"BEZEQ" THE ISRAEL TELECOMMUNICATION CORP. LIMITED

INTERIM CONSOLIDATED FINANCIAL STATEMENTS

JUNE 30, 2003

Interim Consolidated Financial Statements as at June 30, 2003 (unaudited)

Contents

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 and Three Month Periods Ended June 30, 2003

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, 2003, 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 the 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, 2003, constitute approximately 21.8% of the total assets included in the interim consolidated balance sheet and whose revenues constitute approximately 35.72% and approximately 36.8% of the total revenues included in the interim consolidated statement of operations for the six months and the three months, respectively, then ended. Furthermore, the data contained in the interim consolidated financial statements, which relate to the net asset value of the Company's investments in affiliated companies and to its equity in their operating results, is based on interim financial statements which were reviewed by other auditors.

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 in 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 anticipated 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 an affiliated company. As described in Note 4A, the continuation of the activities of the affiliated company is dependent upon the execution of the Amendment to the Financing Agreement which was signed with the banking institutions and the receipt of additional loans from shareholders.

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

August 8, 2003

Interim Consolidated Balance Sheet

In adjusted shekels of June 2003

	June 30 2003 (Unaudited)	June 30 2002 (Unaudited)	December 31 2002 (Audited)
	NIS thousands	NIS thousands	NIS thousands
Current assets			
Cash and cash equivalents	**943,716**	1,653,762	987,450
Short-term investments	**1,318,418**	403,344	1,174,130
Trade receivables	**1,730,892**	1,751,822*	1,743,154
Other receivables and debit balances	**441,723**	445,821	512,160
Inventory	**117,327**	193,375	166,537
	4,552,076	4,448,124	4,583,431
Materials and spare parts	**167,584**	156,172	121,572
Investments and long-term receivables			
Investments, deposits and debit balances	**623,778**	1,836,475*	764,934
Investments in investee companies	**324,985**	466,858	388,107
	948,763	2,303,333	1,153,041
Fixed assets			
Cost	**30,523,543**	30,358,132	29,805,371
Less - accumulated depreciation	**20,940,152**	20,091,583	19,885,681
	9,583,391	10,266,549	9,919,690
Other assets			
Deferred charges and other assets	**255,254**	328,226	281,372
Deferred taxes	**382,401**	438,973	400,049
	637,655	767,199	681,421
	15,889,469	17,941,377	16,459,155

	June 30 2003 (Unaudited)	June 30 2002 (Unaudited)	December 31 2002 (Audited)
	NIS thousands	NIS thousands	NIS thousands
Current liabilities			
Bank credit	**467,482**	227,279	526,158
Current maturities of:			
Long-term bank loans	**586,310**	664,953	542,315
Debentures	**601,552**	200,446	209,234
Trade payables	**985,416**	1,049,443	1,147,547
Employee severance benefits	**467,026**	229,268	211,559
Other current liabilities	**1,302,478**	1,149,668*	1,112,464
	4,410,264	3,521,057	3,749,277
Long-term liabilities			
Long-term loans	**1,833,683**	2,531,085	2,092,759
Debentures	**2,208,763**	2,729,303	2,755,164
Employee severance benefits	**817,779**	1,300,578	1,134,072
Deferred revenues	**35,851**	53,015	44,414
	4,896,076	6,613,981	6,026,409
Minority rights	**393**	–	572
Contingent liabilities (Note 7)			
Shareholders' equity	**6,582,736**	7,806,339	6,682,897
	15,889,469	17,941,377	16,459,155

* Reclassified

Adv. Miriam (Miki) Mazar	Ilan Biran	Ron Eilon
Chairperson of the Board	Chief Executive Officer	Chief Financial Officer

Date of approval of the financial statements: August 8, 2003

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

Interim Consolidated Statement of Operations

In adjusted shekels of June 2003

	For the six month period ended June 30		For the three month period ended June 30		For the year ended December 31
	2003 (Unaudited)	2002 (Unaudited)	2003 (Unaudited)	2002 (Unaudited)	2002 (Audited)
	NIS thousands		NIS thousands		NIS thousands
Revenues from telecommunications services (Note 9)	**3,989,999**	4,100,482	**1,983,764**	2,045,436	8,193,020
Costs and expenses					
Operating and general expenses (Note 10)	**2,231,547**	2,270,998	**1,099,346**	1,134,084	4,605,671*
Depreciation	**1,097,744**	1,153,415	**543,032**	576,941	2,302,167*
Royalties to the Government of Israel	**122,965**	132,176	**61,947**	65,884	253,669
	3,452,256	3,556,589	**1,704,325**	1,776,909	7,161,507
Operating income	**537,743**	543,893	**279,439**	268,527	1,031,513
Financing expenses, net	**85,104**	71,686	**52,883**	26,983	167,646
Earnings after financing expenses, net	**452,639**	472,207	**226,556**	241,544	863,867
Other expenses (income), net (Note 4C)	**39,683**	(5,586)	**39,595**	(3,842)	1,236,974
Earnings (loss) before income tax	**412,956**	477,793	**186,961**	245,386	(373,107)
Income tax	**167,331**	155,436	**80,382**	86,319	210,253
Earnings (loss) after income tax	**245,625**	322,357	**106,579**	159,067	(583,360)
Equity in losses of affiliates	**158,065**	126,092	**88,074**	73,451	345,322
Minority share in losses of a consolidated company	**(236)**	(1,545)	**(814)**	(84)	(3,050)
Net earnings (loss)	**87,796**	197,810	**19,319**	85,700	(925,632)
Primary and diluted earnings (loss) per NIS 1 par value of common shares (in NIS)	**0.036**	0.082	**0.008**	0.045	(0.384)

* Reclassified

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

Interim Statement of Changes in Shareholders' Equity

In adjusted shekels of June 2003

	Share capital	Capital reserve – share premium	Capital reserve in respect of transactions between the Company and a controlling shareholder	Dividend proposed subsequent to the balance sheet date	Retained earnings (deficit)	Total
	NIS thousands					
Six months ended June 30, 2003						
Balance as at December 31, 2002 (audited)	**6,202,524**	**951,348**	**38,306**	**189,042**	**(698,323)**	**6,682,897**
Net earnings (unaudited)	–	–	–	–	**87,796**	**87,796**
Dividend paid (unaudited)	–	–	–	**(189,042)**	**1,085**	**(187,957)**
Balance as at June 30, 2003 (unaudited)	**6,202,524**	**951,348**	**38,306**	–	**(609,442)**	**6,582,736**
Three months ended June 30, 2003						
Balance as at April 1, 2003 (unaudited)	**6,202,524**	**951,348**	**38,306**	–	**(628,761)**	**6,563,417**
Net earnings (unaudited)	–	–	–	–	**19,319**	**19,319**
Balance as at June 30, 2003 (unaudited)	**6,202,524**	**951,348**	**38,306**	–	**(609,442)**	**6,582,736**
Six months ended June 30, 2002						
Balance as at December 31, 2001 (audited)	6,202,524	951,348	38,306	–	416,351	7,608,529
Net earnings (unaudited)	–	–	–	–	197,810	197,810
Balance as at June 30, 2002 (unaudited)	6,202,524	951,348	38,306	–	614,161	7,806,339
Three months ended June 30, 2002						
Balance as at April 1, 2002 (unaudited)	6,202,524	951,348	38,306	–	528,461	7,720,639
Net earnings (unaudited)	–	–	–	–	85,700	85,700
Balance as at June 30, 2002 (unaudited)	6,202,524	951,348	38,306	–	614,161	7,806,339
Year ended December 31, 2002						
Balance as at December 31, 2001 (audited)	6,202,524	951,348	38,306	–	416,351	7,608,529
Net loss (audited)	–	–	–	–	(925,632)	(925,632)
Dividend proposed subsequent to the balance sheet date (audited)	–	–	–	189,042	(189,042)	–
Balance as at December 31, 2002 (audited)	6,202,524	951,348	38,306	189,042	(698,323)	6,682,897

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

Interim Consolidated Statement of Cash Flows

In adjusted shekels of June 2003

	For the six month period ended June 30		For the three month period ended June 30		For the year ended December 31
	2003 (Unaudited)	2002 (Unaudited)	2003 (Unaudited)	2002 (Unaudited)	2002 (Audited)
	NIS thousands		NIS thousands		NIS thousands
Cash flows from operating activities					
Net earnings (loss)	**87,796**	197,810	**19,319**	85,700	(925,632)
Adjustments to reconcile net earnings (loss) to net cash flows from operating activities (see A below)	**1,403,433**	1,112,329*	**759,064**	541,188*	3,795,675*
Net cash derived from operating activities	**1,491,229**	1,310,139	**778,383**	626,888	2,870,043
Cash flows for investing activities					
Investment in fixed assets	**(731,118)**	(548,073)	**(336,751)**	(244,178)	(1,372,986)
Proceeds from disposal of fixed assets	**8,329**	8,363	**3,543**	4,133	25,038
Proceeds from disposal of investment in affiliated companies	**–**	111,051	**–**	–	118,462
Investment in long-term deposits and investments	**(5,036)**	(88,847)*	**(1,604)**	(84,184)*	(290,302)*
Proceeds from long-term deposits and investments	**27,030**	126,590	**2,335**	92,631	161,995
Decrease (increase) in short-term investments, net	**(166,793)**	1,555	**(511,880)**	22,197	(764,935)
Decrease (increase) in materials and spare parts	**(30,533)**	1,136	**(23,684)**	(4,144)	23,090
Acquisition of a partnership consolidated for the first time (see B below)	**–**	–	**–**	–	(3,915)
Investment in investee companies	**(116,889)**	(222,889)	**(65,358)**	(133,051)	(364,580)
Investment in other assets	**(33,302)**	(86,118)	**(17,860)**	(30,051)	(128,108)
Net cash used in investing activities	**(1,048,312)**	(697,232)	**(951,259)**	(376,647)	(2,596,241)
Cash flows from financing activities					
Issuance of debentures (subsequent to deduction of issuance expenses)	**–**	108,493	**–**	–	108,493
Repayment of debentures	**(154,367)**	(177,393)	**(28,119)**	(52,570)	(224,504)
Receipt of long-term loans	**203,376**	193,925	**49,505**	26,450	210,252
Repayment of long-term loans	**(289,027)**	(243,290)	**(172,174)**	(131,707)	(838,248)
Receipt (repayment) of short-term bank credit, net	**(58,676)**	(221,527)	**17,721**	(15,132)	77,008
Dividend paid	**(187,957)**	–	–	–	–
Net cash used in financing activities	**(486,651)**	(339,792)	**(133,067)**	(172,959)	(666,999)
Increase (decrease) in cash and cash equivalents	**(43,734)**	273,115	**(305,943)**	77,282	(393,197)
Balance of cash and cash equivalents at the beginning of the period	**987,450**	1,380,647	**1,249,659**	1,576,480	1,380,647
Balance of cash and cash equivalents at the end of the period	**943,716**	1,653,762	**943,716**	1,653,762	987,450

* Reclassified

The notes to the financial statements are integral part thereof.

Interim Consolidated Statement of Cash Flows (Contd.)

In adjusted shekels of June 2003

	For the six month period ended June 30		For the three month period ended June 30		For the year ended December 31
	2003 (Unaudited)	2002 (Unaudited)	2003 (Unaudited)	2002 (Unaudited)	2002 (Audited)
	NIS thousands		NIS thousands		NIS thousands
A – Adjustments to reconcile net earnings to net cash flows provided by operating activities					
Revenue and expenses not involving cash flows:					
Depreciation	**1,097,744**	1,153,415	**543,032**	576,941	2,302,167*
Deferred taxes	**32,846**	50,713	**14,163**	25,202	30,574
Company's equity in losses of affiliated companies	**158,065**	126,092	**88,074**	73,451	345,322
Minority share in losses of a consolidated company	**(236)**	(1,545)	**(814)**	(84)	(3,050)
Decrease in employee severance benefits, net	**(60,826)**	(100,714)	**(35,490)**	(58,063)	(284,928)
Loss (gain) on disposal of fixed assets	**3,906**	(5,453)	**2,613**	(3,962)	(12,919)
Provision for decrease in value of investments	**35,513**	–	**35,513**	–	1,250,017
Erosion (appreciation) and interest on long-term investments and debts	**126,033**	(176,156)	**111,032**	(114,525)	(207,219)*
Erosion of short-term investments, net	**22,505**	62,014	**18,488**	42,205	57,717
Appreciation (erosion) of long-term liabilities:					
Debentures	**284**	126,112	**(20,959)**	120,861	207,872
Long-term loans	**(120,398)**	(11,449)	**(87,229)**	(53,467)	(13,568)
Amortization of deferred expenses and other adjustments	**78,234**	120,447	**36,767**	59,776	232,901*
Changes in current assets and liabilities:					
Decrease (increase) in trade receivables	**7,269**	14,027*	**(18,970)**	(59,854)*	29,837*
Decrease (increase) in receivables and debit balances	**112,106**	(28,225)	**26,311**	(70,255)	4,954
Decrease (increase) in inventory	**47,931**	(70,801)	**48,512**	(35,093)	(45,434)
Increase (decrease) in trade payables	**(236,642)**	(59,291)	**(60,374)**	33,489	51,777
Increase (decrease) in other current liabilities	**107,662**	(78,379)	**69,038**	8,837	(133,267)
Decrease in deferred revenues	**(8,563)**	(8,478)	**(10,643)**	(4,271)	(17,078)
	1,403,433	1,112,329	**759,064**	541,188	3,795,675
B - Partnership consolidated for the first time					
Working capital (excluding cash and cash equivalents)					6,596
Fixed assets					(6,103)
Long-term liabilities					805
Minority rights as at the acquisition date					733
Investment in an affiliated company					1,082
Goodwill					(7,028)
					(3,915)
C - Non-cash transactions					
Acquisition of fixed assets, other assets, materials and spare parts on credit	**199,007**	145,762	**199,007**	145,762	211,186
Sale of fixed assets on credit	**–**	6,068	**–**	6,068	5,882

* Reclassified

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

NOTE 1 – GENERAL

A. The interim statements were prepared according to generally accepted accounting principles, applicable to the preparation of financial statements for interim financial statements. These statements should be read in conjunction with the Company's annual financial statements as at December 31, 2003 and for the year then ended and the related accompanying notes.

B. In the notes to the interim financial statements, the Company presents only the 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 for 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, 2002. The significant changes that occurred from the date of those annual financial statements to the date of these financial statements, are as follows:

1. In March 2003 the Committee for Regulating the Tariffs of Bezeq presented a report containing its recommendations. The recommendations were approved and amended by the Ministers, and on August 5, 2003, the Knesset Finance Committee approved the recommendations with certain modifications. The changes in the Company's tariffs as approved by the Finance Committee are as follows:

   a. Commencing on September 1, 2003, the overall average level of the Company's tariffs will be lowered compared with the level set in the last tariff update (May 1, 2002) by an average of 5.97% in nominal terms, through a combined process whereby the call tariffs will be reduced by 23% while fixed monthly fees will be increased by 12.8%.

      The lowering of the Company's tariffs will include cancellation of the minimum call tariff (which is 22.5 agorot including VAT), setting tariffs of 13 agorot (including VAT) per call minute during peak hours and 5.5 agorot (including VAT) per call minute in off-peak hours. In addition, interconnect tariffs will be reduced by 8.2%.

   b. Tariff updates in the future will be based on the rise in the CPI less an "efficiency coefficient" of minus 2.5% as long as the Company's average output growth is in the range of minus 1% to minus 3% per year (the efficiency coefficient will decrease by one half of one percent with each decrease of 1% in the growth rate beyond minus 3% and will increase by one half of one percent with each rise of one percent in the growth rate beyond minus1%).

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

   The Company believes, based on its projections, that the above tariff reductions can be expected to have a materially adverse effect on its business results.

2. Further to Note 1E(1) in the financials statements as at December 31, 2002 concerning a reduced deduction rate for the cellular companies due to the bad debts component generated in respect of calls from Company subscribers to cellular company subscribers, in July 2003 the Ministry of Communications announced its decision on the matter as follows:

   a. For the period from October 2, 2000, through August 31, 2003, the deduction will be 1.1%. This rate will be applied to all the cellular operators even if the Company had reached arrangements with some of them.

NOTE 1 – GENERAL (CONTD.)

b. For the period from September 1, 2003, and thereafter, the Company will be required to transfer interconnect fees to the cellular companies according to actual traffic minutes, with no deduction of any kind. Based on the recommendation in the report of the Committee for Regulating the Tariffs of Bezeq, this matter will be reflected in the next Company tariff update which is scheduled to take effect at the beginning of September 2003, subject to receipt of the approvals required by law (it is noted that in accordance with the decision of the Ministers to approve the recommendations of the Committee for Regulating the Tariffs of Bezeq, the additional revenues deriving to the Company in respect of their decision, compared with the recommendations of the committee, includes the component of the bad debts).

c. With reference to the period from March 1, 2000, to October 1, 2000 – an appeal filed by Partner against the Company is pending in the Supreme Court. It is proposed that the decision regarding the 1.1% rate of deduction should also apply to this period if the parties agree, subject to the decision of the court.

The significance of such a decision is that the Company's demand for a deduction rate of 2.5% until January 1, 2003, and a rate higher than 1.1% for the period thereafter, which would reflect the bad debts and collection expenses – will not be accepted.

In the past, the Company's financial statements included a provision for the effect of the decision of the Minister of Communications on a temporary deduction rate of 1.1% of the volume of traffic for the period starting on October 2, 2000. Therefore, the decision to set that rate as a fixed percentage for that period has no further effect on the Company's financial statements. However, the decision of the Minister of Communications to cancel the deduction starting on September 1, 2003, will mean a decrease of approximately NIS 50 million per year (based on airtime data for 2002 compared with a deduction of 2.5%).

The Company intends to appeal the decision.

3. Regarding the settlement agreement between the Company and the State of Israel and the Israel Lands Administration relating to the Company's rights in real estate assets transferred to the Company, see Note 5 below.

4. On July 24, 2003, the State approached several institutions, requesting offers for the purchase of 86,500,000 ordinary shares of a par value of NIS 1 each of the State's shares in the Company. Subsequently, on July 29, 2003, the State sold those shares to Gmul Sahar Underwriters Ltd. (which made the highest offer), at NIS 4.338 per share.

   This share sale was carried out as part of the framework agreement between the State and the Company as described in Note 8 below. Accordingly, the Company allotted to the State, on July 30, 2003, the entire balance of its unissued registered capital, a total of 23,342,462 ordinary shares par value of NIS 1 each. The total consideration received in respect of this issuance was NIS 101,261,807. The Company will issue to the State the balance of the shares sold by the State to Gmul Sahar Underwriters Ltd. (as well as additional shares in accordance with the framework agreement) after increasing its registered share capital as described in Note 8 below.

NOTE 2 - ACCOUNTING POLICY

The significant accounting policies employed in preparation of these financial statements, are the same as those employed in the preparation of the latest annual financial statements, except for the following:

New accounting standards

1. In July 2001 the Israeli Institute for Accounting Standardization ("IIAS") published two new standards:

NOTE 2 - ACCOUNTING POLICY (CONTD.)

a. Accounting Standard No. 12 – Termination of adjustment of financial statements. This standard eliminates adjustment for the effects of the purchasing power of the shekel in financial statements, commencing from January 1, 2003.

In December 2002, the IIAS published Standard No. 17, postponing the application of Standard No. 12 to January 1, 2004. Thus, the adjustment of the financial statements will end on that date. Until December 31, 2003, the Company will continue to prepare statements adjusted in accordance with Opinion No. 36 of the Institute of Certified Public Accountants in Israel ("ICPAI"). The adjusted amounts included in the financial statements as at December 31, 2003, will serve as the starting point for the nominal reporting starting on January 1, 2004. Implementation of Standard No. 12 is liable to have material implications for the reported business results of the Company, the extent of which depends on the rate of inflation, the composition of assets and the Company's financing sources.

b. Accounting Standard No. 13 – Effects of changes in foreign currency exchange rates. The standard deals with the translation of foreign currency transactions and the translation of the financial statements of overseas operations for integration in the financial statements of the reporting corporation and supersedes the provisions of Clarifications 8 and 9 to Opinion No. 36, which will become null and void when Accounting Standard No. 12, described above, takes effect.

2. In February 2003 the IIAS published Accounting Standard No. 15 – Impairment of Asset Value. The Standard determines procedures with which a corporation must comply in order to ensure that its assets in the consolidated balance sheet are not stated in an amount exceeding their recoverable amount, which is the higher of the net sale price and the present value of the estimated future cash flows expected to derive from the use and realization of the asset. In addition, the Standard lays down rules of statement and disclosure for assets whose value is impaired. The Standard applies to financial statements for the periods starting from January 1, 2003. Application of the Standard has no effect on the interim financial statements.

NOTE 3 – FINANCIAL STATEMENTS IN ADJUSTED VALUES

The financial statements were prepared on the basis of historical cost adjusted for changes in the general purchasing power of the Israeli currency. The changes that occurred in the Consumer Price Index ("CPI") and in the foreign currency exchange rates are as follows:

	Consumer Price Index	Exchange rate of the US dollar	Exchange rate of the euro
	%	%	%
During the six month period ended:			
June 30, 2003	**(0.005)**	**(0.089)**	**(0.008)**
June 30, 2002	6.299	7.994	21.149
During the six month period ended:			
June 30, 2003	**(0.013)**	**(0.080)**	**0.028**
June 30, 2002	1.098	3.068	(6.235)
During the year ended December 31, 2002	6.496	7.269	27.182

NOTE 4 – INVESTMENTS IN INVESTEE COMPANIES

A. D.B.S. Satellite Services (1998) Ltd. ("DBS")

The Company's investment in DBS as at the balance sheet date amounts to approximately NIS 1,212 million. The Company's share in the accumulated losses of DBS is approximately NIS 887 million, of which approximately NIS 129 million was recorded in the first half of 2003. The balance of the current debt of DBS to the Company and its consolidated companies amounts to approximately NIS 65 million.

Further to Note 8E to the financial statements as at December 31, 2002, on July 31, 2003, the Ministry of Communications gave its approval for the issuance to the Company of the additional shares in DBS, which will increase the Company's holdings in DBS from approximately 45% to approximately 49.9%. It is expected that the issuance will be carried out within a few days, after the banks give their approval.

Since commencing operations, DBS has accumulated considerable losses and negative cash flows. The loss for the year 2002 amounted to approximately NIS 719 million and the loss in the six month period ended June 30, 2003, amounted to approximately NIS 287 million. As a result of these losses, the capital deficit and the negative working capital of DBS as at June 30, 2003, amounted to approximately NIS 2,569 million and approximately NIS 1,638 million, respectively. The negative working capital includes bank credit of NIS 1,218 million.

On May 23, 2001, a financing agreement ("the Financing Agreement") was signed between DBS and certain banks ("the Banks"), stipulating, *inter alia*, undertakings by DBS to meet certain suspending conditions and to comply with cumulative milestones and financial stipulations ("the Conditions").

An economic study carried out by the Banks at the beginning of 2002 determined that in order to finance the operations of DBS, additional financing would be required which considerably exceeds the financing requirements defined in the Financing Agreement.

On December 30, 2002, DBS, the shareholders and the Banks signed an agreement increasing the credit facility from the Banks ("the Interim Credit Facility"), which will be implemented concurrently with additional investments of the shareholders in an amount not less than a sum equal to 150% of the amount that will be injected by the Banks. Receipt of the Interim Credit Facility is subject, *inter alia*, to DBS's compliance with financial and operating conditions set out in this agreement. At the same time as the aforementioned signing, discussions were being held between the parties regarding the expansion of the Interim Credit Facility within the framework of an amendment to the Financing Agreement ("the Amendment Agreement").

As at the date of approval of these financial statements, the shareholders and the Banks have transferred to DBS approximately $ 36 million and approximately $ 24 million, respectively, which is their entire obligation in the Interim Credit Facility. Nevertheless, some of the conditions in the Financing Agreement and the Interim Credit Facility are not being met.

An economic study carried out by the Banks during the reporting period determined that the overall financing needs of DBS do not exceed the Interim Credit Facility plus its increment as part of the Amendment Agreement (including the proportional part of the shareholders).

On August 6, 2003 the Amendment Agreement was signed by the Banks and DBS. Under that agreement, the Banks will make additional amounts available to DBS, in excess of those made available under the Financing Agreement and the Interim Credit Facility, subject to DBS's compliance with the Conditions and milestones determined in the Amendment Agreement, including additional investments by the shareholders in amounts not less than 150% of the amounts made available by the Banks. The Amendment Agreement will take effect only after meeting certain suspending conditions, and at the latest by August 20, 2003, or by a later date agreed upon by the parties. The principal shareholders are continuing to make further credit available to DBS, beyond the Interim Credit Facility and on account of the Amendment Agreement. As at the date of approval of the financial statements, the credit made available to DBS on account of the Amendment Agreement amounted to approximately $ 18.6 million.

NOTE 4 – INVESTMENTS IN INVESTEE COMPANIES (CONTD.)

A. D.B.S. Satellite Services (1998) Ltd. ("DBS") (contd.)

The grant of additional loans by the Company to DBS is subject, *inter alia*, to the approval of the Ministerial Committee for Privatization (" the Committee"). On January 14, 2003, the Committee gave its approval for the Company to invest in DBS up to the percentage of its holding in DBS multiplied by $ 600 million and up to an exposure ceiling of $ 300 million. The Board of Directors of the Company approved the Company's investment in DBS as derived from the Financing Agreement, the Interim Credit Facility and the Amendment Agreement. The management of DBS estimates that the total investments approved for the Company by the Committee cover the Company's proportional part of the Interim Credit Facility plus its proportional part of the Amendment Agreement.

DBS's continued operation is contingent upon the Amendment Agreement taking effect as aforesaid and upon the receipt of additional loans from the shareholders.

The management of DBS believes that there is a good chance of meeting the aforementioned suspending conditions, of the Amendment Agreement taking effect and of the arrangement of the financial resources required by DBS in the coming year.

B. Goldnet Communications Services – a registered partnership ("the Partnership")

Further to Note 8H to the financial statements as at December 31, 2002, in the matter of exercise of the Put option held by Malam Systems Ltd. ("Malam") relating to the Company, for the sale of 20.9% of its holding in the Partnership, on May 5, 2003, after receipt of the approvals required by law for the change in the holdings in the Partnership and after the consideration of approximately NIS 6.4 million was paid by the Company, the Company's holdings in the Partnership increased to 74.9%, while the holdings of Malam in the Partnership decreased accordingly to 25.1%.

C. Adanet For Business Group Ltd. ("Adanet")

Further to Note 8G to the financial statements as at December 31, 2002, Adanet sustained losses of approximately NIS 11 million in the six month period ended June 30, 2003 and NIS 34.5 million in 2002 and has a deficit in shareholders' equity as at June 30, 2003 amounting to approximately NIS 70 million and negative working capital as at the same date amounting to NIS 37.5 million. During 2002, Adanet started implementation of a plan that included efficiency and cost-cutting measures.

In view of the uncertainty regarding the realization of the business plan of Adanet as planned, as well as regarding the outcome of the discussions with the banks for arranging the financing that Adanet requires, there is considerable concern regarding Adanet's continued existence as a going concern. Consequently the Company recorded a provision in the amount of the balance of its investment in Adanet, approximately NIS 31 million, which is included in the line item Other expenses (income), net in the Statement of Operations in the reporting period.

D. Pelephone Communications Ltd. ("Pelephone")

In May 2003 the Company received a partial update of the estimated value of Pelephone, indicating a rise in its value to between $ 800 million and $ 1 billion, and in August 2003 the Company received an additional partial update indicating a further rise in Pelephone's value to between $ 900 million and $ 1.1 billion. In view of the uncertainty of the continuing existence over time of the factors that led to this update, no change was made in the provision for impairment recorded in 2002. The Company will re-examine the value of Pelephone at a later date.

Notes to the Interim Consolidated Financial Statements as at June 30, 2003 (Unaudited)

NOTE 5 – FIXED ASSETS

A. Further to Note 9C to the financial statements as at December 31, 2002, on May 15, 2003, the Company signed a settlement agreement with the Government of Israel on behalf of the State of Israel and the Israel Lands Administration ("the Administration"). The agreement regulates the dispute between the aforementioned parties relating to the rights of the Company in various real estate assets that were transferred to the Company when it commenced operations in 1984, under an asset transfer agreement which was signed between the Company and the State ("the Asset Transfer Agreement").

Under the settlement agreement, 14 properties will be returned to the State out of the 28 which are in the Company's possession under renewable lease status (complete properties which were leased to the Company for a period of two years and renewable each time for a further two years, unless the State exercised its right to end the lease on terms and conditions laid down in the Asset Transfer Agreement), in addition to three properties which were returned to the Administration prior to the settlement agreement and the Administration will allocate three substitute properties instead of some of those properties which the Company will return to the State. The remainder of the properties in the Company's possession under renewable lease and properties which were leased to the Company under the Asset Transfer Agreement will remain in the Company's possession under capitalized lease terms as set out in the Agreement. The Administration will also allocate and lease to the Company, after completion of planning stages, a net area of 70 dunams at the Sakia site, on lease terms set out in the Agreement. The Agreement also includes a number of individual arrangements in the matter of specific disputes between the parties, some of which related to certain of the properties in dispute and some of which related to other properties which were not part of the dispute. Under these arrangements, it was agreed, *inter alia*, that the Company will return several additional properties (one of which was never in dispute), as set out in the Agreement.

The Agreement was approved by the Audit Committee of the Board of Directors of the Company, the Board of Directors and by the General Meeting of the Shareholders of the Company on August 6, 2003 (since it is an extraordinary transaction between the Company and its controlling shareholder – the State of Israel) and also requires the approval of the Israel Lands Council. The Agreement will take effect after being validated by a decision of the court in which the claim was filed by the State, the Administration and the Development Authority against the Company in the matter of the dispute.

In the opinion of the Company's Management, the aforementioned is not expected to have a material effect on the financial statements of the Company.

B. During June 2003, a proportionally consolidated company signed a declaration of intent, following which an agreement is expected to be signed for a technology upgrade of sites serving the CDMA system to 1X technology. The contact value will be approximately $ 95 million. The upgrade will significantly increase the capacity and quality of the existing network and will enable the provision of advanced services for customers. Deployment of the network is planned in stages, commencing during 2003, with most of the deployment to be completed by the end of 2004 and final installation in 2006. Concurrently, the company performing the network upgrade undertook to buy back the old equipment for $ 41 million.

NOTE 6 – LIABILITY FOR EMPLOYEE SEVERANCE BENEFITS

A. Early retirement plan

In September 2000, the Company reached an agreement with workers' representatives for extension of the 1997 collective agreement for early retirement. Under the agreement 1,770 additional employees would take early retirement from April 1, 2001 through December 31, 2006 (with an option to extend the final retirement date for certain employees through December 31, 2008). The agreement also stated that the Company would be able to terminate the employment of employees in a severance payment track in excess of the aforementioned quota. In the opinion of the Company's Management, the possibility of additional employees retiring under the aforementioned track is low and accordingly no provision has been made in the financial statements. Under this plan, 484 employees had taken early retirement by June 30, 2003.

In May 2003 the Knesset approved the Israeli Economy Recovery Plan (Legislative amendments for attaining budget targets and the economic policy for fiscal years 2003 and 2004), 5763 - 2003. The law includes, *inter alia*, an amendment of the Supervision of Insurance Business Law, 5741 - 1981, which relates to the long established pension funds operating at a deficit including the pension fund with which the Company is contract to with an agreement. The effects of this amendment on the Company as a whole and on the early retirement plan in particular, are still unclear.

The aforementioned amendment has expedited the implementation of the early retirement plan beyond the original plan and in July 2003 another 285 employees retired, bringing the total to 769. In addition, it was agreed with the workers' representatives that by August 31, 2003, another 150 employees would be able to retire and in 2004 the quota would be 100 employees who would retire in accordance with the provisions and terms of the agreement.

In view of the uncertainty generated by the enactment of the law, including with regard to the possible considerable increase in the costs of implementing the retirement agreement in the future and the financing thereof, Company Management and the workers' representatives agreed that without derogating from the validity of the agreement, each of the parties may, on its own initiative, propose talks with the other party on everything relating to the changes and/or implementation of the provisions of the agreement and the other party would consent to such talks.

Due to the aforementioned uncertainties, the Company is unable to estimate, at this stage, the effects of the law, if any, and therefore no provision has been made in the financial statements for possible additional costs in respect of the early retirement agreement.

B. The Company filed a claim against the Makefet Fund ("the Fund") by means of which the early retirement plan is executed. Under the collective agreements applicable to labor relations in the Company and in accordance with agreements with the Fund, Company employees who are “transferred employees” have the option to retire on one of two retirement tracks. The method of calculating the cost of early retirement of the transferred employees is determined in the provisions of several agreements and documents which were drawn up between the Company and the Fund during the years 1990-1996, including a letter of understanding drawn up and signed by the parties in 1996. The Company contends that the Fund violated the provisions of the agreements in general and those of the letter of understanding in particular, in that when it calculated the costs of early retirement for transferred employees, the Fund determined those data on the basis of the assumption that those employees had chosen the track with the higher cost of purchase, irrespective of the track which those employees had actually chosen. According to an actuarial opinion prepared for the Company, the gap between the payments collected by the Fund from the Company according to its calculations and the rate of those costs had they been made, as the Company alleges, on the basis of the retirement track actually chosen by those employees, is a nominal cumulative amount of more than NIS 128 million, the reimbursement of which the Company is suing the Fund.

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 financial statements for the year ended December 31, 2002. No significant changes occurred in respect of the contingent liabilities up to the date of signing these financial statements, except for the following:

1. On May 4, 2003 a derivative statement of claim was received at the Company's offices, which includes an application to the court to approve the filing of the claim as a derivative claim (a claim which is filed by a shareholder or director of a company in the name of the company, with the approval of the court). The claim was filed by a shareholder of the Company against 20 directors serving the Company and certain senior managers who were employed by the Company during October and November 2000 ("the Officers") and against the Company. The statement of claim alleges as the main cause of the action, the negligent conduct of the Officers in the "Pelephone-Shamrock" transaction. In that transaction, Motorola Israel Ltd.'s shares in Pelephone were sold to Pelephone Holding L.L.C., a corporation registered in the U.S.A. ("the Foreign Corporation"), in consideration of approximately $ 591 million.

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

   It is noted that the Company rejected a prior approach sent to it by the plaintiff's lawyer, demanding full exercise of the rights of the Company in the matter by way of filing suit, citing as the reasons, *inter alia*, that the facts creating the cause of action were not described in accordance with the requirements of the Companies Law, 5759 - 1999 and that in any case, since the loan extended by the Company would fall due only in two years' time and since the Company still has an option to convert the loan to shares of the Foreign Corporation, and thus, legally speaking, the claim is speculative. It is further noted that contrary to the statement of claim, which alleges that the Company did not receive collateral for the loan it extended, the Company has registered a second ranking lien on the shares of Pelephone Holding L.L.C. in Pelephone against the same loan (convertible debenture) (after a first lien was given to the bank that financed part of the transaction – see also Note 8D(2) to the financial statements as at December 31, 2002).

   On June 12, 2003, the Company filed an application for dismissal *in limine* of the claim, citing as its reason that the plaintiff did not file a prior application for approval of his claim as a derivative claim, as required by law. At this stage it is not possible to estimate the chances of the outcome of the claim or the application filed by the Company for its dismissal.

NOTE 7 - CONTINGENT LIABILITIES (CONTD.)

A. CLAIMS AND CONTINGENT LIABILITIES (CONTD.)

2. On May 27, 2003, a statement of claim was received at the Company's offices together with an application for recognition as a class action, which was filed in the Tel Aviv District Court against the Company. The plaintiff, who describes himself as "a private Internet user", alleges in his claim that the Company refuses to install splitters for high speed Internet lines of the broadband ADSL/frame relay type used for Internet service in condominiums and does so in order to increase its profits. The plaintiff, who is seeking to represent all the Internet users in Israel, further alleges that the Company's refusal to install the splitters causes losses of thousands of shekels per year to every private Internet user in Israel, since the connection of a number of tenants in a condominium on one telephone line using the aforementioned splitters would considerably reduce the fees paid to the Company by each consumer. The causes of the claim as appear in the statement of claim, are cited by virtue of the Anti-Trust Law, the Torts Ordinance and the Unjust Enrichment Law. The plaintiff also alleges fraud and material deception under the Consumer Protection Law.

   The amount of the claim is estimated by the plaintiff at NIS 2.5 billion (NIS 10,000 per consumer), which he alleges is the loss sustained by the plaintiffs. The plaintiff also petitions to charge the Company, in addition, with special and punitive damages, and for an order for the Company give accounts for all private Internet users in respect of the amounts received from them from the time each user started using the service until the date of the reply. The Company is studying the claim and is unable, at this stage, to estimate its chances and its implications.

3. On June 5, 2003 a statement of claim was received at the Company's offices together with an application for recognition as a class action, which was filed in the Tel Aviv District Court against the Company by two of its subscribers. According to the allegations in the statement of claim, the Company overcharged its subscribers by NIS 0.021 (plus VAT) compared with the charge defined in the regulations, for calls from Company subscribers to subscribers in the cellular networks of Cellcom and Pelephone, during a period (estimated) from June 1996 to August 31st of that year. The plaintiffs allege that in so doing, the Company violated the ban on misleading consumers as laid down in the Consumer Protection Law, breach of duties under the Contracts Law, the Torts Ordinance and the Sale Law, as well as unjust enrichment. The group in whose name the claim is filed is defined by the plaintiffs as "A group of Bezeq subscribers in Israel who dialed to subscribers of Cellcom and Pelephone in June, July, August 1996" and estimated by them as numbering more than four million subscribers. (It is noted that at the relevant time, the Company's subscribers numbered about 2.5 million.) Based on the (erroneous, as aforementioned) estimate of the number of subscribers and the average "loss" to the plaintiffs (NIS 7.5), the plaintiffs estimate the amount of their claim at about NIS 30 million and are claiming compensation in respect of that loss. Alternatively, the plaintiffs are requesting that the court recognize the claim as a claim for declaratory relief or as a claim for a mandamus against the Company. The Company is studying the claim and is unable, at this stage, to estimate the chances of the claim. Nevertheless, and based on statements in the claim, claims for similar cause were filed against Cellcom and Pelephone and the claim against Pelephone was dismissed by the District Court while an appeal in respect of that case is pending in the Supreme Court (the plaintiffs have stated that they are concerned that the ruling of the Supreme Court in this proceeding will be given after elapse of the date for filing their claim, due to limitation).

4. Further to Note 19A(4) to the financial statements as at December 31, 2002, concerning the claim of senior employees for a wage increment of 33%, the court has given its decision denying the claim in full. The plaintiffs have appealed the decision.

5. Further to Notes 19A(11) to the financial statements as at December 31, 2002, concerning denial of an application for approval as a class action against the Company according to which the Company unlawfully collected monies from its subscribers in respect of certain services which it provides, on July 1, 2003 the Supreme Court denied the application for leave to appeal which was filed in respect of that decision (and which was heard as an appeal).

NOTE 7 - CONTINGENT LIABILITIES (CONTD.)

A. CLAIMS AND CONTINGENT LIABILITIES (CONTD.)

6. Further to Notes 19A(12), 19A(14) and 19A(17) to the financial statements as at December 31, 2002, relating to class actions filed against the Company, for which the source of authority for filing the claims is Regulation 29 of the Civil Procedures Regulations. In April 2003 a ruling of principle and precedent was issued by the Supreme Court in a case in which the Company is not a party, whereby it was determined that a class action cannot be filed by virtue of Regulation 29 of the Civil Procedures Regulations where no specific arrangement has been determined for filing the action in primary legislation. It is noted that an application for a further hearing has been filed in the Supreme Court which has not yet given its decision.

7. Further to Note 19A(12) to the financial statements as at December 31, 2002, concerning an action together with an application for approval of the action as a class action which was filed against the Company, in which it is alleged that the Company unlawfully collected payment differences for the fixed monthly fee for a telephone line, and further to Note 7A(6) above in view of the ruling of the Supreme Court, the parties are in contact for filing an agreed application to strike the claim and application for its approval.

8. Further to Note 19A(15) to the financial statements as at December 31, 2002, concerning two class actions and an application for their approval as class actions which were consolidated into one case, in the matter of charging subscribers telephone lease fees, which the plaintiffs allege was unlawful, on June 10, 2003 the Supreme Court denied the application for approval of the action as a class action. The plaintiffs filed an application in the Supreme Court for extension of the date for filing an application for leave to appeal the court's ruling, and the Supreme Court has requested the positions of the parties on the question of the correct proceeding for the decision of a lower instance (appeal by leave or appeal by right).

9. Further to Note 19A(25) to the financial statements as at December 31, 2002, concerning a letter of demand in the name of the Moshav Porath Committee which was received in October 2001, in April 2003 the Company received at its offices a statement of claim filed in the Tel Aviv District Court against the Company, the Broadcasting Authority and the State of Israel by various plaintiffs from Moshav Porath in the Sharon region, including the estates of deceased persons, for compensation due to physical harm pursuant to the Torts Ordinance. The statement of claim alleges violation of legislated duties and acts and/or failures allegedly perpetrated by the defendants jointly and/or severally in connection with the operation of the “Hillel” broadcasting station, which is near the homes of the plaintiffs. It is alleged that as a result, the plaintiffs were subjected to banned radiation from the broadcasting station and bodily harm, most of which ended in the death of some of the plaintiffs.

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

   The Company filed an application for dismissal of the claim *in limine*. Nevertheless, it is unable, at this stage, to estimate the chances of the outcome and the exact financial extent of the claim, or the chances and extent of additional claims that might be filed, if filed, against it. It is noted that in reply to the letter of demand which was sent to the Company by the plaintiffs' lawyer (in October 2001 as referred to above and a short time prior to the filing of the claim), the Company rejected the allegations made by the plaintiffs and repeated that its activities in the “Hillel” station were carried out in accordance with the provisions of the law and the directives and permits granted it by the competent authorities which are responsible for the broadcasting actions taking place in the station. It is further noted that the Company rejected a proposal made by the plaintiffs' lawyer prior to filing the claim to negotiate a settlement with the plaintiffs before the claim was filed.

NOTE 7 - CONTINGENT LIABILITIES (CONTD.)

A. CLAIMS AND CONTINGENT LIABILITIES (CONTD.)

Furthermore, on March 16, 2003, the Company received an additional letter demanding that the Company evacuate the “Hillel” station and in which notice was given of the intention to file a claim in respect of liability for health damages as a result of operation of the station. The Company rejected the demand and for the sake of caution, gave notice of the demand to the relevant insurance companies and to the Ministry of Communications, the Ministry for the Environment and the Broadcasting Authority.

In addition, during April 2003, a petition was filed in the High Court of Justice against the Minister of Environment, the Minister of Defense, the Broadcasting Authority and the Company, by the head of the Zuran Council, in which an order is requested for the immediate cessation of operation of the “Hillel” broadcasting station, since operation of the station is causing radiation that endangers the health of the residents of Moshav Zuran. After the Government decided to close the station until December 31, 2003, the petitioners withdrew the petition on 2 July, 2003, and retained the right to renew it if the station is not closed and the antennae are not removed by that date. Subject to the aforesaid, it was decided to strike the petition.

10. Further to Note 19A(26) to the financial statements as at December 31, 2002, concerning private claims of employees and former employees, in the matter of recognition of various wage components as pension components, and to Note 19A(32) to the financial statements as at December 31, 2002 relating to "Notice of a party in a collective dispute" in the matter of recognition of certain payments as pension components, the National Labor Tribunal ruled on the appeal filed by seven former employees of the Company, recognizing one of the above payments as a pension component in view of the factual circumstances in that case. The decision seriously affects the balance of the chances of the outcome of these claims against the Company as regards that component. Nevertheless, the above decision does not address a number of legal allegations which were made in the statement of allegations filed on behalf of the Company and on which the Labor Tribunal will have to rule. This being the case, Management believes that it is not possible, at this stage, to estimate the chances of the outcome of the above claims and therefore, no provision has been in respect thereof in the financial statements.

11. Further to Note 19A(27) to the financials statements as at December 31, 2002, in connection with guarantees on which the Ministry of Communications of India demanded to foreclose, the proceeding was stricken for "*inaction*" and an application was filed to revive the proceeding. The Indian lawyer who is handling the case for the Company believes that there is a good chance that the application will be allowed.

12. Further to Note 19A(29) to the financials statements as at December 31, 2002, concerning the customer attribution process of a consolidated company, the supplementary referendum which commenced on July 1, 2002, was completed, subsequent to postponements, in February 2003. An examination carried out by the consolidated company found that the effects of the results of the referendum on its financial statements are not significant.

13. Further to Note 19A(34) to the financials statements as at December 31, 2002, concerning a class action against all the cellular companies in Israel and against the Company as a formal defendant, whereby the defendant cellular companies unlawfully collected and collect payments for cellular calls. The parties reached a consensus regarding striking the class action and the action has been stricken by the court.

14. Further to Note 19A(35) to the financials statements as at December 31, 2002, concerning a claim and an application for recognition of the claim as a class action both by virtue of Regulation 29 of the Civil Procedures Regulations and by virtue of the Anti-Trust Law. Following the ruling of the Supreme Court in another case that a class action cannot be filed by virtue of Regulation 29 only, the parties filed an agreed application, which was allowed, to strike the parts relating to approval of the claim as a class action on the basis of Regulation 29. The plaintiffs have filed an amended application relying only on the Anti-Trust Law.

NOTE 7 - CONTINGENT LIABILITIES (CONTD.)

A. CLAIMS AND CONTINGENT LIABILITIES (CONTD.)

15. Further to Note 19A(36) to the financials statements as at December 31, 2002, relating to a class action filed against Pelephone in respect of over-collection, the claim was stricken on 14 November, 2002.

16. Further to Note 19A(5) to the financials statements as at December 31, 2002, in the matter of the statement of claim and application for recognition of the claim as a class action against the Company, Bezeq International, the then Chairman of the Board of Bezeq International and the then CEO of Bezeq International, alleging that Bezeq International unfairly exploited its status in the international calls market and implemented a deliberate policy of misleading the public on the subject of the tariffs of international calls, a hearing was held in the Supreme Court on May 28, 2003, at which it was determined that the District Court had erred procedurally, since it should have decided only in relation to the application to add another plaintiff to the class action and not on the question of dismissal of the application for approval of the claim as a class action. The appeal of Bezeq International was therefore allowed, and the case was returned to the District Court, where a hearing will be scheduled.

17. Further to Note 19A(42) to the financials statements as at December 31, 2002' in the matter of a claim filed against Bezeq International Ltd. in which it was alleged that Bezeq International Ltd. unlawfully cancelled an agreement for the supply and installation of a customer care and billing system. Bezeq International filed a statement of defense on May 26, 2003, and a statement of counter-claim in the amount of NIS 10 million, in which it alleged that the contract was cancelled since the plaintiff violated its undertakings in the agreement. The legal advisers of Bezeq International are unable, at this stage, to estimate the chances of the outcome of the claim and therefore no provision has been made in respect thereof in the financial statements of Bezeq International Ltd.

18. On March 25, 2003, an application was filed in the District Court against DBS for approval as a class action of a claim in connection with imposing the cost of the electricity consumption required for operation of satellite receiver dishes on the tenants of the building in which the dish was installed. The group in whose name the application was filed is all the houses in Israel in which a satellite dish was installed. The claim is for declaratory relief determining that DBS must pay for the electricity consumption of the installations connected by and/or for it on the various premises, and that it must reimburse the members of the group for all the monies they paid for the electricity consumption of DBS's installations as well as compensation and/or restoration of monies paid in respect of such electricity consumption. The amounts assessed as damages for which the applicants are demanding restoration is NIS 25 million.

    In the opinion of the legal advisers of DBS, it is difficult at this stage to estimate whether the claim will be approved as a class action and if approved – its chances. Accordingly, DBS has not included a provision in respect of this claim.

19. On April 3, 2003, a petition was filed in the High Court of Justice against DBS, its shareholders (including the Company), the Government of Israel and others, in which the High Court is requested, *inter alia*, to declare DBS a government company in view of the scope of its investments, and to revoke the decision of the Ministerial Committee for Privatization that enabled the Company to increase its investment in DBS. It is noted that factually speaking, Bezeq's holdings in DBS today are less than 50%. In the hearing of the petition on July 30, 2003, the Supreme Court recommended that the petitioner withdraw the petition. The petitioner agreed to withdraw the petition, following which the petition was dismissed on the same day.

NOTE 7 - CONTINGENT LIABILITIES (CONTD.)

A. CLAIMS AND CONTINGENT LIABILITIES (CONTD.)

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

B. GUARANTEES

In May 2003 the Company, in accordance with the requirement of the Ministry of Communications, gave a bank guarantee in the amount of $ 10 million in connection with its general license for carrying out telecommunications activities and for providing telecommunications services.

C. FUTURE CONTRACTS

1. Hedging Contracts (Forward)

	Currency purchased	Currency payable	Final repayment date	Amounts receivable	Amounts payable
				NIS millions	
Contracts at predetermined interest rates					
	Dollars	CPI-linked NIS	February 2005	713	806
	Euro	CPI-linked NIS	February 2005	1,070	998
Contracts at predetermined exchange rate (excluding premium/discount)					
	Dollars	NIS	May 2004	539	589
	Euro	NIS	March 2004	370	391
	CPI-linked NIS	NIS	June 2003	80	80
Call options purchased	Dollar	NIS	March 2004	13	14

2. Contracts not for hedging purposes

	Currency purchased	Currency payable	Final repayment date	Fair value	Amount
				NIS millions	
Call options written	CPI-linked NIS	NIS	August 2003	–	20
Transactions at a predetermined exchange rate	Dollar	NIS	December 2003	(13)	128

Notes to the Interim Consolidated Financial Statements as at June 30, 2003 (Unaudited)

NOTE 8 – SHARE CAPITAL

A. On January 13, 2002, a framework agreement was signed between the State and the Company, whereby capital would be raised by way of a private sale of the Company shares held by the State in accordance with Sections 15A and 15C(b) of the Securities law, 5728 - 1968 (in one sale or several). Concurrently with that sale, the Company would issue shares to the State for a consideration of the proceeds received by the State in respect of the sale of the shares less a margin of 1%, where the total cumulative number of shares to be issued to the State by the Company will at no time exceed the number of shares sold by the State and the State's holdings in the Company will not fall below 51.02%. The proceeds from raising the capital would be earmarked for financing the costs involved in the retirement of Company employees.

It was determined in the framework agreement that the price at which the shares would be sold would be not less than NIS 6 net per share. According to a resolution of the General Meeting of the Shareholders of the Company, registered share capital not issued as part of the process of raising capital through February 28, 2003 or until another date on which the State would hold 51.02% (at full dilution) of the share capital of the Company (whichever would be the earlier date) would be cancelled. Since the capital was not raised by February 28, 2003, registered capital of 130,000,000 shares was cancelled.

Subsequently, on July 28, 2003, an amendment to the framework agreement was signed, whereby the minimum price set for sale of the shares (NIS 6) was cancelled and the last date for the final sale was cancelled. Instead, it was decided that if the State sold shares in a total number exceeding the limit of the Company's registered share capital on that date and the Company's registered share capital did not have enough shares for issuance t to the State, the Company's obligation to allot shares to the State would be postponed against receipt of the consideration for them not later than 120 hours from the time of increasing the share capital of the Company.

With the cancellation of 130,000,000 shares of the Company's share capital (as described above), the Company remained with 23,342,462 shares as its unissued registered capital. As explained in Note 1 above, the Company allotted these 23,342,462 shares to the State in accordance with the framework agreement, so that as of this date , the issued capital of the Company amounts to NIS 2,435,000,000, divided into 2,435,000,000 ordinary shares of a par value of 1 NIS each and any additional allotment of shares by the Company to the State in accordance with the framework agreement requires an increase in the registered share capital of the Company, approved by a 75% majority of the General Meeting of the Shareholders.

B. On January 27, 2003 the Special General Meeting of the Shareholders of the Company approved the recommendation of the Board of Directors, dated January 2, 2003, that a cash dividend be distributed to the holders of the Company's shares who are registered in the Shareholders Register at the end of the business day on February 5, 2003. The X-date was February 6, 2003 and the payment date was February 20, 2003. The total cash dividend of approximately NIS 190 million represents 7.8784 agorot per share.

Notes to the Interim Consolidated Financial Statements as at June 30, 2003 (Unaudited)

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
	2003 (Unaudited)	2002 (Unaudited)	2003 (Unaudited)	2002 (Unaudited)	2002 (Audited)
	NIS thousands		NIS thousands		NIS thousands
Revenues from communication services -					
Domestic fixed-line communications	**1,074,502**	1,148,638	**523,284**	563,910	2,295,169
Fixed fees	**1,112,341**	1,051,133	**562,656**	524,133	2,136,619
Cellular telephone	**994,649**	1,070,919	**501,936**	530,706	2,123,785
International communications and internet services	**336,428**	336,236	**168,471**	166,373	672,102
Installation and sale of equipment to subscribers	**267,526**	268,315	**130,810**	143,802	534,011
Other	**36,620**	64,579	**17,711**	31,654	110,816
	3,822,066	3,939,820	**1,904,868**	1,960,578	7,872,502
Other revenues	**167,933**	160,662	**78,896**	84,858	320,518
	3,989,999	4,100,482	**1,983,764**	2,045,436	8,193,020

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
	2003 (Unaudited)	2002 (Unaudited)	2003 (Unaudited)	2002 (Unaudited)	2002 (Audited)
	NIS thousands		NIS thousands		NIS thousands
Salaries and related expenses	**993,223**	1,010,829	**480,993**	499,290	2,009,683
General expenses	**342,810**	378,791*	**166,374**	183,587*	754,295*
Materials and spare parts	**283,064**	288,902	**136,445**	157,135	608,183*
Cellular telephone expenses	**230,243**	210,831*	**116,627**	107,240*	479,805
Building maintenance	**170,173**	185,934	**86,484**	91,885	356,637
Services and maintenance by sub-contractors	**144,247**	145,407*	**76,675**	72,083*	259,082*
International communications expenses	**77,653**	63,974	**38,463**	29,944	154,328
Vehicle maintenance expenses	**60,778**	48,432	**31,321**	23,452	97,974
Collection fees	**20,970**	17,078	**12,237**	8,687	35,309
	2,323,161	2,350,178	**1,145,619**	1,173,303	4,755,296
Less – salaries charged to investment in fixed assets	**91,614****	79,180	**46,273**	39,219	149,625
	2,231,547	2,270,998	**1,099,346**	1,134,084	4,605,671

* Reclassified
** See Note 11C

Notes to the Interim Consolidated Financial Statements as at June 30, 2003 (Unaudited)

NOTE 11 – 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
	2003 (Unaudited)	2002 (Unaudited)	2003 (Unaudited)	2002 (Unaudited)	2002 (Audited)
	NIS thousands		NIS thousands		NIS thousands
Revenues from telecommunication services (Note 11B)	**2,684,927**	2,826,905	**1,326,154**	1,396,736	5,539,778
Costs and expenses					
Operating and general expenses (Note 11C)	**1,186,924**	1,230,450	**577,168**	604,444	2,449,515
Depreciation	**909,316**	958,298	**450,354**	479,914	1,915,110
Royalties to the Government of Israel	**92,009**	94,148	**45,994**	46,324	181,549
	2,188,249	2,282,896	**1,073,516**	1,130,682	4,546,174
Operating income	**496,678**	544,009	**252,638**	266,054	993,604
Financing expenses, net	**31,599**	75,408	**15,245**	30,120	118,784
Earnings after financing expenses, net	**465,079**	468,601	**237,393**	235,934	874,820
Other (income) expenses, net (Note 4C)	**34,921**	(5,229)	**36,943**	(3,764)	1,224,185
Earnings (loss) before income tax	**430,158**	473,830	**200,450**	239,698	(349,365)
Income tax	**167,933**	167,733	**80,692**	89,762	232,876
Earnings (loss) after income tax	**262,225**	306,097	**119,758**	149,936	(582,241)
Company's equity in losses of investee companies	**174,429**	108,287	**100,439**	64,236	343,391
Net earnings (loss)	**87,796**	197,810	**19,319**	85,700	(925,632)

Notes to the Interim Consolidated Financial Statements as at June 30, 2003 (Unaudited)

NOTE 11 – 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
	2003 (Unaudited)	2002 (Unaudited)	2003 (Unaudited)	2002 (Unaudited)	2002 (Audited)
	NIS thousands		NIS thousands		NIS thousands
Revenues from communications services					
Domestic fixed-line communications	**1,081,623**	1,161,263	**528,173**	571,372	2,317,820
Fixed fees	**1,060,953**	1,000,555	**537,892**	497,518	2,006,590
Cellular telephone	**250,970**	314,004	**121,377**	150,632	553,822
International communications	**67,566**	73,379	**32,340**	33,538	137,706
Installation and sale of equipment to subscribers	**67,398**	80,597	**34,372**	41,068	154,356
Other	**38,677**	68,041	**18,843**	33,064	116,463
	2,567,187	2,697,839	**1,272,997**	1,327,192	5,286,757
Other revenues	**117,740**	129,066	**53,157**	69,544	253,021
	2,684,927	2,826,905	**1,326,154**	1,396,736	5,539,778

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
	2003 (Unaudited)	2002 (Unaudited)	2003 (Unaudited)	2002 (Unaudited)	2002 (Audited)
	NIS thousands		NIS thousands		NIS thousands
Salaries and related expenses	**757,718**	784,187	**364,943**	385,498	1,546,072
General expenses	**143,658**	165,679*	**70,232**	80,274	324,758
Materials and spare parts	**39,743**	23,650	**17,582**	10,955	66,649*
Building maintenance	**156,831**	160,895	**79,215**	79,567	328,595
Services and maintenance by sub-contractors	**107,866**	113,637*	**54,964**	56,500	208,820*
International communications expenses	**4,458**	3,186	**1,925**	1,775	5,013
Vehicle maintenance expenses	**51,563**	41,378	**26,461**	20,430	84,009
Collection fees	**16,701**	17,018	**8,119**	8,664	35,224
	1,278,538	1,309,630	**623,441**	643,663	2,599,140
Less - salaries charged to investments in fixed assets	**91,614****	79,180	**46,273**	39,219	149,625
	1,186,924	1,230,450	**577,168**	604,444	2,449,515

* Reclassified

** Commencing February 2003, following the installation of a new reporting system at the Company which enables accurate measurement of direct costs of employees of the Engineering and Information Technologies Divisions, the Company capitalized an additional amount for Company-built fixed assets. The additional amount in respect of the six months ended June 30, 2003 is approximately NIS 18.5 million (and for the three month period then ended, approximately NIS 10.5 million).

Notes to the Interim Consolidated Financial Statements as at June 30, 2003 (Unaudited)

NOTE 12 – SEGMENTS OF BUSINESS OPERATIONS

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

For the six month period ended June 30, 2003

	Domestic fixed line communications	Cellular telephone	International communications and Internet services	Others	Adjustments	Consolidated
	NIS thousands					
Revenues						
Revenues from external sources	**2,577,650**	**957,925**	**337,151**	**117,273**	**–**	**3,989,999**
Inter-segment revenues	**107,277**	**5,009**	**4,713**	**21,406**	**(138,405)**	**–**
Total revenues	**2,684,927**	**962,934**	**341,864**	**138,679**	**(138,405)**	**3,989,999**
Segment results	**496,677**	**(6,615)**	**49,414**	**(2,064)**	**331**	**537,743**

For the three month period ended June 30, 2003

	Domestic fixed line communications	Cellular telephone	International communications and Internet services	Others	Adjustments	Consolidated
	NIS thousands					
Revenues						
Revenues from external sources	**1,272,090**	**487,946**	**169,308**	**54,420**	**–**	**1,983,764**
Inter-segment revenues	**54,064**	**3,912**	**2,389**	**13,543**	**(73,908)**	**–**
Total revenues	**1,326,154**	**491,858**	**171,697**	**67,963**	**(73,908)**	**1,983,764**
Segment results	**252,636**	**8,624**	**20,636**	**(2,625)**	**168**	**279,439**

For the year ended December 31, 2002

	Domestic fixed line communications	Cellular telephone	International communications and Internet services	Others	Adjustments	Consolidated
	NIS thousands					
Revenues						
Revenues from external sources	5,331,053	1,986,168	679,893	195,906	–	8,193,020
Inter-segment revenues	208,724	7,750	8,389	29,859	(254,722)	–
Total revenues	5,539,777	1,993,918	688,282	225,765	(254,722)	8,193,020
Segment results	993,608	(63,555)	109,545	(8,736)	651	1,031,513

Notes to the Interim Consolidated Financial Statements as at June 30, 2003 (Unaudited)

NOTE 13 – CONDENSED FINANCIAL STATEMENTS OF BEZEQ INTERNATIONAL LTD. AND PELEPHONE COMMUNICATIONS LTD.

1. BEZEQ INTERNATIONAL LTD.

A. Balance sheet

	June 30 2003	June 30 2002	December 31 2002
	(Unaudited)	(Unaudited)	(Audited)
	NIS thousands	NIS thousands	NIS thousands
Current assets	**152,426**	178,250	196,322
Investments	**12,895**	13,339	10,844
Fixed assets	**502,245**	427,023	490,990
Other assets	**6,210**	12,241	8,549
	673,776	630,853	706,705
Current liabilities	**318,084**	306,044	376,905
Long-term liabilities	**173,710**	200,394	173,157
Shareholders' equity	**181,982**	124,415	156,643
	673,776	630,853	706,705

Notes to the Interim Consolidated Financial Statements as at June 30, 2003 (Unaudited)

NOTE 13 – CONDENSED FINANCIAL STATEMENTS OF BEZEQ INTERNATIONAL LTD. AND PELEPHONE COMMUNICATIONS LTD. (CONTD.)

1. 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
	2003 (Unaudited)	2002 (Unaudited)	2003 (Unaudited)	2002 (Unaudited)	2002 (Audited)
	NIS thousands		NIS thousands		NIS thousands
Revenues from international telecommunications services	**341,864**	343,124	**171,701**	174,224	688,272
Operating expenses	**200,096**	189,227	**101,415**	93,458	385,449
Gross profit	**141,768**	153,897	**70,286**	80,766	302,823
Marketing, general and administrative expenses	**92,354**	108,286	**49,650**	56,286	193,280
Operating income	**49,414**	45,611	**20,636**	24,480	109,543
Financing expenses (income), net	**17,547**	(10,161)	**14,070**	(4,131)	(1,604)
Earnings after financing, net	**31,867**	55,772	**6,566**	28,611	111,147
Other expenses (income), net	**4,901**	(8)	**2,079**	196	(34)
Earnings before income tax	**26,966**	55,780	**4,487**	28,415	111,181
Income tax	**915**	636	**448**	352	10,686
Earnings after income tax	**26,051**	55,144	**4,039**	28,063	100,495
Company's equity in losses of an affiliated company	**712**	11,404	**39**	9,614	24,527
Net earnings	**25,339**	43,740	**4,000**	18,449	75,968

Notes to the Interim Consolidated Financial Statements as at June 30, 2003 (Unaudited)

NOTE 13 – CONDENSED FINANCIAL STATEMENTS OF BEZEQ INTERNATIONAL LTD. AND PELEPHONE COMMUNICATIONS LTD. (CONTD.)

2. PELEPHONE COMMUNICATIONS LTD.

A. Balance sheet

	June 30 2003	June 30 2002	December 31 2002
	(Unaudited)	(Unaudited)	(Audited)
	NIS thousands	NIS thousands	NIS thousands
Current assets	**1,247,095**	1,308,936	1,332,586
Long-term trade receivables	**177,021**	156,639	158,365
Deferred income tax	**337,204**	286,506	334,169
Fixed assets, net	**3,060,397**	2,578,947	2,779,764
Other assets	**409,013**	571,756	457,350
	5,230,730	4,902,784	5,062,234
Current liabilities	**2,199,396**	1,698,573	2,070,023
Provision for losses of investee company	**5,033**	3,752	4,476
Long-term liabilities	**1,242,642**	1,238,154	1,119,571
Shareholders' equity	**1,783,659**	1,962,305	1,868,164
	5,230,730	4,902,784	5,062,234

Notes to the Interim Consolidated Financial Statements as at June 30, 2003 (Unaudited)

NOTE 13 – CONDENSED FINANCIAL STATEMENTS OF BEZEQ INTERNATIONAL LTD. AND PELEPHONE COMMUNICATIONS LTD. (CONTD.)

2. 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
	2003 (Unaudited)	2002 (Unaudited)	2003 (Unaudited)	2002 (Unaudited)	2002 (Audited)
	NIS thousands		NIS thousands		NIS thousands
Revenues from cellular services, sales and services	**1,925,868**	1,959,077	**983,717**	999,681	3,987,835
Cost of cellular services, sales and services	**1,636,048**	1,738,479*	**817,500**	886,436*	3,503,805
Gross profit	**289,820**	220,598	**166,217**	113,245	484,030
Sales and marketing expenses	**230,283**	229,445*	**113,752**	111,414*	472,617
General and administrative expenses	**74,161**	78,042*	**36,611**	38,476*	156,023
	304,444	307,487	**150,363**	149,890	628,640
Operating income (loss)	**(14,624)**	(86,889)	**15,854**	(36,645)	(144,610)
Financing expenses (income), net	**72,596**	7,424	**49,318**	(1,078)	94,203
Other income, net	**(609)**	(805)	**(424)**	(641)	(1,488)
Loss before income tax	**(86,611)**	(93,508)	**(33,040)**	(34,926)	(237,325)
(Tax benefit)	**(3,034)**	(27,417)	**(1,517)**	(8,478)	(75,080)
Loss after income tax	**(83,577)**	(66,091)	**(31,523)**	(26,448)	(162,245)
Minority equity in losses of a consolidated company	**–**	(3,089)	**–**	(165)	(5,785)
Company's equity in losses (earnings) of an affiliate	**929**	(19)	**560**	(124)	664
Net loss	**(84,506)**	(62,983)	**(32,083)**	(26,159)	(157,124)

* Reclassified