



Telefónica

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1986 Annual Report

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Established in 1924, today **Telefónica** is Spain's leading corporation in terms of total assets, market capitalisation and net income. Our core business is to supply a wide variety of telecommunications services, ranging from domestic and international telephone services to integrated business communications; from mobile land and maritime services to high-speed data transmission.

The Spanish telephone network is the ninth largest in the world with 14.8 million telephones linked through almost 10 million lines in service. In addition, Iberpac —our public packet switching data network— is one of the most advanced in Europe. We are also involved, through a number of subsidiaries and joint ventures, in designing, manufacturing and marketing a wide array of Information Age services and products.

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* Submitted to the General Meeting of Shareholders for approval.

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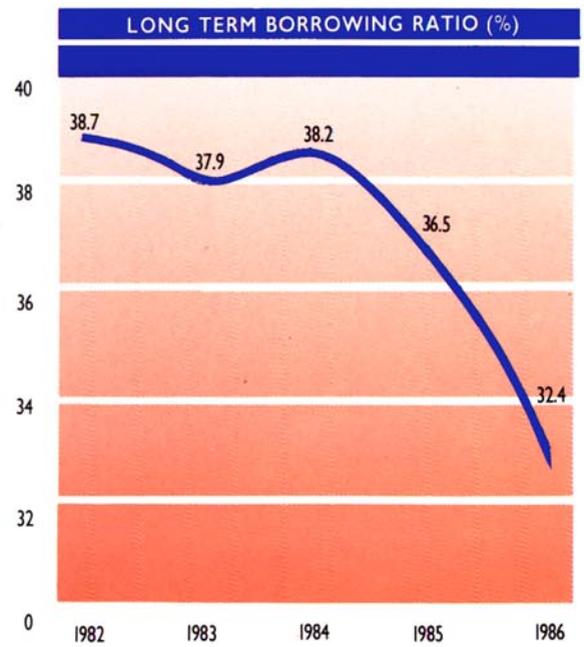
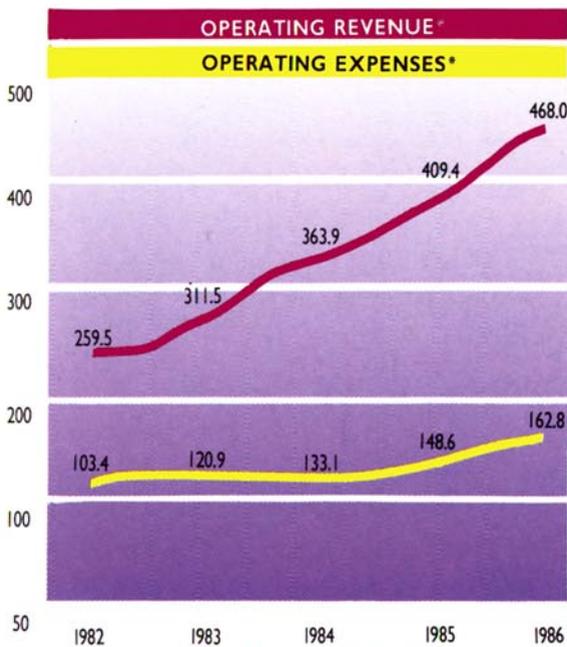
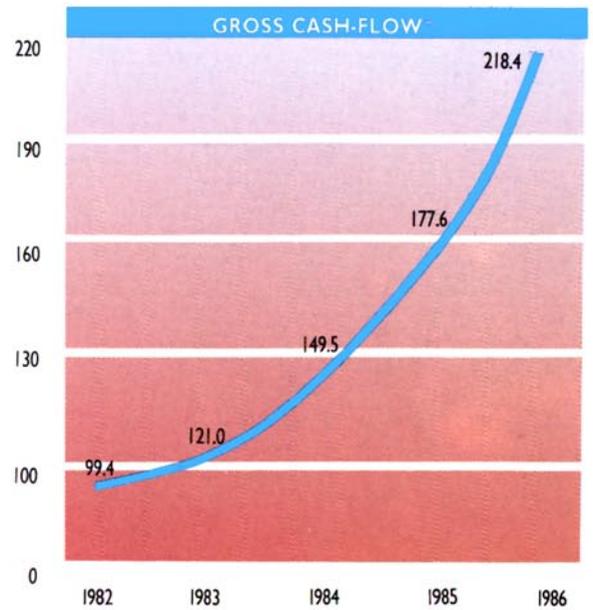
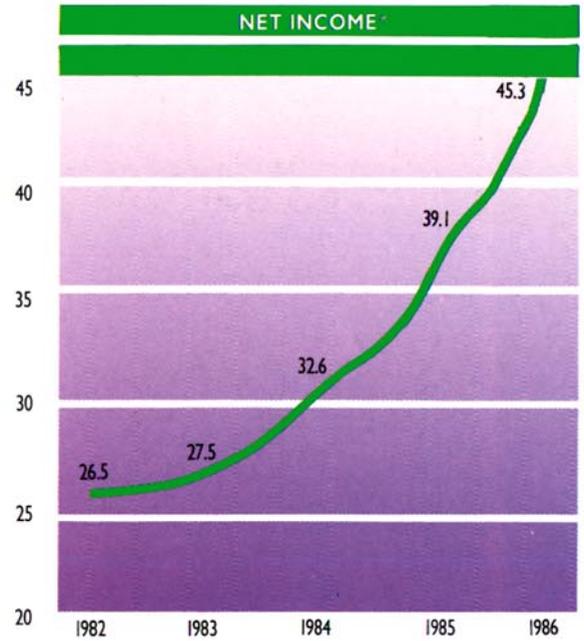
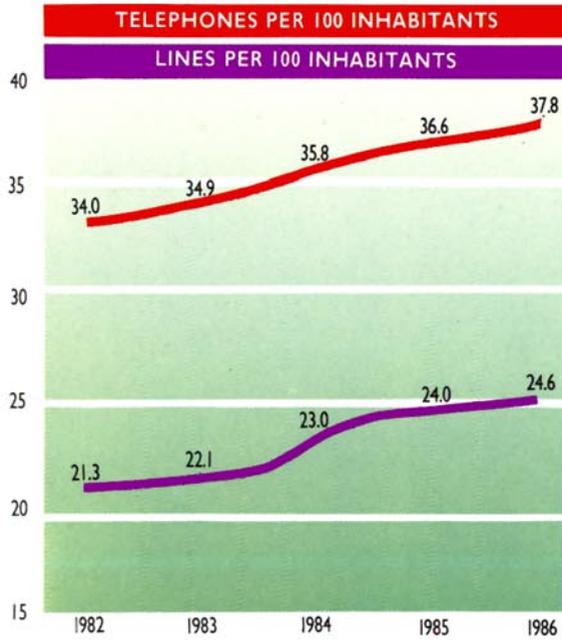
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Highlights



* Amounts expressed in thousands of millions of pesetas.

Letter from the Chairman

Dear Shareholder:

The opening lines of the Annual Report should endeavour to briefly bring to life what those cold facts and figures illustrate in detail in the essential pages of the Company's records - the balance sheet and results. Furthermore, at **Telefónica** we are steadily reshaping our business strategies and corporate organisation to meet the challenges of a fast-moving marketplace. Hence, I shall devote these lines to sharing with you what I think we have already achieved and, above all, what we aim to achieve.

Since 1986 the external framework, within which **Telefónica** operates, has changed course more radically than ever before in our Company's lifetime.

The Telecommunications Bill (LOT) will bring sweeping changes in the regulations which govern the industry. In addition, a new tax law is soon to be applied to our Company, and a Private Television Act will be passed in the near future. All this implies that, from now on, nothing will ever be quite the same again.

What do these new circumstances mean? There will be more opportunities for greater profits and of course more risks may arise. We will have more freedom to succeed and less protection against mistakes. In other words, more responsibility for our own performance.

Are we ready for this new era? I have the fullest confidence that at **Telefónica** we are not only set to face these foreseeable changes but also, more importantly, to seize the opportunities which they provide.

I have two facts to back up this claim: the 1986 Financial Statements and our extensive decentralisation program.



1924



Our strong 1986 results are good news; I would even say that they are better than expected. This also reflects the steady upward trend of the Spanish economy. Having said this, I must add that this successful performance would have been impossible without the vigorous commitment to increasing efficiency of our workers and managerial staff. We are fully aware that **Telefónica's** accomplishments are the fruits of the joint efforts of 65,000 workers and over 700,000 shareholders.

Management and workers have set in motion an extensive market-driven reorganisation and decentralisation program. Provincial Managers will fulfill the essential role of running day-to-day operations and services, thus enhancing **Telefónica's** ability to identify and serve customers' needs efficiently.

Although we have not quite reached the point when **Telefónica** is seen to be a free competitor in the open market, the time will soon come.

I would add that, together with the pursuit of greater profitability, **Telefónica** should also undertake an overall transformation in its corporate culture. Shareholders may rest assured that we will meet this challenge.

On another note, I would like to take this opportunity to send my greetings to the many thousands of shareholders throughout Europe, America and Japan who participate in **Telefónica** and are an integral part of our success. For a company requiring huge financial resources in order to achieve its corporate goals, your support is of vital importance.

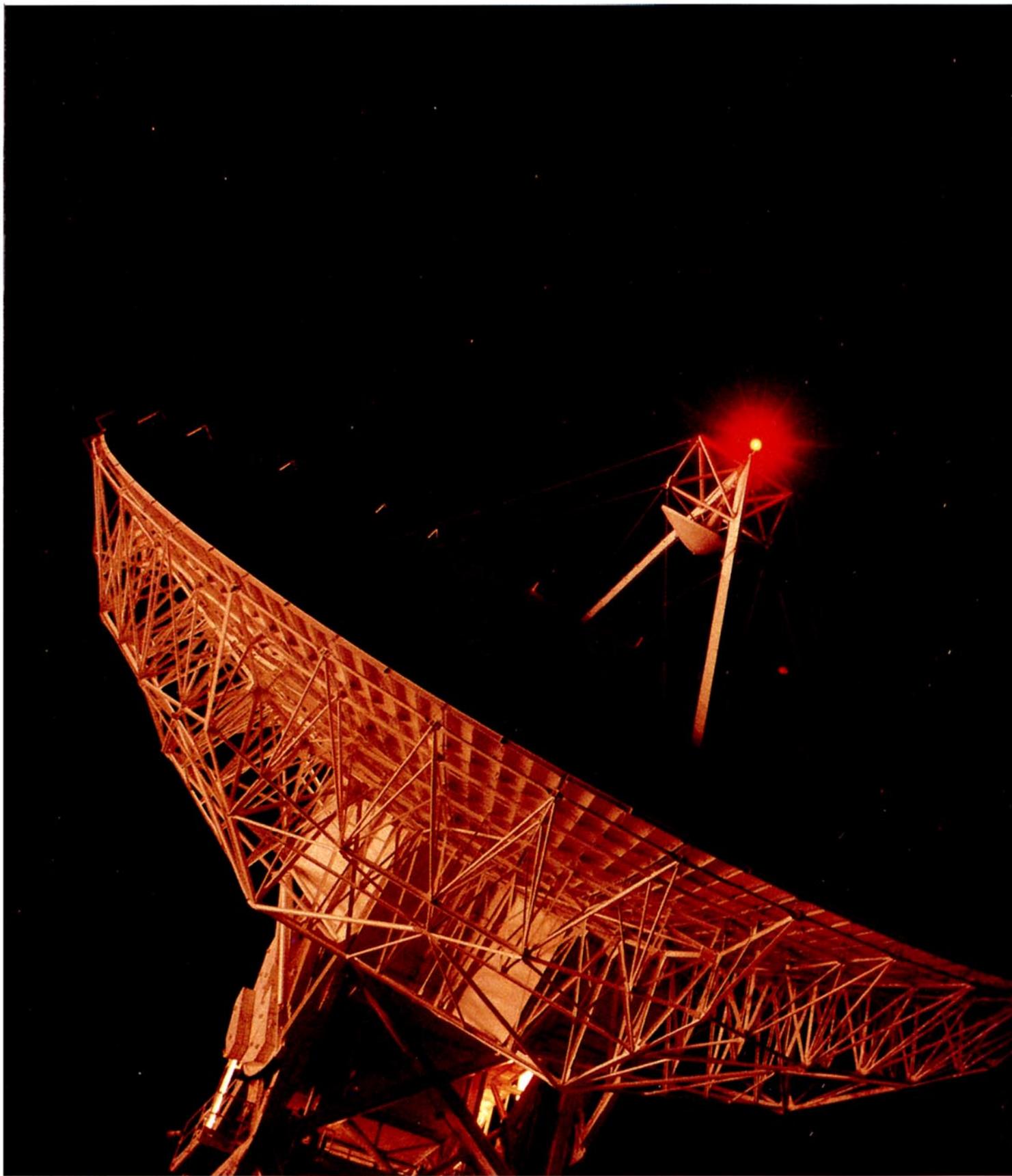
Today **Telefónica** is and intends to remain a worldwide corporation as far as shareholders and activities are concerned. To guarantee this, we are keeping to our «revolving holding company» policy, selling our stake in some industrial concerns while setting up promising new ventures in Spain and abroad. I am fully confident that this strategy will enhance the value of your investment in **Telefónica**.

You may rest assured that you are participants in a stronger and more efficient company, with greater prospects and a firm will to strive for ever better results.

It is not often that I can give you such firm assurance that the future has still greater rewards and corporate achievements in store, serving the public needs for the benefit of the customers, workers and shareholders of **Telefónica**.

Luis Solana
Chairman of the Board







Keeping up with the future

Telefónica is constantly striving to provide top quality telecommunications services to meet the fast-growing demands of modern day Spain, set to step into the Information Age. We are firmly convinced that economic and social developments are becoming increasingly reliant on the quick and efficient transmission of information.

We are currently second in Europe in terms of public packet switching data network connections and have the fifth highest number of telephones in service. However, there is still room for growth. We aim to offer our customers universal telecommunications services, founded on a highly sophisticated digital network which will provide the essential framework for the new Information Age.

At **Telefónica** we have a forward-looking, market-driven approach to growth.

We are determined to keep one step ahead of public demand. This means both expanding the basic telephone service and at the same time offering brand-new Information Age services to satisfy the needs of our residential, business and large corporation customers.

1986: Quantity and quality upgrading

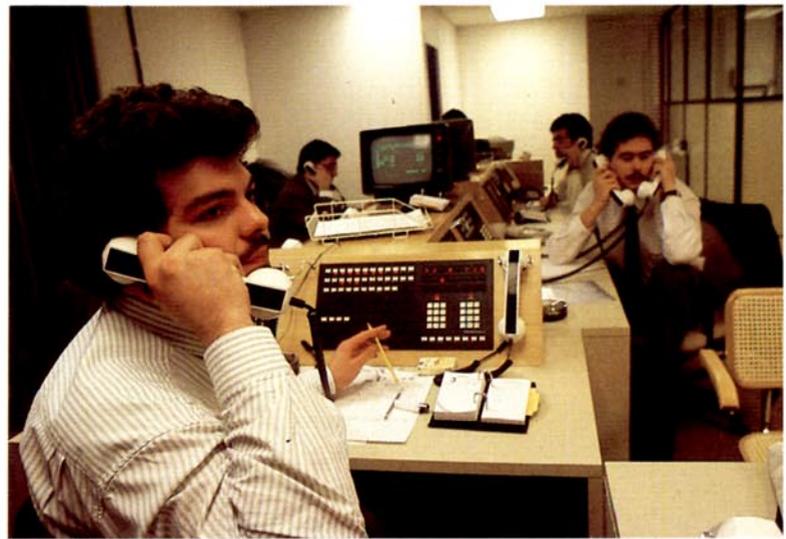
The telephone service is a top priority in Spain, not only because of its economic role but equally due to the social benefits it brings. In 1986, with almost 10 million access lines in service, we are nearing a ratio of 25 lines per 100 inhabitants and providing service to 54% of all homes. Our target for 1990 is 30 lines per 100 inhabitants with 65% of households connected.

1986 was an outstanding year, which witnessed record increases in the Company's performance. Telephone service strategy was modelled on the three criteria of **expansion, quality upgrading and new services provision**. This was matched by a terrific surge in demand, reflecting the progressive transformation of Spain into an **Information Society**. There were 963,037 telephone line applications, a record in the history of **Telefónica** and an increase of 27% over the previous year. The net increase in demand was 506,743 lines, 45.5% up on 1985.

By the end of the year, Spain had a total of 9,785,254 lines installed and 14,784,231 telephones in operation, i.e. 37.81 telephones for every 100 inhabitants. Telephone service enhancement was also reflected in trunk and international traffic, which grew by 7.6% and 14.6% respectively.



Spain is stepping ahead to the Information Age. Bolstering the huge surge in demand for telecommunications there is a new entrepreneurial fabric of information-based firms such as the brokerage house Eurocapital (centre). To meet the new challenges, Telefónica has set out to capture the market with our «Teletiendas» (Teleshops: top, right) and our fleet of Subscriber Service buses (above). At our Information Systems department, Luis Alvarez, Antonio Aceña y Pedro Gamero (bottom, left to right) have developed MIGA, a fully computerised Subscriber Service management system now in operation.



In the rural community

Telefónica is endeavouring to expand telephone services throughout the rural community.

The telephone has a vital role to play in the daily lives of those folk living in sparsely populated areas. **Telefónica** hopes to gain the firm backing of the local and regional authorities, together with that of the European Community via the STAR program.

Last year we formed 168 new Local Zones and installed 604 Public Service Telephones in rural areas. We also signed cooperation agreements with seven of the Regional Autonomies and two of the Provincial Authorities under the Royal Decree 2248/84 governing the expansion of telephone services throughout the rural community. Under these agreements,

Telefónica will form 109 new Local Zones and install 404 more Public Service Telephones.

The expansion of the telephone service has met with a warm welcome and **Telefónica** intends to negotiate further agreements with the different local and regional bodies in order to ensure a healthy growth in this field. What is more, one of our top technological priorities is to develop advanced systems of rural communication and thereby provide an extensive, reliable, cost-efficient service.

Our goal is to build up a network of analog and digital multi-access systems to serve those sparsely populated areas and so ensure that the demand for basic communication services is readily met.





We are committed to expanding the telephone service throughout the rural communities. The village of Urrizola and the farms in the Ulzama valley, on the slopes of the Navarre Pyrenees, is the working area covered by Outside Plant Technicians Manuel García (at the wheel, above), Juan Sarasate and Marino Gorriá (bottom). The installation of modern digital multiaccess radio systems will significantly upgrade the quality and efficiency of communications in rural areas.



Supplementary services breakthrough

Along with basic telephone services, we are aiming to market a whole package of brand-new Supplementary Telephone Services (STS). The steady introduction of digital switching exchanges will enable us to offer our customers a range of highly practical new services along with the more traditional ones. Any user whose telephone is connected to a digital exchange will be able to take full advantage of these. New features will include call waiting, conference calls, rerouting of calls and pre-programmed dialling. By 1990, following the major modernisation and digitization programs currently under way, we plan to be offering these new features to over 500,000 subscribers.

During 1986 we developed several advanced telephone facilities, which are now being piloted from the Madrid-Atocha digital exchange, in preparation for marketing.





The Madrid-Atocha digital switching centre now enables us to offer customers a wide range of Supplementary Telephone Services. Technician Juan Romera checks an LIC subscriber's card. Companies such as the Catalan firm, Takio, S. A., design equipment which uses our network to supply new services such as a medical check-up by phone.

New communication solutions

Telefónica's star product in Data Communications is the Iberpac Network. This has been steadily upgraded since 1971 and was the driving force behind one of our major technological achievements: the Tesys system. It stands at the technological forefront in network management and packet switching and its outstanding quality is reflected in the export rate, in keen competition with other major world suppliers.

There are currently over 32,000 Iberpac connections, making Telefónica's packet switching network one of the largest in Europe. By 1990 there will be 66,000 Iberpac connections, offering a range of telecommunications services, such as the dataphone, teletext and videotex. In addition, we offer Facsimile and Data Communication Services over the telephone network, such as the Dafo, Telefax and Coded Alarm Services.

Particularly important were the steps taken to introduce the X25 protocol into the Iberpac Network, which has led to an eightfold increase in Node Switching capacity. Equally significant was the piloting of the X28 protocol. This service will be in action by early 1987 and will provide simple, low-cost communication between personal and mainframe computers.



Computers need to communicate with each other. When José Luis Ozcoidi (right), from Caja de Ahorros Municipal de Pamplona (Pamplona Savings Bank) decided to modernize their data processing system, our Marketing Area Manager Jesús-Mari Abarzuza (left) came up with the high-tech solution: Iberpac X25. Every day millions of Spaniards use their credit cards. Manuel de Andrés (top right), manager of the 4B Credit Card Authorization Centre, also uses the Iberpac network to connect their terminals. Research workers (bottom right) Juan Pedro Cerezo (seated), Communications Manager of the UAM High Energy Centre and Santiago Ayllón, Systems Programmer, communicate with remote data bases via Iberpac.



New communication solutions

Our **Electronic Funds Transfer at the Point of Sale (EFTPOS or Dataphone) Service**, transmitted over the Iberpac and telephone networks, finally took off at the end of 1986 with the connection of 7,857 terminals, providing excellent growth prospects.

In 1986 **Telefónica** also launched a videotex service called **Ibertex**. Through **Ibertex**, via the telephone and Iberpac networks, any user with a suitable terminal has access to the information and applications of private Data Bases and Information Service Centers.

Ibertex has a wide array of possible applications. These include telebanking, teleshopping, telereservations, educational purposes, weather forecasts, statistics, stock exchange information and entertainment. **Ibertex** provides the market with a new information source and unifies access paths, which all ensures that the customer is the first to benefit. **Ibertex** is currently in operation in Madrid and Barcelona.





For many years Toni Martin's Record Shop has been an essential meeting place for country music, pop, and jazz lovers. Juan Manuel Martínez and Luis María Puente (above) rely on the Electronic Funds Transfer at Point of Sale Service (Datáfono) to help cope with the numerous customer purchases. With more than 10,000 terminals installed throughout the whole country, Spain's EFTPOS network is one of the largest in Europe. Spain's videotex, which is known by the trade-mark Ibertex (bottom left), has begun to make an impact. Several major public service institutions, such as the railways, are about to introduce it in order to offer improved service to the public.

Communications on the move

For anyone on the go, mobile services are becoming a must. To keep up with demand we plan to build a network structure over the next two years to cover 25% of the country and 70% of all vehicles. This 450 MHz. cellular radio network will be enhanced by a digital network on 900 MHz. by 1992. We expect that the new network will be incorporated into the whole European system which is being jointly developed. This would enable a vehicle to travel throughout the continent maintaining telephone contact and full automatic tracking facilities.

Our aim is to expand the **Automatic Mobile Telephone** service from 1,800 subscribers at the end of 1986 to some 30,000 by 1990. We also have a further commitment to **Closed Group Radio Telephony**, and to one-way **Radiopaging**.

Our traditional **Paging** service, which transmitted verbal messages via the operator, will become a fully automatic service. From 1987 onwards it will include a non-verbal Simple Message service (audible and/or visual signal) together with Numeric and Alphanumeric Messages. By 1990, the national radiopaging service will have a 300,000 user capacity and cover 35% of the country and 60% of the population.



*From the port of Santander, José Pérez Barandica fishes the anchovy season in May, the tuna season in July... Channel 16 of his 156.8 MHz UHF radio equipment, supplied by **Telefónica**, keeps him in touch with our Praves Coastal Station. This guarantees his safety on the rough Cantabrian waters and at the same time, via a different channel, allows him to stay in permanent contact with his family or any corner of the world.*

A growing number of cars and leisure craft are taking advantage of our lighter and more compact mobile telephone equipment.



A seafaring country requires reliable, quality **Maritime Services**. **Telefónica's Inmarsat Services** will soon be operating from a coastal station in Spain. We are also working on other new back-up services to guarantee greater **Safety at Sea** and **Aeronautical Communications with Public Network**. In 1986 our, **Maritime Service Coastal Stations** answered 73,892 navigation aid calls, 3,628 radio-medical calls and 148 SOS calls.



Integrated communications

Along with other countries, we are facing major challenges in the field of **Business Communications. Telefónica** is already responding with specialized solutions and the first ISDN (Integrated Services Digital Network) lines should be on the road in 1988. The drawback of traditional business communications is the lack of integration between equipment, networks and information. ISDN provides an integrated solution from a host of new services across **just one network and one line transmitting all communications types:** voice, data, video and facsimile. ISDN means an end to problems of special non-compatible networks, different protocols, and nonstandard terminal junction boxes. By 1992 we expect to have fulfilled most of the EEC 1993 objectives, in terms of the number of ISDN lines: 5% of all telephone lines in service in 1983.

1992 is a year of key significance for **Telefónica** and if we are to meet specialized services demands we do not have a minute to lose. In 1992 Spain will be celebrating the Fifth Centenary of the Discovery of America and hosting the World EXPO in Seville and the XXV Olympic Games in Barcelona. In 1986 we began providing similar services to those which ISDN will be offering over the **Ibercom** and **Ibermic** Networks.

Ibercom aims to offer major corporations and firms «Virtual Private Networks», **custom-built** but sharing resources to cut costs. **Ibercom** is a fully digital switching and transmission system offering a broad spectrum of voice and data communication services. In addition, the system provides 64 Kbit/s end-to-end digital switching continuity for the first time in Spain.

Telefónica began marketing **Ibercom** lines in 1986 with outstanding results, contracting some 15,000 lines. In addition, the Madrid Front-end Centre was launched as an access point to the **Ibercom** transit infrastructure; Front-end Centres are scheduled for 1987 in Barcelona, Oviedo, Valencia and Bilbao with others following on shortly. **Ibercom** has excellent prospects as an Integrated Business Communications Service and we will be offering this service to 365,000 customers by 1990. The **Ibercom Service** is a clear indication of our ongoing commitment to offer high-tech solutions to the growing needs of the business community, be they specific to one customer or multiuser **Centrex** facilities.



Even such historical institutions as the Pamplona City Council will soon be welcoming the most advanced telecommunications technologies. **Telefónica** has signed an agreement with the Council to install Ibercom, the integrated communications network, so that Information Age technology will soon be incorporated into local authority services. State-of-the-art fibre optics will be installed to connect the separate municipal buildings. Ibercom provides connections as if all the terminals were in one building, which ensures minimum interference and maximum transmission capacity. As a result, local people will receive better quality, lower cost service.

Integrated communications

Our venture in the field of high speed data transmission, has been the launching of **Ibermic** to provide 64 Kbit/s and 2 Mbit/s point-to-point digital transmission services. Our basic aim here is to meet the growing demand for medium and high speed data circuits with **state-of-the-art technology**. This should minimize the cost of medium speed point-to-point services, in addition to introducing new services at speeds greater than 2 Mbit/s. Nationwide, the **Ibermic** service comprises seven nodes, called Secondary Ibermic Exchanges, in Barcelona, Bilbao, Leon, Madrid, Seville, Valencia and Zaragoza.

Ibermic also gives access to international, high speed digital signal transmission, care of the **Teleport**. The Teleport is a satellite telecommunications complex comprising several stations. Its services include business connections with Europe via EUTELSAT, using the SMS service, and with the rest of the world via INTELSAT, by its IBS service. By 1989 two Teleports are scheduled for Madrid and Barcelona. These will allow simultaneous transmission of over ten circuits at a rate of 2 Mbit/s for videoconferencing and high speed data and over 50 circuits at 64 Kbit/s. By 1990 **Ibermic** will be handling some 340 high speed point-to-point circuits. We will be well on the way to achieving our goal of meeting the complex communication requirements of our major customers.





José Luis Guezuraga and the other members of **Telefónica's** Corporate Customers' Sales and Marketing team, frequently use our videoconferencing services. On this occasion, they are speaking to the Barcelona commercial department, housed in the Estel building. The videoconferencing service is transmitted through the new Ibermic network via cables and earth stations. Our Buitrago (Madrid) and Armuña de Tajuña (Guadalajara) satellite tracking stations are connected to the Intelsat and Eutelsat services.



A telecommunications strategy for the year 2000

Telefónica intends to meet both the growing demand for the latest telecommunication resources and radically enhance our transmission capacity. We are building up an efficient digital network, using existing coaxial cables, digital radiolinks and particularly optical fibre cables. Some 11,000 km. will be installed over the next four years. At the same time, we plan to install digital loops in the main metropolitan areas to guarantee sufficient digital connections. We are also going to triple the number of earth stations in order to increase satellite transmission capacity and manage with maximum efficiency the increase in traffic brought about by the 1992 events. By 1990 all Spanish provincial capitals will have digital access and at least two digital transmission channels. By the year 2000, we aim to provide each capital with a minimum of two optical fibre routes.

In 1986 we looked at those commercial areas with the greatest potential demand for services requiring transmission capacities of 2 Mbit/s or more. In order to plan optical fibre access loops, we pinpointed buildings likely to require optical fibre cables.

Our network modernisation program is based on a speedy introduction of digital channels by superimposing. This will allow rapid deployment of a digital access and interconnection infrastructure which will be able to carry the necessary services to the points where demand is likely to arise. So a digital network with common channel signalling will be built and superimposed over the original analog network whose capabilities will thus be outdated. In this way **Telefónica** will meet the EEC objective of supplying ISDN services by the early nineties.

In line with **Telefónica's** installation plans, network digitization will rise from 3.2% of subscriber lines and 10.6% of trunks in 1986, to 22% and 45% by 1990, respectively. Before 1991 we will have installed 2.5 million new digital lines, ensuring implementation of new telecommunications services. By 1992 the **Ibermic** and **Iberpac** systems will be fully integrated into the ISDN, providing customer access to the specific services of these networks.

ISDN means **Telefónica** will be providing better quality service at lower cost. Our switching exchanges will operate at higher speeds and switching equipment will be less sensitive to noise and distortion. Most important of all, ISDN will allow the efficient integration of communication services —voice, data, facsimile and video— and provide our customers with single line access to these services. By the early nineties Spain will have a telecommunications framework providing the building blocks for the communications services of the 21st century.





Telefónica is building up a highly sophisticated digital network, capable of sending information to any corner, at space-age speed with maximum reliability. In cities such as Barcelona (left) the first digital loops are being laid with fibre-optics cables. The cable vessel Atlantida (bottom right) will shortly be in service, playing a vital role in the optical cabling of the Mediterranean and North Atlantic seas. At the Buitrago earth station, satellite communications technicians like Antonio Gómez (bottom left) keep watch 24 hours a day to safeguard the quality of services.



On the verge of the Intelligent Network

Enhancement of our switching exchange capacity will soon enable us to offer customers a new range of **Intelligent Network Services**.

Among these is the **Centrex Service** which will provide PABX functions marketed as subscriber services integrated into public exchanges, extending its scope to a whole metropolitan area.

We also plan a new service which we expect to be in popular demand: the **Automatic Reverse Charge 900 Service**. Similar to the British «Freephone», the **900 Service** is specially tailored for companies, to facilitate calls from potential clients. The service provides a specific tollfree number to each company who will then accept charges for all incoming calls from potential customers. **900 Service** offers companies an effective marketing tool for communication with their clients and consumers.

Other Intelligent Network services are in the pipeline. These include **personal telephony**, **multi-link calls** and **credit calls**. These services were defined in 1986 and are scheduled to enter into operation in 1989, in order to be ready and waiting for the 1992 events.



A flexible, market-focused organisation

At **Telefónica** we are fully aware that a flexible, efficient organisational structure is essential in order to meet the telecommunications needs of Spanish society. In 1986 we began a far-reaching business restructuring program, setting up Provincial Units as basic management bodies. This implies, not only

functional decentralisation with work transferred to the Units, but also a significant increase in Provincial Unit decision-making capacity with their management taking on the corresponding business risks.

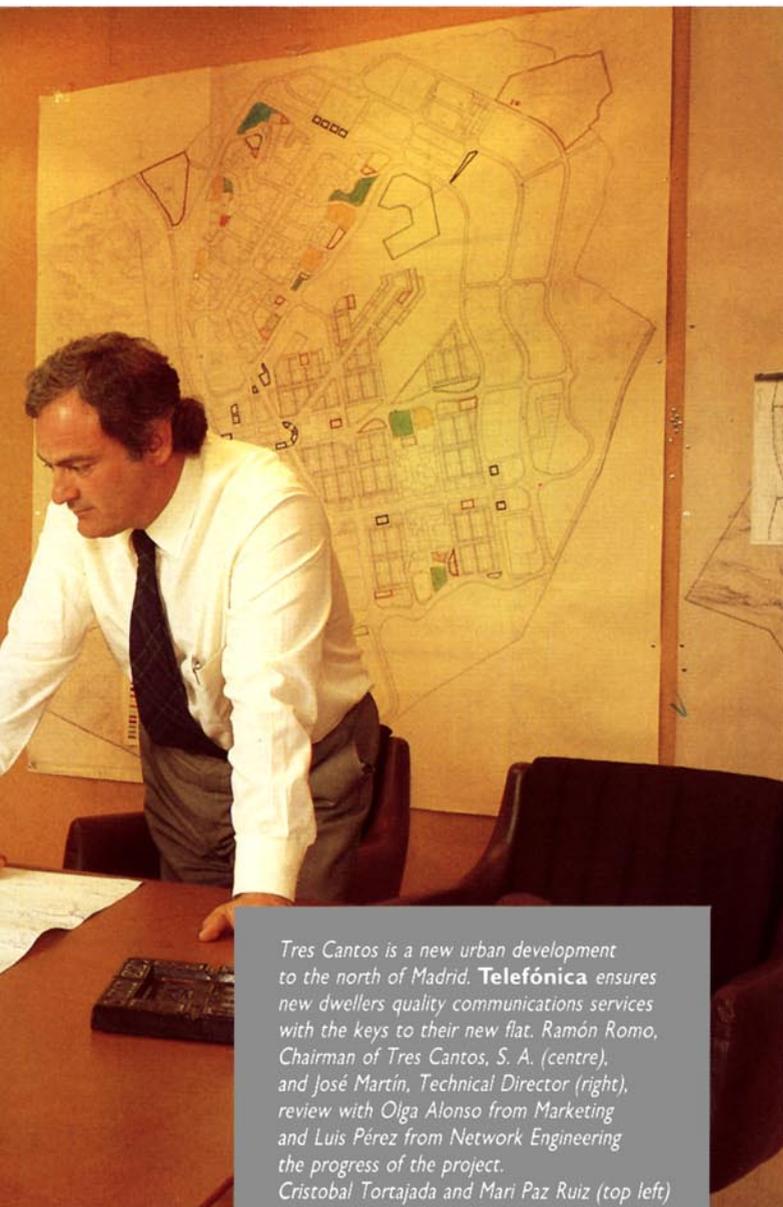
The Provincial Units' corporate structure has consequently been strengthened with a highly qualified executive staff and a small back-up team who see to liaising with Headquarters.

The new organisation chart of the Operations Division has a General Manager, who is on the Management Committee. This ensures that top level decisions take the situation and needs of territorial management units into account.

Each Provincial Unit will operate as a true «**Profit Centre**», planning its own goals and drawing up and carrying out its own revenue and expenditure budget. It will also be responsible for sales and marketing and offering customers a quality-enhanced local service.

The birth of the new corporate structure has maximised use of **Telefónica's** human and physical resources.

Without doubt, a more flexible internal structure means better service for customers and better performance in the marketplace. A new entrepreneurial approach prepares us for future legal regulations and for the fast-growing rate of technological change in Spanish telecommunications.



*Tres Cantos is a new urban development to the north of Madrid. **Telefónica** ensures new dwellers quality communications services with the keys to their new flat. Ramón Romo, Chairman of Tres Cantos, S. A. (centre), and José Martín, Technical Director (right), review with Olga Alonso from Marketing and Luis Pérez from Network Engineering the progress of the project. Cristobal Tortajada and Mari Paz Ruiz (top left) use interactive digital mapping to design new networks at our Ríos Rosas Centre.*

Productivity and human resources

The continuing development of Spanish telecommunications depends on the mobilisation of huge amounts of human and technical resources.

Telefónica's chief asset is its extensive human resource base, whose dedicated efforts are essential to the successful accomplishment of our corporate goals. At the end of 1986 **Telefónica** had 63,021 current employees, with an average service of 17.5 years in the Company.

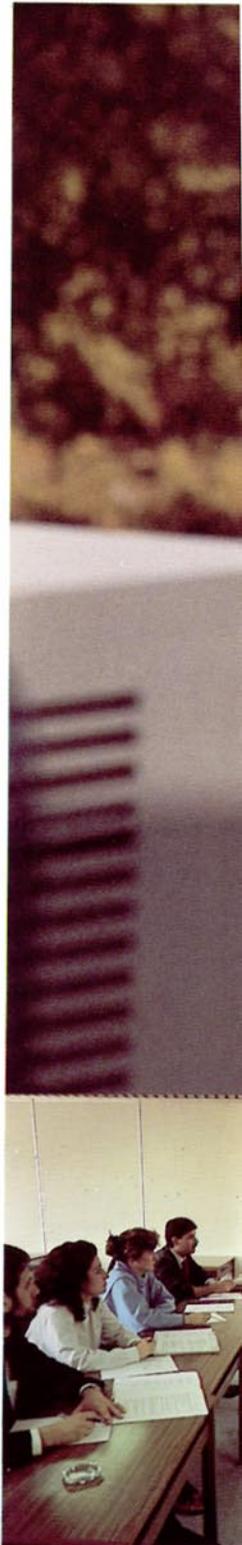
Non-stop technological advances in telecommunications means that labour requirements and levels of technical know-how are constantly changing. Last year the level of qualified employees increased significantly with university graduates and other technically qualified staff accounting for 9.1% of the workforce, as opposed to 8.3% in 1985.

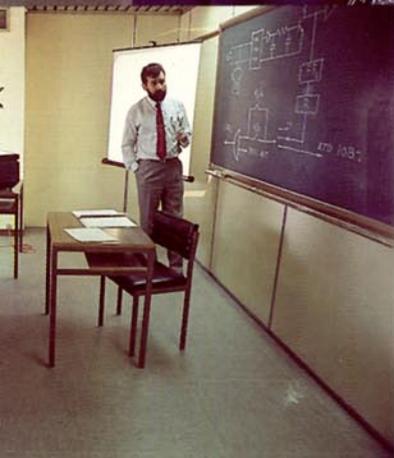
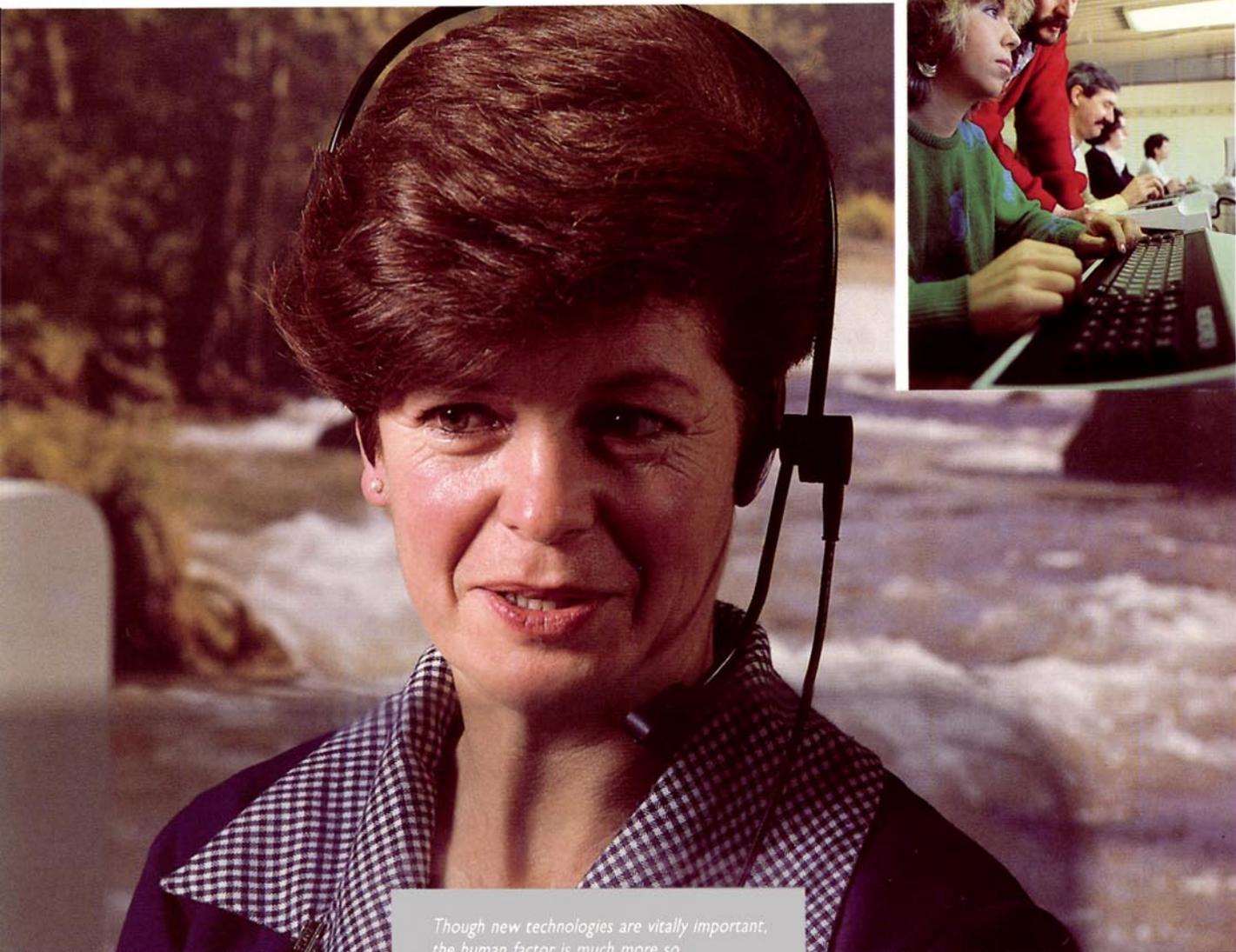
We plan to cope with the changing needs for a specialized work force while maintaining the current number of employees. Our policy is a combination of new recruitment, promotion, the axing of outdated functions and increased training programs.

At the same time, **Telefónica** will take major steps to improve management performance of the network, sales and administration departments. In the next four years there will be major investments in **office automation and information technologies, mechanized monitoring facilities, dynamic network management, network maintenance and security measures.** These investments should lead to substantial productivity gains and a healthy enhancement of overall flexibility and efficiency.

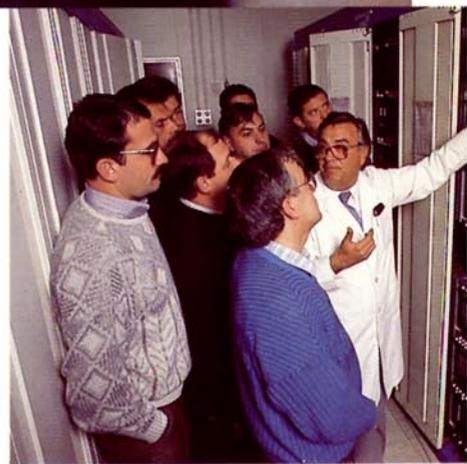
Technological upgrading is already underway with the replacement of manual operator equipment by the latest Multipurpose Operator Workstations. Advanced services, such as credit cards, telemarketing and simultaneous translating will soon be on offer via the operator. To guarantee staff productivity gains, an ongoing professional training program is of vital importance. In 1986, 47,000 employees —almost 75% of the workforce— followed a variety of courses and training programs. These were primarily concerned with new equipment and services, new technologies and management methods.

One of the year's major events was the opening of the new Training Centre in Seville. The Centre offers up-to-date training facilities and equipment. Employing modern teaching techniques, we aim to extend training in the use of the latest tools and design and develop specific training programs in **marketing, data processing and advanced telecommunications technologies.**





*Though new technologies are vitally important, the human factor is much more so. At **Telefónica** we are convinced that it is the quality and expertise of people, rather than the sophistication of machines, that determines success or failure in the Information Age. We have therefore opted for regular staff training programs —seen here taking place in the various rooms at the Madrid Training Centre—. As a result, operator Julia Sanz can today employ modern teleprocessing systems to upgrade the quality of Directory Enquiries.*

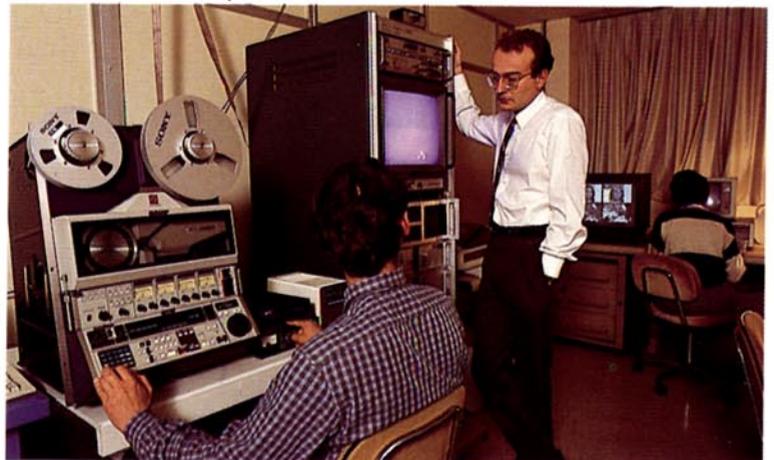


Research and Development

Research and development activities are essential if we are to keep abreast of the changes in telecommunications technology. **Telefónica** is keen to encourage activities in this field in order to safeguard the efficient up-dating of the network and services and to plan future technology. We have therefore stepped up funding of R & D operations. This policy is already bearing fruit in the form of our technical leadership in Packet Switching Data Transmission with the family of Tesys equipment. Now that Tesys A has met all performance requirements, work is underway on a new advanced version, to be unveiled in 1988 as the Tesys AX.

Development work began in 1986 on a new Packet Switching venture called Tesys B. Tesys B will be the equipment of the early nineties. Over the longer term, we are considering development of future Tesys generations within the EEC RACE program, possibly based on High-Speed Packet Switching systems.

We have completed development of a digital multiplexed system for the rural community, called Rural Digital Multiaccess. Our first multiplexed system, in use in our home network and abroad, is analog-based. The new system uses a Time Division Multiplexing Technique (TDM). We have also completed development of a millimetric waveband radiolink which is currently in production.





Telefónica is gradually up-dating the Tesys packet-switching technology. Systems Engineers Francisca Oliva and Juan Carlos González (above) at work on development of the new generation of Tesys equipment. In the digital image laboratory (left), researchers Alfonso V. Castillo and Miguel Roser carry out simulations of video signal coding techniques.

This year has also seen the development of a 2,400 bit/s full duplex modem. This will be followed by high speed digital signal modems.

In 1986 we became full participants in the European «Conformance Testing Service - Wide Area Network (CTS-WAN)» Consortium, set up to define and develop tools for Protocol Certification. This project is partly EEC funded and aims to develop standard tools for future European Certification Centres and to standardize existing ones.

Related to the Integrated Services Digital Network, significant progress was made on terminals and the ULISES project. Terminals which fully comply with the recently standardized S interface are operating in the laboratory. Development work on a range of equipment is well-advanced and will be tested as part of the 1983 ISDN pilot operation. The operational phase of the ULISES Project (Integrated Services Local Unit) has proved the feasibility and defined the architectures of the project, confirming its attraction for subscribers within local networks. The first product within the project, aimed at satisfying Ibercom network requirements, has been defined and development is underway.

Our achievements in the field of voice digitization have provoked wide interest among a great variety of users. **Telefónica** has used the designs to supply spoken information, while our algorithms have led to technology transfer contracts with telecommunications companies and other sectors.

Research and Development

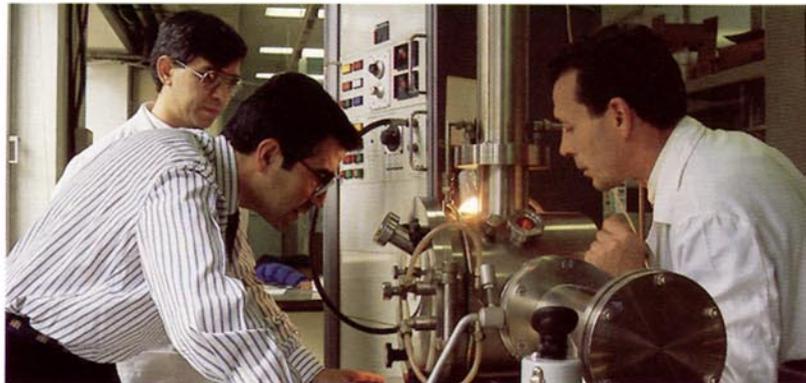
High level designs were completed in 1986 for the Sectorial Control System and the Operations and Maintenance System, intended to optimize network management and maintenance. Both systems, together with the Multipurpose Plant Terminal now at an advanced stage of development, will fulfill advanced network control and monitoring functions for the company.

High quality, low binary speed Voice Signal Coding and Acoustic Echo Cancelling in teleconferencing rooms are other areas where major progress has been made. We have also researched and developed voice signal processing architectures with special attention to the demands of voice recognition techniques.

Work on Video Signals has led to interesting results in high compression graphics coding, which is being successfully applied to videotex displays. In addition, the ESPRIT Project for an ISDN low speed video-conferencing system is coming along on schedule.

During 1986, the first Expert System prototype was completed, developed entirely by **Telefónica**. An application was found and an expert system prototype is now assisting telephone repair personnel. Closer collaboration with EEC Research and Development Programs has led to two new contracts as part of the ESPRIT Program: one for the LION Project for a Local Optical Network and the other for the AMADEUS Project developing a method of Software Specification.

We have also won further contracts with the European Space Agency (ESA), to develop a tool for Digital Signal Processing and an Optical Receiver for the earth prototype of a future satellite link. **Telefónica** will also carry out research on Mobile Satellite Services and New Techniques of Modulation and Access via Satellite, on behalf of the European Space Agency.





Spanish universities work closely with **Telefónica** in developing new technologies. Antonio Castillo (opposite page, centre), Assistant Director of **Telefónica's** Applied Research department, with Ernesto Diéguez (left) and Fernando Abella of the Madrid Autonomo University (UAM), department of Applied Physics, experiment with ways of producing lithium niobate crystals, an exotic material for high-performance integrated optics. Fernando Agulló (opposite page, bottom), head of the UAM, department of Applied Physics, with some of the new crystals produced in collaboration with **Telefónica**.

New Research and Development Centre

Last year witnessed the start of construction work on **Telefónica's** new R & D Centre, in which 6,400 million pesetas are to be invested. With a net area of 20,800 m², it will house some 600 scientists and research workers when it opens in 1988. Design and construction of the centre was contracted to Pacific Telesis International with technical consultancy from Bell Communications Research (BELLCORE).

A subsidiary company called Telefónica Investigación y Desarrollo, S. A. has been set up to promote and manage the new Centre. The Centre will coordinate research projects with Public Research Institutions, Universities, R & D Units and various international programs.

The annual budget will amount to 5,000 million pesetas and the Centre will be one of the first **intelligent buildings** in Madrid. It will expand horizons in the areas of information and telecommunications basic and applied technologies. These will include: design of integrated circuits for specific applications, voice and video signal digitization, automation, artificial intelligence and operating systems.

The goal of the new R & D Centre is to develop products with a clear market focus, by exploring the boundaries of modern science and engineering, so becoming a true «Centre of Excellence» of worldwide renown.





The development of advanced communications systems is one of our top priorities. In the current Madrid Research and Development Centre, engineers José Félix Hernández-Gil (left) and Andrés Gebauer design a millimetric wave transceiver for digital communications in urban areas.

Subsidiaries and Affiliated Companies

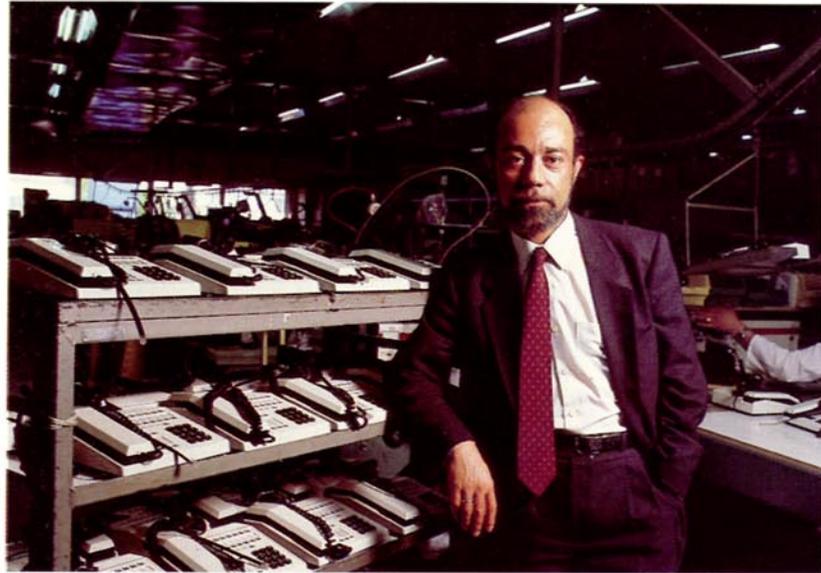
Telefónica is more than a telecommunications company with over 60 years experience and a world leadership in packet switching networks technology. It also comprises an extensive family of companies involved in information technologies, R & D, manufacturing, engineering and installations, marketing and maintenance. This group was initially set up to cover the Company's own requirements but is now expanding towards broader and more ambitious goals with an international focus.

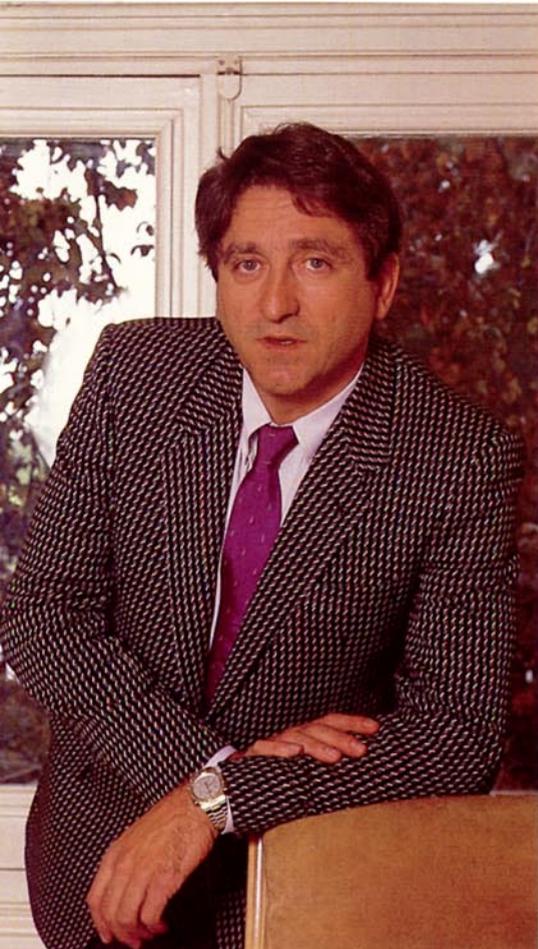
The family of companies was finally formed in 1985 and 1986 was devoted to organisation and structuring, in order to encourage activities, optimize resources and enhance investment profitability.

With these aims in mind, the new group is being structured along the following lines:

- **MANUFACTURING GROUP**, producing telecommunications equipment components and devices. This group is headed by Amper and companies such as Telefonía y Datos and Elasa will be joining Amper and current affiliates.
- **ENGINEERING AND INSTALLATIONS GROUP**, with Sintel as the core company and comprising, among others, of Telefónica Sistemas.

INFORMATION TECHNOLOGY GROUP, with software as a priority, headed by Entel and also comprising Maptel, Ecotel and Ibermatica.





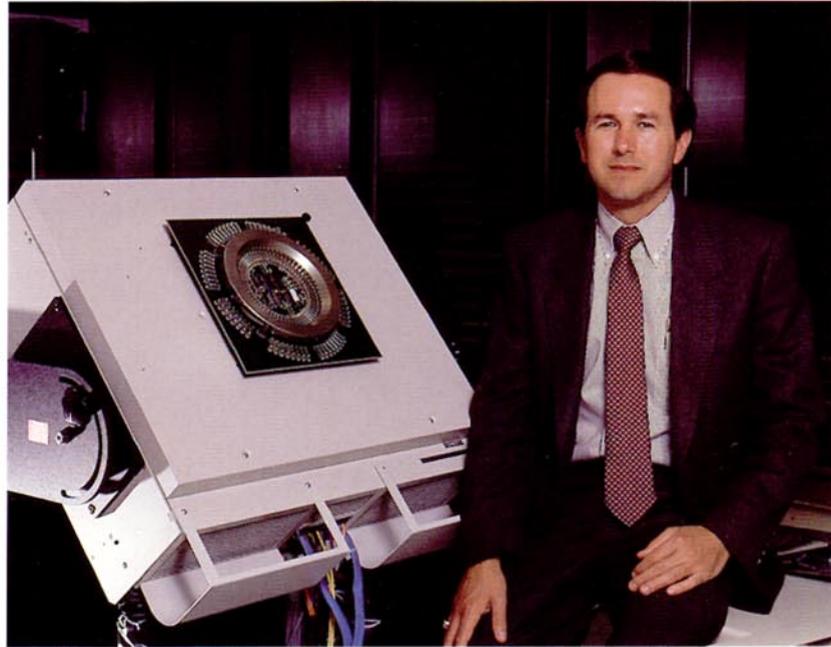
Our Subsidiaries are steadily sharpening their competitive edge with a clear market-focused strategy. Of major importance are (clockwise, from top right). Entel, headed by José Francisco Olascoaga; Sintel, by Baltasar Aymerich; Cetesa, by Julio Camuñas and Amper, by Antonio López.

- **SERVICES GROUP**, which will incorporate all firms exclusively owned by **Telefónica** and active in areas related closely to the marketing or financing of **Telefónica's** services. This group will include commercial concerns such as Cetesa, Cosesa, Telyco and Cabitel, and other companies like Telfisa (finance) and Temasa (submarine cable).
- **INTERNATIONAL GROUP**, led by Telefónica Internacional which, via its Luxembourg subsidiary, will include the enterprises set up abroad to promote **Telefónica's** interests in world markets.
- **RESEARCH AND DEVELOPMENT GROUP**, recently formed and primarily consisting of Telefónica Investigación y Desarrollo, set up in 1987. Bringing all the R & D activities under this one umbrella, will ensure maximum profitability, reaching the «critical mass» level necessary for forging ahead with ambitious new projects in Information Age technologies.

New business ventures

Telefónica is determined to remain a strong, competitive player in the constantly changing world marketplace. A flexible corporate policy has led to joint ventures and agreements with leading partners abroad. The following are some of **Telefónica's** most important new business ventures:

- ATT Microelectrónica España: construction of the factory in Tres Cantos, Madrid, is well ahead of schedule. With a capital of 65 million dollars (20% **Telefónica's**), ATT Microelectrónica España will manufacture high-tech custom integrated circuits aimed particularly at the export market.
- Maptel: this is a digital mapping company, in which our Norwegian partner, SysScan, provide the technology and have a 30% shareholding. The remaining shares belong to Entel and qualified users. The setting up of the company and staff recruitment are progressing according to plan and the firm already has a promising order book.
- European Silicon Structures (ES2): this is a joint venture between British Aerospace, Olivetti, Brown Boveri, Philips, Saab-Scania, Telfin and **Telefónica**. ES2 will specialise in short series of custom integrated circuits.
- Fujitsu España: the new company, resulting from the merger of Fujitsu España and Secoinsa in April 1986, has continued its operations. Fujitsu has a 60% stake in the new company and **Telefónica** 40%. The activities of Fujitsu España mainly involve the design, development, manufacture and marketing of data processing, office automation and telematic equipment, together with related software.





AT&T Microelectrónica España, headed by George Foyo (top, left) has recently handed over to

Telefónica the first custom-made microchip to be used in our network. Managing Director of Fujitsu España, Chiaki Sugishima (left) and Director Kazuto Kojima, appear outside their Málaga Research and Manufacturing Centre. Julian Conthe (right) of Maptel is seen here attending the recent launching of this digital mapping venture.



PHOTO: LUIS DE LAS ALAS, MERCADO MAGAZINE.

TELEFONICA 82-86: SELECTED OPERATING DATA

TELEPHONE SERVICE

Service parameters	31-12-86	31-12-85	31-12-84	31-12-83	31-12-82
Degree of automation (%)	99.7	99.5	99.2	98.9	98.6
Automatic trunk circuits (thousands)	244.3	228.8	217.1	205.8	192
International service automation (%)	86	84	80	79	76
Plant					
Telephones (thousands)	14,784.2	14,258.9	13,825.5	13,345.3	12,820.2
Local lines installed (thousands)	10,650.3	10,313.1	9,989.8	9,630.4	9,207.3
Automatic	10,621.5	10,262.8	9,911.9	9,525.6	9,080.2
(% of those installed)	(99.7)	(99.5)	(99.2)	(98.9)	(98.6)
Digital	350.4	184.3	127.0	78.0	43.0
(% of automatic)	(3.3)	(1.8)	(1.3)	(0.8)	(0.5)
Conventional and semi-electronic	10,271.1	10,078.5	9,784.9	9,447.6	9,037.2
(% of automatic)	(96.7)	(98.2)	(98.7)	(99.2)	(99.5)
Manual	28.8	50.3	77.9	104.8	127.1
(% of those installed)	(0.3)	(0.5)	(0.8)	(1.1)	(1.4)

BASIC INFRASTRUCTURE

	31-12-86	31-12-85	31-12-84	31-12-83	31-12-82
Coaxial cable (Km.)	10,379	10,112	9,933	9,514	9,425
Fibre-optics cable (Km.)	227	93	—	—	—
Trunk pair cable (Km.)	46,095	44,979	44,086	43,085	41,498
Subscriber networks (pair Km.)	35,464,943	33,625,843	32,067,254	30,449,616	28,733,982

TRENDS IN TELEPHONE TRAFFIC AND DEMAND FOR LINES

	31-12-86	31-12-85	31-12-84	31-12-83	31-12-82
TELEPHONE TRAFFIC (*) (Millions of billing units)	99,089	88,477	83,173	79,673	75,789
% Annual growth rate (**)	12.0	6.4	4.4	5.1	7.3
AVERAGE GROWTH IN CONSUMPTION PER LINE	5.0	3.4	1.8	2.5	1.6
DEMAND FOR NEW LINES	963,037	756,164	773,812	783,867	591,313
% Annual growth rate	27.4	(2.3)	(1.3)	32.6	15.5

TRENDS IN DATA TRANSMISSION SERVICES

	31-12-86	31-12-85	31-12-84	31-12-83	31-12-82
DATA TRANSMISSION CIRCUITS	31,152	28,950	26,651	24,001	21,573
Year-on-year growth (%)	7.6	8.6	11.0	11.2	6.0
TELEPHONE NETWORK CONNECTIONS FOR DATA TRANSMISSION	58,175	45,080	24,792	19,451	15,149
Year-on-year growth (%)	29.0	81.8	27.4	28.4	12.6
IBERPAC NETWORK CONNECTIONS	27,632	23,810	20,056	14,302	12,539
Year-on-year growth (%)	16.0	18.7	40.2	14.0	32.8

(*) Includes domestic and international traffic.

(**) The traffic increase is calculated in standard billing units (i.e. of equal length) for billable subscribers, and does not include telephone booths, for which standardised data are not available.

Financial Review

CONTENTS

- Selected financial and operating data.
- Telefónica and the Spanish economy.
- Management's discussion.
- Audited financial statements.
- Notes to the audited financial statements.
- Supplementary shareholder information.

* In this financial information all financial accounts are expressed in Spanish pesetas (ptas.). In certain cases, for convenience only, amounts are also expressed in United State dollars (U.S. \$).

All dollar amounts expressed herein have been translated at the rate of pesetas 132.40 to one U.S. dollar, Bank of Spain fixing exchange rate as of December 30, 1986.

SELECTED FINANCIAL AND OPERATING DATA

(In millions of Ptas., unless otherwise stated)

	1986 \$ in millions	1986	1985	1984	1983	1982
Operating revenue	\$ 3,535	468,011	409,415	363,937	311,469	259,501
Operating expenses	1,230	162,837	148,601	133,143	120,897	103,407
Financial expenses	588	77,781	77,209	75,817	63,790	52,708
Net income	342	45,252	39,149	32,620	27,536	26,547
Gross cash flow	1,650	218,416	177,580	149,518	121,026	99,388
Property, plant and equipment-net	13,075	1,731,182	1,586,206	1,429,833	1,261,882	1,094,642
Medium and long term debt	4,774	632,056	659,545	636,528	562,994	483,543
Shareholders' equity	8,233	1,090,016	947,804	832,543	719,023	599,694
Total assets	14,719	1,948,793	1,806,387	1,664,357	1,486,595	1,250,643
Capital expenditures	1,598	211,514	188,681	173,642	164,404	150,704
Weighted average shares outstanding (thousands)	808,258	808,258	702,720	585,702	493,001	480,623
Book value per share at year end (ptas.)	\$ 9.88	1,308.4	1,297.0	1,278.5	1,231.0	1,231.5
Market price per share (ptas., year end)	6.61	875	637.5	465	350	322.5
Employees in active service at year end	63,021	63,021	62,790	62,817	62,823	61,670
Lines in service at year end (thousands)	9,780.0	9,780.0	9,340.5	8,881.7	8,453.7	8,017.7

Telefónica and the Spanish economy

The major real increase of 5.7% in domestic demand helped boost GDP by 3%. This growth rate exceeded EEC and OECD averages and is the highest recorded in Spain since 1977. The healthy economic performance together with the recovery of the labour market and a reduction in public sector deficit relative to GDP, reflect the Spanish economy's expanding margins for non-inflationary growth over the coming years. Furthermore, if one considers a current account surplus of some \$5,000 million and a \$6,900 million reduction in Spain's net indebtedness, the overall picture is one which highlights Spain's solvency abroad and the encouraging prospects for the future.

In line with the macro-economic environment, the 1986 positive economic climate led to a surge in demand for telecommunications services. There was a 27.4% increase in demand for telephone lines and average consumption per line rose by 5%. The 7.4% real increase in **Telefónica's** gross value added, led to significantly higher labour productivity figures than the national average and boosted gross operating profit by 17%. The slowdown in financial expenses resulted in a 25.9% growth in the company's gross savings and hence considerably reduced the need to turn to capital markets. By the end of 1986, **Telefónica's** gross savings represented 2.18% of Spain's gross savings, compared to 1.71% in 1982.

Telefónica AND THE SPANISH ECONOMY (Telefónica as a % of the national total)

	1986	1985	1984	1983	1982
Gross value added	1.50	1.50	1.47	1.45	1.39
Gross capital formation	3.19	3.44	3.56	3.65	3.51
Gross operating profit	1.88	1.84	1.76	1.77	1.64
Gross savings	2.18	2.11	1.81	1.93	1.71
Employment	0.84	0.88	0.87	0.84	0.81

Management's discussion

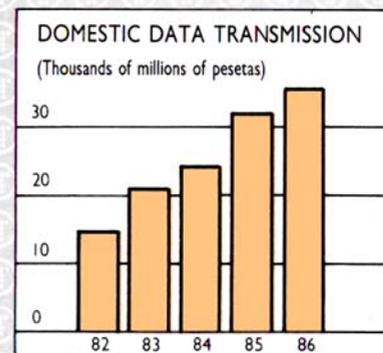
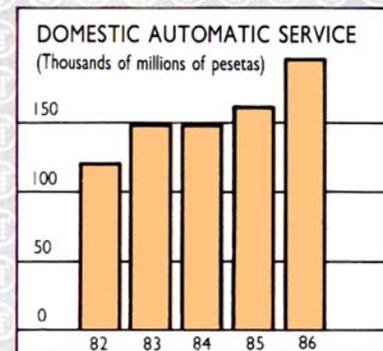
From a financial standpoint, 1986 was a highly successful year.

This was primarily due to the outstanding growth in demand, which far surpassed rates of previous years. Demand for new lines, at 963,037, was a record in the history of the company and marked a sharp increase over 1985. Even more significant as far as results, was the rate of growth in consumption of services. Measured in terms of traffic per line, the 5% rise was again a record for recent years.

Telephone services revenue, which represent 86% of total operating revenue, went up by 15% compared to 1985. Particularly noteworthy was the impressive 20.5% rise in domestic automatic service and the steady upward trend in domestic data transmission services.

The latter have grown at a cumulative annual average rate of 24.9%, over the period 1982-1986 and now account for 8% of total service revenue.

The overall effect of this growth has been a 14.3% increase in operating revenue over 1985, which is more than 7% in real terms.



OPERATING REVENUE (In millions of Ptas., unless otherwise stated)

Description	1986	1986	1985	1984	1983	1982	% Increase	
							over 85	82-86 cum. av.
Subscriber Service Charges	\$ 1,072	141,894	126,834	111,086	74,916	65,337	11.9	21.4
Domestic Automatic Service	1,484	196,526	163,063	149,646	148,023	122,054	20.5	12.6
Trunk Calls through operator	14	1,882	2,186	2,217	2,201	2,554	(13.9)	(7.3)
International service	467	61,787	57,505	51,149	40,299	32,620	7.4	17.3
Domestic Data Transmission	271	35,859	32,252	24,568	21,245	14,722	11.2	24.9
Mobile land and maritime services	12	1,634	1,595	1,437	1,087	983	2.4	13.5
Directories and yearbooks	77	10,216	10,071	9,123	9,112	6,655	1.4	11.3
REVENUE FROM SERVICES	\$ 3,397	449,798	393,506	349,226	296,883	244,925	14.3	16.4
Connection fees and other items	138	18,213	15,909	14,711	14,586	14,576	14.5	5.7
OPERATING REVENUE	\$ 3,535	468,011	409,415	363,937	311,469	259,501	14.3	15.9

Another contributing factor to our 1986 financial performance was **Telefónica's** continuing rigorous cost containment policy and productivity boosting measures.

These had a positive effect on margins and results in general and further cemented the solid financial structure built up by the company over recent years. Operating expenses rose by merely 9.6% and hence the operating margin increased 17% compared to 1985.

The company maintained its policy of strengthening and diversifying its financial structure. This resulted in a negligible increase in financial expenses, which rose by 0.7% over 1985.

There was a 23% growth in gross cash flow or funds generated from operations, which allowed the policy of maximum transfers to depreciation and provisions to proceed ahead. Operating on prudent and conservative accounting criteria, the company continued to improve capital recovery, thus further enhancing the quality of **Telefónica's** earnings and assets.

It is worth mentioning here that for the first time in the annual report we are including, for the benefit of shareholders, the adjusted figures obtained after reconciling net income and shareholders' equity in accordance with International Accounting Standards —IAS— and United States Generally Accepted Accounting Principles —US GAAP— (see pages 70 and 71). This is required for our current listing in a number of foreign stock exchanges and for the New York Stock Exchange, where we shortly expect to be listed. As indicated by these adjusted figures, **Telefónica's** earnings, according to International Accounting Standards and particularly to US GAAP, are significantly greater than those shown in the attached audited financial statements.

Although these fundamental differences are due to the accounting criteria applied in each case, they are also an indication of the company's sound accounting approach.

The aforementioned enhanced operating margins and results, together with our financial program,

Description	1986	Amount
+ Revenue from operations	\$ 3,535	468,011
— Operating expenses	1,230	162,837
= Operating margin	\$ 2,305	305,174
— Financial expenses net of financial income	498	65,973
— Exchange losses	83	11,050
— Depreciation and amortization	1,044	138,204
= Gross operating income	\$ 680	89,947
— Other provisions and charges	181	23,910
± Net extraordinary items	46	6,071
= Income before state levy	\$ 545	72,108
— State levy	203	26,856
= Net income	\$ 342	45,252
+ Depreciation and amortization	1,044	138,204
+ Provisions and charges	264	34,960
= Gross cash flow (funds generated from operations)	\$ 1,650	218,416

have had a positive effect on **Telefónica's** financial position. To wit: a reduction in debt, improved fixed assets coverage and increased expansion capacity.

However, as stated in previous years, if one is to get a broad view of **Telefónica's** ongoing

achievements these trends and management strategies need to be analysed over longer than merely one financial year. As in former years, we have therefore included the main financial figures for the period 1982-86 in order to facilitate overall appraisal and analysis.

RESULTS-PROFIT MARGINS 1982/1986

(In millions of Ptas., unless otherwise stated)

1986		1985		1984		1983		1982		Increase	
% Struct.	Amount	% Struct.	Over 85	82-86							
100.0 (34.8)	409,415 148,601	100.0 (36.3)	363,937 133,143	100.0 (36.6)	311,469 120,897	100.0 (38.8)	259,501 103,407	100.0 (39.8)	14.3 9.6	15.9 12.0	
65.2	260,814	63.7	230,794	63.4	190,572	61.2	156,094	60.2	17.0	18.2	
(14.1)	63,474	(15.5)	63,600	(17.5)	56,216	(18.0)	46,086	(17.7)	3.9	9.4	
(2.4)	9,277	(2.2)	14,230	(3.9)	5,330	(1.7)	3,000	(1.2)	19.1	38.5	
(29.5)	116,964	(28.6)	97,866	(26.8)	83,682	(26.9)	68,935	(26.6)	18.2	19.0	
19.2	71,099	17.4	55,098	15.2	45,344	14.6	38,073	14.7	26.5	24.0	
(5.1)	12,190	(3.0)	4,802	(1.3)	4,478	(1.5)	906	(0.4)	96.1	126.7	
1.3	3,675	0.9	3,170	0.8	4,348	1.4	4,075	1.6	65.2	10.5	
15.4	62,584	15.3	53,466	14.7	45,214	14.5	41,242	15.9	15.2	15.0	
(5.7)	23,435	(5.7)	20,846	(5.7)	17,678	(5.7)	14,695	(5.7)	14.6	16.3	
9.7	39,149	9.6	32,620	9.0	27,536	8.8	26,547	10.2	15.6	14.3	
29.5	116,964	28.6	97,866	26.8	83,682	26.9	68,935	26.6	18.2	19.0	
7.5	21,467	5.2	19,032	5.2	9,808	3.2	3,906	1.6	62.9	73.0	
46.7	177,580	43.3	149,518	41.0	121,026	38.9	99,388	38.4	23.0	21.8	

* 1982-1986

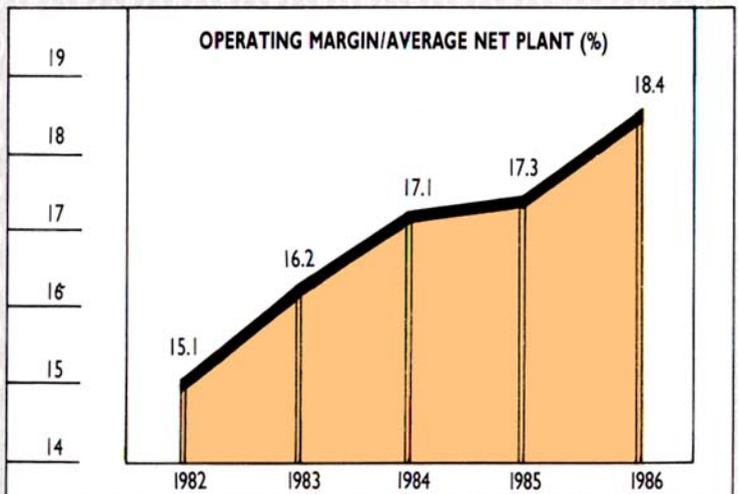
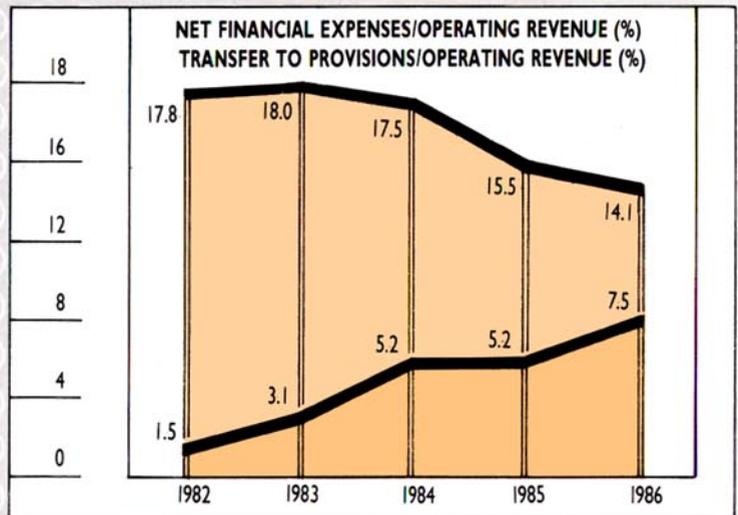
As mentioned previously, **Telefónica's** financial strategy for this period was based on two main criteria:

- Strict cost control coupled with increased productivity, in order to increase operating margins and internally generated funds.
- Strengthening the financial structure, boosting shareholders' equity and diversifying sources of finance to optimise borrowings and reduce debt servicing risks, with the aim of reducing the ratio of financial expenses.

This policy of austerity has radically improved the Company's financial situation, as revealed by the main parameters for 1982-1986:

- The cost control measures and increased productivity have reduced the ratio of operating expenses to operating revenue by five points, thus raising the operating margin from 60.2% to 65.2%.
- The financial policy pursued has stabilised financial expenses, which grew by 1.8% in 1985 and by only 0.7% in 1986, compared to average growth of 20% per year for 1982-1984. If one considers financial expenses net of financial income, the ratio to operating revenue has been cut back by 3.7 points over this period.
- As a consequence of the above, internally generated funds rose substantially from 38.4% to 46.7% of operating revenue, when measured by gross cash flow. This has led to:

- * Improvements in operating profitability, measured by the ratio of the operating margin to average net plant, which rose from 15.1% to 18.4%.
- * Substantial transfers to provisions, in line with a provident policy of maximum prudence (from 3,906 million pesetas in 1982 to 34,960 million pesetas in 1986).
- * Recording all the necessary depreciation charges, which have increased at a cumulative annual average rate of 19%. The average rate of depreciation of fixed assets has risen from 4.9% in 1982 to 5.5% in 1986, involving a 13% reduction in the estimated service lives of telephone plant in service over this period. These figures are particularly significant when calculated on the historic cost value of assets rather than the replacement cost, which **Telefónica** records in the balance sheets;



applying this criteria, the 1986 depreciation rate would mean an estimated average service life of between 9 and 10 years, which compares very favourably with international practice in the telecommunications service sector.

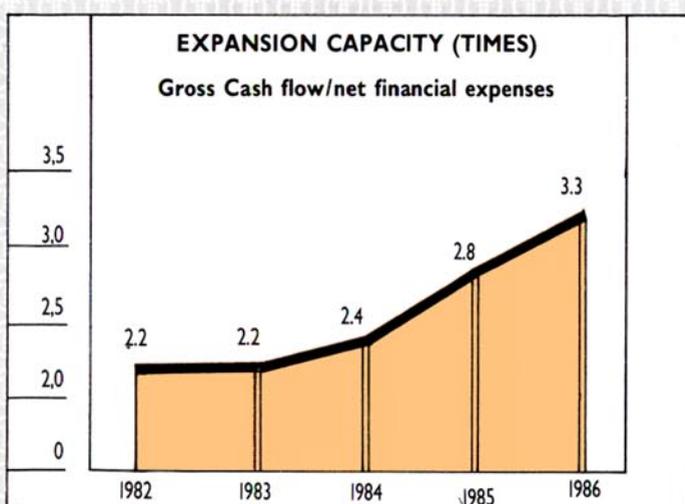
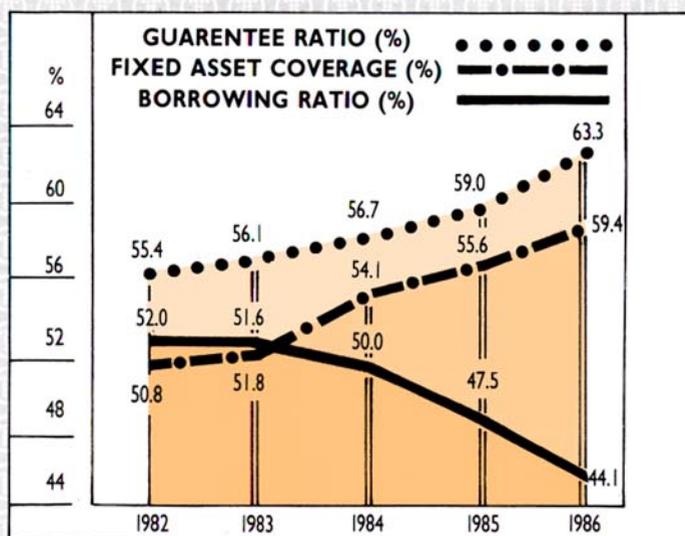
These measures have resulted in the following changes in financial structure over the period 1982-1986:

- Shareholders' equity has increased at an annual cumulative rate of 16.1%, whereas medium and long term debt rose by only 6.9%. The ratio of shareholders' equity to total liabilities and shareholders' equity has risen from 47.9% to 55.9%.
- Due to our active refinancing program, aimed at lowering the company's overall financing costs, the medium and long term debt ratio has fallen by 6.3 points to 32.4% while foreign currency debt has dropped from 11.7% to 5.1% of total liabilities and shareholders' equity.
- The financial diversification policy is reflected in the fact that by the end of 1986, 25% of total debt was in new financial instruments and markets, thus improving **Telefónica's** financing flexibility.

The overall result is a substantial boosting of **Telefónica's** expansion capacity. The funds generated in 1986 were 3.3 times net financial expenses, as compared to 2.2 times in 1982. Furthermore, debt servicing capacity in 1982-1986, measured as the ratio of total debt to gross cash flow, has improved from 5.6 years to only 3.1 years.

To conclude, **Telefónica's** financial structure is now solidly grounded, due to the policies of financial prudence applied. Thus, the company is well prepared to carry out its ambitious expansion plans for the coming years, which are essential if we are to meet the demand for services and exploit market opportunities as they arise.

These trends have also been positively reflected in the company's stock market performance. Pages 76 and 77 provide more detailed information in this respect. The above comments clearly indicate that **Telefónica** will continue to be of prime interest to domestic and international investors, as has indeed been the case over this period. We are firmly committed to ensuring that our shareholders at home and abroad continue to earn a competitive return on their investment in **Telefónica**.



Financial ratios

	1986	1982
Operating margin/Operating revenue	65.2	60.2
Net financial expenses/Operating revenue	14.1	17.8
Transfer to provisions/Operating revenue	7.5	1.5
Operating margin/Av. net plant	18.4	15.1
Fixed assets coverage	59.4	50.8
Guarantee ratio	63.3	55.4
Borrowing ratio	44.1	52.0
Expansion capacity	3.3	2.2

BALANCE SHEETS 1982/1986

(After profit distribution, in millions of Ptas., unless otherwise stated)

ITEMS	1986	1986	1985	1984	1983	1982
Fixed assets	\$ 13,861	1,835,197	1,703,265	1,540,156	1,388,514	1,181,214
Property, plant and equipment	21,364	2,828,586	2,568,812	2,298,083	2,016,193	1,754,272
Depreciation of fixed assets	8,289	(1,097,404)	(982,606)	(868,250)	(754,311)	(659,630)
Property, plant and equipment - net	13,075	1,731,182	1,586,206	1,429,833	1,261,882	1,094,642
Net intangible assets	30	3,997	5,042	4,803	3,797	2,256
Investments	293	38,755	32,987	33,895	37,677	22,054
Deferred charges	94	12,424	12,898	13,461	9,186	7,884
Unrealised exchange losses	369	48,839	66,132	58,164	75,972	54,378
Current assets	\$ 858	113,596	103,122	124,201	98,081	69,429
Consumable inventories	43	5,692	3,699	2,993	2,523	2,051
Accounts receivable	755	100,010	86,078	78,038	75,155	59,138
Cash and banks	18	2,332	7,981	34,297	12,388	2,592
Other current assets and prepayments	42	5,562	5,364	8,873	8,015	5,648
Assets = Liabilities and shareholders' equity	\$ 14,719	1,948,793	1,806,387	1,664,357	1,486,595	1,250,643
Shareholders' equity (1)	\$ 8,233	1,090,016	947,804	832,543	719,023	599,694
Paid-in share capital	3,110	411,793	360,468	320,416	288,374	240,312
Reserves and provisions	5,123	678,223	587,336	512,127	430,649	359,382
Medium and long term debt (2)	\$ 4,774	632,056	659,545	636,528	562,994	483,543
Debt in pesetas	4,025	532,927	450,717	400,374	369,393	337,195
Debt in foreign currencies	749	99,129	208,828	236,154	193,601	146,348
Net capital employed (1 + 2)	\$ 13,007	1,722,072	1,607,349	1,469,071	1,282,017	1,083,237
Current liabilities	\$ 1,712	226,721	199,038	195,286	204,578	167,406
Short term debt	1,417	187,585	168,171	165,381	180,929	146,708
Accruals	295	39,136	30,867	29,905	23,649	20,698
Unused credit facilities (in memorandum accounts)	\$ 740	97,965	121,300	88,680	53,607	35,329

STATEMENT OF CHANGES IN FINANCIAL POSITION

(After profit distribution, in millions of Ptas., unless otherwise stated)

	1986	1986	1985	1984	1983	1982
Gross cash flow	\$ 1,650	218,416	177,580	149,518	121,026	99,388
Reserves	16	2,157	3,369	4,769	4,563	5,109
Share capital increases	272	36,047	32,084	22,387	33,644	—
M. & L.T. Debt	1,547	204,803	154,267	151,510	105,714	86,070
— Domestic	1,275	168,827(a)	139,370	97,409	72,151	62,693
— Foreign	272	35,976	14,897	54,101	33,563	23,377
Total sources and applications of funds	\$ 3,485	461,423	367,300	328,184	264,947	190,567
Capital expenditures and investments	\$ 1,650	218,458	195,726	175,549	185,797	155,375
— Capital expenditures in fixed assets	1,598	211,514	188,681	173,642	164,404	150,704
— Intangible assets	14	1,866	1,778	1,607	1,658	1,515
— Investments in affiliates	38	5,051	48	(3,318)	15,386	844
— Stocks for fixed assets	—	27	5,219	3,618	4,349	2,312
Deferred charges	(55)	(7,307)	(5,882)	(9,511)	(4,628)	(420)
Applications of provisions	467	61,774	55,056	50,770	36,851	28,858
Repayment and redemption of M. & L.T. debt	\$ 1,552	205,534	147,587	78,642	51,518	37,114
— Domestic	506	67,014	86,900	53,032	41,107	30,859
— Foreign	1,046	138,520	60,687	25,610	10,411	6,255
Variation in working capital	\$ (129)	(17,036)	(25,187)	32,734	(4,591)	(30,360)
Variation in unused credit facilities	\$ (128)	(16,976)	29,271	22,839	8,760	6,570

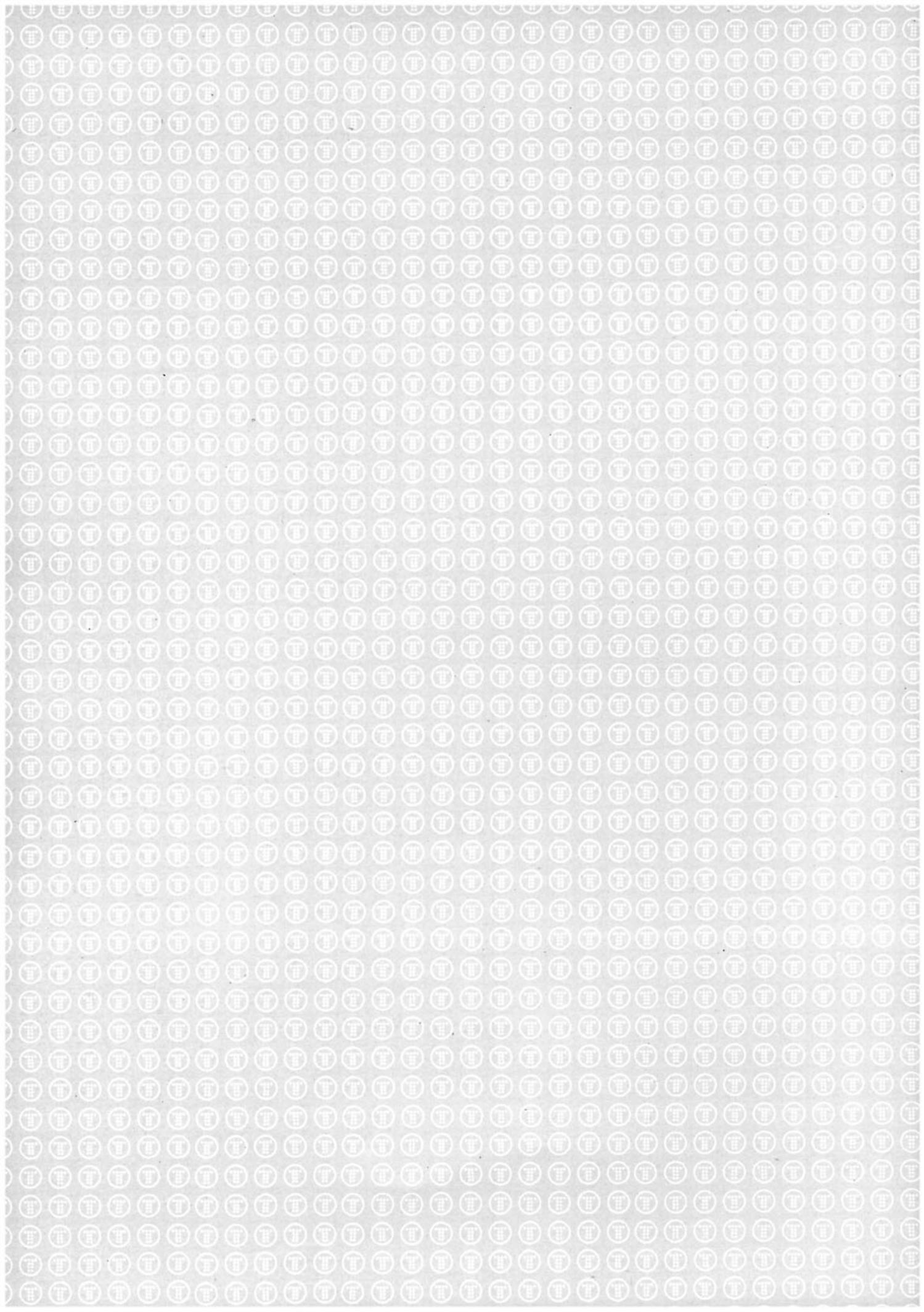
NOTES

The difference between the Variation in Working Capital indicated in this table and that audited is as follows:

Total variation	(17,036)
Increase in 1986 dividends	5,989
TOTAL	(11,047)

(a) This amount includes time period adjustments for Promissory Notes and Zero Coupon Bonds, that figure in the audited statement of changes in financial position as self-financing, in accordance with the following breakdown:

Debenture interest	548
Promissory Note Interest	4,569
TOTAL	5,117



Audited financial statements

Auditing Shareholders' Report

Mr. Fernando Pérez-Olivares Hinojosa and Mr. Javier Salaverri Aguilar, designated auditors of the 1986 accounts by the Annual General Meeting of Shareholders held on June 27, 1986, have examined the independent auditors' report issued by the firms Price Waterhouse and Audiberia, S. A. and the report of the Spanish Statutory Auditors, and propose that the Annual General Meeting approve the Annual Report, Balance Sheet, Statement of Income, Statement of Changes in Financial Position and Statement of Movements and Direct Applications to Reserves for 1986 of Compañía Telefonica Nacional de España, S. A.

And in testimony thereof, we sign this Report in Madrid on the thirtieth of April, nineteen eighty-seven.



Fernando Pérez



Javier Salaverri

Spanish Statutory Auditors' Report

Mr. Pedro Rodríguez San Román and Mr. Enrique Fernández Peña, full members of the Institute of Spanish Statutory Auditors, in compliance with the mandate received from the Management Committee of *Compañía Telefónica Nacional de España, S. A.* in accordance with article 47 of the Stock Exchange Regulations in force (Decree 1506/67 of June 30), have examined the Balance Sheet of the Company at December 31, 1986 and the Statement of Income for that year and the corresponding notes thereto.

In the examination carried out, we have jointly taken into account the working reports prepared by the firms Price Waterhouse and Audiberia, S. A., which have audited the Company's accounts during 1986, all in accordance with **Telefónica**.

The said review has given rise to this Report 12/87, which is issued with the remarks and observations given below.

1. General comments

- 1.1. The figures contained in the Balance Sheet and Statement of Income audited, come from the Company's general ledger and auxiliary books, in accordance with the general account groupings shown in detail in the annual accounts.
- 1.2. The Company's Balance Book number 3, legalised on May 30, 1973, under the number 8,756, shows the trial balances for the year.
- 1.3. The Company's Day Book, numbers 23 and 24, legalised on August 5, 1977 under the number 11,882 and on November 17, 1983 under the number 28,608, show the summary of the entries made each month, in accordance with the account groupings mentioned in 1.1.

2. Comments on the Balance Sheet

2.1. Fixed assets.

This item has increased by 211,542 million pesetas in 1986, fundamentally as a result of purchases, works contracted with others and direct imputations amounting to 188,967 million pesetas and, on the other hand, due to indirect investment costs of 15,995 million pesetas and interest charged to the works of 6,580 million pesetas. Interest has been calculated at 9% by applying a rate of 0.75% per month on the balance of the work in progress at the end of the previous month, without including interest already charged.

Fixed assets have been revalued in accordance with article 3 of the Law of December 31, 1945, by 109,439 million pesetas, with 43,960 million pesetas credited to Accumulated Depreciation and 65,479 million pesetas charged to the Revaluation Surplus. This revaluation, which the Company carried out after obtaining prior approval from the Ministry of Finance, was applied to the Fixed Assets inventory at December 31, 1984.

2.2. Accumulated depreciation and amortization of assets

The relevant credit items charged to the 1986 results amount to 134,897 million pesetas (131,987 million pesetas for depreciation of fixed assets and 2,910 million pesetas for amortization of intangible assets). The overall percentage of the average value of depreciable plant (without including the revaluation mentioned above) was 5.6%.

2.3. Net Shareholdings in Companies.

Investments in the **Telefónica** Group have been valued on the basis of the balance sheets of the companies concerned at December 31, 1985, and represent an increase of 1,206 million pesetas, that has been transferred to the Voluntary Reserves.

The income received as dividends from these shareholdings in 1986 was 318 million pesetas.

2.4. Deferred Exchange Losses

The revaluation of foreign currency borrowings at the year end amounted to 48,839 million pesetas. Of this amount 30,429 million pesetas correspond to deferred realised exchange losses; the remainder is the future potential loss that the Company must bear in the years to come if the present exchange rates remain constant. These concepts are deferred on the basis of **Telefónica's** particular situation as a regulated company, the repercussion of which is incorporated into its tariff structure.

As in previous years, in 1986 the Company absorbed and charged to results all exchange losses attributable to the year in accordance with paragraph 2.2.f of Note 2 and as specified in Note 5, which amounted to 10,140 million pesetas for the repayment of loans and 910 million pesetas for differences relating to services charged in foreign currencies.

At the year end, the self-insurance provision for exchange losses had a balance of 21,598 million pesetas, the purpose of which is explained in Note 9.

2.5. Accounts Receivable

The caption «Subscribers» includes ex-subscribers where debt collection is doubtful, where the total balance amounts to 4,252 million pesetas, pending revaluation. There are 5,245 million pesetas in the «Provision for bad debt accounts» to cover this amount, with the surplus covering other accounts receivable pending classification.

2.6. Share Capital.

The Company, as authorised by the General Meeting of Shareholders, increased share capital by 40,052 million pesetas on the basis of one new share for every nine held, with 10% of the nominal value charged to Reserves (4,005 million pesetas).

As a result of conversion options exercised in 1986 on bonds issued in preceding years, share capital was increased by 11,273 million pesetas nominal, with a share issue premium of 7,748 million pesetas.

2.7. Statutory Reserve

The balance on this account increased by 500 million pesetas to 7,805 million pesetas at December 31, 1986, due to the distribution of 1985 profits.

2.8. Voluntary Reserve and Revaluation Surplus

These have increased by 65,479 million pesetas as a result of net plant revaluation and by 1,206 million pesetas due to the higher valuation placed on shareholdings in group companies; to the contrary, there was a 4,005 million peseta reduction resulting from part of the capital increase being charged to reserves.

2.9. Technological Development Reserve

The balance on this account increased by 2,317 million pesetas due to the difference between materials recovered and dismantling costs.

2.10. Debentures and bonds

Debentures amounting to 80,000 million pesetas were issued in 1986, for which subscription was pending on 28,539 million pesetas, as the second of the two issues was carried out in December and the payment period for subscriptions ended on January 10; by this date the issue was fully subscribed and paid.

2.11. Pensions

Telefónica employees benefit from a social welfare system with pensions substitutory for and complementary to those provided in Spain by the Social Security. These pensions are covered by the «Institucion Telefonica de Prevision (ITP)», a mutual pension fund with independent legal status created under the Law of December 6, 1941 and the regulations pertaining thereto of May 26, 1943 on Social Service Mutual Funds. The circumstances and explanations relating to this matter are described in Note 16 of the financial statements.

Opinions exist of independent legal counsel which reconfirm **Telefónica's** compliance with all of its contractual obligations to ITP and confirm the non-existence of any legal responsibility for **Telefónica** other than that stated in Note 16.

3. *Comments on the Statement of Income*

3.1. Income

The estimates of income at the end of 1985 and 1986 are correct.

3.2. Costs and Expenses

The costs and expenses attributed by the Company are considered to have been reasonably settled and are correctly accounted for in the year.

As a consequence of the above and on the basis of the verifications made, together with the work and report of the firms Price Waterhouse and Audiberia, S. A., we hereby issue the following:

REPORT

As a result of the review carried out, it is our professional opinion that the Balance Sheet and the Statement of Income of the Compañía Telefónica Nacional de España, S. A. and the Notes thereto, attached, present fairly the financial position of **Telefónica** at December 31, 1986 and the results of its operations, in accordance with accounting principles generally accepted in Spain, applied on a basis consistent with that of the preceding year, in conformity with the contracts and agreements in force with the Spanish Authorities and subject to the considerations that we have indicated.

Madrid, April 29, 1987



Pedro Rodríguez San Román



Enrique Fernández Peña

Independent Auditors' Report

To the Board of Directors

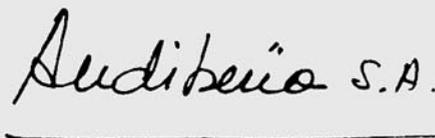
Compañía Telefónica Nacional de España, S. A.

Madrid

1. We have examined the balance sheet of Compañía Telefónica Nacional de España, S. A. (Telefónica) at December 31, 1986, the statements of profit and loss, of movements and direct applications to reserves and of changes in financial position for the year then ended together with the explanatory notes thereto, as set out on pages 54 to 69. Our examination was made in accordance with generally accepted auditing standards.
2. As indicated in Note 1 to the financial statements, tariffs corresponding to the services provided by Telefónica are submitted to the Spanish government for approval, with the prior intervention of the Government Delegate in the Company and agreement of the Price Control Board. Consequently, Telefónica falls within the group of regulated entities whose peculiarities permit that income and expenses may be attributable to each period not only on the accrual basis but also when the related specific concepts of revenue and cost are computed as part of the approved tariffs. On this basis, the recovery of the amounts invested or deferred in the assets of the Company, particularly deferred exchange losses, will depend upon the adequate future consideration, in tariffs, of these concepts.
3. Notes 16 and 17 to the financial statements include a detailed explanation of the characteristics of the pension scheme by which the employees of Telefónica are covered through the mutual pension fund «Institución Telefónica de Previsión» (ITP), as well as the current going concern problems, negotiations in process and the Company's position in respect of these.
There exist opinions of independent legal counsel which reconfirm Telefónica's compliance with all its contractual obligations to ITP, as well as the legal independence of the latter as regards Telefónica and the non existence of any other subsidiary responsibility for Telefónica than that stated in Note 16.
4. In our opinion, the financial statements referred to in paragraph 1 present fairly the financial position of Compañía Telefónica Nacional de España, S. A., at December 31, 1986, and the results of its operations, movements in reserves and changes in financial position for the year then ended, in conformity with accounting principles generally accepted in Spain, and as explained in paragraph 2, those required or permitted by the specific regulations governing Telefónica's activities, applied on a basis consistent with that of the preceding year. Accounting principles which are of significance in the preparation of the financial statements are described in Note 2.
5. These financial statements and related notes were originally issued in the Spanish language; the translation into English is solely for the convenience of international readers.



Price Waterhouse



Audiberia, S. A.

COMPAÑIA TELEFONICA NACIONAL DE ESPAÑA, S. A.
BALANCE SHEETS AT DECEMBER 31
(Before distribution of profits)
(In millions of pesetas)

ASSETS	1986	1985
FIXED ASSETS (Note 3)	1,731,182	1,586,206
Land	31,387	30,989
Buildings and power equipment	187,290	173,265
Telephone installations	2,449,411	2,209,192
Other fixed assets	18,697	16,074
	<u>2,686,785</u>	<u>2,429,520</u>
Accumulated depreciation	(1,097,404)	(982,606)
	<u>1,589,381</u>	<u>1,446,914</u>
Fixed assets under construction:		
Construction in progress	92,353	95,794
Advances to suppliers	19,478	13,556
Stocks for fixed assets	29,970	29,942
	<u>141,801</u>	<u>139,292</u>
INTANGIBLE ASSETS	3,997	5,042
Research and development and others	10,447	8,581
Accumulated amortization	(6,450)	(3,539)
	<u>3,997</u>	<u>5,042</u>
INVESTMENTS	38,755	32,987
Net shareholdings in companies (Note 4)	27,553	25,869
Loans to Group companies	7,894	4,164
Loans to employees	2,578	2,462
Guarantees and deposits	730	492
	<u>38,755</u>	<u>32,987</u>
DEFERRED CHARGES	12,424	12,898
DEFERRED EXCHANGE LOSSES (Note 5)	48,839	66,132
INVENTORIES	5,692	3,699
ACCOUNTS RECEIVABLE	100,010	86,078
Subscribers (Note 6)	85,219	79,686
Provision for bad debts (Note 6)	(5,245)	(3,827)
Miscellaneous receivables	22,678	12,549
Provision for bad debts	(2,642)	(2,330)
	<u>100,010</u>	<u>86,078</u>
CASH AND BANKS	2,332	7,981
Cash and banks	722	1,034
Short term investments	—	2,168
Funds in transit and others	1,610	4,779
	<u>2,332</u>	<u>7,981</u>
OTHER CURRENT ASSETS AND PREPAYMENTS	5,562	5,364
Prepayments	5,562	5,364
	<u>5,562</u>	<u>5,364</u>
Total	<u>1,948,793</u>	<u>1,806,387</u>
MEMORANDUM ACCOUNTS (Note 18)		
Unused credit facilities	97,965	121,300
Others	26,994	25,764
	<u>124,959</u>	<u>147,064</u>

Notes 1 to 19 form an integral part of this statement.

LIABILITIES AND SHAREHOLDERS' EQUITY

	<u>1986</u>	<u>1985</u>
SHAREHOLDERS' EQUITY	1,015,596	890,920
Share capital (Note 7)	411,793	360,468
Reserves: (Note 8)		
Statutory reserve	7,805	7,305
Voluntary reserve and revaluation surplus	559,675	489,141
Technological development reserve	36,249	33,932
Unappropriated profit	74	74
	<u>603,803</u>	<u>530,452</u>
DEFERRED INCOME	2,412	2,577
Non-reimbursable contributions for rights of use and others	<u>2,412</u>	<u>2,577</u>
PROVISIONS (Note 9)	71,394	53,807
Risk and exchange loss self-insurance	50,876	33,698
Other provisions	<u>20,518</u>	<u>20,109</u>
LONG TERM DEBT	632,056	659,516
Debentures and bonds (Note 10)	320,808	325,702
Loans and credit facilities (Note 11)	238,554	270,863
Loans from the Institución Telefónica de Previsión (ITP)	48,516	39,924
Notes payable to suppliers (Note 12)	5,719	12,082
Collective insurance for employees (Note 17)	<u>18,459</u>	<u>10,945</u>
SHORT TERM DEBT	142,947	129,522
Loans and credit facilities (Note 11)	43,627	13,534
Suppliers (Note 12)	30,717	25,681
Notes payable to suppliers (Note 12)	2,948	4,707
Taxes payable (Note 13)	36,543	46,448
Social Security payable	4,640	5,243
Other creditors (Note 14)	24,432	25,559
Dividend payable	<u>40</u>	<u>8,350</u>
ACCRUALS (Note 15)	39,136	30,896
Accrued expenses and deferred income	<u>39,136</u>	<u>30,896</u>
NET INCOME	45,252	39,149
Net income for the year	<u>45,252</u>	<u>39,149</u>
Total	<u>1,948,793</u>	<u>1,806,387</u>
MEMORANDUM ACCOUNTS (Note 18)		
Unused credit facilities	97,965	121,300
Other	26,994	25,764
	<u>124,959</u>	<u>147,064</u>

Notes 1- to 19 form an integral part of this statement.

COMPAÑIA TELEFONICA NACIONAL DE ESPAÑA, S. A.
STATEMENTS OF INCOME FOR THE YEARS ENDED DECEMBER 31
(In millions of pesetas)

	1986	1985
INCOME	468,011	411,689
Revenue from services	449,798	393,506
Connection fees	15,984	13,922
Suburban connection fees and others	1,426	1,632
Surcharges	—	2,274
Private exchange maintenance and other	803	355
COSTS AND EXPENSES	409,342	359,954
Salaries and related costs	176,095	159,572
Subcontractors, supplies and services	39,930	41,012
Taxes	324	275
Provision for doubtful accounts (subscribers)	3,624	3,870
Other charges	20,286	7,925
Exchange losses (Note 5)	11,050	9,277
Financial expenses	77,781	77,209
Sundry expenses	2,140	2,165
Depreciation of fixed assets (Note 3)	131,987	111,083
Amortization of intangible assets	2,910	3,020
Amortization of deferred charges	3,307	2,861
Internal expenditure capitalized in fixed assets:		
Labour, materials and overhead	(53,512)	(51,863)
Notional interest allocated to construction in progress (Note 3)	(6,580)	(6,452)
PROFIT BEFORE OTHER INCOME	58,669	51,735
OTHER INCOME	13,439	10,849
Financial	5,228	7,283
Other	8,211	3,566
INCOME BEFORE STATE LEVY	72,108	62,584
STATE LEVY	(26,856)	(23,435)
NET INCOME (before distribution)	45,252	39,149

Notes 1 to 19 form an integral part of this statement.

STATEMENT OF MOVEMENTS AND DIRECT APPLICATIONS TO RESERVES
FOR THE YEAR ENDED DECEMBER 31, 1986
(In millions of pesetas)

	December	Movements during 1986		December
	31, 1985	Allocation	Application	31, 1986
Statutory reserve	7,305	500	—	7,805
Voluntary reserve	489,141	74,553	(4,019)	559,675
Revaluation of fixed assets	594,393	65,479	—	659,872
Issuance of share capital	(70,481)	—	(4,005)	(74,486)
Share premium	1,733	7,748	—	9,481
Allocations to extraordinary provisions	(39,196)	—	—	(39,196)
Revaluations of investments (Nota 2.1 b)	4,423	1,206	—	5,629
Other	(1,731)	120	(14)	(1,625)
Technological development reserve (Notes 2.1 b and 9.2)	33,932	3,241	(924)	36,249
Unappropriated profit	74	74	(74)	74
Total	530,452	78,368	(5,017)	603,803

Notes 1 to 19 form an integral part of this statement.

COMPAÑIA TELEFONICA NACIONAL DE ESPAÑA, S. A.
STATEMENTS OF CHANGES IN FINANCIAL POSITION FOR THE YEARS
ENDED DECEMBER 31
(Before distribution of profits) (*)
(In millions of pesetas)

	<u>1986</u>	<u>1985</u>
SOURCES		
Net income for the year	45,252	39,149
Depreciation and amortization	138,204	116,964
Net movements in reserves and deferred income	2,157	3,369
Self-insurance, exchange differences and other	<u>33,081</u>	<u>17,841</u>
Funds provided by operations	218,694	177,323
Issuance of share capital	36,047	32,084
Investments in affiliates	2,986	4,599
Debentures issued	51,704	60,143
Foreign currency loans	35,976	14,897
Other loans, credit facilities and notes payable	<u>112,006</u>	<u>74,626</u>
TOTAL SOURCES	<u>457,413</u>	<u>363,672</u>
APPLICATIONS		
Dividends	38,649	32,214
Additions to fixed assets	205,592	187,881
Other additions:	18,685	14,742
Advances to suppliers of fixed assets	5,922	800
Intangible assets	1,866	1,778
Investments in affiliates	8,037	4,647
Stocks for fixed assets	27	5,219
Deferred charges	<u>2,833</u>	<u>2,298</u>
Debentures redeemed	39,849	34,662
Repayment of foreign currency loans	138,520	60,687
Repayment of other loans, credit facilities and notes payable	<u>27,165</u>	<u>52,238</u>
TOTAL APPLICATIONS	<u>468,460</u>	<u>382,424</u>
NET VARIATION	<u>(11,047)</u>	<u>(18,752)</u>
COMPRISING:		
Inventories	1,994	(1,011)
Accounts receivable	13,567	8,081
Cash and banks	(5,649)	(26,316)
Prepayments	176	(2,012)
Short term liabilities	(22,013)	18,596
Accruals	(7,432)	(1,152)
Dividend accounts	<u>8,310</u>	<u>(14,938)</u>
TOTAL	<u>(11,047)</u>	<u>(18,752)</u>

(*) These statements have been prepared in accordance with the classification of short and long term debts as described in Note 2.2 j).

Notes 1 to 19 form an integral part of this statement.

COMPAÑIA TELEFONICA NACIONAL DE ESPAÑA, S. A.

PROPOSAL FOR DISTRIBUTION OF THE NET INCOME FOR THE YEAR 1986

	Millions of pesetas
Unappropriated profit brought forward from previous year	74
Net income for the year	<u>45,252</u>
Total available for distribution	<u>45,326</u>
PROPOSED DISTRIBUTION	
5% Interim dividend on shares No. 1 to 801,038,990 payable as from January 20, 1987	20,026
5% Interim dividend on shares No. 801,038,991 to 801,177,147, rights to dividend as from January 10, 1986, payable as from January 20, 1987	3
5% Interim dividend on shares No. 801,177,148 to 823,585,478, rights to dividend as from July 15, 1986, payable as from January 20, 1987	261
6% Final dividend on shares No. 1 to 801,038,990 pending approval	24,031
6% Final dividend on share No. 801,038,991 to 801,177,147, rights to dividend as from January 10, 1986, pending approval	4
6% Final dividend on shares No. 801,177,148 to 823,585,478, rights to dividend as from July 15, 1986 pending approval	<u>313</u>
To dividends	44,638
To statutory reserve	600
Unappropriated profit carried forward	<u>88</u>
Total proposed distribution	<u>45,326</u>

COMPAÑIA TELEFONICA NACIONAL DE ESPAÑA, S. A.

NOTES TO THE FINANCIAL STATEMENTS AT DECEMBER 31, 1986 AND 1985

NOTE I - ACTIVITY AND CONTRACT WITH THE STATE

I.1 Conditions of the State Contract

The Law of December 31, 1945 authorized the Government to execute a contract with the Compañía Telefónica Nacional de España, S. A. (Telefónica). The contract regulating the conditions of the concession was approved by Decree of October 31, 1946. For this reason Telefónica is a Limited Company regulated by the specific rules of this contract.

Condition 2 of the State Contract, the Decree of December 21, 1970 and the Ministry Order of October 26, 1978 define the telephone and other telecommunications services that the Company operates as a monopoly.

I.2 Fiscal status

The fiscal status of Telefónica is established in Condition 7 of the State Contract by which the State participates in the Company's income and consequently, has the right to receive annually a levy of 15% of the Company's net profits which, under no circumstances, will be less than 6% of the Company's gross revenue from services. For the purposes of calculating the State levy, revaluations which give rise to an increase in assets value, are excluded from the basis for such calculation.

The amounts to be received by the State under the terms of Condition 7 are considered for all legal purposes as a tax. For this reason, and by virtue of the national scope of the Company's services, it is exempt from all other taxes or contributions, excise taxes or duties of any kind.

I.3 Regulation of tariffs

According to the State Contract, tariffs will be reviewed at Telefónica's request when, for two consecutive years, they do not give a sufficiently high yield to cover all operating expenses including depreciation of Company installations and properties, to accumulate and maintain the statutory reserve referred to in Condition 7 of the State Contract or any other required by law and obtain an amount of net income in each fiscal year of no less than 5% of the paid-in share capital plus reserves as defined in the State Contract.

NOTE 2 - BASES OF PRESENTATION AND SIGNIFICANT ACCOUNTING PRINCIPLES

2.1 Bases of presentation

- a) *The financial statements have been prepared on the basis of the accounting records of Telefónica for each year, prior to the distribution of profits. The distribution of 1986 profits is therefore subject to approval by the Shareholders' at the Annual General Meeting.*
- b) *In order to present a statement of profit and loss that reflects service operation as closely as possible, certain items of income and expense, such as those resulting from plant dismantling and property and investment revaluations, are applied directly to the Company's reserves; consequently, they do not form part of net income. These items and their meaning are presented in the Statement of movements and direct applications to reserves.*
- c) *Stocks for fixed assets have been classified under the fixed assets caption. Figures presented for 1985 have been reclassified for comparability purposes.*
- d) *All amounts shown in the Notes to the financial statements are expressed in millions of pesetas.*

2.2 Significant accounting principles

a) Accounting standards.

The accounting standards utilized in drawing up the financial statements are in accordance with generally accepted accounting principles in Spain, together with others required or allowed under the State Contract for Telefónica as a regulated enterprise, especially those referring to the revaluation of fixed assets and investments, treatment of exchange differences, the self-insurance fund and plant dismantling.

b) Fixed assets and method of depreciation.

Telefónica, in accordance with Article 3 of the Law of December 31, 1945 and with the approval of the Finance Ministry, can revalue its assets to current values. Consequently, property, plant and equipment are valued at replacement cost, as explained in Note 3. The net revaluation is accounted for by crediting the revaluation surplus. Property additions are accounted for at cost including installation cost, direct labour and materials used, together with an allocable share of overheads and interest accrued up to the time when the assets are placed in service.

The annual depreciation charge is calculated using the straight line method based on the useful life of the assets.

At the time equipment is retired from service the gross book value is removed from plant and equipment and from accumulated depreciation on the assumption that dismantled equipment is the oldest and is therefore fully depreciated. The net recovered value of dismantled plant and equipment is charged to the corresponding stocks for fixed assets account and credited to the technological development reserve.

Fixed assets maintenance and repair costs not representing an increase of value or improvement, are expensed when incurred.

c) Intangible assets and amortization.

Intangible assets include the costs incurred in developing new product lines and the value of rights acquired for the use of equipment and installations owned by others as a consequence of official concessions or irrevocable rights of use. These assets are amortized on a straight line basis over periods not exceeding the estimated recovery period, of 5 and 25 years, respectively.

d) Investments - net shareholdings in companies.

The financial statements do not present the consolidated financial position of Telefónica and its majority-owned subsidiaries. Consolidation exercises have been carried out, the results of which show no significant impact on the Company's financial statements.

The valuation of shareholdings in companies are adjusted against the related revaluation reserve, on the basis of the proportional equity value of these companies, using the balance sheets as at December 31 of the previous fiscal year, as approved by the Shareholders at their Annual General Meeting. Dividends are recorded as revenue when received, and capital gains obtained from sales of investments are recorded as income when received.

e) Deferred charges

Debenture issue expenses are amortized based on the respective capitals outstanding at each year end.

Issuance expenses of bonds converted to share capital and expenses related to the issuance of share capital are amortized on a straight line basis over five years (up to 1985, amortization period was ten years) from the date of each share capital increase. The impact on the 1986 net income of the change in the amortization period is not significant.

f) Valuation of foreign currency accounts.

Foreign currency accounts are translated to pesetas at the end of the year at the official exchange rate quoted by the Bank of Spain. Unrealized exchange gains or losses are recorded in the deferred exchange losses account and are charged to expenses each year, as realised, in accordance with the repayment of the foreign currency debt to which they relate. When early repayment occurs, given the nature and characteristics of Telefónica as a regulated price and services company and the tariff review mechanisms described in Note 1.3, the realized exchange losses are charged to expenses in accordance with the initial maturity schedule. The fixing of tariffs each year takes into consideration the recovery of these deferred expenses.

g) Inventories and stocks for fixed assets.

Inventories and stocks are generally valued at their weighted average cost. Provisions are made each year to reduce the value of these assets for technical obsolescence.

h) *Revenue from services.*

Revenue from services is accounted for on the accrual basis. For this reason, at the end of each year adjustments are recorded to defer prepayments with respect to services invoiced bimonthly in advance and to accrue for unbilled services.

i) *Retirement pensions and endowment insurance.*

Retirement pensions of Telefónica's employees are covered by the Institución Telefónica de Previsión (ITP), whose relationship with the Company is described in Note 16.

Endowment insurance (Note 17) is accrued against income by applying the actuarially calculated coefficients to the base-salaries paid; these coefficients include current and past service costs.

j) *Short and long-term debts.*

For the purposes of the balance sheet, debts are classified according to their maturity dates, from the time they are contracted and up to settlement, as follows:

Short-term - Maturity up to 18 months.

Long-term - Maturity over 18 months.

Nevertheless, the corresponding notes disclose the maturities within the 12 months from the balance sheet dates and those subsequent to 12 months.

NOTE 3 - FIXED ASSETS

3.1 *The composition by type of fixed assets and accumulated depreciation, incorporating their corresponding revaluations, is as follows:*

	<u>1986</u>	<u>1985</u>	<u>Years of useful life</u>
Land	31,387	30,989	
Buildings	134,546	125,542	40
Accumulated depreciation	(38,748)	(29,759)	
Power equipment	52,744	47,723	19-21
Accumulated depreciation	(27,099)	(22,312)	
Exchange equipment	845,800	771,243	22-24
Accumulated depreciation	(334,967)	(304,699)	
Transmission equipment	275,406	250,018	15-18
Accumulated depreciation	(148,265)	(143,676)	
Local and trunk networks	1,009,434	895,593	20-24
Accumulated depreciation	(392,622)	(363,597)	
Subscriber sets and other related installations	318,771	292,338	6-10
Accumulated depreciation	(146,671)	(110,918)	
Furniture, office and other equipment	18,697	16,074	8-12
Accumulated depreciation	(9,032)	(7,645)	
Fixed assets in service	2,686,785	2,429,520	
Accumulated depreciation	(1,097,404)	(982,606)	
Net book amount	1,589,381	1,446,914	
Construction in progress	92,353	95,794	
Advances to suppliers of fixed assets	19,478	13,556	
Stocks for fixed assets	29,970	29,942	
Total net book amount	<u>1,731,182</u>	<u>1,586,206</u>	

3.2 *Annual variations were as follows:*

	<u>1986</u>	<u>1985</u>
Revaluations for the year:		
— Gross book value	109,439	123,808
— Accumulated depreciation	43,960	48,534
Additions for the year	211,542	193,900
Dismantled plant (Note 2.2 b)	61,150	45,261
Depreciation charge for the year	131,987	111,083
Average rate of depreciation applied	5.6 %	5.3 %
Stocks for fixed assets:		
Reserve for obsolescence	4,542	2,864
Provision for obsolescence	2,180	2,100

- 3.3 Service and operating conditions and the obligations of the Concession Agreement require Telefónica to maintain a permanent investment program to ensure a service with the most up-to-date and efficient equipment.
The investment budget for 1987 amounts to Ptas 274,047 million, of which Ptas 262,447 million is to be invested in fixed assets and the remainder largely in companies. The continuous and long-term nature of Telefónica's investments means that a part of this budget is related to the completion of projects initiated in previous years.
- 3.4 According to the State Contract, Telefónica's fixed assets used to provide telephone services cannot be mortgaged.
- 3.5 At December 31, 1986, assets amounting to Ptas 283,602 million are subject to legal regulations (mainly inspection by the relevant authorities) derived from Decree Law 19/1961 and Law 61/1978, which regulate the benefits obtained for the reduction of withholding tax on interest on the loans and borrowings indicated in Notes 10 and 11.
- 3.6 Insurance policies contracted by Telefónica cover all assets owned by the Company, with the exception of the local and trunk networks and the subscriber sets, to which the corresponding self-insurance provisions are applied.
- 3.7 Revaluations made to date, in accordance with the criteria of the Concession Agreement mentioned in Note 2.2 b) have resulted in the following movements:

Year	Fixed assets	Accumulated depreciation	Revaluation reserve
From 1946 to 1982	811,174	457,957	353,217
1983	134,420	54,076	80,344
1984	143,342	57,784	85,558
1985	123,808	48,534	75,274
1986	109,439	43,960	65,479
Total	1,322,183	662,311	659,872

- 3.8 The useful lives of the different elements of Telefónica's fixed assets are calculated and based on technical studies carried out by the Company, periodically revised on the basis of technological development and the dismantling program. These useful lives are as described in 3.1. above.

NOTE 4 - INVESTMENTS - Net shareholdings in companies

- 4.1 The details of net shareholdings in companies at December 31 are as follows:

	1986	1985
Group companies	23,284	20,578
Other investments	4,269	5,291
Total	27,553	25,869

Other investments consists of the Company's participation in telecommunication satellites (Intelsat, Eutelsat and Inmarsat).

- 4.2 The information presented in the following table under the titles «Equity value at December 31, 1986» and «Income before tax» have been prepared on the basis of Group Companies financial statements at December 31, 1986. The equity value calculation takes into account audit adjustments required to present the best estimate of the share of net worth at the end of 1986. The accounting principles are described in Note 2.2. d).

4.3. Relevant data for **Telefónica** Group Companies are as follows:

Company name	Share capital	Telefónica holding %	Telefónica book value
Comercial de Servicios Electrónicos, S. A. (COSESA)	700	99.14	1,163
ENTEL, S. A.	650	100.00	861
Compañía Publicitaria de Exclusivas Telefónicas (CETESA)	434	97.33	659
Hispano Radio Marítima, S. A.	500	100.00	681
Gráficas de Burgos, S. A. (GRAFIBUR)	325	100.00	360
Electrónica Aragonesa (ELASA)	300	100.00	458
Telefonía y Finanzas, S. A. (TELFISA)	500	100.00	2,115
Sistemas e Instalaciones de Telecomunicación (SINTEL)	1,100	100.00	2,992
Urbana Ibérica, S. A.	330	100.00	49
Telefónica Internacional de España, S. A.	200	100.00	200
Control Electrónico Integrado	200	73.00	92
Telefonía Sistemas, S. A.	300	100.00	257
Telefonía y Datos, S. A.	225	100.00	175
Telecomunicaciones Marinas, S. A. (TEMASA)	600	100.00	439
T. P. Servicios Integrales de Protección Civil, S. A.	100	56.00	45
Total affiliates			10,546
Telettra Española, S. A.	2,800	51.00	2,052
Cables de Comunicaciones, S. A. (CCSA)	782	49.00	1,087
Industrias de Telecomunicación, S. A. (INTELSA)	2,600	49.00	2,182
Standard Eléctrica, S. A.	17,604	20.99	3,439
INDELEC	600	30.00	149
Amper, S. A.	2,400	15.63	520
Fujitsu España, S. A.	6,000	40.00	2,400
Total associates			11,829
ATT Microelectrónica, S. A.	4,843	20.00	592
European Silicon Structures	380	1.20	148
Other			169
Total others			909
Total Group			23,294

4.4. In April 1986, in connection with the listing of Amper, S. A., shares on the Spanish Stock Exchange, Telefónica reduced its interest in the share capital of such company to 15.63%. In addition, in 1986 Secoinsa was merged with Fujitsu España, S. A., Telefónica's share in the new company being as detailed in 4.3.

4.5. The most relevant operations recorded during the year between Telefónica and Group Companies were as follows:

	Dividends received		Purchase of goods and services by Telefónica	
	1986	1985	1986	1985
Affiliates	140	275	28,525	37,771
Associates	178	191	78,811	54,531
Total	318	466	107,336	92,302

Equity value at December 31, 1986	1986 income before tax profit (loss)	Activity
1,148	83	Marketing of electronic equipment and services for telecommunications.
1,122	248	Development and implementation of projects in data processing.
743	86	Promotion of advertising services for directories, telephone booths and others.
696	10	Marketing and maintenance of electronic marine communication equipment and navigation aids.
323	(41)	Printing telephone directories.
542	130	Manufacture and repair of telephones.
2,117	139	Investment management.
2,620	42	Telecommunication cable and line laying and equipment installation.
1	(36)	Real estate activities.
204	4	Export of telecommunication equipment and resources.
57	(52)	Security systems engineering.
185	(110)	Systems engineering.
161	(64)	Telephone sets repair.
426	(24)	Surveying, laying and repairing submarine cables.
58	22	Education and training in fire, safety and civil protection techniques.
<u>10,403</u>		
2,181	102	Development, manufacture and installation of electronic telecommunication equipment, especially in transmission and radio.
1,349	782	Installation and sale of cables for telecommunications and electrical applications.
2,821	1,588	Manufacture and installation of telecommunication equipment, especially public and private switchboards and defense systems.
1,433	(5,947)	Manufacture of telephone and telegraph transmission and exchange systems.
168	63	Manufacture of portable and mobile communication equipment.
728	1,285	Development, manufacture and repair of telephone and telematic terminals. Manufacture of components (hybrid and flexible circuits).
3,252	1,227	Data transmission and data processing equipment.
<u>11,932</u>		
592	—	Design, manufacture, assembling and marketing of high technology integrated circuits.
148	—	Manufacture and marketing of integrated circuits.
169		
<u>909</u>		
<u>23,244</u>		

NOTE 5 - DEFERRED EXCHANGE LOSSES

The accounting principles applicable are described in Note 2.2 f).

The components of the balance and amortization schedule are as follows:

	Maturities				Balance 31-12-86	Balance 31-12-85
	1987	1988	1989	Subsequent		
Unrealised exchange losses (subject to exchange rate fluctuation)	2,633	2,389	1,639	11,749	18,410	54,292
Deferred realized exchange losses (corresponding to early repayment of loans)	6,591	8,271	6,283	9,284	30,429	11,840
Total	9,224	10,660	7,922	21,033	48,839	66,132
Details of the charge to expenses for the year are as follows:				1986	1985	
Repayment of loans and other debts				10,140	9,937	
Service charges in foreign currency and other				910	(660)	
Net				11,050	9,277	

NOTE 6 - SUBSCRIBERS

The balances at December 31, comprise the following:

	1986	1985
Subscribers services billed:		
Private subscribers	6,778	7,809
Public entity subscribers	16,749	15,622
Ex-subscribers	4,252	3,485
Uncollectible and pending classification	201	130
Unbilled services	27,980	27,046
	57,239	52,640
Provision for bad debts	85,219	79,686
	(5,245)	(3,827)
Total	79,974	75,859

During 1986 cancellation of bad debts amounted to Ptas. 2,206 million (1985, Ptas. 2,927 million).

NOTE 7 - SHARE CAPITAL

All of the outstanding shares of the Company at December 31, 1986 have been fully subscribed and paid-in, and are bearer shares of Ptas 500 par value each. Telefónica shares are listed on the four Spanish Stock Exchanges and, since 1985, also on the Stock Exchanges of Frankfurt, London, Paris and Tokyo.

At December 31, 1986, the State has an approximate 30.4% direct shareholding, together with a further interest estimated at 11.2% through official institutions; the total number of shareholders is estimated to be approximately 700,000. Under Spanish legislation, total foreign shareholdings cannot exceed 25% of its share capital.

The Annual General Meeting of Shareholders held in Madrid on June 27, 1986 authorized the Board of Directors to carry out further issuances of shares until the Company's issued share capital amounts to Ptas 600,882.8 million.

The table below reflects the movements of share capital:

	Number of shares	Par value	Ratio	Price as a percentage of par value	Paid-in
Balance December 31, 1985	720,935,091	360,468			
Issue of January, 1986	80,103,899	40,052	1 X 9	90%	36,047
Issue of May, 1986*	138,157	69		128.375%	89
Issue of October, 1986*	22,408,331	11,204		168.975%	18,932
Balance December 31, 1986	823,585,478	411,793			
Issue of January, 1987*	362,309	181		154.993%	281
Issue of January, 1987*	5,583,542	2,792		148.115%	4,135

* Share capital issued in connection with conversion of convertible bonds - see Note 10.

NOTE 8 - RESERVES AND UNAPPROPRIATED PROFIT

The reserves and unappropriated profit of Telefónica are regulated by the State Contract (Condition 24), under which the Company may make free use of the statutory reserve, whenever operating or financial requirements make this necessary. Said Condition 24 prohibits transferring amounts to the statutory reserve from other reserves.

The availability of the technological development, revaluation and other voluntary reserves is not regulated by specific legislation for the Company, and Telefónica may utilize them on the same basis as the statutory reserve.

NOTE 9 - PROVISIONS

The composition of the provisions is as follows:

	1986	1985
Exchange losses	21,598	21,598
Self-insurance	9,428	7,428
Contingencies	19,850	4,672
	50,876	33,698
Secondary responsibility for complementary pensions of ITP	18,829	18,829
Others	1,689	1,280
	20,518	20,109
Total	71,394	53,807

The provisions for exchange losses and for secondary responsibility, created in 1982, do not correspond to conventional accounting practices and were motivated by criteria of exceptional prudence, thus linking free reserves with possible but not probable contingencies, as follows:

- With respect to exchange losses, the possibility that revenues (tariffs) in future periods would not allow the usual practice of absorbing the realized losses in each year.
- With respect to secondary responsibility for ITP, this provision was set up unilaterally on the part of Telefónica for, if it should decide in the future, to cover eventual shortages in the complementary pension benefits that have to be met by ITP (see Note 16).

NOTE 10 - DEBENTURES AND BONDS

10.1 Composition and movements:

	Balance 31-12-85	New issues	Repayments	Revaluations and other movements	Balance 31-12-86
Debentures and bonds:					
Non-convertible	278,648	25,000	(38,467)	548	265,729
Convertible and/or exchangeable	25,000	55,000	(20,399)	—	59,601
Debentures and bonds in foreign currency	22,299	—	—	1,718	24,017
	325,947	80,000	(58,866)	2,266	349,347
Bonds pending subscription	(245)				(28,539)
Total	325,702				320,808

10.2. Redemption:

	Maturities				Total
	1987	1988	1989	Subsequent	31-12-86
Amount	48,772	36,767	68,804	166,465	320,808

Maturities in 1987 include Ptas 14,455 million corresponding to debentures and bonds whose year of redemption is 1991 and 1992. The debenture and bond holders of the maturities have the option to reclaim redemption in 1987 and/or 1989.

10.3 Additional information:

	1986	1985
Interest expense	39,078	37,648
Accrued interest at December 31	12,742	13,327
Issues subject to fiscal benefits:		
Debentures	136,163	170,505
Debentures in foreign currency	22,712	21,086

- 10.4 Foreign currency debentures were issued for US dollars 50 million and Deutsche Marks 200 million. The US dollars 50 million have been subjected to a swap operation for Belgian Francs 3,183 million.
These debentures are valued at the official closing exchange rate of each currency at year end. The exchange differences charged in 1986 to the unrealised exchange losses account amounted to Ptas 1,718 million (1985-2,556 million).
- 10.5 In December 1986, Ptas 30,000 million of convertible bonds were issued. At December 31, Ptas 28,539 million were pending subscription (see 10.1), as the period for credit of the proceeds ended on January 10, 1987. This issue was fully subscribed and paid within the aforementioned period.
Right to convert these bonds is exercisable on January 1, 1988, 1989 or 1990.
- 10.6 Conversion and exchange options of convertible bonds were exercised in January, 1987 in the amount of Ptas 7,110 million, of which Ptas 2,975 million correspond to the December 1984 issue, and Ptas 4,135 million to the June 1986 issue, leaving Ptas 20,555 million and Ptas 1,936 million of the respective issues outstanding.

NOTE 11 - LOANS AND CREDIT FACILITIES

- 11.1 As mentioned in Note 2.2 j), these accounts are classified in the balance sheet according to maturity dates at the time they are contracted. The balances at December 31 are as follows:

	1986			1985		
	Long term	Short term	Total	Long term	Short term	Total
Loans in foreign currencies	71,023	—	71,023	180,975	—	180,975
Loans and credit facilities	134,114	5,276	139,390	58,859	41	58,900
Other loans	4,651	—	4,651	3,939	1	3,940
Commercial paper (face value)	37,364	40,299	77,663	40,257	13,841	54,098
	247,152	45,575	292,727	284,030	13,883	297,913
Less:						
Deferred interest on commercial paper	8,598	1,948	10,546	13,167	349	13,516
Total	238,554	43,627	282,181	270,863	13,534	284,397

- 11.2 The maturities are as follows:

	Maturities				Balance 31-12-86
	1987	1988	1989	Subsequent	
Loans in foreign currencies	6,126	6,743	6,710	51,444	71,023
Loans and credit facilities	26,310	37,053	17,635	58,392	139,390
Other loans	—	—	—	4,651	4,651
Commercial paper	54,337	83	23,243	—	77,663
Total	86,773	43,879	47,588	114,487	292,727

Telefónica made early repayments of foreign currency loans in 1986 amounting to Ptas 130,371 million.

- 11.3 Additional information:

	Financial charges		Interest accrual (Deferral)		Interest rates	
	1986	1985	1986	1985	1986	1985
Loans in foreign currency	8,976	16,415	1,157	2,928	5.25-13%	4.5-13%
Loans and credit facilities	12,405	6,629	3,010	1,465	10-17%	11-18%
Commercial paper:	5,970	7,470	—	—	8.80-17%	10-17%
Long term			(8,598)	(13,167)		
Short term			(1,948)	(349)		

- 11.4 Loans denominated in foreign currencies include a "multiple financing operation" amounting to US dollars 250 million (Ptas 33,140 million at the closing exchange rate of December 31, 1986) represented by euro commercial paper with maturities of less than six months. When these notes become due, the Company may opt to:
- issue new euro commercial paper.
 - use the credit facility stipulated in the contract for the amounts due.
 - with prior permission of the Bank of Spain, repay the notes without using such credit facility.
- In the event that alternative c) is selected, the Company may, during the period the operation is in force (ten years from April 25, 1986), use the unused balance, either as a loan/credit facility or for commercial paper issues. The maturities schedule (see 11.2) reflects this operation in accordance with the final due date of the contract (1996) and not according to the maturities of the financial instruments in which it is currently denominated.
- 11.5 The loans and credit facilities accounts reflect only the drawn down part of the facilities obtained. Unused facilities are included in the memorandum accounts (see Note 18).
- 11.6 At December 31, 1986, of the total foreign currency loans, Ptas 60,073 million are covered by the fiscal benefits of Decree law 19/1961 and Law 61/1978.
- 11.7 In accordance with the accounting criteria mentioned in Note 2.2 f), the amount of exchange differences arising from these loans in 1986 resulted in a credit to the account of unrealized exchange losses of Ptas 8,853 million (in 1985 there was a debit of Ptas 13,068 million).
The composition of foreign currency debt is shown below although, as a function of the multicurrency clause, the composition of those denominated in US dollars at December 31, 1986, may undergo changes throughout their life in accordance with currency expectations at any given time:

	Millions	
	1986	1985
US Dollars (USA\$)	295.7	530.5
Deutsche Marks (DM)	50.0	273.8
Swiss Francs (SF)	215.0	652.7
Canadian Dollars (CAN\$)	—	10.0
Swedish Crowns (SKR)	12.0	23.2
Dutch Florins (DFL)	40.0	50.0
Pounds Sterling (£)	—	50.0
ECU's	—	75.0
Yens	10000.0	10000.0

- 11.8 Commercial paper is accounted for at face value, less interest deferred at December, 31. Interest costs are accounted for over the period during which the commercial paper is outstanding, with the charge to results being calculated using the capital outstanding method. The charges attributable to expenses in future periods are as follows:

	1987	1988	1989	Subsequent	Total
Interest on commercial paper-long term	3,448	3,381	1,769	—	8,598
Interest on commercial paper-short term	1,948	—	—	—	1,948

NOTE 12 - SUPPLIERS AND NOTES PAYABLE TO SUPPLIERS

The balances at December 31, 1986 include Ptas 15,665 million corresponding to transactions with affiliated and associated companies, Ptas 6,250 million relating to transactions with suppliers in foreign currencies, and the remainder to Spanish suppliers and contractors.

	1987	1988	1989	Subsequent	Total
Repayment schedule of notes payable	4,880	1,334	799	1,654	8,667

NOTE 13 - TAXES PAYABLE

The balances at December, 31 comprise the following:

	1986	1985
State Levy	26,856	23,435
Telephone Usage Tax and other	—	17,142
Value Added Tax	1,242	—
Payroll withholding tax	5,671	4,753
Tax withholdings on dividends and interest	2,774	1,118
Total	36,543	46,448

NOTE 14 - OTHER CREDITORS

These comprise the following groups of accounts:

	1986	1985
Staff bonus provision	9,657	8,630
Telephone service interchange	4,856	3,992
Guarantees and deposits	1,690	1,408
Other creditors	8,229	11,529
Total	24,432	25,559

NOTE 15 - ACCRUED EXPENSES AND DEFERRED INCOME

These are disclosed as follows:

	1986	1985
Accrued interest	16,909	17,174
Services billed in advance	10,435	9,496
Deferred income - Value Added Tax (transitory rules)	5,778	—
Other	6,014	4,226
Total	39,136	30,896

NOTE 16 - PENSIONS

- 16.1 *Telefónica's employees benefit from pensions substitutory for and complementary to those provided in Spain by the Social Security, and from a Group Endowment Insurance scheme (the latter is explained in Note 17).*

All benefits, other than the Group Endowment Insurance, are covered by the «Institución Telefónica de Previsión (ITP)», a mutual pension fund created under the «Ley de Montepíos y Mutualidades de Previsión Social» (Social Service Mutual Law) of December 6, 1941 and the regulations pertaining thereto of May 26, 1943. In accordance with such legal framework, ITP is an entity with a completely independent legal status, and as such is governed by its own Regulations as approved by the Sub-secretary of Social Security on January 28, 1977.

Benefits provided by ITP to its members are of various types, as detailed in Article 4 of the ITP's Revised Text of Regulations, and mainly include retirement pensions, permanent disability, widowhood and pension bonus payments. Pension benefits are calculated in relation to length of service, applying a percentage scale to the pension-base salary, up to a limit of 90% of such base salary; the maximum current pension is Ptas 4.2 million per annum.

The members covered by this plan comprise approximately 9,450 retired persons (pensioners) and 62,260 members currently on the payroll, whose current contributions represent 4.3% of their total gross salary (pension-base salary).

To meet the abovementioned combination of benefits ITP relies principally on the profits earned on its assets and on the contributions of Telefónica and those of its members. During 1986 the contributions of Telefónica amounted to Ptas 11,141 million and those of its employees to Ptas 5,325 million.

The financial policy of ITP is governed by the regulations in force and requires the establishment of the necessary reserve funds in order to meet the benefits of its retired members. Studies carried out show a shortfall in reserves and the insufficiency of income to cover medium and long-term commitments.

In August 1984, the General Law for Private Insurance was promulgated which in the case of ITP requires the segregation of its two pensions plans, the substitutory and the complementary, before August 1987. The complementary plan is also to be adapted to the new regulation which requires, among other matters, the obligation to adopt a capitalization method, based on actuarial calculations.

- 16.2 *Telefónica's commitments to the ITP comprise the obligation to contribute annual payments as determined in the ITP regulation, together with a guarantee of up to Ptas 8,000 million, included under memorandum accounts. This guarantee was granted in 1977 for the purpose indicated by Transitory Stipulation 4 of the ITP Regulations, which read: «Telefónica guarantees the effectiveness of the benefits to be satisfied by the ITP during the period of ten years...».*

For its part, as principal respondent, ITP is obligated to readjust its revenue or the benefits granted or to be granted, should the guarantee not be renewed or whensoever it considers necessary (Article 19 and Transitory Stipulation 4 of the ITP Regulations).

On January 28, 1987 this guarantee matured and was not renewed by Telefónica.

- 16.3 *Independently of the above, Telefónica has a provision of Ptas 18,829 million charged in 1982 against the revaluation surplus and which, as indicated in Note 11, was set up unilaterally on the part of Telefónica for, if it should decide in the future, to cover eventual shortages in the complementary pension benefits that have to be met by ITP.*

- 16.4 *Telefónica has shown its willingness to collaborate in the configuration of a future scheme that would make its workers' social service system viable. Consequently, negotiations have been held since 1985 without a final agreement being reached. The contribution offered by Telefónica during this negotiation process have been properly accrued at December 31, 1986 and 1985.*

Should a final agreement be reached, Telefónica will not accept, as a consequence thereof, and also considering the contributions that it may have to make as compensation for integrating its employees in the Social Security, any obligation that would involve any modification to its shareholders' equity at December 31, 1986 nor a significant impact on its prospective future profitability.

NOTE 17 - ENDOWMENT INSURANCE

Telefónica's employees have the right on reaching 65 years of age, whether still at work or retired, to receive a single payment for endowment insurance, which depends on the personal situation of each employee.

To cover payment of these benefits, funds have been constituted and placed with an insurance company and in Telefónica that, at December 31, 1986, amounted to Ptas 5,839 million and Ptas 20,428 million, respectively; of the latter, Ptas 1,969 million are shown in short-term balance sheet liabilities. In 1986 the Company has provided these Funds, including interests accrued on capitals constituted, with a total of Ptas 7,513 million charged against income (1985, Ptas 5,251 million).

Based on the actuarial calculations that have been carried out on the basis of charging these benefits throughout the average working life of the employees, the effect is as follows:

- a) The annual charge for the year 1986, 4.8% of the overall payroll cost, is sufficient to cover this objective.
- b) At December 31, 1986, the present values of the future commitments, calculated at an interest rate of 8% applied on current salaries amounts to approximately Ptas 74,000 million (68,000 million in 1985).

NOTE 18 - MEMORANDUM ACCOUNTS

The detail of balances at December 31, is as follows:

	1986	1985
Unused credit facilities: (Note 12.3)		
Available credit - long-term	53,965	70,941
Floating rate credit facilities	42,500	48,900
Available credit - short-term	1,500	1,459
	97,965	121,300
Guarantees of financial operations	3,294	4,419
Guarantee to ITP	8,000	8,000
Guarantees granted to employees	4,667	5,137
Others	11,033	8,208
	26,994	25,764
Total	124,959	147,064

Guarantees of financial operations refers primarily to guarantees given by the Company involving bank guarantees to cover financial operations of group companies.

NOTE 19 - SUBSEQUENT EVENTS

- 19.1 After December 31, 1986 two draft laws were approved by the Government and sent to the Parliament, regarding the regulation of telecommunications in Spain and a new taxation regime for Telefónica. Upon reading these draft laws as presented, management expects that no significant impact in Company's operations and profitability will arise from these proposed laws.
- 19.2 Subsequent to December 31, 1986 Telefónica sold its interests in Intelsa, Gráficas Burgos, S. A., Telefonía y Datos, S. A., Electrónica Aragonesa, S. A. and Electrónica Básica, S. A., for approximately Ptas 6,150 million which exceeded the recorded book value of these companies at December 31, 1986. On April 11, 1987 agreements in connection with the viability plan for Standard Electric, S. A., were finalized. These agreements provide for additional capital contributions by the co-owners, Telefónica's share of which will be up to a maximum of Ptas 3,720 million.

RECONCILIATION OF NET INCOME AND SHAREHOLDERS'S EQUITY AS REPORTED IN THE SPANISH STATUTORY ACCOUNTS WITH NET INCOME AND SHAREHOLDER'S EQUITY IN ACCORDANCE WITH INTERNATIONAL ACCOUNTING STANDARDS (IAS) AND UNITED STATES GENERALLY ACCEPTED ACCOUNTING PRINCIPLES (US GAAP)

Certain accounting practices applied by **Telefónica** in its financial statements prepared for use in Spain, together with others required or allowed under the Conditions of Concession of **Telefónica** as a regulated entity (Note 2.2 a)*, may not conform with International Accounting Standards (IAS) nor with generally accepted accounting principles in the United States (US GAAP).

As a result of **Telefónica**'s shares being traded in various foreign stock exchanges and our intended listing in the New York Stock Exchange, the Company is requested to adjust its net income and shareholder's equity based on different accounting principles.

The most significant of these accounting practices are summarized bellow:

Presente practice for Local Spanish purposes

Treatment for IAS purposes

- | | |
|--|---|
| 1. Intangible assets (See Note 2.2 c)* | Research and development cost are expenses as incurred. The effect is shown below. |
| 2. Technological development reserve (See Note 2.2 b)* | Net effect of costs and revenue arising from dismantling should be taken into the profit and loss account. The effect is shown below. |
| 3. Short and long term debt (See Note 2.2 j)* | Short and long term debt is classified on the basis of twelve months from the balance sheet date. Note 10 to 12, show the classification on this basis. |
| 4. Foreign currency accounts (See Notes 2.2 f) and 6)* | IAS No. 21 establishes a different treatment. However, in view of Telefónica 's special position as a regulated entity, the treatment in the accounts is considered appropriate. |

Treatment for US GAAP purposes

- | | |
|--|---|
| 5. Property, plant and equipment (See Notes 2.2 b) and 3)* | Revaluation of fixed assets is not permitted. Property, plant and equipment and related accumulated depreciation are stated at historical cost values. |
| 6. Investments (See Notes 2.2.d) and 4)* | Investments in subsidiaries should generally be accounted for as follows: <ul style="list-style-type: none"> — More than 50% holding: consolidated or equity method of accounting. — Between 20 and 50% holding: Equity method of accounting. — Less than 20% holding: At the lower of cost or net realizable value. |
| 7. Costs of new equity capital (See Note 2.2. e)* | US GAAP require expenses of raising equity capital to be deducted from the proceeds of the new capital. |
| 8. Income per share is not required to be in the financial statements nor in any other obligatory financial information. | Per share computations are required to be shown. |
| 9. Endowment insurance (See Note 2.2 i)* | Past service costs were actuarially computed at December 31, 1986. Unit credit method was used based on current salary with a 40 year amortization of prior service obligations, retroactively applied to January 1, 1967. |

The total effect on the income statement and on the statement of changes in shareholders' equity is as follows (in millions of pesetas):

	1986	1985
Net income for the year as reported in the Spanish statutory accounts at December 31	45,252	39,149
Adjustments for IAS purposes:		
Research and development expenses - Net effect between prior write-offs and current amortization	1,140	1,030
Release of technological development reserve	2,317	3,560
Self-insurance and other	2,000	1,500
Approximate net income for the year in accordance with IAS	50,709	45,239
Adjustments for US GAAP purposes:		
Reversal of depreciation on revalued portion of fixed assets	55,126	47,794
Reversal of amortization of costs of new equity capital	501	150
Adjustment of investments to net equity value	(2,449)	(1,383)
Adjustment of endowment insurance cost	1,150	(800)
Approximate net income for the year in accordance with US GAAP	105,037	91,000
Approximate net income per share	132.2	130.7
Shareholders' equity as reported in the Spanish statutory accounts at December 31.	1,015,596	890,920
Net income for the year	45,252	39,149
Adjustments for IAS purposes:		
Investments	(5,735)	(4,423)
Research and development written-off	(3,257)	(4,397)
Release of provisions set up in prior years not required under IAS	48,624	46,624
Approximate shareholders' equity in accordance with IAS	1,100,480	967,873
Adjustment for US GAAP purposes:		
Reversal of net effect of revaluation of fixed assets and related accumulated depreciation	(452,706)	(443,460)
Cost of new equity capital	(693)	(765)
Adjustment of investments to equity value	(6,788)	3,583
Accrual of past service cost of endowment insurance	(1,201)	(2,351)
Approximate shareholders' equity in accordance with US GAAP	639,092	542,880

Shareholders' rights and all dividend distributions are based on the financial statements as drawn up for local Spanish statutory purposes.

* Notes in parenthesis refer to the notes to the financial statements in pages 58 to 69 of this Annual Report.

Board of Directors

CHAIRMAN

Luis Solana Madariaga*

VICE-CHAIRMEN

Pablo Garnica y Mansi*

José María Concejo Alvarez*

José María Amusátegui de la Cierva*

MANAGING DIRECTOR

Diego Martínez Boudes*

DIRECTORS (Representing shareholders)

Juan Antonio Blanco-Magadán Amutio

Emilio Botín-Sanz de Sautuola y García de los Ríos

Jaime Carvajal y Urquijo

Luis Delso Heras

Francisco Javier Eiroa Villarnovo**

Alvaro Espina Montero

Eugenio Estévez Cepeda

María Paz Fernández Felgueroso*

Jesús González del Yerro Martínez**

Julio González Sabat*

José Montes Fernández

Juan Manuel Rebollo Castrillo

Epifanio Ridruejo Brieva*

DIRECTORS (Representing the Government)

Prudencio García Gómez*

Saturnino Suanzes de la Hidalga

José María García Alonso*

SECRETARY

Manuel María de Araluce y Araluce**

VICE-SECRETARY

Mariano Aldama Magnet

GOVERNMENT DELEGATE

Javier Nadal Ariño*

* Members of the Executive Committee of the Board of Directors.

Management Committee

Chairman:

Luis Solana Madariaga

Members:

Diego Martínez Boudes

José Antonio Adell García

Germán Ramajo Romero

Enrique Used Aznar

Carlos Viada Fernández-Velilla

Secretary:

Luis Terol Miller

Changes recorded after year-end

**Francisco Javier Eiroa Villarnovo, retired on February 25, 1987. **Jesús González del Yerro Martínez, retired on January 28, 1987. **Manuel María de Araluce y Araluce retired on January 14, 1987 as secretary to the Board and the Executive Committee. Miguel Cruz Amorós, was appointed Director on February 25, 1987. Antonio Flos Bassols, was appointed Director on January 28, 1987. Heliodoro Alcaraz García de la Barrera, was appointed Secretary to the Board and the Executive Committee on January 28, 1987.

General Managers

José Antonio Adell García - **Network**
Germán Ramajo Romero - **Operations**
Enrique Used Aznar - **Marketing**
Carlos Viada Fernández-Velilla - **Administration and Finance**

Deputy General Managers

Heliodoro Alcaraz García de la Barrera,
Legal Services

Juan Manuel Barreiro de las Llanderas,
Marketing (Business Customers)

José Caballero Guerrero,
Economic Control

Jaime Comenge Puig,
International Coordination

Juan Cruz Larrea Arechavala,
Managing Director's Office

José Luis Fernández Dopico,
Security

Guillermo Fernández Vidal,
Marketing (Major Customers)

Francisco Ferre Ferre,
Outside Plant

José Luis Franganillo Asensio,
Labour Relations, Administration and Procurement

Rafael Hernández García,
Operations

Luis Lada Díaz,
Network Management, Planning and Technology

Antonio López-Barajas y García Valdecasas,
Marketing (Residential customers)

Francisco Martínez Martínez,
Expansion of Rural Telephone Service

Francisco Javier Monzón de Cáceres,
Finance and Holdings

Crisanto Plaza Bayón,
Planning Office

Faustino Rivero Morales,
Inspection

Luis Terol Miller,
Secretary and Management Committee

José María Vázquez Quintana,
Inside Plant

Roberto Velázquez Martín,
Corporate Relations and Communications

Provincial Managers

Madrid Abilio Bolaños Rodríguez Ríos Rosas, 24-26. Tel.: (91) 441 43 98. 28003 MADRID	Barcelona José María Canals y Cabiro Avda. de Roma, 73-91. Tel.: (93) 317 22 22. 08029 BARCELONA
Juan Cruz Aguirre Bravo, Alava C/ Vitoria, 22. Tel.: (945) 28 30 32/28 30 33 01013 VITORIA	Salvador Montalvá Montalvá, Castellón Avda. Tárrega Montebianco, 28. Tel.: (964) 21 35 53 12006 CASTELLON
Francisco Payán Fernández, Albacete C/ Iris, 4. Tel.: (967) 21 10 17 02005 ALBACETE	Francisco González Arroyo, Ciudad Real Ronda de Calatrava, s/n. Tel.: (926) 22 00 22 13004 CIUDAD REAL
José Antonio Aranda Muñoz, Alicante C/ San Mateo, 10. Tel.: (96) 521 53 12 03013 ALICANTE	Fidel Fernández Pérez, Córdoba C/ Hermanos González Murga, 10. Tel.: (957) 47 42 28 14001 CORDOBA
Carlos J. Cruz Fernández, Almería C/ González Garbin, 12. Tel. (951) 23 56 56 04001 ALMERIA	Francisco Viniegra Pacheco, La Coruña C/ de la Cerca, 18. Tel.: (981) 29 55 33 15009 LA CORUÑA
José García Iglesias, Asturias C/ Evaristo Valle, s/n. Tel.: (985) 28 80 00 33011 OVIEDO	Luis Rosado Calatayud, Cuenca C/ Escultor Marco Pérez, 3. Tel.: (966) 22 08 08 16003 CUENCA
Luis González Fernández, Avila C/ Alfonso de Montalvo, 24. Tel.: (918) 21 11 71 05001 AVILA	Santiago Pratdepadua Roca, Gerona Carretera de Barcelona, 55. Tel.: (972) 20 15 25/21 01 21 17001 GERONA
Juan López Tourón, Badajoz C/ Enrique Segura Otaño, 8. Tel.: (924) 23 05 05 06004 BADAJOZ	José Miguel Jiménez Ortiz, Granada Carretera de la Zubia, s/n. Tel.: (958) 12 19 12 18080 GRANADA
Antonio Salamero Salas, Balearic islands C/ Almirante Gravina, 3. Tel.: (971) 23 80 32 07014 PALMA DE MALLORCA	José Ortega Martínez, Guadalajara C/ Doctor Mayoral, 1. Tel.: (911) 21 22 12 19001 GUADALAJARA
Alberto González Soto, Burgos Glorieta de Logroño, 1. Tel.: (947) 20 12 21 09006 BURGOS	Juan M. Santiago Burruchaga, Guipúzcoa C/ Sagrada Familia, s/n. Tel.: (943) 45 33 66 20010 SAN SEBASTIAN
Santiago Teresa Cobo, Cáceres C/ Antonio Reyes Huertas, 21. Tel.: (927) 22 13 14 10002 CACERES	Francisco García Báñez, Huelva C/ Puerto, 23. Tel.: (955) 25 66 77 21001 HUELVA
Hilario Laguna Martínez, Cádiz Avda. Andalucía, 77. Tel.: (956) 25 31 50 11009 CADIZ	Antonio Trávez Armingol, Huesca C/ José María Lacasa, 6. Tel.: (974) 22 67 67/24 01 24 22001 HUESCA
Pedro Sañudo Arredondo, Cantabria C/ Cisneros, 76. Tel.: (942) 23 10 85 39007 SANTANDER	Juan Francisco Rodríguez García de Quesada, Jaén C/ Albéniz, 8 Tel.: (953) 26 49 92 23008 JAEN

Pilar Garrido Martínez, León Avda. del Padre Isla, 26. Tel.: (987) 22 07 90 24002 LEON	Juan Pascual Rincón, Segovia Plaza de los Huertos, 1. Tel.: (911) 43 36 42 40001 SEGOVIA
Antonio Arbonés Viñes, Lérida C/ Francesc Maciá, 33. Tel.: (973) 24 54 24/24 53 33 25007 LERIDA	Julio Ferreiro Castro, Seville Avda. Dr. Pedro de Castro, s/n. Tel.: (954) 41 80 80 41004 SEVILLA
Alejandro Buixaderas Martínez, Lugo Río Neira, s/n. Tel.: (982) 22 31 00 27002 LUGO	José Luis Lozano Burguillo, Soria Plaza de San Clemente, 7. Tel.: (975) 22 55 28 42002 SORIA
José Borrajo Quinteiros, Málaga C/ Eurgenio Gross, 1. Tel.: (952) 35 14 10 29010 MÁLAGA	Enrique Claverol Arbonés, Tarragona Avda. Prat de la Riva, 32. Tel.: (977) 21 55 00 43001 TARRAGONA
José Pagán Vicente, Murcia C/ San Antón, 4. Tel.: (968) 29 22 29 30005 MURCIA	Fernando Fernández Sánchez, Tenerife C/ Porlier, 36. Tel.: (922) 27 11 72 38080 SANTA CRUZ DE TENERIFE
Bernardo F. Santos Alvarez, Navarre Monasterio de la Oliva, 9. Tel.: (948) 22 66 62/27 60 27 31011 PAMPLONA	Juan García Justos, Teruel Plaza del Tremedal, 4. Tel.: (974) 60 23 82 44001 TERUEL
Emilio Salgado Rodríguez, Orense C/ Marcelo Macías, 1. Tel.: (988) 22 75 50 32005 ORENSE	José A. Deniz Cubas, Toledo C/ General Villalva, 15. Tel.: (925) 22 09 88 45003 TOLEDO
José Luis Garrido Hernández, Palencia C/ Pintor Oliva, 6. Tel.: (988) 72 14 45 34004 PALENCIA	Manuel Conejos Valdés, Valencia C/ San Vicente Mártir, 148. Tel.: (96) 352 14 44 46007 VALENCIA
Juan Jesús Martín Tardío, Las Palmas C/ José Franchy Roca, 11. Tel.: (928) 26 57 01 35007 LAS PALMAS DE GRAN CANARIA	Alberto Gallegos Quintano, Valladolid Paseo Zorrilla, 104. Tel.: (983) 47 16 92 47006 VALLADOLID
Jaime C. González Fernández, Pontevedra Avda. de Zamora, 3. Tfno.: (986) 41 10 40 VIGO (Pontevedra)	Fernando Nebot Couchoud, Vizcaya Gregorio de la Revilla, 27. Tel.: (94) 432 78 00 48010 BILBAO
Honorio Millán Ibáñez, La Rioja C/ San Millán, s/n. Tel.: (941) 23 07 22/23 07 23 26004 LOGROÑO	Miguel A. Ruiz de Diego, Zamora Avda. Generalísimo, 18. Tel.: (988) 52 17 13 49004 ZAMORA
Nicolás Escudero Romero, Salamanca C/ Velázquez, 6. Tel.: (923) 22 11 66 37005 SALAMANCA	Valeriano Delgado Grijalvo, Zaragoza Plaza del Portillo, 10. Tel.: (976) 43 24 23 50004 ZARAGOZA

Area Support Managers

Andrés Ramíez Yéboles.—**Northeast**
Eduardo Ibarra, 6. ZARAGOZA. Tel.: (976) 35 21 12
Juan Tarragó Galcerá.—**Northwest**
Avda. Fernández Ladreda, 67. LEON. Tel.: (987) 20 24 25

Fausto González Valle.—**Southeast**
San Vicente Mártir, 148. VALENCIA. Tel.: (963) 341 29 11
Antonio López Fernández.—**Southwest**
Ruben Dario, s/n. SEVILLE. Tel.: (954) 45 15 15.

Share Capital

The share capital of **Telefónica** at April 30, 1987 was 414,765,664,500 pesetas, represented by 829,531,329 bearer shares of 500 Ptas. nominal value, fully paid-in.

Capital increases since 1982 are as follows:

Year	Ratio	Issue Price (pts.)	Paid by the shareholder (pts.)	Nominal amount Millions of Ptas.
1982	—	—	—	—
1983	1 × 5	500.—	350.—	48,062.3
1984	1 × 9	500.—	350.—	32,041.6
1985	1 × 8	500.—	400.—	40,051.9
1986	1 × 9	500.—	450.—	40,051.9
1986*	—	642.875	641.875	69.1
1986*	—	844.875	844.875	11,204.2
1987*	—	774.965	774.965	181.2
1987*	—	740.575	740.575	2,791.8

* Conversion.

Share Listings

Telefónica shares are listed on all the Spanish Stock Exchanges —Madrid, Barcelona, Bilbao and Valencia—, and on four foreign Stock Exchanges: London, Paris, Frankfurt and Tokyo.

Market prices

The table below shows closing prices on the Madrid Stock Exchange, in pesetas.

Year	High	Low	Year-end close
1982	370.00	301.25	322.50
1983	465.00	301.25	350.00
1984	523.75	330.00	465.00
1985	720.00	472.50	637.50
1986	1,142.50	632.50	875.00

Turnover on the Madrid Stock Exchange (MSE)

	1986	1985	1984	1983	1982	Growth 86/82*
Telefónica	179.3	98.5	19.3	11.6	3.7	163.8
Total MSE	1,757.2	492.5	286.0	137.2	125.5	93.4

(Figures in thousands of millions of Pesetas, at December 31)

* % Cumulative annual average rate.

Stock Market Capitalisation

	1986	1985	1984	1983	1982	Growth 86/82*
Telefónica	701.0	459.6	298.0	201.9	155.0	45.83
Total MSE	6,433.0	3,007.3	2,294.5	1,711.0	1,403.5	46.32

(Figures in thousands of millions of Pesetas, at December 31).

* % Cumulative annual average rate.

Dividend Policy

Telefónica normally pays an interim dividend at year end, and a final dividend once the total dividend for the year has been approved by the General Meeting of Shareholders pursuant to the proposal of the Board of Directors.

New shares from capital increases participate in net income on the basis of the time that they have been outstanding.

Recent dividends were:

	1986	% of par val.	1985	% of par val.
Interim	25 Pts.	5	25 Pts.	5
Final	30 Pts.*	6*	30 Pts.	6
TOTAL	55 Pts.	11	55 Pts.	11

* Pending approval by the General Meeting of Shareholders, in accordance with the proposal for net income distribution (page 58).

Principal shareholders of Telefónica

Since **Telefónica** shares are bearer shares, no official register of shareholders exists. Nevertheless, on paying the interim dividend for 1986 on January 20, 1987 it was verified that the main shareholders are:

	Interest as % of Share Capital
Spanish State	30.43%
Bank of Spain	10.18%
Caja Postal (Post Office Savings Bank)	1.06%

The Company is not aware of any other shareholder owning more than 5% of the shares issued. According to the General Register of Foreign Transactions at the Directorate General of Foreign Transactions of the Ministry of Finance, foreign shareholdings in the Company amounted to 15.05% as of January 31, 1987.

Notice of the General Meeting of Shareholders

Date: May 22, 1987 (at the second notice)

Time: 12.00 h.

Place: Paseo de la Castellana, 259

Shareholder Information

Copies of this Annual Report may be obtained without charge at the Company's offices or by writing to:

FINANCIAL DEPARTMENT - Investor Relations
Compañía Telefónica Nacional de España, S. A.
General Perón, 38 - MASTER II - planta 15
28020 MADRID

In compliance with the stipulations of the Ministry Orders of November 17, 1981 and February 26, 1982, a half-yearly information brochure is available to shareholders.

SHAREHOLDER INFORMATION

	1986 \$	1986	1985	1984	1983	1982
Share capital at December 31 (millions of Ptas.) (1)	\$ 3,110.22	411,793.00	360,468.00	320,416.00	288,374.00	240,311.70
Weighted average shares outstanding (thousands)	808,258.00	808,258.00	702,720.00	585,702.20	493,001.00	480,623.40
Market price at December 31 (Ptas.)	\$ 6.61	875.00	637.50	465.00	350.00	322.50
Adjusted book value per share (Ptas.)	\$ 9.88	1,308.41	1,263.47	1,205.33	1,135.92	1,110.88
Adjusted cash flow per share (Ptas.)	\$ 2.04	270.23	246.21	240.74	226.57	186.56
Adjusted earnings per share (Ptas.)	\$ 0.42	55.99	54.28	52.52	51.56	49.84
Market price/book value	0.67	0.67	0.49	0.39	0.28	0.26
Market price/cash flow	3.25	3.25	2.52	1.82	1.43	1.56
P/E ratio	15.63	15.63	11.44	8.35	6.27	5.84
Adjusted dividend per share (Ptas.)	\$ 0.42	55.00	53.59	51.87	50.76	49.62
Dividend yield (%)	6.29	6.29	8.63	11.83	15.71	17.05
Overall rate of return on the Madrid Stock Exchange (%) (2)	48.66	48.66	52.85	50.73	27.55	3.42
Payout (%)	98.64	98.64	98.72	98.76	98.40	99.58
Turnover in Telefónica shares/Total turnover on the Madrid Stock Exchange (%)	10.21	10.21	19.99	6.76	8.45	2.95
Dealing frequency (%)	100.00	100.00	100.00	100.00	100.00	100.00
Weighting in the Madrid Stock Exchange Index (%)	15.20	15.20	11.90	10.71	11.20	9.60

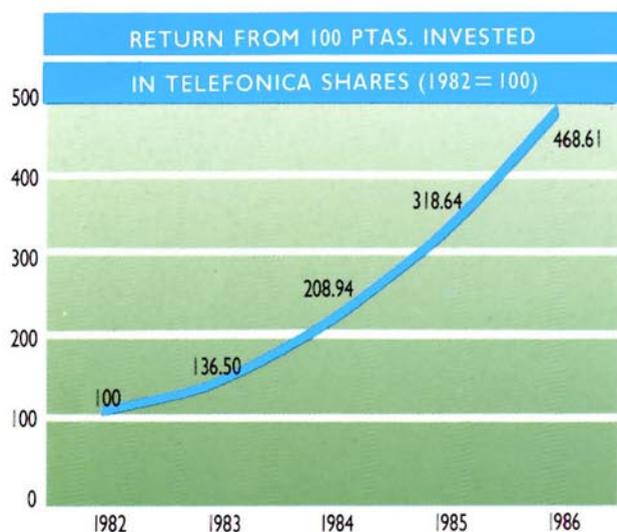
(1) Divided into shares of 500 Ptas. nominal value.

(2) Includes: gross dividend, average subscription rights and capital gains.

1986 return* on Telefónica shares in:

Frankfurt	30.45%	London	65.26%
Paris	49.54%	Tokyo	33.82%

* Overall return, including: dividends, average subscription rights and capital gains in local currency.



TELEFONICA: INTERNATIONAL COMPARISONS AT DECEMBER 31, 1986



IT — INTERNATIONAL TELECOMMUNICATIONS INDEX (source: "Capital International Perspective")

T — TELEFONICA.—Data according to spanish accounting principles.

T (US. GAAP.) - TELEFONICA.—Data according to US accounting principles.

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