REPORT ON THE OPERATION OF THE AUDIT AND CONTROL COMMITTEE OF THE BOARD OF DIRECTORS OF TELEFÓNICA, S.A., FISCAL YEAR 2017
INDEX

I. Introduction

II. Regulation of the Committee.

III. Composition of the Committee.

IV. Functions and duties of the Committee.

V. Meetings of the Committee.

VI. Significant activities of the Committee.

VII. Evaluation of the operation and performance of the Committee.

VIII. Information on the Committee's opinion regarding the independence of the Statutory Auditor.

IX. Information on the practical guides regarding Audit Committees followed by the Committee.

X. Conclusions.

XI. Date of preparation and of approval of the Report.
I. INTRODUCTION.

This Report on the Operation of the Committee for fiscal year 2017 has been prepared pursuant to the provisions of Recommendation 6 of the Code of Good Governance of Listed Companies, of Section 79 of Technical Guide 3/2017 of the National Securities Market Commission (Comisión Nacional del Mercado de Valores, or CNMV) on Audit Committees at Public-Interest Entities, and of Article 9 of the Regulations of the Audit and Control Committee of Telefónica, S.A. (hereinafter, the Company).

II. REGULATION OF THE COMMITTEE.

The Audit and Control Committee was created by a resolution adopted by the Board of Directors of the Company at its meeting held on January 29, 1997; the duties, powers and activities of which have since then been extensively developed pursuant to legal requirements and both domestic and international corporate governance recommendations (with particular reference to the legal reforms made to the Companies Act (Ley de Sociedades de Capital) by Law 31/2014, of December 3, amending the Companies Act to improve corporate governance; to the Code of Good Governance published by the CNMV in February 2015; to Technical Guide 3/2017 of the CNMV on Audit Committees at Public-Interest Entities; to the Sarbanes-Oxley Act; and to the regulations of the New York Stock Exchange (NYSE)).

The Audit and Control Committee of Telefónica, S.A. is regulated in Article 39 of the Company’s By-Laws and in Article 22 of the Regulations of the Board of Directors.

Additionally, and in order to comply with the recommendations of Technical Guide 3/2017 of the CNMV on Audit Committees at Public-Interest Entities, upon a proposal from the Audit and Control Committee, the Board of Directors approved the Regulations of the Audit and Control Committee of Telefónica, S.A. at its meeting held on December 13, 2017.

All the aforementioned internal regulations of Telefónica, S.A. (By-Laws, Regulations of the Board of Directors and Regulations of the Audit and Control Committee) are available to the public on the Company’s corporate website (https://www.telefonica.com/es/web/shareholders-investors).

III. COMPOSITION OF THE COMMITTEE.

As regards its composition and pursuant to the provisions of Article 39 of the Company’s By-Laws, Article 22 of the Regulations of the Board of Directors, and Articles 1 and 2 of the Regulations of the Audit and Control Committee, the Committee will consist of the number of Directors that the Board of Directors determines from
time to time, which shall in no case be less than three, to be appointed by the Board of Directors. All members thereof must be External or Non-Executive Directors, and at least a majority of them must be Independent Directors.

The Chairman of the Audit and Control Committee, who shall in all events be an Independent Director, shall be appointed from among its Members and must be replaced every four years. The Chairman may be re-elected after the passage of one year from when they ceased to hold office.

The Members of the Audit and Control Committee must have the experience and expertise in management, economics, finance and business that is required of any Director. The Board of Directors shall also endeavor to ensure that the Members of the Committee, taken as a whole, combine the necessary expertise not only in accounting and auditing but also in finance, internal control, risk management and the business.

All of the aforementioned standards as to the composition, expertise and training of the Audit and Control Committee are intended to secure the utmost independence for the Committee.

Additionally, in accordance with the provisions of Rule 10A 3 and Section 303 of the Securities and Exchange Commission (SEC) and of the New York Stock Exchange (NYSE), respectively, in 2017 the NYSE was informed of the composition of the Audit and Control Committee, as well as of the status of its members (expressly stating their expertise and experience in the area of accounting and auditing), with the conclusion that they all satisfy the independence requirements established in the aforementioned Rule 10A 3.

The composition of the Audit and Control Committee as of December 31, 2017 was as follows:
Ms. Carmen García de Andrés was appointed as a Member of the Audit and Control Committee on May 4, 2017, replacing Mr. Gonzalo Hinojosa Fernández de Angulo who voluntarily tendered his resignation from the position of Director of Telefónica, S.A., and consequently, from his position as Member of the Audit and Control Committee on the same date. As regards the professional profile of the Director Ms. Carmen García de Andrés, in addition to her expertise in the above aspects, of note are her experience in corporate social responsibility and particularly her dedication to social work through Fundación Tomillo, a private, non-denominational and independent not-for-profit entity in which she performs executive duties and has held the position of President since 2014.

It is also stated for the record that on December 21, 2017, Mr. Antonio Massanell Lavilla (Proprietary Director) voluntarily tendered his resignation from the position of Director of Telefónica, S.A., and consequently from his position as Member of the Audit and Control Committee.

The professional profiles of the members comprising the Audit and Control Committee are available to the public on the corporate website of Telefónica, S.A.


The Secretary of the Audit and Control Committee is Mr. Ramiro Sánchez de Lerín García-Ovies, General Secretary and Secretary of the Board of Directors of Telefónica, S.A.
IV. DUTIES AND TASKS OF THE COMMITTEE.

The responsibilities and duties assigned to the Audit and Control Committee are set out in Article 39 of the Company's By-Laws and described in greater detail in Article 22 of the Regulations of the Board of Directors and in Article 4 of the Regulations of the Audit and Control Committee.

Without prejudice to any other task that the Board of Directors may assign thereto, the primary duty of the Audit and Control Committee shall be to support the Board of Directors in its supervisory duties. Specifically, it shall have at least the following powers and duties:

1) To report to the shareholders at the General Shareholders' Meeting on matters raised at the Committee and within the purview of the Committee, and particularly regarding the results of the audit, explaining how it has contributed to the integrity of the financial information and the function performed by the Committee in such process.

2) To submit to the Board of Directors proposals for the selection, appointment, re-election or replacement of the statutory auditor, taking responsibility for the selection process in accordance with the provisions of law, as well as the terms for the hiring thereof, and to regularly obtain information from the auditor regarding the audit plan and the implementation thereof, in addition to preserving the independence thereof in the performance of its duties.

3) To supervise internal audit and in particular:
   a) To ensure the independence and efficiency of the internal audit function;
   b) To propose the selection, appointment and removal of the person responsible for the internal audit service;
   c) To propose the budget for such service;
   d) To review the internal audit annual work plan and its annual activities report;
   e) To receive periodic information on its activities; and
   f) To verify that the senior executive officers take into account the conclusions and recommendations of its reports.

4) To supervise the process of preparing and submitting mandatory financial information and submit recommendations or proposals to the board of directors intended to safeguard the integrity thereof. With respect thereto, it shall be responsible for supervising the preparation process and the integrity of the financial information relating to the Company and the Group, reviewing
compliance with regulatory requirements, the proper determination of the scope of consolidation, and the correct application of accounting standards, informing the Board of Directors thereof.

5) To supervise the effectiveness of the Company’s internal control system, internal audit and systems for the management of risk, including tax risks, and to discuss with the Statutory Auditor significant weaknesses detected in the internal control system during the audit, all without infringing the independence thereof. For such purposes and if applicable, it may submit recommendations or proposals to the Board of Directors and the corresponding period for follow-up thereon. With respect thereto, it shall be responsible for proposing to the Board of Directors a risk control and management policy, which shall identify at least the following:

a) the types of risk (at least, operational, technological, financial, legal and reputational) facing the company;

b) the setting of the risk level that the Company deems acceptable; the measures to mitigate the impact of the identified risks, should they materialize; and

c) the control and information systems to be used to control and manage the above-mentioned risks.

6) To establish and supervise a mechanism to allow employees to confidentially and anonymously report potentially significant irregularities, particularly any financial or accounting irregularities, detected within the Company.

7) To establish and maintain appropriate relations with the Statutory Auditor in order to receive, for review by the Committee, information on all matters that could entail a threat to the independence of the Statutory Auditor, as well as any other matters relating to the audit procedure, and when applicable, authorization of services other than those that are prohibited, upon the terms contemplated by applicable law, and such other communications as may be provided for in auditing legislation and auditing rules. In any event, the Audit and Control Committee must receive an annual declaration from the Statutory Auditor of its independence vis-à-vis the entity or entities directly or indirectly related thereto, as well as detailed and itemized information regarding additional services of any kind provided and the corresponding fees received from such entities by the Statutory Auditor or by the persons or entities related thereto pursuant to the provisions of applicable law.

8) To issue on an annual basis, prior to the issuance of the audit report, a report stating an opinion on whether the independence of the Statutory Auditor has been compromised. This report must in all cases include a reasoned assessment
of the provision of each and every one of the additional services referred to in
point 7) above, both individually and as a whole, other than the legal audit and
regarding the rules on independence or regulations on the auditing activity.

9) To analyze and report on the financial terms, accounting impact and, if
applicable, the exchange ratio proposed for structural modifications and
corporate transactions that the Company expects to carry out, prior to
submission to the Board of Directors.

10) To report in advance to the Board of Directors on all matters provided for by
law and the By-Laws, and particularly regarding:

1. The financial information that the Company must periodically make public;

2. The creation or acquisition of interests in special-purpose entities or entities
domiciled in countries or territories considered to be tax havens; and

3. Related-party transactions.

11) As regards those companies of the Group that are deemed to be Public-Interest
Entities (Entidades de Interés Público) (as defined by applicable law), and with
respect to which it is so approved by the Board of Directors, to perform all
those duties of the Audit Committee at any time contemplated by applicable law,
provided that such companies are directly or indirectly wholly-owned by the
Company pursuant to the provisions of applicable law and that the
administration thereof is not vested in a Board of Directors.

The provisions of sub-sections 2, 7 and 8 of this article are deemed to be
without prejudice to the regulations on auditing.

Section VI of this Report describes the most significant activities carried out by the
Committee during fiscal year 2017 with relation to the above-described functions and
duties.

V. MEETINGS OF THE COMMITTEE AND ATTENDEES.

Pursuant to the provisions of Article 22 of the Regulations of the Board of Directors
and of Article 3 of the Regulations of the Audit and Control Committee, the Committee
shall meet at least once every quarter and as often as appropriate, when called by its
Chairman.

In any event, the Committee shall meet at least on the occasion of each annual or
interim financial reporting date, in which cases it shall request the presence of the
Internal Auditor and, if any review report is issued, the Statutory Auditor.
Moreover, in the performance of its duties the Committee may require that its meetings be attended by the Statutory Auditor, the head of Internal Audit, any employee or Senior Executive Officer of the Company, and the experts it deems appropriate.

Attendance at formal meetings of the Committee requires the sufficient prior dedication of its Members to analyze and assess the information received.

Additionally, as stated, the Committee has a Secretary and is provided with the necessary assistance for planning meetings and agendas, drafting documents and minutes of meetings, and compiling and distributing information, among other tasks.

In order to provide for adequate planning to ensure that the intended objectives are effectively fulfilled, the Committee established its Annual Work Program for 2017 at its meeting held on January 24, 2017.

Meetings are planned by the Chairman of the Committee and communicated to the Secretary thereof, so that its Members receive the documentation sufficiently in advance. All of the foregoing takes into account that the Members of the Committee have primarily supervisory and advisory duties and do not become involved in executive or management duties, which are within the purview of Senior Management.

Pursuant to its Annual Work Program for 2017, during fiscal year 2017 the Audit and Control Committee held a total of 12 meetings, which took place on the following dates:

- January 24, 2017
- February 21, 2017
- March 28, 2017
- April 25, 2017
- May 9, 2017
- May 30, 2017
- June 27, 2017
- July 25, 2017
- September 26, 2017
- October 24, 2017
- November 28, 2017
- December 12, 2017

These meetings lasted for an average of approximately two hours each, with the Committee members dedicating an appropriate number of hours to the study and analysis of the matters to be addressed.

Attendance was monitored at the commencement of each meeting and recorded in the corresponding Minutes. During 2017, all members of the Committee attended or were represented at all of its sessions.
Additionally, and in addition to its members, various members of the Telefónica Group’s management team attended meetings of the Audit and Control Committee when appropriate, with duties to support and assist the members of the Committee on the matters being analyzed in each meeting. Specifically, at the invitation of the Chairman of the Committee and when deemed necessary, meetings of the Committee were attended by representatives of the General Secretary and Secretary of the Board, Finance and Control, Internal Audit, Intervention and Inspection, and Compliance.

In addition to the above-mentioned attendance and at the specific request of the Committee, other Senior Executive Officers of the Company and of its Subsidiaries participated in order to address specific matters affecting their respective businesses or the duties assigned thereto.

Moreover, the meetings held with the Statutory Auditor and with the Internal Auditor complied with the provisions of Article 7 of the Regulations of the Audit and Control Committee of the Company, which establishes that for the proper performance of its supervisory role, the Committee must be aware of and understand Management decisions on the application of key criteria and the outcome of reviews conducted by the Internal Audit unit, maintaining fluid communications with the Statutory Auditor.

In this respect, the partners representing the Company’s External Auditor, PricewaterhouseCoopers Auditores, S.L. (hereinafter, PwC), participated in 11 of the 12 meetings held by the Committee in 2017. Specifically, they intervened to explain the work performed as well as to clarify, at the request of the Committee, those issues that arose relating to the duties assigned to such audit firm.

Representatives of Internal Audit, Intervention and Inspection of the Company, Finance and Control, and Compliance also participated in all the meetings held by the Committee in 2017, to address specific items of the Agenda falling within their purview.

Moreover, and with relation to the preparation of the Agenda for the meetings, it should also be noted that a preparatory meeting is held, coordinated by the General Secretary and Secretary of the Board, with the Finance, Internal Audit and Compliance areas, in order to propose and analyze the matters and issues to be addressed at each meeting, taking as a guide the aforementioned Annual Work Program, the Meetings Schedule, and the suggestions of the Directors who comprise the Committee, and thereby supporting the Chairman of the Committee in the preparation of the Agenda for and the Call to each meeting.

The various matters submitted for deliberation and where appropriate, decision-making, are addressed in due detail at all meetings of the Audit and Control Committee. The members thereof actively participate in the various debates and discussions, stating their opinions in such regard when they deem it appropriate.
The deliberations of the Committee and the resolutions and decisions that it adopts are recorded in the corresponding Minutes of each meeting.

As regards the rules governing the composition and the adoption of resolutions by the Audit and Control Committee, its meetings are quorate when at least half of the members are present, directly or by proxy; and resolutions are adopted by simple majority of those present. In the event of a tie, the Chairman holds a casting vote.

It should also be noted that all documentation relating to the items on the Agenda for the meetings is generally sent sufficiently in advance to the Directors and is also made available through the corresponding IT application. Likewise, through the e-Audit internal Audit Portal (available on Telefónica’s Intranet), the Directors comprising the Committee can access all documents addressed at each meeting via the Internal Audit Area, which enables them to properly follow the information.

Finally, and as stated, relations between the Audit and Control Committee and the Company’s Board of Directors are based on the principle of full transparency. In this regard, the Chairman of the Committee reports to the Board of Directors at each of its monthly meetings on the main issues discussed and the activities and work performed by the Committee and when necessary proposes to the Company’s Board of Directors of the Company that the corresponding resolutions be adopted.

VI. SIGNIFICANT ACTIVITIES OF THE COMMITTEE.

Of the issues that the Audit and Control Committee examines at its meetings, some correspond to legal requirements and others relate to the interests that arise pursuant to the powers assigned to the Committee.

The most significant activities performed by the Committee in 2017 with respect to both Telefónica, S.A. and other Public-Interest Entities of the Group were as follows:

**Financial and Non-Financial Information.**


The Audit and Control Committee, in accordance with the duties attributed thereto in this area, examined and analyzed the process of preparation of the Company's financial information. Specifically, the Committee examined and discussed the most important aspects regarding:

- The Individual Annual Accounts, Consolidated Financial Statements (Consolidated Annual Accounts) and Management Reports corresponding to Fiscal Year 2016 for Telefónica, S.A. and for its Consolidated Group, as well as the process for preparing such information and the accounting principles used (International Financial Reporting Standards - IFRS - and General Chart of Accounts in force in Spain).
- Quarterly and Semiannual Periodic Financial Information in 2017 for the Telefónica Group and the Public-Interest Entities of the Group, with respect to which this Committee assumed the duties of their Audit Committees.

- The Alternative Performance Measures included in the Company’s Financial Information.

2. Financial Debt.
The Audit and Control Committee also examined and analyzed the Telefónica Group’s situation in terms of financial debt, and its evolution over the course of the fiscal year.

3. Company Filings.
The Committee examined and was informed over the course of various meetings of the following Filings made by the Company before different Supervisory Bodies:


- Share Registration Document of Telefónica, S.A., prepared in accordance with Annex I to Regulation (EC) No. 809/2004 of the Commission of 29 April 2004, filed with the CNMV.

- Base Prospectus for the European Medium Term Note (EMTN) Programme, filed with the Financial Conduct Authority (FCA) in the UK.

- Prospectus Supplement to the Base Prospectus for the issuance of debt filed with the Securities and Exchange Commission (SEC), in the United States.

External Auditor.

During Fiscal Year 2017, the Committee was also informed of the completion of the transition process changing the statutory auditor from Ernst & Young, S.L., former External Auditor, to PricewaterhouseCoopers Auditores, S.L. (hereinafter, PwC), current External Auditor of the Company.

In this respect, PwC presented the Committee with its Annual Work Plan for 2017, reporting on the main services to be provided as External Auditor of the Group and on the most significant matters to be reviewed.
In this regard, the different tasks performed by the Group’s External Auditor were presented over the course of the various meetings of the Audit and Control Committee:

1. **Financial Statements.**

The representatives of the former Statutory Auditor, Ernst & Young, presented the Committee with the main findings of the audit work performed in relation to the Individual Annual Accounts and the Consolidated Annual Accounts of the Company for Fiscal Year 2016.

In addition, the Committee was informed of the limited reviews carried out by the current Statutory Auditor, PwC, with regard to the Periodic Quarterly and Semiannual Financial Information for Fiscal Year 2017 of the Telefónica Group and of the Public-Interest Entities of the Group with respect to which this Committee assumed the duties of their Audit Committees.

2. **Internal Control Systems and Information Technology Systems.**

The representatives of the current and former External Auditors, PwC and Ernst & Young (the latter with respect to fiscal year 2016), also reported on the work carried out with regard to the Internal Control Systems and Information Technology Systems as required by applicable law, including the Sarbanes-Oxley Act.

3. **Fees of the External Auditor.**

The Committee reviewed the proposed fee estimate for the auditing firm PwC for Fiscal Year 2017 in respect of works performed on auditing and other related services. Similarly, the proposed fees for other firms of auditors who carry out work for the Telefónica Group were presented.

4. **External Auditor Assignments.**

Over the course of Fiscal Year 2017, the Audit and Control Committee also approved various non-auditing assignments to be performed by companies within the PwC Group for various companies of the Telefónica Group, all of which were duly justified and motivated in accordance with the internal regulations defined for this purpose.


In accordance with the provisions of section 529.4 *quaterdecies* of the Restated Text of the Spanish Companies Act (*Ley de Sociedades de Capital*), having been notified by the External Auditor for fiscal year 2016 (Ernst & Young) of its statement of independence, at its meeting held on February 21, 2017, the Audit and Control Committee issued its report on the independence of such External Auditor, which indicated, among other things, the non-audit services directly and indirectly entrusted to the former External Auditor, Ernst & Young and its related entities by Telefónica, S.A. and its related companies during the period covered by the Annual Accounts for the fiscal year ended December 31, 2016, as well as the corresponding fees.
This report concluded that such External Auditor was independent from Telefónica, S.A. and its related companies on the terms established by applicable law.


At its meeting held on 12 December 2017, the Audit and Control Committee was notified of the changes in terms of External Audit to be applied for the review of Fiscal Year 2017 with respect to the new Audit Report on the Financial Statements.

Internal Audit and Internal Control.

At its meetings held during Fiscal Year 2017, the Audit and Control Committee was informed of the actions carried out by the Internal Audit, Intervention and Inspection Directorate of Telefónica, S.A. in relation to the Internal Control Systems of the Company as required both by Spanish and international law (including the Sarbanes-Oxley Act).

The Committee discussed the following issues, among others, during the course of Fiscal Year 2017:

- The 2017 Internal Audit, Intervention and Inspection Plan as well as the budget proposal for this area and the details of its work plans.
- Internal Audit reports on reviews of transversal processes.
- Updating the Risk Management Policy, the Risk Management System and the Risk Map.
- Monitoring of complaints filed within the Telefónica Group.

Compliance.

At its meetings held during Fiscal Year 2017, the Audit and Control Committee was notified of the following actions carried out by the Compliance Directorate of Telefónica, S.A.:

- Compliance Directorate Plan 2017, and details of its work plans.
- Quarterly and Semiannual Review of the main activities carried out by the Compliance Directorate in 2017.
- Preventive Model for Basic Risk Control and Assessment Compliance.
- Criminal Prevention Model.
**Other matters of interest analyzed by the Audit and Control Committee.**

- Monthly report from the Head of the Treasury Stock Management Team of Telefónica, S.A. on treasury stock transactions.
- Verifying that the financial information published on the Company’s website is continuously updated and matches what has been prepared in each case by the Board of Directors and published on the CNMV website.
- Supervision of Action Plans.
- Disclosures to Regulators.
- Preparation of Induction Program for new members of the Audit and Control Committee of Telefónica, S.A.
- Regular training to ensure up-to-date expertise of the Committee members.

As set forth in Article 5 of the Regulations of the Audit and Control Committee, the Committee shall be provided with the resources necessary for the members of the Committee to obtain external advice on legal, accounting, risk assessment and other matters as required.

**VII. EVALUATION OF THE OPERATION AND PERFORMANCE OF THE COMMITTEE.**

Pursuant to the provisions of Article 8 of the Regulations of the Company’s Audit and Control Committee, the Committee carried out its evaluation process at the end of Fiscal Year 2017, particularly with regard to its composition, work program, documentation, calls thereto, frequency, duration and conduct of meetings, contact with Senior Executive Officers of the Company and with the External Auditors, powers, duties and resources.

The description of the results allows for confirmation of the proper operation of the Committee and have been communicated to the Board of Directors. However, although the aforementioned evaluation produced satisfactory results, the following aspects were identified as having the potential for improvement:

- Having more time to analyze the documentation and information presented to the Committee. For these purposes, information is beginning to be made available to the Directors one week in advance.
In light of the intensity and duration of Committee meetings, two additional meetings were included in the Annual Work Program for 2018 and in the Meetings Schedule for 2018 in comparison with 2017.

In accordance with suggestions received:

a) The focus of the Annual Work Program for 2018 has been expanded to encompass business risks.

b) Work continues with the Technical Area for use of the “Board Library” (“Biblioteca del Consejo”) IT application (in which Committee members have access to all the information and documentation of this Committee) providing access to permanent basic information regarding laws, regulations and functional and legal organizational charts.

VIII. INFORMATION ON THE COMMITTEE’S OPINION REGARDING THE INDEPENDENCE OF THE STATUTORY AUDITOR.

Additionally, and as stated in Section VI above, on February 21, 2017 the Committee issued its report on the independence of the former External Auditor, Ernst & Young, concluding that such External Auditor was independent of Telefónica, S.A. and of its related companies on the terms established by applicable law.

Likewise, and as regards the current External Auditor (PwC), on February 20, 2018, after having received the communication from such External Auditor of its independence, the Committee issued its report on the independence of PwC, concluding that such External Auditor is independent of Telefónica, S.A. and of its related companies, on the terms established by applicable law.

IX. INFORMATION ON THE PRACTICAL GUIDES REGARDING AUDIT COMMITTEES FOLLOWED BY THE COMMITTEE.


X. CONCLUSIONS.

As reflected above, the Audit and Control Committee has analyzed and examined the main issues and aspects within its purview during the course of Fiscal Year 2017, regularly reporting to the Company’s Board of Directors on the most significant issues.

During Fiscal Year 2018, the Audit and Control Committee plans to continue to review and monitor the situation affecting all matters within its purview, pursuant to its Meetings Schedule and Annual Work Program 2018.
XI. DATE OF PREPARATION AND OF APPROVAL OF THE REPORT.

This Report was prepared by the Audit and Control Committee on February 20, 2018 and approved by the Board of Directors of Telefónica, S.A. on February 21, 2018.

Madrid, February 21, 2018

*****