the application for recognition as a class action claim.

(6) Further to Note 19A(13) to the financial statements as at December 31, 2003, regarding the notice of a party to a collective dispute filed by the New General Trade Union on behalf of employees of the Company, the financial implications of which suits as described in that Note being material and likely to reach approximately NIS 1.357 billion under certain presumptions. According to the Company’s legal counsel, it is not possible, at this stage, to estimate the chances of success of this suit with respect to certain components of it. Given the heavy claims that the Company has, and the circumstances of the suit, the Company decided not to make a provision in its financial statements over and above the provision made based on Management estimations prior to the issuing of a ruling by the National Labor Court in the other case to which the Company is not a party. At the same time, a provision has been made in these financial statements regarding that component which the Company and its legal counsel believe is under significant risk, calculated in accordance with certain presumptions which in the opinion of the Company are appropriate. On July 15, 2004, the Court handed down its ruling to the effect that the Trade Union’s suit in the said proceedings was to be struck out due to the failure to file closing arguments on time, however, soon thereafter, the plaintiff filed an application to overturn the ruling and to extend the date for filing closing arguments, claiming that two applications by consent to extend the date for filing closing arguments, filed by it to the Court, had not been brought to the Court’s attention before the aforesaid ruling was handed down.

(7) Further to the Note 19A(14) to the financial statements as at December 31, 2003, concerning a claim accompanied by an application for recognition as a class action filed against the Company alleging that the Company unlawfully collects overdue interest on arrears in payments for services provided by other communications providers, the Company filed its amended response on May 3, 2004.

NOTE 7 – CONTINGENT LIABILITIES (CONTD.)

A. CLAIMS AND CONTINGENT LIABILITIES (CONTD.)

(8) Further to Note 19A(16) to the financial statements as at December 31, 2003, concerning the "derivative claim" filed by a Company shareholder against 20 directors and certain senior managers who served the Company during October-November 2000, and against the Company, the plaintiff was granted an extension for filing the application until April 1, 2004, but failed to file the application by such date. On May 17, 2004, the plaintiff filed an application to strike out the claim *in limine* without an order as to costs, and the claim was struck out.

(9) Further to Note 19A(18) to the financial statements as at December 31, 2003, concerning a claim accompanied by an application to recognize the claim as a class action, in the matter of alleged overcharging for calls from Company subscribers to cellular network subscribers of Cellcom and Pelephone during part of 1996, the application for approval of the claim as a class action claim was dismissed by consent on February 17, 2004 and accordingly, the statement of claim that accompanied it was also struck out.

(10) Further to Note 19A(20) to the financial statements as at December 31, 2003, concerning a renewed statement of claim filed against Bezeq International and against the State of Israel and an application for recognition of the claim as a class action claim, alleging that the tariffs for international telecommunications services during the period from May 10, 1996 through July 8, 1997 were overpriced and unreasonable, in abuse of Bezeq International's status as a monopoly based on the reduction of prices when the international call market was opened to competition, the District Court stayed execution of the ruling regarding approval of the claim as a representative claim in February 2004, at the application of the State and Bezeq International. On January 23, 2004, the State filed an application for permission to appeal the ruling recognizing the claim as a representative, with the Supreme Court and on March 7, 2004, Bezeq International also filed an application for permission to appeal this ruling.

The Supreme Court ruled, on February 10, 2004, that the State's application requires a response, and on April 4, 2004, that Bezeq International's application also requires a response.

On May 9, 2004, the respondent filed its response to the applications for permission to appeal by the State and Bezeq International after the Court unified the hearing in the three files (the class action claim and the two applications for permission to appeal), an order was handed to file closing statements, which provided that the respondent was to file its closing statements by August 12, 2004 and the State and Bezeq International were to file their closing statements by December 2, 2004. The respondent is to submit closing statements on its behalf, in response, by January 20, 2005.

Bezeq International's legal counsel estimate that Bezeq International has credible arguments against the decision of the District Court and therefore, no provision was included in the financial statements of Bezeq International in respect of this claim.

(11) Further to Note 19A(23) to the financial statements as at December 31, 2003, concerning a claim filed by the State of Israel against Pelepone in respect of royalties allegedly payable to the State for the period from January 1994 through February 1996, mediation proceedings commenced in 2002 have not yet ended and it is uncertain whether they will produce results.

In the opinion of Management of Pelephone, in reliance on the opinion of its external legal counsel dealing with the claim, Pelephone has a genuine defense against the claim. Pelephone's financial statements contain a provision which, in the estimation of Pelephone's Management is proper and sufficient should Pelephone be required to pay any amount under the suit / mediation proceedings.

On the matter of the undertaking made by the Company towards Pelephone, the Company estimates that the risk that it will be charged with payment is low and therefore, no provision has been made in the financial statements.

NOTE 7 – CONTINGENT LIABILITIES (CONTD.)

A. CLAIMS AND CONTINGENT LIABILITIES (CONTD.)

(12) Further to Note 19A(25) to the financial statements as at December 31, 2003, concerning a claim filed with the District Court at Ramallah by the General Palestinian Public Communications Company Ltd. ("Paltel") against Pelephone and another cellular company, to the best of Pelephone's knowledge, Paltel alleges in this claim to have been granted a license to provide communications services in the areas of the Palestinian Authority and that Pelephone carried out telecommunications operations and granted telecommunications services in the areas of the Palestinian Authority without a permit and in violation of local law.

It recently became apparent that the Court at Ramallah may have issued a decision in this claim. According to the State of Emergency Order (Judea, Samaria and Gaza Strip – Jurisdiction for Offenses and Legal Aid) (Areas of the Palestinian Authority, Legal Aid in Civil Matters), 5759-1999, enforcement of decisions issued by a court of the Authority may only be executed if they receive the approval of the Commissioner for Legal Aid at the Ministry of Justice. Pelephone is of the belief that such a ruling, if made, was made without jurisdiction, contrary to public order and to the provisions of the Interim Agreement and the Extension of the Term of State of Emergency Regulations Law (Judea, Samaria and the Gaza Strip, Jurisdiction for Offenses and Legal Aid), 5727-1967. Should an attempt be made to submit this ruling for the approval of the Commissioner, or to enforce it in any way, the Company shall act to prevent such approval and/or enforcement of the judgment and/or proceedings for execution of judgment or to cancel such for the reasons set out above, which formed the basis of the Commissioner's decision to prevent service of the claim on the Company in the first place, and due to the fact that the very fact of the holding of hearing of a claim in the Court at Ramallah without the process having been served in accordance with the Order and the Agreement, constitute 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 is of no force.

(13) Further to Note 19A(28) to the financial statements as at December 31, 2003, concerning a claim and an application to approve the claim as a representative claim, filed with the District Court at Tel Aviv against Pelephone, alleging that as of June 2003, the plaintiffs suffer from a high percentage of dropped calls and blocked calls, over and above the threshold set out in Pelephone's license, at the recommendation of the Court, the plaintiffs withdrew their claim in June 2004, as well as the application to have it approved as a representative claim.

(14) Further to Note 19A(31) to the financial statements as at December 31, 2003, regarding the claim of 66 pensioners of the Company who retired under the retirement agreement of November 1997, for specific performance of the agreement dated April 2001, which was supposed to enable employees to change the track that they elected, on May 3, 2004, the plaintiffs filed an application to amend the statement of claim, requesting the Court to allow the joining of a further 155 pensioners to the claim.

(15) On May 17, 2004, a petition filed on May 13, 2004 by the municipalities and local planning and building committees of Herzliya and Ramat Hasharon against the State of Israel, the National Council for Planning and Building, the Minister of Health, the Ministry of the Interior, the Head of the Noise and Radiation Prevention Department at the Ministry of the Environment, the Attorney-General, the Future Generations Commission and Pelephone, Cellcom, Partner and MIRS was served on the offices of Pelephone. The petition seeks relief in matters relating, *inter alia*, to the setting of radiation and safety standards for cellular sites, to supervision and enforcement. On July 5, 2004, a hearing was held in the petition, in which the High Court of Justice ruled to stay the hearing of the petition to a later date, and to rule on continuation of proceedings in light of a supplementary notice to be submitted by the State Attorney's office within three or four months. The notice shall relate to the Government's position on legislation regarding non-ionizing radiation. The date for the further hearing in this petition has yet to be set. At this stage, Pelephone is unable to estimate the chances of success of the petition, nor its implications.

NOTE 7 – CONTINGENT LIABILITIES (CONTD.)

A. CLAIMS AND CONTINGENT LIABILITIES (CONTD.)

(16) A group of employees comprising some 130 employees filed a claim with the Regional Labor Court in June 1997 via the General Trade Union applying for declaratory relief regarding the pension rights of the employees in the group who are transferred employees from the Ministry of Communications, who act as managers of fields, and are employed under personal contracts. According to the plaintiffs, they are entitled to identical pension conditions to those of the rest of the employees of the Company who are under a collective agreement. In September 1997, the Attorney-General gave notice that he would appear in the proceedings. In May 1998, the Company submitted an actuarial opinion to the Regional Labor Court which stated that the cost of the plaintiffs' demand amounts to approximately NIS 155 million. In November 1999, a ruling was handed down dismissing the large part of the causes of action in the claim. An appeal was filed against this ruling with the National Labor Court, which was dismissed in full. On May 23, 2004, the plaintiffs filed a petition to the High Court of Justice applying to cancel the ruling of the National Labor Court. On June 23, 2004, the Company filed a preliminary response to the petition via its legal counsel, seeking to have the petition dismissed *in limine*. A ruling on these pleadings has yet to be handed down. In the estimation of the Company's legal counsel, there are strong chances that the High Court of Justice will not even hold a hearing on the petition, but rather, will strike it out *in limine*. Therefore, no provision has been made in the financial statements regarding this petition.

(17) In the beginning of July 2004, a claim for declarative relief was filed with the Regional Labor Court by the Bezeq Pensioners' Organization and six pensioners, against the Makefet Fund, the State of Israel and the Company, alleging that the defendants were in breach of agreements for binding arrangements which were agreed upon when the employees were transferred to the Company from the public service. According to the plaintiffs, the standard bylaws under the Pension Fund Recovery Law should not be applied to them, or alternatively, the defendants or any of them must compensate the plaintiffs for application of the standard bylaws to them. According to the Company's legal counsel, there are weighty preliminary claims in favor of dismissal of the claim, and with respect to the claim itself, there is only a minor chance that it will end up imposing any financial obligation on the Company and therefore, no provision has been included for this claim.

(18) In August 2004, Pelephone received a demand from the Customs and VAT Department of the Ministry of Finance to provide documents relating to the Stamp Duty Law. Pelephone's Management is currently studying this matter and is unable to estimate the extent of the obligations for this demand, if any.

B. COMMITMENTS

Further to Note 19B(6) to the financial statements as at December 31, 2003 regarding Pelephone winning a tender of frequencies, Pelephone was granted a right to future allocation of the said frequencies, upon the exercise of which Pelephone shall pay the reduced amount, plus the frequency fees in respect of the relevant period, all plus linkage differentials and interest as is customary. During the months of March and April 2004, Pelephone paid the sum of NIS 32 million and NIS 33 million (proportionally consolidated amount approximately NIS 16 million) on account of the balance of these payments. The balance of NIS 34 million (proportionally consolidated amount approximately NIS 17 million) was recorded on Pelephone's books as a right to use frequencies, under the Other Assets items against Trade Payables.

On May 4, 2004, Pelephone received a letter from the Director General of the Ministry of Communications and the Commissioner for Budgets at the Ministry of Finance, informing it that according to an amended calculation made by the Ministries of Finance and Communications, the sum that Pelephone would be required to pay upon allocation of the frequencies in the future would be NIS 51 million rather than the NIS 33 million agreed upon in March 2004. Pelephone has not yet presented its position on this to the Ministries. Pelephone is unable to estimate when the third generation frequencies will come into use, however it estimates that it will need them in the future and therefore it is reserving the option of buying them back.

NOTE 7 – CONTINGENT LIABILITIES (CONTD.)

C. SECURITIES AND CHARGES

The Company undertook towards two groups of foreign banks which provided it with loans in the amount of NIS 760 million (presented under long-term loans) financial covenants under which the Company is to maintain a ratio of 35% between its tangible shareholders' equity and its tangible assets (as at the balance sheet date, the Company had fallen below this ratio). In order to reduce the Company's possible exposure to the possibility of failure to meet the above financial conditions, the Company came to an agreement with one group of banks to reduce the ratio to 15%, and with the other group of banks to reduce the ratio to 25% for the period of one year (as of the date of exercise of the option granted to the Company to purchase shares in Pelephone). The Company is currently in negotiations with the second group to cancel this ratio or alternatively to replace the loan with another loan, for which the Company has received a financing offer from another bank.

D. FUTURE CONTRACTS (CONSOLIDATED)

1. Futures Currency Transactions – Hedging Contracts

	Currency purchased	Currency payable	Final repayment date	Amounts receivable	Amounts payable
				NIS millions	
Currency exchange contracts at predetermined interest rates -	Dollars	CPI-linked NIS	February 2005	142	151
	Euro	CPI-linked NIS	September 2005	515	479
Forward contracts at predetermined exchange rate-	Dollars	NIS	December 2005	1,021	1,049
(excluding premium/discount)	Euro	NIS	December 2005	1,100	1,123
	CPI-linked NIS	NIS	January 2006	642	644

2. Futures Currency Transactions – Contracts not for Hedging Purposes

	Currency purchased	Currency payable	Final repayment date	Fair value	Total transactions
				NIS millions	
Call options acquired	Dollar	NIS	June 2005	0.4	121

NOTE 8 – TRANSACTIONS WITH INTERESTED PARTIES AND RELATED PARTIES

A. Further to Note 27A to the financial statements as at December 31, 2003 regarding a claim filed by the Company against the Ministry of Defense for payment of amounts in connection with a dispute regarding a discount of 18% which the Ministry of Defense deducted from payments collected by the Company for other communications providers, on March 16, 2004, the State filed a statement of defense. On May 17, 2004, the Company filed a statement of response. According to the Company, in reliance on its legal counsel, it is not possible to assess the chances of success of the Company's claim. No revenue was recorded in the financial statements regarding this claim.

B. Further to Note 27D to the financial statements as at December 31, 2003 regarding the officers' insurance policy held by the Company, on August 5, 2004 the Board of Directors of the Company, and its audit committee, approved an extension of the insurance policy for a period of 12 months until July 31, 2005. The insurance ceiling is $ 150 million per event and into total for the entire period of the policy (12 months) plus 20% for legal expenses. This extension is subject to the approval of the general meeting of shareholders.

NOTE 8 – TRANSACTIONS WITH INTERESTED PARTIES AND RELATED PARTIES CONTD.)

On December 3, 2003, the general meeting of shareholders of the Company approved the making of an undertaking to indemnify the officers of the Company regarding a framework agreement signed between the Company and the State, including in connection with an allotment of shares to the State under the framework agreement. The undertaking was limited to the sum of NIS 890 million (the extent of the financing) linked to the Consumer Price Index published after the capital is raised, in accordance with the framework agreement.

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

(1) 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.

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

a. The claim of a shareholder who held 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.

b. Any matter relating to a prospectus for an offer for sale of securities of the Company by the State of Israel and an offering by the Company, which is scheduled for publication at the end of May 2004. The total extent of the indemnity (including in respect of the advance undertakings to indemnify 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 November 2003 CPI).

D. 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 the financial liability that will be imposed upon them and in respect of reasonable litigation expenses that they might face, with respect to the prospectus, by way of a deed of indemnity given to officers of the Company.

Notes to the Interim Consolidated Financial Statements as at June 30, 2004

NOTE 9 – REVENUES FROM TELECOMMUNICATION SERVICES

	For the six-month period ending June 30		For the three-month period ending June 30		For the year ending December 31
	2004 (Unaudited)	2003 (Unaudited)	2004 (Unaudited)	2003 (Unaudited)	2003 (Audited)
	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	Adjusted for the effects of inflation in shekels of December 2003
	NIS thousands		NIS thousands		NIS thousands
Revenues from communication services -					
Domestic fixed-line communications	**833,328**	1,059,578	**410,865**	516,016	1,990,649
Fixed fees	**1,228,485**	1,096,892	**615,840**	554,841	2,289,868
Cellular telephone	**1,050,893**	980,834	**533,541**	494,965	1,989,970
International communications and internet services	**379,052**	331,755	**188,710**	166,131	683,037
Installation and sale of equipment to subscribers	**326,479**	263,810	**159,373**	128,993	590,866
Other	**39,078**	36,111	**22,069**	17,465	74,851
	3,857,315	3,768,980	**1,930,398**	1,878,411	7,619,241
Other revenues	**163,466**	165,602	**81,162**	77,801	362,027
	4,020,781	3,934,582	**2,011,560**	1,956,212	7,981,268

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

Notes to the Interim Consolidated Financial Statements as at June 30, 2004

NOTE 10 – OPERATING AND GENERAL EXPENSES

	For the six-month period ending June 30		For the three-month period ending June 30		For the year ending December 31
	2004 (Unaudited)	2003 (Unaudited)	2004 (Unaudited)	2003 (Unaudited)	2003 (Audited)
	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	Adjusted for the effects of inflation in shekels of December 2003
	NIS thousands		NIS thousands		NIS thousands
Salaries and related expenses-					
Operations	**717,481**	731,102 **	**311,667**	305,986 **	1,648,415 **
General and administrative	**244,314**	248,326 **	**169,205**	168,327 **	304,463 **
General expenses	**368,960**	338,049	**190,825**	164,063	733,412
Materials and spare parts	**271,444**	279,133	**132,877**	134,550	597,676
Cellular telephone expenses	**251,425**	227,045	**124,530**	115,007	480,536
Building maintenance	**153,176**	167,809	**84,399**	85,283	352,405
Services and maintenance by subcontractors	**136,275**	142,244	**66,740**	75,610	250,220
International communications expenses	**103,491**	76,574	**57,721**	37,929	159,478
Vehicle maintenance expenses	**60,748**	59,934	**31,023**	30,886	118,050
Collection fees	**18,911**	20,679	**10,153**	12,067	36,160
	2,326,225	2,290,895	**1,179,140**	1,129,708	4,680,815
Less – salaries charged to investment in fixed assets	**102,245**	90,342	**45,972**	45,631	195,515
	2,223,980	2,200,553	**1,133,168**	1,084,077	4,485,300

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

NOTE 11 – TAXATION ON INCOME

On June 29, 2004, the Knesset passed the Income Tax Ordinance Law (Amendment) (No. 140 and Temporary Provision), 5764-2004 (hereinafter - the "Amendment"). The Amendment provides a gradual reduction of the tax rate for companies from 36% to 30%, in the following manner:

During the 2004 tax year, the tax rate shall be 35%; in 2005, the tax rate shall be 34%; in 2006, the tax rate shall be 32%; and from 2007 and onwards, the tax rate shall be 30%.

Current taxes and deferred tax balances as at June 30, 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 second quarter of 2004 is an increase in tax expenses on revenue in the statement of operations and a reduction in deferred taxes in the balance sheets in the sum of NIS 78 million (the effect of the change over the six month period is not significantly different).

Notes to the Interim Consolidated Financial Statements as at June 30, 2004

NOTE 12 – CONDENSED INTERIM FINANCIAL STATEMENTS OF THE COMPANY

A. STATEMENTS OF OPERATIONS

	For the six-month period ending June 30		For the three-month period ending June 30		For the year ending December 31
	2004 (Unaudited)	2003 (Unaudited)	2004 (Unaudited)	2003 (Unaudited)	2003 (Audited)
	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	Adjusted for the effects of inflation in shekels of December 2003
	NIS thousands		NIS thousands		NIS thousands
Revenues from telecommunication services (Note 12B)	**2,522,148**	2,647,636	**1,254,170**	1,307,735	5,230,561
Costs and expenses					
Operating and general expenses (Note 12C)	**1,139,849**	1,170,439	**585,646**	569,152	2,366,547
Depreciation	**756,346**	896,687	**375,651**	444,099	1,776,279
Royalties to the Government of Israel	**74,573**	90,731	**37,802**	45,355	181,116
	1,970,768	2,157,857	**999,099**	1,058,606	4,323,942
Operating income	**551,380**	489,779	**255,071**	249,129	906,619
Financing expenses, net	**31,234**	31,163	**17,368**	15,033	62,372
Earnings after financing expenses	**520,146**	458,616	**237,703**	234,096	844,247
Other (income) expenses, net	**28,357**	4,298 **	**(1,575)**	6,292 **	846,948
Earnings (losses) before income tax	**491,789**	454,318	**239,278**	227,804	(2,701)
Income tax	**228,871**	165,601	**142,780**	79,571	33,513
Earnings (losses) after income tax	**262,918**	288,717	**96,498**	148,233	(36,214)
Company's equity in losses (earnings) of investee companies	**(11,305)**	202,144 **	**(9,803)**	129,182 **	401,622
Net earnings (losses)	**274,223**	86,573	**106,301**	19,051	(437,836)

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

** Reclassified

Notes to the Interim Consolidated Financial Statements as at June 30, 2004

NOTE 12 – CONDENSED INTERIM FINANCIAL STATEMENTS OF THE COMPANY (CONTD.)

B. REVENUES FROM TELECOMMUNICATIONS SERVICES

	For the six-month period ending June 30		For the three-month period ending June 30		For the year ending December 31
	2004 (Unaudited)	2003 (Unaudited)	2004 (Unaudited)	2003 (Unaudited)	2003 (Audited)
	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	Adjusted for the effects of inflation in shekels of December 2003
	NIS thousands		NIS thousands		NIS thousands
Domestic fixed-line communications	**839,487**	1,066,600	**413,510**	520,837	2,006,567
Fixed fees	**1,167,538**	1,046,218	**582,672**	530,421	2,184,650
Cellular telephone	**219,268**	247,484	**112,201**	119,691	428,149
International communications	**66,015**	66,628	**31,131**	31,891	134,212
Installation and sale of equipment to subscribers	**84,861**	66,462	**39,428**	33,895	144,338
Other	**44,335**	38,140	**24,968**	18,581	80,105
	2,421,504	2,531,532	**1,203,910**	1,255,316	4,978,021
Other revenues	**100,644**	116,104	**50,260**	52,419	252,540
	2,522,148	2,647,636	**1,254,170**	1,307,735	5,230,561

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

Notes to the Interim Consolidated Financial Statements as at June 30, 2004

NOTE 12 – CONDENSED INTERIM FINANCIAL STATEMENTS OF THE COMPANY (CONTD.)

C. Operating and General Expenses

	For the six-month period ending June 30		For the three-month period ending June 30		For the year ending December 31
	2004	2003	2004	2003	2003
	(Unaudited)	(Unaudited)	(Unaudited)	(Unaudited)	(Audited)
	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	Adjusted for the effects of inflation in shekels of December 2003
	NIS thousands		NIS thousands		NIS thousands
Salaries and related expenses –					
Operations	**562,908**	597,755 **	**272,185**	274,770 **	1,206,623 **
General & administrative	**135,955**	149,439 **	**77,982**	85,104 **	241,206 **
General expenses	**157,493**	141,663	**79,176**	69,257	342,492
Materials and spare parts	**62,795**	39,191	**33,067**	17,338	93,601
Building maintenance	**140,392**	154,653	**78,355**	78,115	322,099
Services and maintenance by subcontractors	**102,791**	106,368	**49,267**	54,201	207,843
International communications expenses	**9,340**	4,396	**5,030**	1,898	10,685
Vehicle maintenance expenses	**51,726**	50,847	**26,409**	26,093	101,597
Collection fees	**18,694**	16,469	**10,147**	8,007	35,916
	1,242,094	1,260,781	**631,618**	614,783	2,562,062
Less - salaries charged to investments in fixed assets	**102,245**	90,342	**45,972**	45,631	195,515
	1,139,849	1,170,439	**585,646**	569,152	2,366,547

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

** Reclassified

Notes to the Interim Consolidated Financial Statements as at June 30, 2004

NOTE 13 – SEGMENTS OF BUSINESS OPERATIONS

The Company and the investee companies operate in various segments of the communications industry. Data on activities by segment are set out according to the segments of operation of those companies.

	For the six-month period ended June 30, 2004					
	Domestic fixed line communications	Cellular telephone	International communications and Internet services	Others	Adjustments	Consolidated
	Reported amounts*					
	NIS thousands					
Revenues						
Revenues from externals	**2,420,696**	**1,074,786**	**396,638**	**128,661**	**–**	**4,020,781**
Inter-segment revenues	**101,452**	**3,126**	**4,405**	**22,623**	**(131,606)**	**–**
Total revenues	**2,522,148**	**1,077,912**	**401,043**	**151,284**	**(131,606)**	**4,020,781**
Segment results	**551,380**	**140,007**	**66,559**	**4,005**	**–**	**761,951**

	For the six -month period ended June 30, 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					
Revenues						
Revenues from externals	2,541,849	944,620	332,468	115,645	–	3,934,582
Inter-segment revenues	105,787	4,939	4,648	21,109	(136,483)	–
Total revenues	2,647,636	949,559	337,116	136,754	(136,483)	3,934,582
Segment results	489,779	(6,523)	48,728	(2,035)	325	530,274

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

Notes to the Interim Consolidated Financial Statements as at June 30, 2004

NOTE 13 – SEGMENTS OF BUSINESS OPERATIONS (CONTD.)

	For the three-month period ended June 30, 2004					
	Domestic fixed line communications	Cellular telephone	International communications and Internet services	Others	Adjustments	Consolidated
	Reported amounts*					
	NIS thousands					
Revenues						
Revenues from externals	**1,203,825**	**541,125**	**203,075**	**63,535**	**–**	**2,011,560**
Inter-segment revenues	**50,345**	**1,654**	**358**	**13,095**	**(65,452)**	**–**
Total revenues	**1,254,170**	**542,779**	**203,433**	**76,630**	**(65,452)**	**2,011,560**
Segment results	**255,071**	**73,197**	**32,010**	**2,428**	**–**	**362,706**

	For the three-month period ended June 30, 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					
Revenues						
Revenues from externals	1,254,422	481,169	166,957	53,664	–	1,956,212
Inter-segment revenues	53,313	3,858	2,356	13,355	(72,882)	–
Total revenues	1,307,735	485,027	169,313	67,019	(72,882)	1,956,212
Segment results	249,127	8,504	20,349	(2,589)	167	275,558

	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					
Revenues						
Revenues from externals	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

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

Notes to the Interim Consolidated Financial Statements as at June 30, 2004

NOTE 14 – CONDENSED INTERIM FINANCIAL STATEMENTS OF PARTIALLY CONSOLIDATED COMPANY AND CONSOLIDATED COMPANIES

1. PELEPHONE COMMUNICATIONS LTD.

A. Balance sheet

	June 30 2004	June 30 2003	December 31 2003
	(Unaudited)	(Unaudited)	(Audited)
	Reported amounts*	Adjusted for the effects of inflation in shekels of December 2003	
	NIS thousands	NIS thousands	NIS thousands
Current assets	**1,325,899**	1,229,761	1,264,002
Long-term trade receivables	**232,998**	174,560	199,136
Investment in investee companies	**4,996**	–	2,253
Deferred income tax	**158,180**	335,509	238,367
Fixed assets, net	**2,931,469**	3,009,547	2,977,528
Other assets	**368,394**	403,327	339,506
	5,021,936	5,152,704	5,020,792
Current liabilities	**1,962,997**	2,168,824	1,761,626
Provision for losses of investee company	**–**	4,963	5,372
Long-term liabilities	**1,050,458**	1,225,370	1,386,774
Shareholders' equity	**2,008,481**	1,753,547	1,867,020
	5,021,936	5,152,704	5,020,792

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

Notes to the Interim Consolidated Financial Statements as at June 30, 2004

NOTE 14 – CONDENSED INTERIM FINANCIAL STATEMENTS OF PARTIALLY CONSOLIDATED COMPANY AND CONSOLIDATED COMPANIES (CONTD.)

1. Pelephone Communications Ltd. (Contd.)

B. Statement of Operations

	For the six-month period ending June 30		For the three-month period ending June 30		For the year ending December 31
	2004 (Unaudited)	2003 (Unaudited)	2004 (Unaudited)	2003 (Unaudited)	2003 (Audited)
	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	Adjusted for the effects of inflation in shekels of December 2003
	NIS thousands		NIS thousands		NIS thousands
Revenues from Pelephone services, sales and services	**2,155,823**	1,899,120	**1,085,559**	970,054	4,054,749
Cost of cellular services, sales and services	**1,563,675**	1,613,325	**783,644**	806,146	3,238,098
Gross profit	**592,148**	285,795	**301,915**	163,908	816,651
Sales and marketing expenses	**236,366**	227,085	**120,373**	112,172	470,935
General and administrative expenses	**77,167**	73,131	**35,845**	36,103	152,447
	313,533	300,216	**156,218**	148,275	623,382
Operating gain (loss)	**278,615**	(14,421)	**145,697**	15,633	193,269
Financing expenses, net	**62,944**	71,588	**39,234**	48,633	143,786
Other expenses (income), net	**(2,872)**	(601)	**(5,617)**	(418)	167
Earnings (loss) before income tax	**218,543**	(85,408)	**112,080**	(32,582)	49,316
Income tax (tax benefit)	**73,800**	(2,992)	**36,000**	(1,496)	18,289
Earnings (loss) after income tax	**144,743**	(82,416)	**76,080**	(31,086)	31,027
Company's equity in losses of an affiliate	**3,282**	916	**876**	552	6,224
Net earnings (loss)	**141,461**	(83,332)	**75,204**	(31,638)	24,803

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

NOTE 14 – CONDENSED INTERIM FINANCIAL STATEMENTS OF PARTIALLY CONSOLIDATED COMPANY AND CONSOLIDATED COMPANIES (CONTD.)

2. DBS Satellite Services (1998) Ltd.

A. Balance sheet

	June 30 2004	June 30 2003	December 31 2003
	(Unaudited)	(Unaudited)	(Audited)
	Reported amounts*	Adjusted for the effects of inflation in shekels of December 2003	
	NIS thousands	NIS thousands	NIS thousands
Current assets	**111,184**	107,869	107,188
Broadcasting rights, net	**122,980**	150,001	128,334
Fixed assets, net	**1,081,071**	1,214,181	1,124,158
	1,315,235	1,472,051	1,359,680
Current liabilities	**1,910,456**	1,723,368	1,862,403
Long-term liabilities	**20,862**	85,822	31,858
Loans from shareholders	**2,418,194**	2,196,468	2,271,283
Equity deficit	**(3,034,277)**	(2,533,607)	(2,805,864)
	1,315,235	1,472,051	1,359,680

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

Notes to the Interim Consolidated Financial Statements as at June 30, 2004

NOTE 14 – CONDENSED INTERIM FINANCIAL STATEMENTS OF PARTIALLY CONSOLIDATED COMPANY AND CONSOLIDATED COMPANIES (CONTD.)

2. DBS Satellite Services (1998) Ltd. (Contd.)

A. Statement of Operations

	For the six-month period ending June 30		For the three-month period ending June 30		For the year ending December 31
	2004 (Unaudited)	2003 (Unaudited)	2004 (Unaudited)	2003 (Unaudited)	2003 (Audited)
	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	Adjusted for the effects of inflation in shekels of December 2003
	NIS thousands		NIS thousands		NIS thousands
Revenues from DBS services	**485,870**	398,340	**250,082**	204,405	842,374
DBS operating expenses	**498,853**	499,390	**236,606**	248,825	1,012,159
Gross profit (loss)	**(12,983)**	(101,050)	**13,476**	(44,420)	(169,785)
Sales and marketing expenses	**60,773**	51,175	**32,884**	26,276	109,859
General and administrative expenses	**36,058**	40,776	**17,266**	19,328	84,691
	96,831	91,951	**50,150**	45,604	194,550
Operating loss	**109,814**	193,001	**36,674**	90,024	364,335
Financing expenses, net	**94,304**	85,526	**58,468**	71,173	179,608
Other expenses (income), net	**1,370**	4,353	**(17)**	1,742	11,201
Net loss	**205,488**	282,880	**95,125**	162,939	555,144

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

NOTE 14 – CONDENSED INTERIM FINANCIAL STATEMENTS OF PARTIALLY CONSOLIDATED COMPANY AND CONSOLIDATED COMPANIES (CONTD.)

3. Bezeq International Ltd. (Contd.)

A. Balance sheet

	June 30 2004	June 30 2003	December 31 2003
	(Unaudited)	(Unaudited)	(Audited)
	Reported amounts*	Adjusted for the effects of inflation in shekels of December 2003	
	NIS thousands	NIS thousands	NIS thousands
Current assets	**170,450**	150,314	149,765
Investments	**26,061**	12,716	12,704
Fixed assets	**373,650**	495,284	375,703
Other assets	**11,099**	6,123	2,695
	581,260	664,437	540,867
Current liabilities	**249,817**	313,675	276,061
Long-term liabilities	**183,424**	171,302	180,881
Shareholders' equity	**148,019**	179,460	83,925
	581,260	664,437	540,867

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

Notes to the Interim Consolidated Financial Statements as at June 30, 2004

NOTE 14 – CONDENSED INTERIM FINANCIAL STATEMENTS OF PARTIALLY CONSOLIDATED COMPANY AND CONSOLIDATED COMPANIES (CONTD.)

3. Bezeq International Ltd. (Contd.)

B. Statement of Operations

	For the six-month period ending June 30		For the three-month period ending June 30		For the year ending December 31
	2004 (Unaudited)	2003 (Unaudited)	2004 (Unaudited)	2003 (Unaudited)	2003 (Audited)
	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	Adjusted for the effects of inflation in shekels of December 2003
	NIS thousands		NIS thousands		NIS thousands
Revenues from international telecommunications services	**401,043**	337,126	**203,433**	169,321	703,336
Operating expenses	**245,309**	197,323	**127,595**	100,009	431,066
Gross profit	**155,734**	139,803	**75,838**	69,312	272,270
Marketing, general and administrative expenses	**90,075**	91,072	**44,728**	48,962	188,299
Operating income	**65,659**	48,731	**31,110**	20,350	83,971
Financing expenses, net	**3,687**	17,306	**581**	13,874	21,830
Earnings after financing, net	**61,972**	31,425	**30,529**	6,476	62,141
Other expenses (income), net	**(4,583)**	4,833	**(3,416)**	2,050	128,580
Earnings (loss) before income tax	**66,555**	26,592	**33,945**	4,426	(66,439)
Income tax	**454**	902	**131**	442	3,489
Earnings (loss) after income tax	**66,101**	25,690	**33,814**	3,984	(69,928)
Company's equity in losses (earnings) of an affiliated company	**(838)**	702	**(307)**	38	619
Net earnings (loss)	**66,939**	24,988	**34,121**	3,946	(70,547)

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