

## PARTNER COMMUNICATIONS REPORTS 2004 RESULTS

# COMPANY CONTINUES TO POST STRONG EARNINGS AND OPERATING RESULTS

- Revenues NIS 5.141 billion
- EBITDA NIS 1.576 billion
- Repaid bank debt of NIS 624 million 33% of outstanding bank debt
- 2.340 million year end subscribers

Rosh Ha'ayin, Israel, February 7<sup>th</sup>, 2005 – Partner Communications Company Ltd. ("Partner") (NASDAQ and TASE; PTNR, LSE; PCCD) today announced its results for the year and quarter ended December 31<sup>st</sup>, 2004.

Partner reported record revenues for 2004 of NIS 5,140.7 million (US\$ 1,193.3 million), along with record income before taxes of NIS 758.8 million (US\$ 176.1 million). Partner reported net income for 2004 of NIS 471.6 million (US\$ 109.5 million), or NIS 2.56 per diluted ADS or share (US\$ 0.60 per ADS or share).

For the fourth quarter of 2004, Partner reported revenues of NIS 1,319.1 million (US\$ 306.2 million), income before taxes of NIS 178.8 million (US\$ 41.5 million), and net income of NIS 131.4 million (US\$ 30.5 million).

In NIS '000	2002	2003	2004
Revenues	4,054,563	4,467,719	5,140,737
Cost of revenues	3,069,458	3,136,456	3,615,014
Gross profit	985,105	1,331,263	1,525,723
SG&A	451,673	476,395	506,377
Operating profit	533,432	854,868	1,019,346
Other	4,054	3,530	
Financial expenses	445,180	321,710	260,545
Income before taxes	84,198	529,628	758,801
Tax benefit (tax expenses)		633,022	(287,248)
Net income for the period	84, 198	1,162,650	471,553

3 Month period ended							
In NIS '000	December 31,	March 31,	June 30,	September 30,	December 31,		
	2003	2004	2004	2004	2004		
Revenues	1,162,930	1,218,646	1,254,580	1,348,379	1,319,132		
Cost of revenues	807,241	<u>855,666</u>	<u>863,723</u>	944,617	<u>951,008</u>		
Gross profit	355,689	362,980	390,857	403,762	368,124		
SG&A	116,140	<u>127,665</u>	<u>125,057</u>	<u>127,825</u>	<u>125,830</u>		
Operating profit	239,549	235,315	265,800	275,937	242,294		
Financial Expenses							
& Other	<u>68,417</u>	<u>87,028</u>	<u>66,011</u>	44,042	<u>63,464</u>		
Income before taxes	171,132	148,287	199,789	231,895	178,830		
Tax benefit (tax							
expenses)	633,022	<u>(56,468)</u>	<u>(66,374)</u>	<u>(116,992)</u>	<u>(47,414)</u>		
Net income for							
period	<u>804,154</u>	<u>91,819</u>	<u>133,415</u>	<u>114,903</u>	<u>131,416</u>		

### **Key Operating Indicators:**

	2002	2003	2004
EBITDA (NIS millions)	1,052	1,380	1,576
EBITDA as a percentage of total revenues	26.0%	30.9%	30.7%
Subscribers (thousands)	1,837	2,103	2,340
Estimated Market Share (%)	29%	31%	32%
Annual Churn Rate (%)	10.9%	13.6%	12.0%
Average Monthly Usage per Subscriber (in minutes)	280	277	286
Average Monthly Revenue per Subscriber (NIS)	183	171	170
Average Subscriber Acquisition Costs (NIS)	470	362	295

Commenting on the results, Amikam Cohen, Partner's CEO said: "We are pleased to have completed an excellent year at Partner. The continued improvement of our financial and operational performance was a reflection of the outstanding quality of our network, the strength of our award-winning brand, our excellent customer service, and our superb technological solutions for the Israeli market. orange™ was named by Globes, Israel's business daily, as the leading telecom brand in Israel for the second consecutive year. We were chosen by the Israeli Management Institute as the best provider of customer service in the industry for the third straight year. We continued to grow our subscriber base and improve our financial performance. In December we launched our 3G network in the central part of Israel, creating a powerful user experience with an exciting portfolio of services including person to person video capabilities. By year end approximately 8 thousand subscribers were already experiencing the 3G revolution. We expect to continue the role out of our 3G network in 2005 and by year's end reach nation wide population coverage.

We expect 2005 to be a challenging year for Partner and we are ready to meet these challenges. Specifically we have plans in place to maintain the levels of profitability we reached in 2004 and to mitigate the effects of the inter-carrier termination rate reductions that were mandated by the regulator. Measures we have implemented and are considering in order to achieve these results include cost cutting, price increases and repackaging our product offerings.

#### **Financial Review**

Revenues in 2004 were a record NIS 5,140.7 million (US\$ 1,193.3 million), up 15.1% from NIS 4,467.7 million in 2003. Q4 2004 revenues increased by 13.4% to NIS 1,319.1 million as compared to Q4 2003 revenues of NIS 1,162.9 million. These increases were due to increased revenue from services (including data and content) and equipment, as discussed below.

Revenues in 2004 from services increased by 12.1% to NIS 4,615.8 million (US\$ 1071.4 million), as compared to NIS 4,117.9 million in 2003. Revenues from services in Q4 2004 increased by 10.1% to NIS 1,177.8 million as compared to NIS 1,069.9 million in Q4 2003. The increases were driven primarily by a 16.2 percent increase in total network minutes, offset by a 7.1% dilution in the average tariff per minute including incoming calls. The increase in total network minutes was driven primarily by an expanding subscriber base

which grew by 11.3% from the end of 2003 to the end of 2004. The dilution in average tariff per minute in 2004 as compared to 2003 was caused by increased competition and the increased weight of business subscribers in our customer base. The average business subscriber generates substantially more minutes of use than post-paid private and prepaid subscribers, whilst their average tariff per minute is materially lower.

Revenues in 2004 from equipment increased by 50.1% to NIS 525.0 million (US\$ 121.9 million) as compared to NIS 349.8 million in 2003. Revenues from equipment in Q4 2004 increased by 51.9% to NIS 141.4 million as compared to NIS 93 million in Q4 2003. The increases were driven primarily by increased revenue per sale and an approximately 13% growth in the number of sales to new and upgrading subscribers in 2004 as compared to 2003, as well as Q4 2004 as compared to Q4 2003.

Data and content revenues, including SMS messages, in 2004 were NIS 351.1 million (US\$ 81.5 million), or 6.8% of total revenues, up 15.6% from NIS 303.8 million, or 6.8% of total revenues in 2003. Data and content revenues, including SMS messages, in Q4 2004 were NIS 94.3 million or 7.2% of total revenues for the quarter, up 17.6% from NIS 80.2 million, or 6.9% of total revenues in Q4 2003. The increases in revenues in 2004 as compared to 2003, as well as Q4 2004 as compared to Q4 2003 were driven primarily by a 32% increase in revenues from non-SMS services. Revenues from SMS services grew by approximately 5% in 2004 as compared to 2003. SMS messages in 2004 accounted for approximately 50% of data and content revenues as compared to approximately 55% in 2003.

Cost of revenues in 2004 increased by 15.3% to NIS 3,615.0 million (US\$ 839.3 million) from NIS 3,136.5 million in 2003.

Cost of revenues - Services in 2004 increased by 11.5% to NIS 2,885.1 million (US\$ 669.9 million) from NIS 2,586.7 million in 2003. The increase in 2004 as compared to 2003 resulted primarily from the 12.1% increase in service revenues, as the higher level of service revenues, driven by increased minutes of use, resulted in higher variable costs including inter-carrier termination fees and transmission. Cost of revenues - Services in Q4 2004 increased by 10.8% to NIS 739.5 million from NIS 667.7 million in Q4 2003. The increase was driven primarily by the same factors that drove the annual increase and the increased depreciation and amortization of approximately NIS 6 million which were

recorded since the Company commercially launched its 3G services on December 1, 2004.

Cost of revenues - Equipment in 2004 increased by 32.8% to NIS 729.9 million (US\$ 169.4 million) from NIS 549.7 million in 2003. The increase was driven primarily by higher priced handsets and approximately 13% growth in the number of sales transactions to new and upgrading subscribers. Cost of revenues - Equipment in Q4 2004 increased by 51.5% to NIS 211.5 million from NIS 139.6 million in Q4 2003. The increase was driven primarily by more advanced and higher priced handsets, additional handset subsidies for the 3G launch and 2004 year-end sales promotions, and approximately 13% growth in the number of sales transactions to new and upgrading subscribers.

Gross profit for 2004 was NIS 1,525.7 million (US\$ 354.2 million), 29.7% of revenues, up 14.6% from NIS 1,331.3 million, 29.8% of revenues, in 2003. Gross profit for Q4 2004 was NIS 368.1 million, 27.9% of revenues, up 3.5% from NIS 355.7 million, 30.6% of revenues in Q4 2003. Gross profit margin decreased in Q4 2004 as compared to Q4 2003 primarily due to increased depreciation, amortization, network expenses and handset subsidies from the launch of the Company's 3G network and 2004 year-end sales promotions.

Selling and marketing expenses in 2004 were NIS 325.2 million (US\$ 75.5 million), an increase of 3.6% from NIS 314.0 million in 2003. Selling and marketing expenses in Q4 2004 were NIS 76.3 million, up 7.3% from NIS 71.1 million in Q4 2003. The increases were driven primarily by higher distribution and advertising costs in response to increasing competition and the introduction of our 3G network.

General and administrative expenses in 2004 were NIS 181.1 million (US\$ 41.9 million), up 11.5% from NIS 162.4 million in 2003. The increase was driven primarily by a larger provision for doubtful accounts resulting from the increased volume of handset sales, compensation costs under the new stock option plan, and one-time costs incurred in the Company's attempt to purchase a controlling interest in Matav and a write-off of legal and accounting fees incurred in 2001 in preparing the Company's shelf registration with the United States Securities and Exchange Commission.

General and administrative expenses in Q4 2004 were NIS 49.5 million, an increase of 10.0% from NIS 45.0 million in Q4 2003. The increase resulted primarily from the compensation costs under the new stock option plan.

Operating profit for 2004 was NIS 1,019.3 million (US\$ 236.6 million), an increase of 19.2% from NIS 854.9 million in 2003. Operating profit as a percentage of revenues increased to 19.8% from 19.1% in 2003. Operating profit for Q4 2004 was NIS 242.3 million, 18.4% of revenues, up 1.1% from NIS 239.5 million and 20.6% of revenues in Q4 2003. Q4 2004 operating profit margins were influenced negatively by the compensation costs under the new stock option plan and the increased depreciation, amortization, network expenses and handset subsidies from the launch of the Company's 3G network and 2004 year-end sales promotions.

Financial expenses in 2004 were NIS 260.5 million (US\$ 60.5 million), a decrease of 19.0% compared to NIS 321.7 million in 2003. Financial expenses in Q4 2004 were NIS 63.5 million, down 2.2% from NIS 64.9 million in Q4 2003. The decrease in financial expenses in 2004 compared to 2003 as well as Q4 2004 compared to Q4 2003 was driven primarily by lower bank debt levels and lower shekel interest rates offset by the negative revaluation of U.S. dollar foreign currency hedging positions covering foreign exchange exposure on the US\$ 175 million 13% subordinated notes. The fair value of these derivative contracts as of December 31, 2004, is a liability of NIS 55.3 million as compared to a liability of NIS 11.5 million on December 31, 2003. The increase in the liability is derived primarily from the strengthening of the shekel by 3.9% in Q4 2004.

Income before taxes for 2004 was NIS 758.8 million (US\$ 176.1 million), up 43.3% compared to NIS 529.6 million in 2003. Income before taxes in Q4 2004 was NIS 178.8 million, up 4.5% from NIS 171.1 million in Q4 2003.

In 2004, the Company had net income of NIS 471.6 million (US\$ 109.5 million), or NIS 2.56 (US\$ 0.60) per ADS or per share, compared to NIS 1,162.7 million, or NIS 6.34 per ADS or per share in 2003. Net income for Q4 2004 was NIS 131.4 million (US\$ 30.5 million), compared to NIS 804.2 million in Q4 2003. The decrease in net income for 2004 compared to net income for 2003 as well as Q4 2004 compared to Q4 2003 resulted primarily from the utilization of the Company's accumulated tax loss carry forwards and the creation of deferred tax assets in Q4 2003, in the amount of NIS 633.0 million.

#### **Funding and Investing Review**

In 2004, the Company generated cash flows from operating activities, net of cash flows from investing activities, of NIS 599.2 million (US\$ 139.1 million), and reduced its bank debt by NIS 624 million. Compared to 2003, cash flows from operating activities increased by 23.4%, an increase of NIS 241.3 million. Cash flows from operating activities, net of cash flows from investing activities, in 2004 decreased by 8.5% (NIS 55.5 million) as compared to 2003, from NIS 654.7 million<sup>1</sup>. The primary reason for the decrease was additional expenditures of NIS 259.5 million in 2004 for fixed assets, primarily for the Company's 3G network.

As of December 31, 2004, the NIS equivalent of US\$ 268 million was drawn under the Company's bank facilities, leaving available credit of US\$ 155 million.

Commenting on the Company's credit position, Mr. Alan Gelman, Partner's Chief Financial Officer, said: "Our 2004 results further strengthened our balance sheet and leverage ratios. We intend, subject to market conditions, to call our US\$ 175 million 13% subordinated notes in August 2005. In order to facilitate the call and provide the Company with a more flexible and appropriate financial structure, we are currently renegotiating our bank facility and considering other financing alternatives which might include notes with substantially lower coupons."

In 2004, Maalot, the Israel Rating Company Ltd., strategic partner of Standard & Poor's, upgraded the Company's credit rating to 'AA-'. Also, Standard & Poor's upgraded the outlook of Partner's credit rating to Positive. This followed previous upgrades in December 2003 by Standard & Poor's, which raised the Company's long-term rating to 'BB-', and by Moody's, which upgraded the Company's rating to Ba2 and changed their outlook on Partner's credit rating from Stable to Positive.

Fixed assets purchased net of retirements and sales in 2004 totaled NIS 601.0 million (US\$ 139.5 million), 11.7% of revenues, compared to fixed assets purchased net of retirements and sales in 2003 of NIS 232.3 million, 5.2% of revenues. The increase in

\_

<sup>&</sup>lt;sup>1</sup> Includes NIS 99 million transferred from security deposits on December 31, 2003

2004 as compared to 2003 was driven primarily by NIS 370 million in 3G network assets purchased in 2004.

#### **Operational Review**

During 2004, net active subscribers increased by 237,000, or 11.3%.

The Company's active subscriber base as of December 31, 2004 was 2,340,000, accounting for an approximate market share of 32%, up from 31% at the end of 2003. The subscriber base is comprised of 1,208,000 post-paid private subscribers (51.6% of the base) 700,000 prepaid subscribers (29.9% of the base) and 433,000 business subscribers (18.5% of the base for 2004. Net new active subscribers in the business sector accounted for approximately 36% of net new active subscribers in 2004.

The annual churn rate for 2004 decreased to 12.0%, compared to 13.6% in 2003. Management believes that the decrease in churn resulted primarily from an increased level of retention activities in 2004 as compared to 2003.

Average monthly usage per subscriber ("MOU") for 2004 was 286 minutes, an increase of 3.2% from the MOU for 2003, which was 277 minutes. Average monthly revenue per subscriber ("ARPU") for 2004 was 170 NIS compared to NIS 171 in 2003, a decline of 0.6%. The decrease in ARPU, despite the increase in MOU, is derived primarily from downward pressure on tariffs, driven by increasing competition.

In 2004, lower handset subsidies caused the average cost of acquiring a new subscriber (SAC) to decline from 2003. 2004 SAC was NIS 295, compared to NIS 362 for 2003, a decline of 18.5%. SAC in Q4 2004 (NIS 339) was higher than the annual average in part due to larger initial subsidies on 3G handsets and year-end sales promotions.

#### **Outlook and Guidance:**

Commenting on the Company's outlook Mr. Gelman added: "In 2005, Due to a more penetrated market, we expect a lower rate of subscriber growth, approximately 4 to 5 percent, compared to the 11.3% growth in our subscriber base in 2004. In addition, we will continue our efforts to control costs, with the goal of maintaining EBITDA at the levels

achieved in 2004, despite the reductions in inter-carrier termination rates mandated by the Ministry of Communications. We expect ARPU to decline by approximately 10%, following the reduction in the inter-carrier termination rates. SAC levels for 2005 are expected to remain stable, at 2004 average levels. We intend to complete our roll-out of our 3G network and expect fixed asset purchases to be approximately the same level as 2004. We don't foresee any material impact, in 2005, as a result of the adoption of the new accounting rules (FAS 123R) relating to employee stock based compensation. The Company intends to implement FAS 123R beginning July 1, 2005."

#### **Other**

Partner Communications Company announced today the appointment of Mr. Uzi Ish-Hurwitz to its Board of Directors. Mr. Ish-Hurwitz has served as Chairman and CEO of Shira Computers Ltd., President and Member of the Board of Neuromedical Systems, Inc., President and Co-founder of Indigo Graphic Systems Ltd. and Vice President Operations of Scitex Corporation. Mr. Ish-Hurwitz also served as Procurement Department Manager at the Ministry of Defense and as Senior Project Engineer of GTE International Systems Ltd. Mr. Ish-Hurwitz holds a B.Sc and M.Sc in Electrical Engineering, from the Technion – Israel Institute of Technology, and he has participated in the Advanced Management Program (AMP) of Harvard University. Mr. Canning Fok, the Chairman of the Board of Partner, wished Mr. Ish-Hurwitz success in his new role.

#### **Conference Call Details**

Partner Communications will hold a conference call to discuss the company's full year 2004 and fourth quarter on Tuesday, February 8<sup>th</sup>, 2005, at 18:00 Israel local time (11:00 AM Eastern time). This conference call will be broadcast live over the Internet and can be accessed by all interested parties through our investors' web site at www.investors.partner.co.il.

To listen to the broadcast, please go to the web site at least 15 minutes prior to the start of the call to register, download and install any necessary audio software. For those unable to listen to the live broadcast, an archive of the call will be available shortly after the call ends via the Internet (at the same location as the live broadcast) until midnight on February 15<sup>th</sup>, 2005.

#### **About Partner Communications**

Partner Communications Company Ltd. is a leading Israeli mobile communications operator providing GSM/GPRS/UMTS services and wire free applications under the orange™ brand. The Company commenced full commercial operations in January 1999 and, through its network, provides quality of service and a range of features to 2.34 million subscribers in Israel. Partner subscribers can use roaming services in 152 destinations using 333 GSM networks. The Company launched its 3G service in 2004. Partner's ADSs are quoted on NASDAQ under the symbol PTNR and on the London Stock Exchange (LSE) under the symbol PCCD. Its shares are quoted on the Tel Aviv Stock Exchange (TASE) under the symbol PTNR. For further information: http://www.investors.partner.co.il

**Notes:** Some of the information in this release contains forward-looking statements that involve risks and uncertainties within the meaning of Section 27A of the Securities Act of 1933 and Section 21E of the Securities Exchange Act of 1934. We have based these forward-looking statements on our current expectations and projections about future events. These forward-looking statements are subject to risks, uncertainties and assumptions about us.

Words such as "believe," "anticipate," "expect," "intend," "seek," "will," "plan," "could," "may," "project," "goal," "target," and similar expressions often identify forward-looking statements but are not the only way we identify these statements. Because such statements involve risks and uncertainties, actual results may differ materially from the results currently expected. Factors that could cause such differences include, but are not limited to:

- Uncertainties about the degree of growth in the number of consumers using wireless personal communications services and in the number of residents;
- The risks associated with the implementation of a third-generation network and business strategy, including risks relating to the operations of new systems and technologies, substantial expenditures required and potential unanticipated costs, uncertainties regarding the adequacy of suppliers on whom we must rely to provide both network and consumer equipment and consumer acceptance of the products and services to be offered:
- The impact of existing and new competitors in the market in which we compete, including competitors that may offer less expensive products and services, desirable or innovative products, technological substitutes, or have extensive resources or better financing;
- The introduction or popularity of new products and services, including pre-paid phone products, which could increase churn;
- The effects of vigorous competition in the market in which we operate and for more valuable customers, which may decrease prices charged, increase churn and change the customer mix, profitability and average revenue per user;
- The availability and cost of capital and the consequences of increased leverage;

- The risks and costs associated with the need to acquire additional spectrum for current and future services:
- The risks associated with technological requirements, technology substitution and changes and other technological developments;
- Fluctuations in exchange rates;
- The results of litigation filed or to be filed against us; and
- The possibility of the market in which we compete being impacted by changes in political, economic or other factors, such as monetary policy, legal and regulatory changes or other external factors over which we have no control;
- As well as the risk factors specified under the heading "Risk Factors" in our 2003 annual report on Form 20-F filed with the SEC on April 30, 2004.

The attached financial statements were prepared in accordance with U.S. GAAP. The attached financial statements for 2004 are audited.

The convenience translations of the Nominal New Israeli Shekel (NIS) figures into US Dollars were made at the rate of exchange prevailing at December 31<sup>st</sup>, 2004: US \$1.00 equals NIS 4.308. The translations were made purely for the convenience of the reader.

Earnings before interest, taxes, depreciation, amortization, exceptional items and capitalization of intangible assets ('EBITDA') is presented because it is a measure commonly used in the telecommunications industry and is presented solely in order to improve the understanding of the Company's operating results and to provide further perspective on these results. EBITDA, however, should not be considered as an alternative to operating income or income for the year as an indicator of the operating performance of the Company. Similarly, EBITDA should not be considered as an alternative to cash flows from operating activities as a measure of liquidity. EBITDA is not a measure of financial performance under generally accepted accounting principles and may not be comparable to other similarly titled measures for other companies. EBITDA may not be indicative of the historic operating results of the Company; nor is it meant to be predictive of potential future results.

Reconciliation between our cash flows from operating activities and EBITDA is presented in the attached summary financial statements.

#### Contacts:

Mr. Alan Gelman Dr. Dan Eldar

Chief Financial Officer V.P. Carrier, Investor and International Relations

Tel: +972-54-7814951 Tel: +972-54-7814151 Fax: +972-54-7815961 Fax: +972-54-7814161 E-mail: alan.gelman@orange.co.il E-mail: dan.eldar@orange.co.il

(An Israeli Corporation) 2004 ANNUAL REPORT

(An Israeli Corporation) 2004 ANNUAL REPORT

#### **TABLE OF CONTENTS**

	Page
REPORT OF INDEPENDENT REGISTERED PUBLIC ACCOUNTING FIRM	2
CONSOLIDATED FINANCIAL STATEMENTS:	
Balance sheets as of December 31, 2003 and 2004	3-4
Statements of operations for the years ended December 31, 2002, 2003 and 2004	5
Statements of changes in shareholders' equity (capital deficiency) for the years ended	
December 31, 2002, 2003 and 2004	6
Statements of cash flows for the years ended December 31, 2002, 2003 and 2004	7-8
Notes to financial statements	9-40

The amounts are stated in New Israeli Shekels (NIS) in thousands.

\_\_\_\_

#### REPORT OF INDEPENDENT REGISTERED PUBLIC ACCOUNTING FIRM

To the Shareholders of

#### PARTNER COMMUNICATIONS COMPANY LTD.

We have audited the consolidated balance sheets of Partner Communications Company Ltd. and its subsidiary (collectively "the Company") as of December 31, 2003 and 2004 and the related consolidated statements of operations, changes in shareholders' equity (capital deficiency) and cash flows for each of the three years in the period ended December 31, 2004. These financial statements are the responsibility of the Company's Board of Directors and management. Our responsibility is to express an opinion on these financial statements based on our audits.

We conducted our audits in accordance with the standards of the Public Company Accounting Oversight Board (United States), and with auditing standards generally accepted in Israel, including those prescribed by the Israeli Auditors (Mode of Performance) Regulations, 1973. Those standards require that we plan and perform the audits to obtain reasonable assurance about whether the financial statements are free of material misstatement. An audit includes examining, on a test basis, evidence supporting the amounts and disclosures in the financial statements. An audit also includes assessing the accounting principles used and significant estimates made by management, as well as evaluating the overall financial statement presentation. We believe that our audits provide a reasonable basis for our opinion.

In our opinion, the consolidated financial statements referred to above, present fairly, in all material respects, the consolidated financial position of the Company as of December 31, 2003 and 2004 and the consolidated results of operations, changes in shareholders' equity (capital deficiency) and cash flows for each of the three years in the period ended December 31, 2004, in conformity with accounting principles generally accepted in the United States.

Tel-Aviv, Israel February 7, 2005 Kesselman & Kesselman Certified Public Accountants (Israel)

# (An Israeli Corporation) CONSOLIDATED BALANCE SHEETS

	December 31			
	2003	2004	2004	
	New Israeli shekels		Convenience translation into U.S. dollars (note 1a)	
		In thousands		
Assets				
CURRENT ASSETS:				
Cash and cash equivalents Accounts receivable (note 13):	3,774	4,611	1,070	
Trade	482,141	625,220	145,130	
Other	56,543	70,158	16,286	
Inventories	102,861	101,656	23,597	
Deferred income taxes (note 10)	220,000	255,503	59,309	
T o t a I current assets	865,319	1,057,148	245,392	
INVESTMENTS AND LONG-TERM RECEIVABLES:				
Accounts receivable - trade (note 13)	13,906	96,687	22,444	
Funds in respect of employee rights upon retirement (note 7)	58,724	69,128	16,046	
	72,630	165,815	38,490	
FIXED ASSETS, net of accumulated depreciation and				
amortization (note 3)	1,694,584	1,843,182	427,851	
LICENSE AND DEFERRED CHARGES,				
net of accumulated amortization (note 4)	1,325,948	1,325,592	307,705	
DEFERRED INCOME TAXES (note 10)	413,752	94,442	21,922	
	4,372,233	4,486,179	1,041,360	

Alan Gelman

**Chief Financial Officer** 

**Amikam Cohen** 

**Chief Executive Officer** 

Ben-Zion Zilberfarb

**Director** 

	December 31		
	2003	2003 2004	
	New Israeli shekels		Convenience translation into U.S. dollars (note 1a)
		In thousands	
Liabilities and shareholders' equity			
CURRENT LIABILITIES:			
Current maturities of long-term bank loans (note 5)	119,853		
Accounts payable and accruals: Trade	207.010	552,377	128,221
Other (note 13)	387,818 252,585	307,364	71,347
T o t a L current liabilities	760,256	859,741	199,568
LONG-TERM LIABILITIES:	100,200	000,7 11	100,000
Bank loans, net of current maturities (note 5)	1,687,215	1,185,088	275,090
Notes payable (note 6)	766,325	753,900	175,000
Liability for employee rights upon retirement (note 7)	76,506	92,808	21,543
Asset retirement obligations (note 13)	6,367	7,567	1,757
T o t a I long-term liabilities	2,536,413	2,039,363	473,390
COMMITMENTS AND CONTINGENCIES (note 8)	-		
Total liabilities	3,296,669	2,899,104	672,958
SHAREHOLDERS' EQUITY (note 9): Share capital – ordinary shares of NIS 0.01 par			
value: authorized - December 31, 2003 and 2004 -			
235,000,000 shares; issued and outstanding -			
December 31, 2003 - 182,695,574 shares and			
December 31, 2004 - 184,037,221 shares issued	1,827	1,840	427
Less – receivables in respect of shares	(4,374)	(2,260)	(525)
Capital surplus	2,303,055	2,362,027	548,289
Deferred compensation	(2,509)	(23,650)	(5,490)
Accumulated deficit	(1,222,435)	(750,882)	(174,299)
T o t a I shareholders' equity	1,075,564	1,587,075	368,402
	4,372,233	4,486,179	1,041,360

The accompanying notes are an integral part of the financial statements.

(An Israeli Corporation)
CONSOLIDATED STATEMENTS OF OPERATIONS

		Year ended December 31				
	2002	2003	2004	2004 Convenience translation into U.S. dollars		
		w Israeli sheke		(note 1a)		
	ln t	housands (exc	ept per share d	lata)		
REVENUES - net:						
Services	3,766,584	4,117,887	4,615,781	1,071,444		
Equipment	287,979	349,832	524,956	121,856		
11-11-1-1	4,054,563	4,467,719	5,140,737	1,193,300		
COST OF REVENUES:						
Services	2,499,534	2,586,707	2,885,077	669,702		
Equipment	569,924	549,749	729,937	169,438		
	3,069,458	3,136,456	3,615,014	839,140		
GROSS PROFIT	985,105	1,331,263	1,525,723	354,160		
SELLING AND MARKETING EXPENSES	308,079	314,008	325,244	75,498		
GENERAL AND ADMINISTRATIVE EXPENSES	143,594	162,387	181,133	42,045		
OPERATING PROFIT	533,432	854,868	1,019,346	236,617		
FINANCIAL EXPENSES, net (note 13)	445,180	321,710	260,545	60,479		
LOSS ON IMPAIRMENT OF INVESTMENTS						
IN NON-MARKETABLE SECURITIES (note 2)	4,054	3,530				
INCOME BEFORE TAX	84,198	529,628	758,801	176,138		
TAX BENEFIT (TAX EXPENSES) (note 10)	,	633,022	(287,248)	(66,678)		
NET INCOME FOR THE YEAR	84,198	1,162,650	471,553	109,460		
EARNINGS PER SHARE ("EPS"):						
Basic	0.47	6.39	2.57	0.60		
Diluted	0.46	6.34	2.56	0.60		
WEIGHTED AVERAGE NUMBER OF		_ <del></del>		_ <del></del>		
SHARES OUTSTANDING:						
Basic	179,984,090	181,930,803	183,389,383	183,389,383		

The accompanying notes are an integral part of the financial statements.

Diluted

183,069,394

183,243,157 184,108,917 184,108,917

(An Israeli Corporation)
CONSOLIDATED STATEMENTS OF CHANGES IN SHAREHOLDERS' EQUITY (CAPITAL DEFICIANCIES)

	Share capital						
	Number of shares	Amount	Receivables in respect of shares issued	Capital surplus	Deferred compensation	Accumulated deficit	Total
				(In the	o u s a n d s )		
New Israeli Shekels:	170 004 505	4 700		0.000.000	(0.4.000)	(0.400.000)	(400 770)
BALANCE AT DECEMBER 31, 2001	178,924,585	1,789		2,298,080	(24,362)	(2,469,283)	(193,776)
CHANGES DURING THE YEAR ENDED DECEMBER 31, 2002:  Exercise of options granted to employees  Amortization of deferred compensation related to employee stock option grants	2,670,637	27		4,210			4,237
net of deferred compensation with respect to stock options forfeited Net income				(9,020)	17,977	84,198	8,957 84,198
BALANCE AT DECEMBER 31, 2002	181,595,222	1,816	_	2,293,270	(6,385)	(2,385,085)	(96,384)
CHANGES DURING THE YEAR ENDED DECEMBER 31, 2003:							
Exercise of options granted to employees	1,100,352	11	(4,374)	7,754			3,391
Income tax benefit in respect of exercise of options granted to employees  Deferred compensation related to employee stock option grants				730 2.666	(2,666)		730
Amortization of deferred compensation related to employee stock option				2,000	(2,000)		
grants							
net of deferred compensation with respect to stock options forfeited				(1,365)	6,542		5,177
Net income						1,162,650	1,162,650
BALANCE AT DECEMBER 31, 2003	182,695,574	1,827	(4,374)	2,303,055	(2,509)	(1,222,435)	1,075,564
CHANGES DURING THE YEAR ENDED DECEMBER 31, 2004:							
Exercise of options granted to employees	1,341,647	13	2,114	23,671			25,798
Income tax benefit in respect of exercise of options granted to employees  Deferred compensation related to employee stock option grants  Amortization of deferred compensation related to employee stock option				3,440 32,560	(32,560)		3,440
grants				(222)	44.440		40.700
net of deferred compensation with respect to stock options forfeited Net income				(699)	11,419	471,553	10,720 471,553
BALANCE AT DECEMBER 31, 2004	184,037,221	1,840	(2,260)	2,362,027	(23,650)	(750,882)	1,587,075
Convenience translation into u.s. dollars (note 1a):							
BALANCE AT JANUARY 1, 2004	182,695,574	424	(1,015)	534,600	(582)	(283,759)	249,668
CHANGES DURING THE YEAR ENDED DECEMBER 31, 2004:							
Exercise of options granted to employees	1,341,647	3	490	5,495			5,988
Income tax benefit in respect of exercise of options granted to employees Deferred compensation related to employee stock option grants Amortization of deferred compensation related to employee stock option				798 7,558	(7,558)		798
grants net of deferred compensation with respect to stock options forfeited Net income				(162)	2,650	109,460	2,488 109,460
BALANCE AT DECEMBER 31, 2004	184,037,221	427	(525)	548,289	(5,490)	(174,299)	368,402

The accompanying notes are an integral part of the financial statements.

(An Israeli Corporation) CONSOLIDATED STATEMENTS OF CASH FLOWS

Year ended	December 31
2003	2004

		rear ended	December 31	
	2002	2003	2004	2004
	Ne	w Israeli shek		Convenience translation into U.S. dollars (note 1a)
		In the	ousands	
CASH FLOWS FROM OPERATING ACTIVITIES:  Net income for the year  Adjustments to reconcile net income to net cash provided by operating activities:	84,198	1,162,650	471,553	109,460
Depreciation and amortization  Loss on impairment of investments in	516,199	536,871	558,222	129,578
non-marketable securities  Amortization of deferred compensation related	4,054	3,530		
to employee stock option grants, net Liability for employee rights upon retirement Deferred income taxes Income tax benefit in respect of exercise of options	8,957 18,632	5,177 15,540 (633,752)	10,720 16,302 283,807	2,488 3,784 65,879
granted to employees  Accrued interest, exchange and linkage		730	3,440	798
differences on (erosion of) long-term liabilities Erosion of (accrued interest and exchange	91,027	(67,438)	(10,258)	(2,381)
differences on) security deposit  Amount carried to deferred charges	(6,925) (3,805)	8,877		
Capital loss (gain) on sale of fixed assets Changes in operating asset and liability items: Decrease (increase) in accounts receivable:	839	(7,829)	(391)	(91)
Trade Other	(56,638) (8,056)	22,721 (5,557)	(225,860) (13,615)	(52,428) (3,160)
Increase (decrease) in accounts payable and accruals:				
Trade Other Increase in asset retirement obligations	31,909 14,796	(93,444) 47,541 1,228	135,600 41,613 464	31,476 9,659 108
Decrease (increase) in inventories	(12,996)	34,647	1,205	280
Net cash provided by operating activities	682,191	1,031,492	1,272,802	295,450
CASH FLOWS FROM INVESTING ACTIVITIES:				
Purchase of fixed assets	(599,769)	(350,344)	(609,795)	(141,549)
Proceeds from sale of fixed assets Withdrawal of security deposit	5,737	12,309 98,917	552	128
Purchase of additional spectrum Funds in respect of employee rights upon retirement	(207,635) (14,301)	(121,388) (16,263)	(53,969) (10,404)	(12,528) (2,415)
Net cash used in investing activities	(815,968)	(376,769)	(673,616)	(156,364)

(An Israeli Corporation)
CONSOLIDATED STATEMENTS OF CASH FLOWS

		Year ended [	December 31	
	2002	2003	2004	2004
	Ne	w Israeli shekel	ls	Convenience translation into U.S. Dollars (note 1a)
		In thou	sands	
CASH FLOWS FROM FINANCING ACTIVITIES:  Proceeds from exercise of stock options granted to employees	4,237	3,391	25,798	5,988
Long-term bank loans received Repayment of long-term bank loans Net cash provided by (used in) financing activities	1,349,326 (1,223,698) 129,865	240,000 (895,700) (652,309)	(624,147) (598,349)	(144,880) (138,892)
INCREASE (DECREASE) IN CASH AND CASH EQUIVALENTS	(3,912)	2,414	837	194
CASH AND CASH EQUIVALENTS AT BEGINNING OF YEAR	5,272	1,360	3,774	876
CASH AND CASH EQUIVALENTS AT END OF YEAR	1,360	3,774	4,611	1,070
SUPPLEMENTARY DISCLOSURE OF CASH  FLOW INFORMATION - cash paid during the year: Interest	323,841	287,629	179,205	41,598
Advances to income tax authorities	5,207	3,750	4,900	1,137

#### Supplementary information on investing and financing activities not involving cash flows

At December 31, 2002, 2003 and 2004, trade payables include NIS 117,406,000, NIS 65,681,000 and NIS 81,795,000 (\$ 18,987,000), respectively, in respect of acquisition of fixed assets. In addition, at December 31, 2003 and 2004 trade payables include NIS 7.2 million and NIS 13.8 million (\$3.2 million) in respect of acquisition of additional spectrum, respectively, and at December 31, 2003 and 2004, shareholders' equity include NIS 4.4 million and NIS 2.3 million (\$0.5 million) receivable in respect of shares issued, respectively. These balances are recognized in the cash flow statements upon payment.

The accompanying notes are an integral part of the financial statements.

(An Israeli Corporation)
NOTES TO CONSOLIDATED FINANCIAL STATEMENTS

#### **NOTE 1 - SIGNIFICANT ACCOUNTING POLICIES**

#### a. General:

#### **Nature of operations:**

- 1) Partner Communications Company Ltd. ("the Company") operates a mobile telecommunications network based upon the Global System for Mobile Communications ("GSM") Standard in Israel. The Company launched its 3G network on December 1, 2004.
- 2) The Company was incorporated on September 29, 1997, and operates under a license granted by the Ministry of Communications to operate a cellular telephone network for a period of 10 years beginning April 7, 1998. The Company commenced full commercial operations on January 1, 1999. The Company paid a "one-time" license fee of approximately new Israeli shekels (NIS) 1.6 billion which is presented under "license and deferred charges". The Company is entitled to request an extension of the license for an additional period of six years and then renewal for one or more additional six year periods. Should the license not be renewed, the new license-holder is obliged to purchase the communications network and all the rights and obligations of the subscribers for a fair price, as agreed between the parties or as determined by an arbitrator.

In December 2001, the Company was awarded additional spectrum (2G band (1800MHz) and third generation (3G) UMTS band (1900MHz and 2100MHz)). Following the award of the above spectrum, the Company's license was amended and extended through 2017. During June 2002, the Minister of Communications amended and further extended the license through 2022. As to the change in estimate of the useful life of the license see note f(1) below.

In consideration for the above additional spectrum the Company paid NIS 180 million (\$41 million) for the 2G spectrum, and is committed to pay NIS 220 million (\$51 million) for the 3G spectrum in six installments through 2006, of which approximately NIS 165 million (approximately \$38 million) was paid as of December 31, 2004.

Under the terms of the amended license, the Company provided a guarantee in NIS equivalent of \$ 10 million to the State of Israel to secure the Company's adherence to the terms of the license.

#### Use of estimates in the preparation of financial statements

The preparation of financial statements in conformity with generally accepted accounting principles ("GAAP") requires management to make estimates and assumptions that affect the reported amounts of assets and liabilities, and disclosure of contingent assets and liabilities at the dates of the financial statements and the reported amounts of revenues and expenses during the reporting years. Actual results could differ from those estimates.

(An Israeli Corporation)

NOTES TO CONSOLIDATED FINANCIAL STATEMENTS (continued)

#### NOTE 1 - SIGNIFICANT ACCOUNTING POLICIES (continued):

#### a. General (continued):

#### Functional currency and reporting currency

The functional currency of the Company and its subsidiary is the local currency New Israeli Shekels - NIS. The consolidated financial statements have been drawn up on the basis of the historical cost of Israeli currency and are presented in NIS.

#### Convenience translation into U.S. dollars ("dollars" or "\$")

The NIS figures at December 31, 2004 and for the year then ended have been translated into dollars using the representative exchange rate of the dollar at December 31, 2004

(\$1 = NIS 4.308). The translation was made solely for convenience. The translated dollar figures should not be construed as a representation that the Israeli currency amounts actually represent, or could be converted into, dollars.

#### **Accounting principles**

The consolidated financial statements have been prepared in accordance with accounting principles generally accepted in the United States (U.S. GAAP).

#### b. Principles of consolidation:

- 1) The consolidated financial statements include the accounts of the Company and its wholly-owned subsidiary (together the Group).
- 2) Intercompany balances between the Company and its subsidiary have been eliminated.

#### c. Inventories

Inventories of cellular telephones (handsets) and accessories are stated at the lower of cost or estimated net realizable value. Cost is determined on the "first-in, first-out" basis.

The Company determines its allowance for inventory obsolescence and slow moving inventory, based upon expected inventory turnover, inventory aging and current and future expectations with respect to product offerings.

#### d. Non - marketable securities

These investments are stated at cost, less provision for impairment losses, see note 2.

(An Israeli Corporation)

NOTES TO CONSOLIDATED FINANCIAL STATEMENTS (continued)

#### NOTE 1 - SIGNIFICANT ACCOUNTING POLICIES (continued):

#### e. Fixed assets:

- 1) These assets are stated at cost.
- 2) Direct consultation and supervision costs and other direct costs relating to setting up the Company's communications network and information systems for recording and billing calls are capitalized to cost of the assets.

During 2004, costs incurred relating to the 3G network, prior to the launch of the network, in the amount of NIS 23.4 million (\$5.4 million) were capitalized.

- 3) Interest costs in respect of loans and credit which served to finance the construction or acquisition of fixed assets incurred until installations of the fixed assets are completed are capitalized to cost of such assets.
- 4) Assets are depreciated by the straight-line method, on basis of their estimated useful life.

Annual rates of depreciation are as follows:

	<u>%</u>
Communications network*	10 - 20
	(mainly 15)
Computers, hardware and software for	
information systems	15-33
Vehicles	20
Office furniture and equipment	7-15

Leasehold improvements are amortized by the straight-line method over the term of the lease, or the estimated useful life of the improvements, whichever is shorter.

\*As of December 31, 2004, the Company invested approximately NIS 370 million (\$ 86 million) in the 3G network. Depreciation of the costs relating to the 3G network commenced as of December 1, 2004.

The Company terminated the lease agreement for one of its headquarter buildings in March 2003, in favor of a new building (see note 8a(2)b) and abandoned part of its leasehold improvements. Following the decision to abandon the leasehold improvements, in October 2002, the un-amortized balance of the existing leasehold improvements was amortized on a straight-line basis as of October 1, 2002 - over the period of 6 months ending March 31, 2003.

#### 5) Computer Software Costs

The cost of internal-use software is capitalized in accordance with Statement of Position (SOP) No. 98-1, "Accounting for the Costs of Computer Software Developed or Obtained for Internal Use." Subsequent additions, modifications or upgrades to internal-use software are capitalized only to the extent that they allow the software to perform a task it previously did not perform. Software maintenance and training costs are expensed in the period in which they are incurred. Capitalized computer software costs are amortized using the straight-line method over a period of 5 to 7 years.

(An Israeli Corporation)

NOTES TO CONSOLIDATED FINANCIAL STATEMENTS (continued)

#### NOTE 1 - SIGNIFICANT ACCOUNTING POLICIES (continued):

#### f. License and deferred charges:

#### 1) License:

The license (see also 1a(2) above) is stated at cost and is amortized by the straight-line method over the utilization period of the license starting January 1, 1999.

Following the extensions of the license (as described in note 1a(2) above) the unamortized balance of the Company's existing license as well as the cost of the additional spectrum put into service are amortized on a straight-line basis as follows: as of January 1, 2002 - over the period ending in 2017; as of April 1, 2002 - over the period ending in 2022.

The costs relating to the 3G band are amortized as of December 1, 2004, by the straight-line method over the period ending in 2022. Interest expenses which served to finance the license fee - incurred until the commencement of utilization of the license - were capitalized to cost of the license. During the years 2002, 2003 and 2004 - NIS 7 million, NIS 10 million and NIS 8 million (\$ 2 million) interest costs were capitalized to the cost of the license, respectively.

#### 2) Deferred charges:

- a) Costs relating to the obtaining of long-term credit lines are amortized using the effective interest rate determined for the borrowing transactions.
- b) Issuance costs relating to Notes payable (see note 6) are amortized using the effective interest rate stipulated for the Notes.

#### g. Impairment of long-lived assets

The Company has adopted Statement of Financial Accounting Standards No. 144 (FAS 144), "Accounting for the Impairment or Disposal of Long-Lived Assets". FAS 144 requires that long-lived assets, including certain intangible assets, to be held and used by an entity be reviewed for impairment whenever events or changes in circumstances indicate that the carrying amount of the assets may not be recoverable. Under FAS 144, if the sum of the expected future cash flows (undiscounted and without interest charges) of the long-lived assets is less than the carrying amount of such assets, an impairment loss would be recognized, and the assets written down to their estimated fair values.

#### h. Cash equivalents

The Company considers all highly liquid investments, which include short-term bank deposits (up to 3 months from date of deposit) that are not restricted as to withdrawal or use, to be cash equivalents.

#### i. Comprehensive income

The Company has no comprehensive income components other than net income.

(An Israeli Corporation)

NOTES TO CONSOLIDATED FINANCIAL STATEMENTS (continued)

#### NOTE 1 - SIGNIFICANT ACCOUNTING POLICIES (continued):

#### j. Revenue recognition

Revenues from services primarily consist of charges for airtime, roaming and value added services provided to the Company's customers, are recognized upon performance of the services, net of credits and adjustments for services discounts. Revenues from pre-paid calling cards are recognized upon customer's usage of the cards. Revenues from sale of handsets and accessories are recognized upon delivery and the transfer of ownership to the subscriber.

Emerging Issues Task Force ("EITF") Issue 00-21, "Revenue Arrangements with Multiple Deliverables" addresses the accounting, by a vendor, for contractual arrangements in which multiple revenue-generating activities will be performed by the vendor. It is effective prospectively for all arrangements entered into in fiscal periods beginning after June 15, 2003. EITF Issue 00-21 addresses when and, if so, how an arrangement involving multiple deliverables should be divided into separate units of accounting. The Company adopted EITF Issue 00-21 in the year ended December 31, 2003. The adoption had no impact on its financial position and results of operations. Based on EITF 00-21, the Company determined that the sale of handsets with accompanying services constitutes a revenue arrangement with multiple deliverables. Accordingly consideration received for handsets, up to their fair value, that is not contingent upon the delivery of additional items (such as the services), is recognized as equipment revenues, when revenue recognition criteria for the equipment as stated above are met. Consideration for services is recognized as services revenues, when earned.

#### k. Concentration of credit risks - allowance for doubtful accounts

The Company's revenues are derived from a large number of customers. Accordingly, the Company's trade balances do not represent a substantial concentration of credit risk.

An appropriate provision for doubtful accounts is included in the accounts of the Company. The allowance charged to expenses (including bad debts), determined as a percentage of specific debts doubtful of collection, based upon historical experience, for the years ended December 31, 2002, 2003 and 2004 totaled NIS 17,752,000, NIS 15,601,000 and NIS 21,256,000 (\$ 4,934,000) (see note 13a), respectively.

The cash and cash equivalents as of December 31, 2004 are deposited mainly with leading Israeli banks. Therefore, in the opinion of the Company, the credit risk inherent in these balances is remote.

During the reported periods, the Company factored most of its long-term trade receivables resulting from sales of handsets. The factoring is made through clearing companies, on a non-recourse basis. The sale of accounts receivable was recorded by the Company as a sales transaction under the provisions of Statement of Financial Accounting Standards No.140, "Accounting for Transfers and Servicing of Financial Assets and Extinguishments of Liabilities".

The resulting costs are charged to "financial expenses-net", as incurred. During the years ended December 31, 2002, 2003 and 2004, the Company factored NIS 209,568,000, NIS 295,827,000 and NIS 331,611,000 (\$76,976,000), respectively, from long-term trade receivables.

(An Israeli Corporation)

NOTES TO CONSOLIDATED FINANCIAL STATEMENTS (continued)

#### NOTE 1 - SIGNIFICANT ACCOUNTING POLICIES (continued):

#### I. Handsets warranty obligations

The Company has entered into several agreements under which the supplier does not provide any warranty but rather provides additional handsets to satisfy its warranty obligation. In these cases, the Company provides for warranty costs at the same time as the revenues are recognized. The annual provision is calculated at the rate of 1.5%-3.5% of the cost of the handsets sold, see note 13c.

#### m. Advertising expenses

Advertising expenses are charged to the statement of operations as incurred. Advertising expenses for the years ended December 31, 2002, 2003 and 2004 totaled NIS 96,061,000, NIS 99,061,000 and NIS 115,909,000 (\$ 26,906,000), respectively.

#### n. Deferred income taxes

Deferred taxes are determined utilizing the asset and liability method, based on the differences between the amounts presented in these financial statements and those taken into account for tax purposes, in accordance with the applicable tax laws. Valuation allowances are provided if, based upon the weight of available evidence, it is more likely than not that some or all of the deferred tax assets will not be realized (see note 10d).

Deferred tax assets and liabilities are presented as current or long-term items in accordance with the nature of assets or liabilities to which they relate. Deferred tax assets in respect of carryforward tax losses are presented as current or long-term assets, according to their expected utilization date.

#### o. Foreign currency transactions and balances

Balances in, or linked to, foreign currency are stated on the basis of the exchange rates prevailing at balance sheet dates. For foreign currency transactions included in the statements of operations, the exchange rates at transaction dates are used. Transaction gains or losses arising from changes in the exchange rates used in the translation of such balances are carried to financial income or expenses.

#### p. Derivative financial instruments ("derivatives")

The Company has adopted FAS 133, as amended, which establishes accounting and reporting standards for derivatives, including certain derivatives embedded in other contracts, and for hedging activities. Under FAS 133, all derivatives are recognized on the balance sheet at their fair value. On the date that the Company enters into a derivative contract, it designates the derivative, for accounting purposes, as: (1) hedging instrument, or (2) non-hedging instrument. Any changes in fair value are to be reflected as current gains or losses or other comprehensive gains or losses, depending upon whether the derivative is designated as a hedge and what type of hedging relationship exists. Changes in fair value of non-hedging instruments are carried to "financial expenses-net" on a current basis. To date, the Company did not have any contracts that qualify for hedge accounting under FAS 133.

The Company occasionally enters into commercial (foreign currency) contracts in which a derivative instrument is "embedded". This embedded derivative is separated from the host contract and carried at fair value when (1) the embedded derivative possesses economic characteristics that are not clearly and closely related to the economic characteristics of the host contract and (2) a separate, stand-alone instrument with the same terms would qualify as a derivative instrument (see note 12).

(An Israeli Corporation)
NOTES TO CONSOLIDATED FINANCIAL STATEMENTS (continued)

#### NOTE 1 - SIGNIFICANT ACCOUNTING POLICIES (continued):

#### q. Earning Per Share (EPS)

Basic EPS is computed by dividing net income by the weighted average number of shares outstanding during the years.

Diluted EPS reflects the increase in the weighted average number of shares outstanding that would result from the assumed exercise of employee stock options, calculated using the treasury-stock-method.

#### r. Stock based compensation

The Company accounts for employee stock based compensation under the intrinsic value model in accordance with Accounting Principles Board Opinion No. 25 "Accounting for Stock Issued to Employees" ("APB 25") and related interpretations. In accordance with FAS 123 – "Accounting for Stock-Based Compensation" ("FAS 123"), the Company discloses pro forma data assuming the group had accounted for employee stock option grants using the fair value-based method defined in FAS 123. As to the recently issued revised FAS 123, see t. below. Compensation cost for employee stock option plans is charged to shareholders' equity, on the date of grant of the options, under "deferred compensation costs" and is then amortized over the vesting period using the accelerated method of amortization.

The weighted average fair value of options granted using the Black & Scholes option-pricing model during 2002, 2003 and 2004 is NIS 16.68, NIS 26.96 and NIS 18.98 (\$4.41), respectively. The fair value of each option granted is estimated on the date of grant based on the following weighted average assumptions: weighted average dividend yield of 0%; expected volatility of 69%, 62% and 55%, respectively; risk-free interest rate in NIS terms: 2002 - 7.7%, 2003-4.5%, 2004 - 4%; weighted expected life: the 1998 plan - 2002 - 9 years; the 2000 plan - 9 years; the 2004 plan - 5 years

(An Israeli Corporation)

NOTES TO CONSOLIDATED FINANCIAL STATEMENTS (continued)

#### NOTE 1 - SIGNIFICANT ACCOUNTING POLICIES (continued):

The following table illustrates the effect on net income and EPS assuming the Company had applied the fair value recognition provisions of FAS 123 to its stock based employee compensation:

	Year ended December 31,			
	2002	2003	2004	2004
		NIS		Convenience translation into dollars
	In	thousands, ex	cept per share	e data
Net income, as reported Add: stock based employee compensation expense-net, included in reported net income (2003 and 2004-net of income	84,198	1,162,650	471,553	109,460
taxes) Deduct: stock based employee compensation expense-net, determined under fair value method for all awards (2003 and	8,957	3,313	10,122	2,350
2004 -net of income taxes)	(30,029)	(12,225)	(29,879)	(6,936)
Pro-forma net income	63,126	1,153,738	451,796	104,874
Earning per share:				
Basic - as reported	0.47	6.39	2.57	0.60
Basic - pro forma	0.35	6.34	2.46	0.57
Diluted - as reported	0.46	6.34	2.56	0.60
Diluted - pro-forma	0.34	6.31	2.46	0.57

#### s. Asset retirement obligations

The Company has adopted as of January 1, 2003 FAS 143 "Accounting for Asset Retirement Obligations" ("FAS 143"). FAS 143 requires that an asset retirement obligation (ARO) associated with the retirement of a tangible long lived asset be recognized as a liability in the period in which it is incurred and becomes determinable (as defined by the standard), with an offsetting increase in the carrying amount of the associated asset. The cost of the tangible asset, including the initially recognized ARO, is depreciated such that the cost of the ARO is recognized over the useful life of the asset.

The ARO is recorded at fair value, and the accretion expense will be recognized over time as the discounted liability is accreted to its expected settlement value. The fair value of the ARO is measured using expected future cash out flows discounted at the Company's credit-adjusted risk-free interest rate.

The Company is subject to asset retirement obligations associated with its cell sites operating leases. These lease agreements contain clauses requiring restoration of the leased site at the end of the lease term, creating asset retirement obligations, see also note 13d.

(An Israeli Corporation)

NOTES TO CONSOLIDATED FINANCIAL STATEMENTS (continued)

#### NOTE 1 - SIGNIFICANT ACCOUNTING POLICIES (continued):

#### t. Recently issued accounting pronouncements:

1) FAS 123 (revised 2004) Share-based Payment

In December 2004, the Financial Accounting Standards Board ("FASB") issued the revised Statement of Financial Accounting Standards ("FAS") No. 123, Share-Based Payment (FAS 123R), which addresses the accounting for sharebased payment transactions in which the Company obtains employee services in exchange for (a) equity instruments of the Company or (b) liabilities that are based on the fair value of the Company's equity instruments or that may be settled by the issuance of such equity instruments. This Statement eliminates the ability to account for employee share-based payment transactions using APB Opinion No. 25, Accounting for Stock Issued to Employees, and requires instead that such transactions be accounted for using the grant-date fair value based method. This Statement will be effective as of the beginning of the first interim or annual reporting period that begins after June 15, 2005 (July 1, 2005 for the Company). Early adoption of FAS 123R is encouraged. This Statement applies to all awards granted or modified after the Statement's effective date. In addition, compensation cost for the unvested portion of previously granted awards that remain outstanding on the Statement's effective date shall be recognized on or after the effective date, as the related services are rendered, based on the awards' grant-date fair value as previously calculated for the proforma disclosure under FAS 123.

The Company estimates that the cumulative effect of adopting FAS 123R as of its adoption date by the Company (July 1, 2005), based on the awards outstanding as of December 31, 2004, will not be material. This estimate does not include the impact of additional awards, which may be granted, or forfeitures, which may occur subsequent to December 31, 2004 and prior to our adoption of FAS 123R. The Company expects that upon the adoption of FAS 123R, it will apply the modified prospective application transition method, as permitted by the Statement. Under such transition method, upon the adoption of FAS 123R, the Company's financial statements for periods prior to the effective date of the Statement will not be restated. The impact of this statement on the Company in 2005 will not be material. The impact in 2006 and beyond will depend upon various factors, among them the Company's future compensation strategy.

#### 2) FAS 151 Inventory Costs - an amendment of ARB 43, Chapter 4

In November 2004, the FASB issued FAS No. 151, "Inventory Costs - an amendment of ARB 43, Chapter 4" (FAS 151). This Statement amends the guidance in ARB No. 43, Chapter 4, "Inventory Pricing," to clarify the accounting for abnormal amounts of idle facility expense, freight, handling costs, and wasted material. This Statement requires that those items be recognized as current-period charges. In addition, this Statement requires that allocation of fixed production overheads to the costs of conversion be based on the normal capacity of the production facilities. This Statement will be effective for inventory costs incurred during fiscal years beginning after June 15, 2005 (January 1, 2006 for the Company). Earlier application of FAS 151 is permitted. The provisions of this Statement shall be applied prospectively. The Company does not expect this Statement to have a material effect on the Company's financial statements or its results of operations.

(An Israeli Corporation)

NOTES TO CONSOLIDATED FINANCIAL STATEMENTS (continued)

#### NOTE 1 - SIGNIFICANT ACCOUNTING POLICIES (continued):

3) FAS 153 Exchanges of Nonmonetary Assets - An Amendment of APB Opinion No. 29

In December 2004, the FASB issued FAS No. 153, *Exchanges of Nonmonetary Assets - An Amendment of APB Opinion No. 29* (FAS 153). FAS 153 amends APB Opinion No. 29, Accounting for Nonmonetary Transactions (Opinion 29). The amendments made by FAS 153 are based on the principle that exchanges of nonmonetary assets should be measured based on the fair value of the assets exchanged. Further, the amendments eliminate the exception for nonmonetary exchanges of similar productive assets and replace it with a general exception for exchanges of nonmonetary assets that do not have commercial substance. The provisions in FAS 153 are effective for nonmonetary asset exchanges occurring in fiscal periods beginning after June 15, 2005 (July 1, 2005 for the Company). Early application of the FAS 153 is permitted. The provisions of this Statement shall be applied prospectively. The Company does not expect the adoption of FAS 153 to have a material effect on the Company's financial statements or its results of operations.

#### **NOTE 2 - INVESTMENTS IN NON-MARKETABLE SECURITIES**

The Company and its subsidiary have entered into agreements with a number of technological companies in the early stages of development of cellular products (hereafter - the start-up companies). Under the agreements, the Group is to supply infrastructure and support services which the start-up companies need to develop their products, in consideration of options and shares in those companies. In some cases, the Group is also entitled to royalties on future sales of the products of the start-up companies. Based on the financial position of the companies, management is of the opinion that the fair value of the securities granted to the Group, on the grant date and as of December 31, 2004 is not material.

The Group's holdings in the start-up companies (current and fully diluted) do not exceed 15% of the share capital of any one of them and does not give the Group significant influence over any one of them. Therefore, the investments therein are presented on a cost basis.

During 2003, the Company recorded an impairment loss of approximately NIS 3.5 million (2002 - approximately NIS 4.1 million), in respect of the above investments. As of December 31, 2003 and 2004, the balance of these investments was fully impaired.

(An Israeli Corporation)
NOTES TO CONSOLIDATED FINANCIAL STATEMENTS (continued)

#### **NOTE 3 - FIXED ASSETS:**

**a.** Composition of fixed assets - net, is as follows:

	December 31		
	2003	2004	2004
	NI	s	Convenience translation into dollars
	-	In thousand	ds
Communications network Computers, hardware and software for	2,553,982	3,059,305	710,145
information systems	548,700	607,283	140,966
Office furniture and equipment	35,934	37,069	8,605
Vehicles	2,697	2,121	492
Leasehold improvements	146,431	194,417	45,129
Cellular telephones – base stock	6,309	6,309	1,465
	3,294,053	3,906,504	906,802
Communications network - construction in progress			
(see note 1a(2))	11,507		
	3,305,560	3,906,504	906,802
Less - accumulated depreciation and amortization	1,610,976	2,063,322	478,951
	1,694,584	1,843,182	427,851

December 31

Depreciation and amortization in respect of fixed assets totaled NIS 446,970,000, NIS 469,205,000 and NIS 482,390,000 (\$111,976,000) for the years ended December 31, 2002, 2003 and 2004, respectively.

**b.** Fixed assets include interest expenses, direct consultation and supervision costs and other direct costs of establishing the cellular communications network and information systems, which were capitalized (before commencing full commercial operations or utilization of the related fixed assets) in respect of:

	December 31		
	2003 2004		2004
	NIS	1	Convenience translation into dollars
		In thousand	ls
Communications network Computers, hardware and software for	73,575	96,939	22,502
information systems	15,566	15,920	3,695
•	89,141	112,859	26,197
L e s s - accumulated depreciation	63,775	75,597	17,548
Depreciated balance	25,366	37,262	8,649

**c.** As to pledges on the fixed assets - see note 11.

(An Israeli Corporation)

NOTES TO CONSOLIDATED FINANCIAL STATEMENTS (continued)

#### **NOTE 4 - LICENSE AND DEFERRED CHARGES:**

	December 31		
	2003	2004	2004
	NI	s	Convenience translation into dollars
		In thousands	S
License (note 1a(2))	*1,916,980	1,992,455	462,501
Less - accumulated amortization	629,893	693,823	161,054
	1,287,087	1,298,632	301,447
Deferred charges - in respect of:			
Obtaining long-term credit lines	55,996	55,996	12,998
Notes payable	22,017	22,017	5,111
	78,013	78,013	18,109
Less - accumulated amortization	39,152	51,053	11,851
	38,861	26,960	6,258
	1,325,948	1,325,592	307,705

<sup>\*</sup> As of December 31, 2003 NIS 153,773,000 in respect of 3G band spectrum were not amortized, see also note 1f(1).

License amortization expenses for the years ended December 31, 2002, 2003 and 2004 totaled NIS 62,042,000, NIS 58,408,000 and NIS 63,931,000 (\$ 14,840,000), respectively. Amortization expenses on deferred charges for the years ended December 31, 2002, 2003 and 2004 totaled NIS 7,187,000 NIS 9,258,000 and NIS 11,901,000 (\$ 2,762,000), respectively.

The expected license amortization expenses for the next five years are as follows:

	NIS	Convenience translation into dollars
	In the	ousands
Year ended December 31:		
2005	76,018	17,646
2006	76,018	17,646
2007	76,018	17,646
2008	76,018	17,646
2009	76,018	17,646

(An Israeli Corporation)

#### NOTES TO CONSOLIDATED FINANCIAL STATEMENTS (continued)

#### **NOTE 5 - LONG-TERM BANK LOANS**

In December 2002, the Company entered into an Amending Agreement in connection with its primary secured bank credit facility, with Bank Leumi B.M., Bank Hapoalim B.M., Israel Discount Bank Ltd., The First International Bank of Israel Ltd., United Mizrahi Bank Ltd., Mercantile Discount Bank Ltd. and Citibank N.A., which amends the bank facility agreement dated August 1998 between the Company and the above mentioned banks, as amended from time to time.

The amended facility is divided into three tranches: A multi-currency term loan facility of \$410 million ("Facility A"), a revolving multi-currency loan facility of \$150 million ("Facility B") and a fixed-term NIS loan facility of \$150 million ("Facility C").

Facility A was available to be drawn through March 31, 2003, from the said amount; \$ 383 million have been drawn. On July 28, 2004, the Board of Directors of the Company approved the permanent reduction of the long-term bank facility A by an aggregate of \$100 million. The amount drawn from facility A is to be repaid in quarterly installments with a final maturity of June 30, 2008. Facility B may be drawn and repaid until June 30, 2008. During 2004, the Facility was reduced by \$10 million. Facility C was available to be drawn through December 31, 2004. The facility was not utilized and expired at the end of the availability period.

The bank facility is a dollar denominated facility and it may be drawn in different currencies, see c. below.

**a.** Status of the facility at December 31, 2004 is as follows:

	The total facility	Amounts drawn	awailable for drawing			
	D	Dollars in millions				
Facility A	283	266	17			
Facility B	140	2	138			
	423	*268	155			

**b.** The amounts outstanding, classified by linkage terms and interest rates, are as follows:

	December 31,		December 31		
	2004	2003	2004	2004	
	Weighted average interest rates		Amount		
	<u>%</u>	NIS	<b>.</b>	Convenience translation into dollars	
			In thousands	S	
In NIS - linked to the Israeli					
consumer price index (CPI) (1)	5.82	364,268	358,088	83,122	
In NIS - unlinked (2)	4.75	1,442,800	827,000	191,968	
	•	1,807,068	1,185,088	*275,090	
Less - current maturities		119,853			
		1,687,215	1,185,088	*275,090	

(An Israeli Corporation)
NOTES TO CONSOLIDATED FINANCIAL STATEMENTS (continued)

- (1) Linkage terms apply both to principal and interest.
- (2) The loans bear interest at the "on-call" rate (a varying interbank rate in Israel), prime rate or fixed unlinked rate.
- \* The difference between the amounts displayed is the difference in exchange rates between the date the amounts were drawn and that at the balance sheet date.

(An Israeli Corporation)

NOTES TO CONSOLIDATED FINANCIAL STATEMENTS (continued)

#### NOTE 5 - LONG-TERM BANK LOANS (continued):

- **c.** Facilities A and B, may be drawn in NIS, US dollars or Euros, provided that not less than 60% of the outstanding Facilities A and B shall, at any time, be in NIS.
- **d.** There is a range of options as to how interest is calculated on borrowings under the amended facility. These options include rates based on LIBOR, the bond rate, fixed linked rate, fixed unlinked rate, on-call rate and prime rate. The margin for facility A and B is 0.90% per annum and can be reduced to 0.45% on fulfillment of some terms specified in the agreement.
- **e.** The total commitments under the Facilities will be reduced during each of the following years to the following amounts:

	Doll	Dollars in millions			
	Α	<u>B</u>	Total		
December	2 <del>6</del> 6	1 <del>4</del> 0	406		
2005					
2006	172	140	312		
2007	62	140	202		
June 30, 2008	0	0	0		

- f. Under the amended facility the Company is required, inter alia, to fulfill certain operational conditions and to maintain certain financial ratios. If the Company defaults on the covenants, the banks are entitled to demand early repayment of the credit facility in whole or in part. The Company believes that it is in compliance with all covenants stipulated by the amended facility. Under the amended facility, the Company has undertaken not to transfer any amounts, including dividends, to its shareholders, except in cases specified in the Agreement.
- **g.** As to pledges to secure loans and liabilities and other restrictions placed with respect thereto, see note 11.

#### **NOTE 6 - NOTES PAYABLE**

On August 10, 2000, the Company completed an offering of \$ 175 million of unsecured Senior Subordinated Notes due 2010, which have been issued at their dollar par value. The Notes have been registered under the U.S. Securities Act of 1933. The net proceeds from the offering (approximately \$ 170.5 million after deducting commissions and offering expenses) were used mainly to repay a portion of the indebtedness under the credit facility.

The Notes bear dollar interest at the rate of 13% per annum which are payable semiannually on each February 15 and August 15, commencing February 15, 2001. The Company may redeem 100% of the aggregate principal amount of the Notes beginning August 15, 2005, at the following redemption price:

August 15:	<u>price</u>
ັ2005	106.500%
2006	104.333%
2007	102.167%
2008 and thereafter	100.000%

(An Israeli Corporation)
NOTES TO CONSOLIDATED FINANCIAL STATEMENTS (continued)

#### **NOTE 6 - NOTES PAYABLE** (continued)

On December 31, 2004, the Notes closing price was 113.25 points.

Commission fees and offering expenses in respect of the Notes totaled approximately NIS 22 million. These expenses are presented as deferred charges and the amortization in respect thereof is included in "financial expenses, net".

#### NOTE 7 - LIABILITY FOR EMPLOYEE RIGHTS UPON RETIREMENT:

- a. Israeli labor laws and agreements require payment of severance pay upon dismissal of an employee or upon termination of employment in certain other circumstances. The Company's severance pay liability to its employees, mainly based upon length of service and the latest monthly salary (one month's salary for each year worked), is reflected by the balance sheet accrual under the "liability for employee rights upon retirement". The Company records the liability as if it was payable at each balance sheet date on an undiscounted basis. The liability is partly funded by purchase of insurance policies and the amounts funded are included in the balance sheet under investments and long-term receivables, as "funds in respect of employee rights upon retirement". The policies are the Company's assets and under labor agreements, subject to certain limitations, they may be transferred to the ownership of the beneficiary employees.
- **b.** The severance pay expenses for the years ended December 31, 2002, 2003 and 2004 were approximately NIS 24 million, NIS 20 million and NIS 27 million (approximately \$ 6 million), respectively.
- **c.** Cash flows information regarding the company's liability for employee rights upon retirement:

The Company expects to contribute NIS 21 million (\$ 4.9 million) in respect of severance pay in 2005.

Due to the relatively young age of the Company's employees, benefit payments to employees reaching retirement age in the next 10 years, are not material. The amounts were determined based on the employees' current salary rates and the number of service years that will accumulate upon their retirement date. These amounts do not include amounts that might be paid to employees how will cease working for the Company before their normal retirement age.

(An Israeli Corporation)

NOTES TO CONSOLIDATED FINANCIAL STATEMENTS (continued)

#### **NOTE 8 - COMMITMENTS AND CONTINGENCIES:**

#### a. Commitments:

#### 1) Royalty Commitments

The Company is committed to pay royalties to the Government of Israel on its "income from cellular services" as defined in the Regulations (see below), which includes all kinds of income of the Company from the granting of Bezeq services under the license - including airtime, roaming services and non-recurring connection fees, but excluding income transferred to another holder of a communications license and deducting bad debts, payments to another communication licensee in respect of interconnection, payments for roaming services to foreign operators and expenses related to the sale of equipment.

On June 18, 2001, the Knesset's Finance Committee approved the "Telecommunications (Royalties) Regulations, 2001" (hereafter - the Regulations). The principal change to the old regulations was the reduction of the percentage of royalties payable by mobile phone companies from 8% to 5% in 2001, 4.5% in 2002, 4% in 2003 and 3.5% in 2004 and thereafter. In addition, the basis in respect of which the royalties are paid has been expanded (as described above). As mentioned in note 1a(4), the rate of royalty payments paid by cellular operators will be reduced annually by 0.5%, starting January 1st 2006, to a level of 1%.

The royalty expenses for the years ended December 31, 2002, 2003 and 2004 were approximately NIS 117,281,000, NIS 119,387,000 and NIS 120,131,000 (\$27,886,000), respectively, and are included under "cost of services revenues".

#### 2) Operating leases

The Company has entered into operating lease agreements as follows:

- a) Lease agreements for its headquarters facility in Rosh Ha'ayin for a fifteen year period (until 2018). The Company has an option to shorten the lease periods by 3.5 to 8.5 years. The rental payments are linked to the Israeli CPI.
- b) Lease agreements for service centers and retail stores for a period of two to five years. The Company has an option to extend the lease periods for up to twenty additional years (including the original lease periods). The rental payments are linked partly to the dollar and partly to the Israeli CPI.
- c) Lease agreements in respect of cell sites throughout Israel are for periods of two to three years. The Company has an option to extend the lease periods up to ten additional years (including the original lease periods). The rental payments fees are partly linked to the dollar and are partly linked to the Israeli CPI.
- d) Operating lease agreements in respect of vehicles are for periods of three years. The rental payments are linked to the Israeli CPI.

(An Israeli Corporation)

NOTES TO CONSOLIDATED FINANCIAL STATEMENTS (continued)

## NOTE 8 - COMMITMENTS AND CONTINGENCIES (continued):

e) The minimum projected rental payments (based upon agreements in force as of December 31, 2004) for the next five years, at rates in effect at December 31, 2004, are as follows:

	NIS	Convenience translation into dollars
	In th	ousands
Year ended December 31:	<del></del>	
2005	145,392	33,749
2006	87,101	20,218
2007	40,877	9,489
2008	28,624	6,644
2009	22,459	5,213
2010 and thereafter	50,178	11,648
	374,631	86,961

- f) The rental expenses for the years ended December 31, 2002, 2003 and 2004 were approximately NIS 113 million, NIS 163 million, and NIS 176 million (\$ 41 million), respectively.
- 3) At December 31, 2004, the Company is committed to acquire fixed assets (including the first phase of the Nortel agreement), as described above, for approximately NIS 141 million (approximately \$ 33 million).
- 4) At December 31, 2004, the Company is committed to acquire handsets for approximately NIS 128 million (approximately \$ 30 million).
- 5) As to the Company's commitment to pay NIS 69 million (approximately \$ 16 million) regarding the award of the new spectrum, see note 1a.
- 6) As to cost sharing agreement with Hutchison Telecommunications Limited, see note 14c.

#### b. Contingencies:

1) On October 28, 1999, an Israeli consumer organization lodged a claim against the Company, alleging a variety of consumer complaints and requested that this claim be recognized as a class action.

On March 20, 2002, the Haifa District Court decided to strike the claim, because the consumer organization lost, on December 31, 2001, a special status required under Israeli law for consumer organizations to file class action claims.

Another claim, involving a substantial amount, which was filed by a private consumer who had previously asked to join the above class action, has been brought again before the court. The court had previously frozen the proceedings of the private consumer's claim, until a decision was made in the case filed by the consumer organization.

(An Israeli Corporation)

NOTES TO CONSOLIDATED FINANCIAL STATEMENTS (continued)

## NOTE 8 - COMMITMENTS AND CONTINGENCIES (continued):

On May 25, 2003, the private consumer filed a request to amend his motion to file a class action claim and the proposed claim itself, and also a draft of the proposed amended motion and claim. The motion to amend was granted and on January 21, 2004, the Company has submitted its response to the certification motion.

On November 24, 2004, the court decided to strike the motion to recognize the claim as a class action.

2) On April 8, 2002, a claim was filed against the Company, together with a motion to certify this claim as a class action, alleging a variety of consumer complaints. The amount of the claim against the Company is estimated at approximately NIS 545 million plus additional significant amounts relating to other alleged damages. Only preliminary hearings have taken place and the parties await a decision by the court with regard to a preliminary motion to dismiss the claim, which was submitted by the Company.

At this stage, and until the claim is recognized as a class action, the Company and its legal council are unable to evaluate the probability of success of such claim, and therefore no provision has been made.

In addition the Company and its legal council are of the opinion that even if the request to recognize this claim as a class action is granted, and even if the plaintiff's arguments are accepted, the outcome of the claim will be significantly lower than the abovementioned amount.

- 3) On April 13, 2003, a claim was filed against the Company and other cellular telecommunication companies, together with a request to recognize this claim as a class action, for alleged violation of antitrust law, alleging that no fee should have been collected for incoming SMS messages or alternatively, that the fee collected is excessive and that it is a result of illegal co-operation between the defendants. The amount of the claim against all the defendants is estimated at approximately NIS 90 million. The Company filed its response on October 1, 2003.
  - At this stage, no hearings have taken place and unless and until the claim is recognized as a class action, the Company and its legal council are unable to evaluate the probability of success of such claim, and therefore no provision has been made.
- 4) On September 14, 2004, a claim was filed against the Company, together with a motion to recognize this claim as a class action, alleging errors in client accounts, including charges in respect of Internet access after the client requested to block the service, and in the recording of credit balances as charges. The plaintiff claims that Partner clients have suffered damages of approximately NIS 173 million over a period of two years and that Partner is in violation of the Consumer Protection Law. The Company has not yet filed a response. At this stage, no hearings have taken place and unless and until the claim is recognized as a class action, the Company and its legal council are unable to evaluate the probability of success of such claim, and therefore no provision has been made.

(An Israeli Corporation)

NOTES TO CONSOLIDATED FINANCIAL STATEMENTS (continued)

## NOTE 8 - COMMITMENTS AND CONTINGENCIES (continued):

5) The Company does not have building permits for many of its cell sites and as a result is involved in numerous legal actions (including criminal proceedings against officers and directors) relating to this issue.

Most of these proceedings have been settled under plea bargain arrangements, whereby the Company has paid fines of insignificant amounts.

Management, based upon current experience and the opinion of legal counsel, does not believe that these legal actions will result in significant costs to the Company. The accounts do not include a provision in respect thereof.

- 6) The Company is a party to various claims arising in the ordinary course of its operations. Management, based upon the opinion of its legal counsel, is of the opinion that the ultimate resolution of these claims will not have a material effect on the financial position of the Company, its result of operations and cash flows. The accounts do not include a provision in respect thereof.
- 7) On July 15, 2003, the Ministry of Communications decided to decrease the deduction rate in respect of payments that "Bezeq" The Israel Communication Corp. Limited fails to collect from its customers for using the Company's network to 1.1% from 2.5%. The decision is effective retroactively for the period from October 2, 2000 and through August 31, 2003. As from September 1, 2003 the deduction rate was cancelled altogether.

Bezeq lodged an appeal with the Jerusalem District Court against the Minister's decision.

On January 6, 2004, the Supreme Court - within the framework of Partner's appeal against the District Court's verdict in respect of previous case between the parties, that related to Bezeq's failure to collect payments from its customers for using the Company's network for calls from fixed lines to mobile lines - ruled that the Minister's decision concerning the aforementioned deduction of 1.1% shall also apply to the period from March 1, 2000 to October 2, 2000, and that this deduction rate shall remain in effect or shall be amended in accordance with the outcome of the appeal lodged by Bezeq against the aforesaid decision of the Minister.

On August 9, 2004, the appeal was dismissed due to lack of jurisdiction. As a result of the dismissal of the appeal the Company has recognized as financial income an amount of NIS 19.5 million, which after tax resulted in an increase of the Company's net income of NIS 12.5 million.

(An Israeli Corporation)

NOTES TO CONSOLIDATED FINANCIAL STATEMENTS (continued)

#### **NOTE 9 - SHAREHOLDERS' EQUITY:**

#### a. Share capital:

The Company's shares are traded on the Tel-Aviv stock exchange (TASE), on the London Stock Exchange ("LSE") and, in the form of American Depository Receipts ("ADRs"), each represent one ordinary share, on the NASDAQ National Market ("Nasdaq - NM"). During 2001, the Company listed its shares in the TASE according to the dual listing regulations. On December 31, 2004, the closing price per ADR on the Nasdaq - NM was \$8.59; the Company's shares were quoted on that date on the LSE at GBP4.35 (\$8.39), and on the TASE at NIS 36.98 (\$8.58).

Under the provisions of the license granted to the Company (note 1a(2)), restrictions are placed on transfer of Company shares and placing liens thereon. The restrictions include the requirement that the advance written consent of the Minister of Communications be received prior to transfer of 10% or more of the Company's shares to a third party.

On December 26, 2001, the Company filed a shelf registration statement on Form F-3 with the United States Securities and Exchange Commission for future offerings of its securities. Under the shelf registration, the Company can raise up to \$400 million from the issue of ordinary shares and debt securities.

### b. Employee stock option plans:

a. On March 3, 1999, the Company's Board of Directors approved an employee stock option plan (hereafter - the "1998 Plan"), pursuant to which 5,833,333 ordinary shares were reserved for issuance upon the exercise of 5,833,333 options to be granted to key employees without consideration, of which 729,166 options were later cancelled. Through December 31, 2004 - 5,505,557 options have been granted pursuant to the 1998 Plan, of which 3,945,193 options have been exercised and 597,141 options have been forfeited (options forfeited were available for subsequent grants).

The options vest in five equal annual batches over a period of five years from the beginning of employment of each employee, unless otherwise provided in the grant instrument, provided the employee is still in the Company's employ. An option not exercised within 8 years from the date of its allotment shall expire. The exercise price per share of the options granted through December 31, 2000, which is denominated in dollars, is \$ 0.343. During 2002, the Company granted options under the 1998 Plan in accordance with the terms of the 2000 plan, including the exercise price, vesting schedule and expiration date (see b. below).

As of December 31, 2004 - 195,751 options of the 1998 Plan remain ungranted.

(An Israeli Corporation)
NOTES TO CONSOLIDATED FINANCIAL STATEMENTS (continued)

## NOTE 9 - SHAREHOLDERS' EQUITY (continued):

b. In October 2000, the Company's Board of Directors approved an employee stock option plan (hereafter - the "2000 Plan"), pursuant to which 4,472,222 ordinary shares were reserved for issuance upon the exercise of 4,472,222 options to be granted to employees without consideration. The options vest in four equal annual batches over a period of four years from the date of grant of the option, provided the employee is still in the Company's employ. The option holder may exercise all or part of his options at any time after the date of vesting but no later than the expiration of the exercise period, which will fixed by the Employee Stock Option Committee and will not exceed ten years from the date of option grant.

The NIS denominated exercise price per share of the options, is equal to the market price of the Company's shares on the date on which the options are granted.

During November 2003, 419,930 options of this plan were transferred to options under the 2003 amendment Plan (see c. below). Through December 31, 2004 - 5,317,555 options were granted pursuant to the 2000 Plan, of which 1,198,678 options have been exercised, 1,382,833 options were forfeited and 74,000 expired (options forfeited and expired were available for subsequent grants). As of December 31, 2004 - 191,570 options of the 2000 Plan remain ungranted.

c. On November 13, 2003, the Company's Board of Directors approved an amendment to the terms and provision of the 2000 Plan, in order to adjust the terms of the 2000 Plan to comply with new tax legislation that came into force in January 2003. On December 2003, the Company offered the employees, who received options under the 2000 plan, to exchange their unvested options, with the same amount of identical options, under the amended plan and to benefit from the capital gain's tax route pursuant to Section 102(b)(2) of the Israeli Income Tax Ordinance. Employees holding options to purchase 962,104 ordinary shares accepted this offer.

On December 30, 2003, the Company's Board of Directors approved the grant of 195,000 options, under the 2003 amended Plan with an exercise price of NIS 20.45 - which was less than the market price on the date of grant. As of December 31, 2004 - 224,930 options of the 2003 amended Plan remain ungranted.

d. In July 2004, the Company's Board of Directors approved a stock option plan (hereafter - the "2004 Plan"), pursuant to which 5,775,000 ordinary shares were reserved for issuance upon the exercise of 5,775,000 options to be granted without consideration. The options will be granted to employees under the provisions of the capital gain's tax route provided for in Section 102 of the Israeli Income Tax Ordinance. The options vest in four equal annual batches, provided the employee is still in the Company's employ. The option holder may exercise all or part of his options at any time after the date of vesting but no later than the expiration of the exercise period, which will fixed by the Employee Stock Option Committee and will not exceed ten years from the date of option grant.

(An Israeli Corporation)

NOTES TO CONSOLIDATED FINANCIAL STATEMENTS (continued)

## NOTE 9 - SHAREHOLDERS' EQUITY (continued):

Through December 31, 2004 - 5,095,500 options have been granted to Company's employees pursuant to the 2004 Plan, of which 5,000 options have been exercised.

As of December 31, 2004 - 679,500 options of the 2004 Plan remain ungranted.

The NIS denominated exercise price per share of the options, is equal to the average market price of the Company's shares for the 30 trading days preceding the day on which the options are granted, less 15%.

- **e.** The ordinary shares derived from the exercise of the options confer the same rights as the other ordinary shares of the Company.
- f. The plans are subject to the terms stipulated by Section 102 of the Israeli Income Tax Ordinance. Inter alia, these terms provide that the Company will be allowed to claim, as an expense for tax purposes, the amounts credited to the employees as a benefit in respect of shares or options granted under the plans, as follows:

Through December 31, 2003, the amount that the Company will be allowed to claim as an expense for tax purposes will be the amount of the benefit taxable in the hands of the employee.

From January 1, 2004, the amount that the Company will be allowed to claim as an expense for tax purposes, will be the amount of the benefit taxable as work income in the hands of the employee, while that part of the benefit that is taxable as capital gains in the hands of the employee shall not be allowable. All the above is subject to the restrictions specified in Section 102 of the Income Tax Ordinance.

The aforementioned expense for tax purposes will be recognized in the tax year that the employee is taxed, except as described below.

In December 2002, the Company signed an agreement with the tax authorities concerning the tax liabilities of its employees regarding the benefit arising from the options granted to them. According to the agreement, the individual tax rate on the taxable income received by the employees in connection with the benefit arising from the options will be reduced; in exchange, the Company will defer the deduction of such taxable income as an expense, for a period of 4 years from the date it commences paying income taxes.

The agreement applies only to employees who have joined the agreement, and relate to (1) options that were exercised by December 31, 2002; and/or (2) options that vest by December 31, 2003 and are exercised by March 31, 2004. In each case, the Section 102 trustee must have held the options for a period of 24 months from the date on which they were granted.

(An Israeli Corporation)

NOTES TO CONSOLIDATED FINANCIAL STATEMENTS (continued)

## NOTE 9 - SHAREHOLDERS' EQUITY (continued):

2) Following is a summary of the status of the plans as of December 31, 2002, 2003 and 2004 and the changes therein during the years ended on those dates:

	Year ended December 31					
	200	)2	200	2003		)4
	Number	Weighte d average exercise price*	Number	Weighte d average exercise price*	Number	Weighte d average exercise price*
		<u>NIS</u>		<u>NIS</u>		<u>NIS</u>
Balance outstanding at beginning of year	8,962,235	12.746	6,611,110	18.001	5,340,970	19.945
Changes during the year:						
Granted**	768,000	20.976	195,000	20.450	5,095,500	26.740
Exercised	(2,670,637	1.591	(1,100,352)	7.057	(1,341,647)	17.670
	)					
Forfeited	(448,488)	16.747	(304,538)	23.025	(169,768)	21.855
Expired			(60,250)	26.284	(13,750)	27.350
Balance outstanding at end of year	6,611,110	18.001	5,340,970	19.945	8,911,305	24.117
Options exercisable at end of year	2,728,806	17.740	3,504,914	19.351	3,424,675	21.285

<sup>\*</sup> Includes options under the 1998 Plan, the exercise price of which is weighted based on the applicable date's NIS - dollar exchange rate.

The following table summarizes information about options outstanding at December 31, 2004:

	Options outstanding				rcisable
Range of exercise prices	Number outstanding at December 31, 2004	Weighted average remaining contractual life	Weighted average exercise price	Number exercisable at December 31, 2004	Weighted average exercise price
<u>NIS</u>		<u>Years</u>	<u>NIS</u>		<u>NIS</u>
1.478 17.25-22.23 26.74 27.35 1.478 - 27.35	636,608 1,294,208 5,090,500 1,889,989 8,911,305	1.7 6.3 9.9 4.8 7.7	1.478 20.22 26.74 27.35	604,155 693,031 237,500 1,889,989 3,424,675	1.478 20.14 26.74 27.35 21.29

### c. Dividends

As to restrictions with respect to cash dividend distributions, see note 5f.

<sup>\*\* 2002 -</sup> at market value, 2003 and 2004 - below market value.

(An Israeli Corporation)

NOTES TO CONSOLIDATED FINANCIAL STATEMENTS (continued)

#### **NOTE 10 - TAXES ON INCOME:**

# a. Measurement of results for tax purposes under the Income Tax (Inflationary Adjustments) Law, 1985

Under this law, results for tax purposes are measured in real terms, having regard to the changes in the Israeli CPI. The Company and its subsidiary are taxed under this law.

## b. Tax rates applicable to income of the Company and its subsidiary

The income of the company and its subsidiary is taxed at the regular rate. Through to December 31, 2004, the corporate tax was 36%. In July 2004, an amendment to the Income Tax Ordinance was enacted. One of the provisions of this amendment is that the corporate tax rate is to be gradually reduced from 36% to 30%, in the following manner: the rate for 2004 will be 35%, in 2005 - 34%, in 2006 - 32%, and in 2007 and thereafter - 30%.

The effect of the Amendment is included in the financial statements for the year 2004, resulting in an increase in the Company's deferred income tax expenses, by NIS 34.5 million.

## c. Losses carried forward to future years

At December 31, 2004, the Group had carryforward losses of approximately NIS 712 million (approximately \$ 165 million). The carryforward tax losses are linked to the Israeli CPI and can be utilized indefinitely.

#### d. Deferred income taxes

The major components of the net deferred tax asset, current and non-current, in respect of the balances of temporary differences and the related valuation allowance as of December 31, 2003 and 2004, are as follows:

		December 31	
	2003	2004	2004
	NIS		Convenience translation into dollars
		In thousands	
In respect of carryforward tax			
losses (see c. above)	508,916	239,894	55,685
Subscriber acquisition costs	47,766	39,976	9,279
Allowance for doubtful accounts	27,826	28,595	6,638
Provisions for employee rights	14,011	15,297	3,551
Depreciable fixed assets	(45,048)	(31,053)	(7,208)
Amortized license	66,149	52,619	12,214
Options granted to employees	17,051	9,614	2,232
Other	5,636	697	162
Valuation allowance - in respect of carryforward tax losses and	642,307	355,639	82,553
deductions that may not be utilized	(8,555)	(5,694)	(1,322)
-	633,752	349,945	81,231

(An Israeli Corporation)

NOTES TO CONSOLIDATED FINANCIAL STATEMENTS (continued)

## **NOTE 10 – TAXES ON INCOME** (continued):

The changes in the valuation allowance for the years ended December 31, 2002, 2003, and 2004, are as follows:

2000, and 200+, are as ionow	<b>2002</b>	2003	2004	2004
		NIS		Convenience translation into dollars
		In thou	sands	
Balance at beginning of year	745,703	823,072	8,555	1,986
Utilization during the year Change during the year	(30,410) 107,779	(161,541) (652,976)	(2,107) (754)	(489) (175)
Balance at end of year	823,072	8,555	5,694	1,322

The Company analyzes its deferred tax asset with regard to potential realization. The Company's determination of the realizability of its net deferred tax asset involves considering all available evidence, both positive and negative, regarding the likelihood of sufficient future income. The methodology used involves estimates of future income, which assumes ongoing profitability of its business. These estimates of future income are projected through the life of the deferred tax asset using assumptions which management believes to be reasonable.

As of December 31, 2002, the Company had carryforward tax losses of approximately NIS 2,000 million and timing differences of approximately NIS 300 million. The Company did not have a substantial record of utilization of the carryforward tax losses (the Company had its first net income during 2002), and the Company had not been assessed for tax purposes since incorporation. Consequently, management's assessment was, that a full valuation allowance should be established.

Based on the methodology described above, the Company's updated estimates of its future earnings and profitability, assessments relating to the cellular market and trends, and the receipt of final tax assessments for the tax years through December 31, 2001, which validated the amount of the carryforward tax losses, the Company concluded that a valuation allowance is no longer necessary. Accordingly, a valuation allowance of approximately NIS 653 million was reversed during 2003.

The carryforward tax losses are linked to the Israeli CPI and can be utilized indefinitely.

During 2003 and 2004, the Company utilized NIS approximately 450 million and approximately NIS 700 million (\$ 162 million) of its carryforward tax losses, respectively.

As of December 31, 2004, the Company would require approximately NIS 705 million of future taxable income in order to fully realize the carryforward tax losses assets.

A full valuation allowance was provided in respect of the wholly-owned subsidiary, as it is more likely than not that its deferred tax assets will not be realized.

(An Israeli Corporation)

NOTES TO CONSOLIDATED FINANCIAL STATEMENTS (continued)

## **NOTE 10 - TAXES ON INCOME** (cont.):

**e.** Following is a reconciliation of the theoretical tax expense, assuming all income is taxed at the regular tax rates applicable to companies in Israel (see b. above), and the actual tax expense:

	Year ended December 31			
	2002	2003	2004	2004
		NIS		Convenience translation into dollars
		In tho	usands	
Income before taxes on income, as reported in the income statements	84,198	529,628	758,801	176,138
Theoretical tax expense	30,312	190,666	265,580	61,648
Increase in taxes resulting from adjustment to deferred tax balances due to changes in tax rates, see b above  Difference between the basis of measurement of income reported for tax purposes and	30,312	190,000	34,521	8,013
the basis of measurement of income for financial reporting purposes - net Decrease in taxes in respect of valuation			(10,124)	(2,350)
allowance reversal  Decrease in taxes resulting from utilization, in the reported year, of carryforward tax losses for which deferred taxes		(652,976)		
were not created in previous years	(30,410)	(161,541)	(2,107)	(489)
Other	98	(9,171)	(622)	(144)
Taxes on income for the reported year		(633,022)	287,248	66,678

#### f. Tax assessments:

- 1) The Company has received final assessment through the year ended December 31, 2001.
- 2) The subsidiary has not been assessed for tax purposes since incorporation.

# NOTE 11 - LIABILITIES SECURED BY PLEDGES AND RESTRICTIONS PLACED IN RESPECT OF LIABILITIES

At December 31, 2004, balances of liabilities of the Company in the amount of NIS 1,185 million (\$ 275 million), are secured by fixed charges on the fixed assets (including leasehold rights), share capital and insurance rights, and by floating charges on the assets. The Company has also undertaken under the facility agreement not to register any further charges on its assets, with certain exceptions (see note 5).

(An Israeli Corporation)

NOTES TO CONSOLIDATED FINANCIAL STATEMENTS (continued)

## **NOTE 12 - FINANCIAL INSTRUMENTS AND RISK MANAGEMENT:**

## a. Linkage of monetary balances:

1) As follows:

7,6 1011011011	<b>December 31, 2004</b>				
	In or linked to foreign currencies (mainly dollars)	Linked to the Israeli CPI	Unlinked		
	I	n thousands			
NIS:					
Assets	1,081	23,109	758,238		
Liabilities	912,044	359,865	1,493,793		
Convenience translation into dollars:					
Assets	251	5,364	176,007		
Liabilities	211,709	83,534	346,749		

2) Data regarding the dollar exchange rate and the Israeli CPI:

	Exchange rate of one dollar	Israeli CPI*
At December 31:		
2004	NIS 4.308	180.74 points
2003	NIS 4.379	178.58 points
2002	NIS 4.737	182.01 points
2001	NIS 4.416	170.91 points
Increase (decrease) during the year:		
2004	(1.6%)	1.2%
2003	(7.6%)	(1.9%)
2002	7.3%	6.5%

<sup>\*</sup> Based on the index for the month ending on each balance sheet date, on the basis of 1993 average = 100.

(An Israeli Corporation)

NOTES TO CONSOLIDATED FINANCIAL STATEMENTS (continued)

## NOTE 12 - FINANCIAL INSTRUMENTS AND RISK MANAGEMENT (continued):

# b. Derivative financial instrument - foreign exchange risk management

The Company enters into foreign currency forward transactions and purchases and writes foreign currency options in order to protect itself against the risk that the eventual dollar cash flows resulting from the existing assets and liabilities will be affected by changes in exchange rates. The writing of such options is part of a comprehensive hedging strategy and is designed to effectively swap the currencies relating to existing assets and liabilities. Each of the options written is combined with purchase of an option for the same period and the same notional amount. The Company does not hold or issue derivative financial instruments for trading purposes.

The transactions are designated to hedge the cash flows related to payments of dollar interest on notes payable as well as those related to anticipate payments in respect of purchases of handsets and capital expenditures in foreign currency. However, these contracts do not qualify for hedge accounting under FAS 133.

As the counterparties to the foreign currency options and forward transactions are Israeli banks, the Company considers the inherent credit risks remote.

The notional amounts of foreign currency derivatives as of December 31, 2003 and 2004 are as follows:

	December 31				
	2003	2004	2004		
	NI		Convenience translation into dollars		
		(In millions)			
Currency options purchased - for the exchange of dollars into NIS	88				
Currency options written - for the exchange of dollars into NIS	44				
Forward transactions for the exchange of dollars into NIS	568	*1,094	*254		
Embedded derivatives - dollars into NIS	209	132	31		

\* On August 2004, the Company entered into a forward transaction that hedges the Notes payable principal (\$ 175 million) until August 2005.

The derivatives financial instruments are for a period of up to one year. As of December 31, 2004, the remaining contractual lives are for periods up to one year.

(An Israeli Corporation)

NOTES TO CONSOLIDATED FINANCIAL STATEMENTS (continued)

## NOTE 12 - FINANCIAL INSTRUMENTS AND RISK MANAGEMENT (continued):

#### c. Fair value of financial instruments

The financial instruments of the Company as of December 31, 2004 consist mainly of non-derivative assets and liabilities (items included in working capital and long-term liabilities); the Company also has some derivatives, which are presented at their fair value.

In view of their nature, the fair value of the financial instruments included in working capital is usually identical or close to their carrying value. The fair value of long-term loans approximates the carrying value, since they bear interest at rates close to the prevailing market rates.

Regarding the fair value of Notes payable see note 6.

The fair value of derivatives as of December 31, 2004, is a liability of approximately NIS 55.3 million (approximately \$12.8 million) (December 31, 2003 - approximately NIS 11.5 million).

## **NOTE 13 - SUPPLEMENTARY FINANCIAL STATEMENT INFORMATION:**

a. Accounts receivable:

			December 31		
			2003	2004	2004
			NIS	<b>S</b>	Convenience translation into dollars
				In thousand	S
1) -		(current and long-term) e item is presented after the deduction			
•	(a)	Deferred interest income*	(3,183)	(16,968)	(3,939)
	(b)	Allowance for doubtful	(77,295)	(86,651)	(20,114)

\* Long-term trade receivables (including current maturities) as of December 31, 2003 and 2004 in the amount of NIS 26,275,000 and NIS 184,706,000 (\$ 42,875,000), respectively, bear no interest. These balances are in respect of handsets sold in installments (mostly 36 monthly payments). Income in respect of deferred interest is the difference between the original and the present value of the trade receivable. The current amount is computed on the basis of the interest rate relevant to the date of the transaction (5% - 5.9%) (2003 – 6.3% - 10%).

2) Other:

	December 31			
	2003	2003 2004		
	NI		Convenience translation into dollars	
		In thousand	ls	
Government institutions	19,396	24,183	5,614	
Prepaid expenses	17,603	14,248	3,307	
Sundry	19,544	31,727	7,365	
	56,543	70,158	16,286	

(An Israeli Corporation)

NOTES TO CONSOLIDATED FINANCIAL STATEMENTS (continued)

## NOTE 13 - SUPPLEMENTARY FINANCIAL STATEMENT INFORMATION (continued):

b. Accounts payable and accruals - other:

of

p,	December 31			
	2003	2004	2004	
	NIS	6	Convenience translation into dollars	
		In thousand	s	
Employees and employee institutions	86,130	87,537	20,320	
Provision for vacation and recreation pay	21,138	22,844	5,303	
Government institutions	38,235	45,830	10,638	
Income received in advance	44,601	53,019	12,307	
Accrued interest on long-term liabilities	45,156	39,553	9,181	
Derivative instruments	11,546	55,331	12,844	
Handsets warranty	2,053	1,734	402	
Sundry	3,726	1,516	352	
	252,585	307,364	71,347	

**c.** Provision for warranty - the changes in the provision for warranty for the years ended December 31, 2002, 2003, and 2004, are as follows:

	2002	2003	2004	2004 Convenience translation
		NIS		into dollars
_	-	In tho	usands	
Balance at beginning of year  Product warranties issued for new sales Changes in accrual in respect	2,589	2,589 4,215	2,053 2,943	477 683
pre-existing warranties Balance at end of year	2,589	<u>(4,751)</u> <u>2,053</u>	(3,262) 1,734	(757) 403

**d.** Asset retirement obligations - the changes in the asset retirement obligations for the years ended December 31, 2004 and 2003, are as follows:

	2003	2004	2004
	NIS	6	Convenience translation into dollars
		In thousands	3
Balance at January 1, Liability incurred during the year Liability settled during the year Accretion expenses Revision in the estimates during the year	4,665 626 (341) 296 1,121	6,367 833 (271) 638	1,478 194 (63) 148
Balance at December 31,	6,367	7,567	1,757

(An Israeli Corporation)
NOTES TO CONSOLIDATED FINANCIAL STATEMENTS (continued)

## NOTE 13 - SUPPLEMENTARY FINANCIAL STATEMENT INFORMATION (continued):

## e. Financial expenses, net:

	Year ended December 31				
	2002	2003	2004	2004	
		NIS		Convenien ce translation into dollars	
		In thous	ands		
Financial income	(5,052)	(1,952)	(3,521)	(817)	
Financial expenses	350,377	320,771	203,115	47,14 <b>8</b>	
Derivative instruments	(8,302)	59,580	63,356	14,707	
Exchange rate differences	69,797	(59,168)	(8,978)	(2,084)	
CPI Linkage differences	35,723	(4,554)	2,285	530	
Factoring costs	9,614	17,111	17,459	4,052	
Less - capitalized interest	(6,977)	(10,078)	(13,171)	(3,057)	
	445,180	321,710	260,545	60,479	

## f. Diluted EPS

Following are data relating to the net income and the weighted average number of shares that were taken into account in computing the basic and diluted EPS:

	Year ended December 31			
	2002	2003	2004	2004
		NIS		Convenienc e translation into dollars
	In thousands			
Net income used for the computation of basic and diluted EPS (in thousands)	84,198	1,162,650	471,553	109,460
Weighted average number of shares used in computation of basic EPS  A d d - net additional shares from assumed	179,984,090	181,930,803	183,389,383	183,389,383
exercise of employee stock options	3,085,304	1,312,354	725,534	725,534
Weighted average number of shares used in computation of diluted EPS	183,069,394	183,243,157	184,108,917	184,108,917

(An Israeli Corporation)

NOTES TO CONSOLIDATED FINANCIAL STATEMENTS (continued)

#### NOTE 14 - TRANSACTIONS AND BALANCES WITH RELATED PARTIES:

### a. Transactions with related parties:

	2002	2003	2004	2004
		NIS		Convenience translation into dollars
		Intho	usands	
Purchase of fixed assets from related party			4,678	1,086
Acquisition of handsets from related parties	185,237	203,675	380,721	88,375
Financial expenses, mainly in respect of the Facility agreement, net	81,212	67,906	55,048	12,778
Selling commissions and maintenance expenses	20,624	7,458	4,116	955

Year ended December 31

## b. Balances with related parties:

	December 31			
	2003	2004	2004	
	NIS		Convenience translation into dollars	
		In thous	sands	
Cash and cash equivalents	1,855	4,136	960	
Current liabilities	19,066	15,314	3,555	
Long-term liabilities	491,987	316,166	73,390	

## c. Cost sharing agreement

The Company entered, on August 15, 2002, into a Cost Sharing Agreement (the "Agreement") with Hutchison Telecommunications Limited, or HTL, and certain of its subsidiaries (hereafter -"the Hutchison group"). The principal purpose of the Agreement is to regulate the sharing of costs associated with various joint procurement and development activities relating to the roll out and operation of a 3G Business.

The Agreement sets out the basis upon which expenses and liabilities are paid or discharged by the Hutchison group companies in connection with the joint procurement or development activities.

Under the Agreement, the Company has the right to decide, and give notice of, which of the joint projects it wishes to participate in.

As of December 31, 2004, the Company had given notice of its participation in 6 projects. The Company's expected share in these projects in financial terms (including its share of joint expenses and liabilities) is not material.

## (An Israeli Corporation)

## **Summary Operating Data**

	DECEMBER 31, 2004	DECEMBER 31, 2003
Subscribers (in thousands)	2,340	2,103
Estimated share of total Israeli mobile telephone subscribers	32%	31%
Churn rate in year	12.0%	13.6%
Average monthly usage in Year per subscriber (minutes)	286	277
Average monthly revenue in year per subscriber, including in-roaming revenue (NIS)	170	171
Number of operational base stations (in parenthesis number of micro sites out of total number of base stations)	2,243 (723)	2,138 (729)
Subscriber acquisition costs in year per subscriber (NIS)	295	362
Number of employees (full-time equivalent)	3,164	2,769

	Q4 2004	Q4 2003
Subscribers (in thousands)	2,340	2,103
Estimated share of total Israeli mobile telephone subscribers	32%	31%
Churn rate in quarter	2.9%	3.2%
Average monthly usage in quarter per subscriber (minutes)	288	276
Average monthly revenue in quarter per subscriber, including in-roaming revenue (NIS)	167	170
Number of operational base stations (in parenthesis number of micro sites out of total number of base stations)	2,243 (723)	2,138 (729)
Subscriber acquisition costs in quarter per subscriber (NIS)	339	298
Number of employees (full-time equivalent)	3,164	2,769