

6. Economy and Finance

The economic and financial objectives that Telefónica established the year before, as defined in the 1983-1986 Four Year Plan, have been consolidated in 1984 in coordination with the other management and activity objectives.

These objectives were as follows: to intensify commercial action to improve income generation, to reinforce policies for the rationalization and control of spending, to promote restructuring of the different assets to a maximum and to improve and strengthen the basic financial and asset balances.

Advances have been made on all of these fronts in 1984, thus laying firm foundations on which the Company can build its future activity, maintaining the strong rates of investment and service expansion required of the Company, as manifested in the 1985-1988 Plan.

Despite the progress made, efforts to improve management and the economic and financial situation will have to continue to take pride of place in the coming years. The fundamental objectives of Telefónica continue to be an increase in self-financing capacity, continuation of restructuring and rationalization policies, improvement in the level of borrowings, etc.

In the following pages, complementary to the audited financial statements and the detailed notes attached thereto, an analysis is made of the financial and economic management performance and the results obtained, both from an internal point of view and considering the general economic environment in which the Company has been operating, together with developments in the different financial markets in which the Company has a presence.

Although this external context has demonstrated clearly positive aspects in 1984, it will continue to be a major conditioning factor in 1985, so that the basic financial and economic objectives set out will continue to be maintained this year, involving reinforcing existing efforts to these ends, in particular with respect to the financial structure. To the extent made possible by the progressive liberation and innovation of the markets, a trend that can be clearly be appreciated in domestic markets, new fund-raising and management formulae and instruments will be used to achieve a better financial structure, in both quantitative and qualitative terms.

The March, 1985 capital increase for a nominal amount of 40,052 millions Ptas was completely satisfactory and was granted full support by our shareholders, confirming the important and solid appraisal given to Telefónica shares by the market, allowing them to rise steadily to levels significantly higher than in previous years.

In this same context, and as complementary action to the measures already adopted to increase the shareholder base and to attract new shareholders' equity, progress has been made in negotiations to obtain a listing of the Company's shares in various major foreign stock exchanges.

At the same time, measures have been taken to reduce and improve the characteristics of foreign borrowings, and the degree to which this type debt is employed (if the external conditioning factors of the country's monetary and economic policy so permit, Telefónica will consider repaying a significant part of its present foreign debt before maturity).

The beneficial effects that this will all have on the future economic and financial situation of the Company ensure the stability of 1984's achievements and their strengthening and improvement over the coming years.

I. Economic environment

Throughout 1984 the Spanish economy evolved positively with respect to recovery in the basic economic balances. This behaviour has been the result of an economic policy basically emphasizing money supply and incomes and aiming to achieve targets in both, and from a highly favourable international environment, which has enabled overall production to grow by 2%, of which international trade has contributed with 3.1 percentage points, compensating for a drop in domestic demand of 1.1%.

This growth rate, although less than OECD Companies overall (which has been 4.8%, boosted by the United States and Japanese economies) has been similar to that of the EEC.

In these other countries, growth has been basically supported by domestic demand, as they started from overall situations that were generally more balanced, requiring less intense structural changes; this has allowed them to slow the fall in employment. On the other hand, the Spanish economy, on having to carry out these structural changes in the last two years and with a less balanced growth as mentioned above, has recorded a record loss of employment, with the unemployment rate being 21.7% at the end of 1984.

The evolution of the following economic figures demonstrates the achievements made:

- The **balance of payments on the current account** recorded a surplus of 2,069 million dollars, after five successive years of deficits, since the start of the second oil crisis.

The surplus for basic balance reached 5,371 million dollars, with net foreign reserves amounting to 15,788 million dollars, 6,000 million dollars higher than the low point recorded in June 1983, thus producing a general improvement in the solvency and liquidity indicators of the economy.

- **Inflation**, measured by the RPI increase at the year end, stood at 9%, with this rate being the lowest for the last 11 years and, in turn, signifying the most important reduction in relative prices for this period, on having achieved a reduction in the inflation differential with OECD countries from 6.9 percentage points in 1983 to 3.9 percentage points in 1984; and, with the EEC, from 5.3 to 2.5 percent points over the same period.
- With respect to the **budget deficit**, despite its size and structure continuing to be a cause for worry, 1984 saw a favourable trend in terms of its proportion of G.D.P. this being reduced to 4.8% as compared to 5.4% in 1983 (in which a containment was also achieved in this sense) - thus staying in line with the OECD countries.
- Lastly, given the weakness in domestic consumption, **gross savings** have grown strongly, the highest growth rate since 1970 which, together with the fall in gross investment in the economy, has generated net lendings to the rest of the world; consequently, Spain has changed from having major finance requirements with negative investment growth in recent years, to a significant international financing capacity.

The realignment mentioned of the basic economic balances has become evident at an overall business level in the execution of a major financial restructuring and adjustment, strengthening the growth in gross operating profit. Nevertheless, this process has followed different paths according to companies' degree of dependence on the domestic market. Those which have not been able to benefit from the positive behaviour of international trade have been forced, to a greater extent than those less constrained by domestic

demand, to continue the adjustment process, basically operating on the investment and employment variables. This, on the other hand, explains the behaviour of these two variables in the economy overall.

In this environment, Telefónica's activity indicators have been influenced by the trend of domestic demand, affecting the net gain in lines; however, the important growth rate of 1983 has been maintained in absolute terms. Consumption growth, measured by the traffic indicators, has also moderated: the total number of trunk calls grew by 6.2%, against 8.3% the previous year; average consumption per line has grown by 1.6%, less than the 2.3% for 1983, but higher than the average rate observed for 1980-1982.

Nevertheless, despite this activity trend, Telefónica has made a positive contribution to the country's overall output. Real value added growth of 6.7% compared to 2% for the nation overall and 2.2% for the services sector, means that in this respect its share of the Spanish economy continues to grow.

In turn, the price containment of this value added is significantly below the corresponding gdp deflator, positively contributing to the considerable reduction recorded in the inflation rate.

This trend in the Company's basic parameters, together with a cost containment policy, has allowed, whilst keeping employee numbers steady, an increase in the gross operating profit of 19.6% to be obtained, which has been in line with the general picture of the Spanish economy, as mentioned above.

In turn, a real growth in gross investment which, given the relative importance of the Company in total national investments, contributed to reducing their falling off, without having affected the Company's basic financial balances, since gross domestic savings grew by 22%.

In conclusion, the progress made by Telefónica demonstrates the solid potential of the Company to maintain a stable rate of growth. Its capacity to generate value added has allowed it to face up to an unfavourable environment on the demand side, maintaining its level of employment and rate of investment while continuing to improve its financial structure and internal organization.

From a global perspective, the results obtained in the economy in general provide a greater operating margin for economic policy in 1985, laying the foundations for a more sustained period of recovery in line with the international

economic background, an environment that will be positive for Telefónica, given the reinforcement achieved in its capacity for expansion.

2. Financial markets

The aforesaid considerable improvement in the Companies' operating profits, weak investment in real terms, disinflation and the achievement of the trade balance, together with the capital call on international financial markets, especially at the beginning of the year, favoured by the pronounced upturn in activity levels together with the levelling off of the public sector borrowing requirement and its new financing institutional framework, allowed a financing programme to be developed in 1984 within the overall objectives desired by the monetary authorities.

Thus, during 1984 the credit funds available were able to meet demand without problems, with a diversification of markets and a parallel improvement in loan terms and cost conditions.

This development occurred progressively throughout the year, becoming clearly evident in the second half after the balance of payments and inflation prospects were favourably reduced in general, which facilitated the reduction in domestic and international interest rate differentials.

The effects of this trend were transmitted quite quickly to the money markets which, in turn, induced investors and lenders to intensify their supply of long-term funds and to diversify their placings in different markets, with a strong effect on the share and fixed interest security

markets, leading to a rapid increase in turnover and placing volumes, despite the gradual reduction that has been occurring in the yields available.

This trend became evident somewhat later in the credit and loan markets (the last four months of the year), reducing the prime rates for asset operations, although maintaining the differential with other interest rates.

At the end of the year, a clear intensification, and generalization of this panorama can be appreciated, with an abundant supply of funds and clear-cut competition between the different lenders.

In this context, Telefónica has consolidated and continued with its financial policy initiated the year before of expanding and diversifying its sources of funds in order to consolidate its financial structure, dampen the impact of future changes in the institutional markets, promote the inflow of permanent resources (paying special attention to obtaining shareholders' equity) and improve current asset management, stabilising working capital and providing it with suitable coverage, quantitatively and qualitatively.

In the international field, the Company has exploited the general favourable environment and the clear interest shown in our sector by both lenders and risk capital investors.

All of this has been carried out with a global view of the universal nature and interdependence of markets, attempting to overcome certain traditional ways of regarding them, which will allow a greater flexibility and efficiency to be achieved in resource management and utilization.

SIGNIFICANT TELEFONICA-SPANISH ECONOMY VARIABLES 1983-1984 (Thousands of million of current Pesetas)						
					Telefónica %	
	Telefónica		Spain		Spain	
	1983	1984	1983	1984	1983	1984
Total gross value added	323.6	373.2	22,682.8	25,870.4	1.43	1.44
Gross value added: service sector	323.6	373.2	13,152.1	15,009.5	2.46	2.49
Total capital investment	164.2	180.2	4,307.8	4,635.0	3.81	3.89
Employment (thousands)	66.8	66.8	10,776.5	10,475.8	0.62	0.64
Employment in Telefónica and Industrial Group (1) (thousands)	77.9	78.0	10,776.5	10,475.8	0.72	0.74

Figures in terms of national accounts.
(1) Not including Standard nor Secoinsa.

Credit and Loan Market

In this market Telefónica has continued with the activities initiated in 1983, achieving the double objective of making it a stable and basic source for raising funds, both to cover its large cash flow and to obtain long-term finance, thus widening its possibilities for cash calls in the free finance markets, compared to the progressive reduction (accelerated at the beginning of 1985) in the privileged institutional circuits for raising funds.

At the end of the year, the financing capacity of this market had been reinforced. The number of entities granting the Company this type of risk amounted to 70 at the year end, having increased by 12 during 1984.

Fixed Interest Security Markets

The presence of Telefónica in the fixed interest security markets has been particularly relevant in 1984. This is due to several reasons: on the one hand, due to the volumes issued; secondly, due to its capacity to gain access to non-privileged

finance markets, consolidating the Company's position in them, especially with relation to attracting funds from small investors and savers; additionally, by the diversity of instruments used (floating rate and fixed interest issues, zero coupon bonds, issues convertible into shares); fourthly, by the reduction obtained in nominal interest rates (from 15% to 14%); and, lastly, due to the long-term nature of all of these funds obtained.

The different issues by Telefónica, exploiting the positive factors existing in these markets mentioned at the beginning of these comments, obtained a warm reception and the initial volumes had to be extended in view of the demand, and in the last issue it was even necessary to make a pro rata allocation for subscription applications above one million pesetas.

On the other hand, despite the important volume issued in absolute terms, the Company evaluates the pressure exerted on these markets as being not excessive, as proven by the fact that the total net amount placed by Telefónica was only 5.6% of total market volume.

TELEFONICA - ISSUES OF FIXED INTEREST SECURITIES						
(millions of pesetas)						
	(1)		(2)		Net Placings	
	Total Issued	Total Placed	Redemptions	Savings Banks	Other Markets	Total (1)-(2)
1980	28,000	25,600	4,000	20,900	700	21,600
1981	31,000	20,400	2,503	15,094	2,803	17,897
1982	30,000	36,700	15,201	16,900	4,599	21,499
1983	25,000	31,300	19,697	2,200	9,403	11,603
1984	67,455	47,536 *	25,364	4,672	17,500	22,172

* The difference between the amount issued and placed corresponds to the latest bond issued where the subscription period ended on January 11, 1985; at this date the whose issue was fully placed and even had to be extended by 5,000 million pesetas as result of the strong demand.

New Financial Instruments

These short-term instruments are being developed in the heart of the Money Market, which has enabled the trend towards lower interest rates mentioned previously to be exploited.

The expansion of these instruments continued in 1984, particularly in the case of Company promissory notes, with which Telefónica has a direct presence in the Money Market.

The use of this instrument by Telefónica continues through both "direct placings" and "stock exchange placings".

After the opening up of this new market for the Company in 1983, a presence has been maintained during 1984 in line with the objectives set out: to achieve a stable financial relationship with a large group of small savers: to match issue volumes to future prospects, avoiding bunching of important volumes that could make renewal difficult; and, lastly, to adapt their cost and offered yield to market developments.

A broad uniform distribution has been guaranteed for this operation via promissory notes in direct placings, underwritten by a large syndicate of banks and savings banks. Presence in the market with regard to volumes and prices has been regulated by promissory notes placed in the Stock Exchange circuit. In this respect it should be mentioned that the discount rate started the year at 13.94% and by the year end was 11%.

The comparison between the most significant figures of 1983 and 1984 is given below:

TELEFONICA - COMPANY PROMISSORY NOTES (millions of Pesetas)		
	1983	1984
Direct placing	17,843.5	26,136.5
Stock Exchange placing	4,743	7,999.5
TOTAL PLACINGS IN THE YEAR	22,586.5	34,136.0
BALANCE OUTSTANDING AT 31-12.	22,586.5	34,041.5
DISCOUNT RATES APPLIED(%):		
— Direct placing	14.2 - 13.4	14.0 - 12.2
— Stock Exchange placing	14.0 - 13.2	14.0 - 11.0

The most outstanding aspect of international financial markets in 1984 has been the recovery of activity levels after two years of recession and consolidation of major institutional changes that will influence future market development.

The rate of international financial activity turned sharply upwards during the year, after a persistent recession since 1981. The most reliable estimates for overall turnover in international fixed interest security issues and loans give a figure exceeding 200,000 million dollars, 47% more than the previous year. Bank loans grew by 53%, although part of this figure is due to the arrangement of various jumbo operations (for amounts exceeding 1,000 million dollars) for several international oil companies in order to take-over smaller companies. Bond issues grew by 41%.

Institutional changes include:

- Consolidation of the ECU (European Currency Unit) as a unit on which international private financial transactions are based, that was fully reflected in the international loan market and Eurobond market, in which ECU-denominated issues increased by more than 50% over the previous year.
- The agreement reached in May between the United States and Japan to liberalise access to the Japanese financial market for foreign lenders and to gradually eliminate obstacles impeding yen internationalization, the most obvious result of which has been a significant growth in the Euroyen market and Eurobond issues in the Japanese currency, which reached a volume six times larger in 1984 than in 1983.
- Abolition by the United States Authorities of the 30% withholding tax in July, on income derived from bonds purchased by non-U.S. residents and the development of a bearer-bond market exclusively orientated to foreign investors, which has provided a boost to the dollar-denominated international fixed interest security market.
- Lastly, the position of the major American banks in the international syndicated loan market, a consequence of their risk situation and levels in Latin America.

In this favourable climate for international borrowers, Telefónica arranged four international financing operations in 1984: three international syndicated loans with a multicurrency clause for 100 million dollars, 100 million ECU and 68 million pounds sterling, respectively, and an operation in the domestic Japanese market for 10,000 million yen.

Continuing the policy of the year before, the three objectives of new foreign borrowing in 1984 were: to lengthen the average maturities of operations, to improve the economic conditions thereof and to enter into new financial markets.

Satisfactory results have been obtained on all three accounts:

- For the first objective, average maturities for these operations were extended up to 12.53 years.
- As regards the improvement in economic conditions, the differentials over the Euro-market interbank rates were reduced to 3/8%.
- Lastly, Telefónica introduced itself into two new markets which, as mentioned above, improved substantially in 1984: the ECU and the domestic yen market. In the former, an international syndicated loan was arranged in ECU with a multicurrency clause and possibility of partial or total conversion into ECU-denominated bond issues. The first Installment Sale Facility operation was arranged in the Japanese market, with a total maturity of 15 years at the long-term prime rate with no differential, reviewed half-yearly.

On the other hand, by the end of 1984, 80% of Telefónica's foreign currency debt comprised syndicated loans with a multicurrency clause, allowing active management of this debt by modifying the currency structure.

During this year the U.S. dollar interest differentials in the London inter-bank market were 5 points above the Swiss franc and four points higher than the West German mark, while the peseta depreciated 10% against the U.S. dollar and appreciated 7% against the Swiss franc and 4% with respect to the West German mark.

The forecast and later confirmation of this trend made it advisable to reduce borrowings in dollars and to increase the weighting of European currencies, especially the West German mark, Swiss franc and ECU. Consequently, the Company's foreign debt structure was gra-

dually adapted to the forecasts and trend of the financial market and the international exchange and interest rates, as mentioned, thus achieving a positive effect on the profit and loss account and on net worth by reducing potential losses due to exchange rate fluctuations.

Shares

The Spanish Stock Exchanges have had a good year in 1984. Investors have evaluated the adjustment achieved in the Spanish economy positively, realising the greater capacity that this grants to economic policy and reacting to the immediate fallout of the considerable reduction in money market interest rates.

Therefore, average share price rises have been historical, reaching 40.66%. Turnover has increased by 108%, particularly significant when taking into account the increases mentioned in share prices and the increase in stock exchange capitalization, which has amounted to 34.7%. This enabled the continuance of the important growth in issue volumes, which commenced in 1983 (and amounted to 28.5% in 1984).

The market for shares has attracted both Spanish and foreign investors during the year.

The balance of purchases by the latter has been 3.4 times higher than that of the year before, demonstrating not only the favourable price and yield conditions of the Spanish Stock Exchange in comparison with world bourses, as shown in the table below (it is also to be remembered that the Spanish Stock Exchange has taken second place in the world ranking for stock exchange index rises) but also the greater trust of these foreign investors in the economic situation of our country and the trend during 1984.

In this context Telefónica has continued and consolidated in 1984 the major Stock Exchange recovery that it had initiated in 1983, boosting the share price by 32.85% and offering a total effective return of 50.7%. In this year the share price rose above par after 7 years of having a below par quote. Turnover volume, which mul-

TELEFONICA AND WORLD BOURSES-1984						
	Share price/ Book value	Share price/ Cash Flow	PER	Dividend yield	Annual Index*	Turnover/Stock Exchange Capitalization
FRANKFURT	1.7	4.3	13.5	3.9	107.4	36.8
LONDON	1.4	6.4	11.1	4.5	123.6	22.4
NEW YORK	1.4	5.6	9.9	4.7	96.1	49.5
PARIS	1.2	3.8	15.3	4.4	116.0	24.5
TOKYO	2.6	9.3	27.3	1.1	123.6	46.0
ZURICH	1.1	5.5	11.4	2.7	—	—
MADRID	0.40	3.0	9.0	9.0	140.9	12.5
• INTERNATIONAL INDICES FOR TELECOMUNI- CATIONS SECTOR	1.1	4.0	9.2	6.8	115.1	—
• TELEFONICA- MADRID	0.4	2.5	10.0	11.5	132.9	7.2

Source: Capital International Perspective.

* Local Indices.

tripled by four in 1983, has continued to grow and be consolidated, exceeding the levels achieved the previous year. Furthermore, in 1984 Telefónica shares were dealt in on every working day, amounting to 11.67% of Stock Exchange capitalization and 7% of total turnover volume on the Madrid Stock Exchange. On a wider basis of comparison, the Telefónica stock exchange ratios are among the normal international levels.

Following the general trend described above, foreign investment in Telefónica shares has also grown significantly, exceeding the average levels for the Stock Exchange as a whole, demonstrating not only the favourable environment offered by the Spanish Stock Exchange but also the attention that is being paid to the telecommunications sector, the protagonist of world stock exchanges in 1984.

The favourable evolution of Telefónica shares in 1984 was ratified by the good results achieved

for the capital increase carried out in October for a nominal amount of 32,042 million pesetas, in the ratio of one new share for every nine held, with subscribers paying 70% of face value.

Developments in the prices of shares and subscription rights together with turnover volumes recorded during the capital increase period were completely satisfactory, demonstrating a favourable response from both traditional shareholders and large numbers of small savers, thus greatly diversifying and improving the stability of our shareholder base.

As the capital increase was oversubscribed, it was considered advisable to make the bonds issued in December 1984-January 1985 for an amount of 25,000 million pesetas convertible into shares, for the first time in the history of the Company, thus expanding possibilities for attracting funds while offering savers greater flexibility for decision taking.

3. Results and analysis of financial management

This section analyses the development of the Company from the economic and financial management point of view. Included below are presentations of the Balance Sheets, Statements of Profit and Loss, Statement of Changes in Financial Position and other significant ratios and data, to facilitate detailed analysis.

The *level of activity*, measured by the Revenue from Services, has shown a nominal increase of 17.6%, a satisfactory growth rate in the context of overall activity in the Spanish economy, demonstrating the positive effects of the more active commercial policy put into practice to utilise the considerable growth margin that the present market shares of telephone services still permit in our country.

If we break down this increase into its component parts of real growth and price growth, this positive appraisal is reinforced on having reduced the latter (with respect to 1983) by more than 3 percentage points, compared to a value added deflator for the economy overall, which has grown at a similar rate to that of the previous year.

As a result of the policy of rationalising and improving management, the rate of growth of *operating expenses* has been reduced, allowing for substantial improvements in the *gross operating margin* which, from representing 50.18% of the revenue from services in 1980 and 53.05% in 1983, amounted to 55.47% in 1984.

One basic reason for this trend has been the behaviour of the *salaries and related costs* item, that shows obvious improvements in productivity levels and resource assignment resulting from staff recycling and training activities, with strict internal cost imputation and internal expenditure capitalised in fixed assets growing by only 8.4%.

The improvement in the operating margin has allowed the restructuring policy of the previous year to continue and be consolidated, thus reinforcing the economic and financial balances, the net asset situation and the quality of assets and results obtained.

In this respect, it is interesting to emphasise:

- The **depreciation rate** has been held at 5.2% as opposed to 4.9% in 1982, thus consolidating the 1983 level in accordance with the technical studies on the useful life of plant. The fixed assets were 40% depreciated as at December 31, 1984.

- The **transfer to provisions** has followed the practice established the previous year, dedicating the amounts necessary to this heading in accordance with strict criteria of prudence. The transfer has risen from 3,906 million pesetas in 1982 to 9,808 million pesetas in 1983 and 19,032 million pesetas in 1984, amounting to 14.7%, 35.6% and 58.3% of net profits, respectively.
- The **transfer to exchange loss provisions** is worthy of special mention, having exceeded 14,000 million pesetas and being 167% higher with respect to 1983, thus allowing for the writing off of all exchange losses recorded during the year.
- The **interest expenses** have seen a slowing down compared both to the previous year's growth rate, and to that for the period included in the accompanying data. Nevertheless, the manner of presentation of this item in the table does not allow the favourable trend recorded to be fully appreciated.

Cash and liquid asset management has improved in 1984, in accordance with the possibilities available in the money markets, which has allowed for a significant reduction in net finance costs. For accounting reasons these effects are not shown in the *interest expenses*, but in the income corresponding to this caption (see the important growth in "Other Income" in the Statement of Profit and Loss and its corresponding breakdown).

If we consider this trend overall, the growth in financial charges has been 15.70% in 1984. With the same criterion, it was 21.22% in 1983. As a percentage of revenue from services, it has fallen from 21.2% in 1983 to 18.7% in 1984.

This positive trend has also been achieved in a partially negative environment due to the change recorded in attracting funds from privileged financing circuits, taking into account the considerable amount of funds from this source paid back during the year, with a cost much lower than at present.

RESULTS - PROFIT MARGINS 1980-1984

(In millions of pesetas)

ITEM	1980	1981	1982	1983	1984	Yearly Growth		
						Rate %	Growth Rate %	Rate %
+ Revenue from Services ...	168,455	204,856	244,925	296,883	349,226	20.0	17.6	21.2
— Levy and Taxes	10,107	12,269	14,845	17,959	21,117	20.2	17.6	21.0
= Net Revenue from Services	158,348	192,587	230,080	278,924	328,109	20.0	17.6	21.2
+ Internal Expenditure								
Capitalised in Fixed Assets.	29,150	32,956	39,296	43,959	47,634	13.1	8.4	11.9
— Salaries and Related Costs	85,731	99,134	117,439	132,765	144,686	14.0	9.0	13.1
— Other Costs and Expenses	17,236	19,736	26,098	32,728	37,346	21.3	14.1	25.4
= Gross Operating Margin....	84,531	106,673	125,839	157,390	193,711	23.0	23.1	25.1
+ Connection Fees	11,355	11,914	11,925	11,785	12,118	1.6	2.8	(1.2)
+ Non-Reimbursable Contributions and Others	2,598	4,385	5,300	5,287	4,902	17.2	(7.3)	(0.2)
+ Surcharges	1,788	1,852	1,805	1,953	1,842	0.7	(5.7)	8.2
= Resources provided by								
Operations	100,272	124,824	144,869	176,415	212,573	20.7	20.5	21.8
+ Other Income	5,797	6,714	7,578	8,676	13,143	22.7	51.5	14.5
— Interest Expenses	33,672	47,180	53,654	65,090	77,655	23.2	19.3	21.3
— Non-Operating Expenses..	165	202	351	275	381	23.3	38.5	(21.7)
Extraordinary Items and Others								
— Exchange Loss Provisions.	1,500	3,000	3,000	5,330	14,230	75.5	167.0	77.7
— Transfer to Provisions	723	604	906	4,478	4,802	60.5	7.2	394.3
= Gross Operating Profit	70,009	80,552	94,536	109,918	128,648	16.4	17.0	16.3
— Depreciation of Fixed Assets	46,193	56,674	67,989	82,382	96,028	20.1	16.6	21.2
= Net Profit	23,816	23,878	26,547	27,536	32,620	8.2	18.5	3.7

— **Self-financing capacity** strongly, increased by 33%, amounting to 58% of investment in fixed assets (16 percentage points higher than 5 years ago). This demonstrates, on the one hand, the benefit of the adjustment made and, on

the other, the reinforcement of the future capacity of the Company to maintain its rate of investment. Nevertheless, the low starting point means that the rate of self-financing achieved is still insufficient and will have to be in-

FINANCIAL RATIOS

	1980	1981	1982	1983	1984
A — Current ratio	40.51	51.76	47.87	57.47	83.51
B — Solvency ratio	57.68	54.16	50.77	51.78	54.05
C — Guarantee ratio	90.73	79.56	76.15	77.30	82.44
D — Total gearing	43.93	47.56	50.36	49.85	47.96
1. Long term	30.87	35.48	37.89	37.35	37.90
2. Short term	13.06	12.08	12.47	12.50	10.06
E — Self-financing ratio	42.02	45.05	50.94	54.37	57.91
F — Gross Operating Margin ratio	50.18	52.07	51.38	53.01	55.47
G — Rate of return from operations					
1. On average shareholders' equity	14.53	15.59	17.25	18.56	19.35
2. On average net capital employed	9.32	9.47	9.77	10.28	10.83
3. On average fixed assets employed	12.45	13.35	14.03	14.97	15.79
H — Rate of return on capital					
1. On paid-in share capital	11.10	11.00	11.05	11.18	11.11
2. On stock market capitalization.	17.60	15.10	17.10	16.00	12.00
I — Debt repayment capacity	8.19	8.25	8.00	7.68	6.81
J — Resources generated/Interest expenses	2.15	1.78	1.83	1.86	1.91
K — Theoretical book value of shares....	249.02	227.24	246.27	246.15	255.63

Definitions and formulae:

- 1) Overdrafts are considered at the amount drawn and not the overall limit.
 2) Remunerated liabilities = Share capital + Debentures + Bank Loans + Promissory Notes + Notes payable to suppliers.

A — (%) $\frac{\text{Current Assets}}{\text{Current liabilities}}$

B — (%) $\frac{\text{Shareholders' Equity}}{\text{Net Fixed Assets}}$

C — (%) $\frac{\text{Shareholders' Equity}}{\text{Remunerated liabilities}}$

D — (%) $\frac{\text{Debt Finance}}{\text{Total liabilities}}$

I — (%) $\frac{\text{Medium and Long-Term Debt}}{\text{Total liabilities}}$

2 — (%) $\frac{\text{Current Liabilities (excluding transitory accounts)}}{\text{Total liabilities}}$

E — (%) $\frac{\text{Annual Self-Financing}}{\text{Investment in Fixed Assets}}$

F — (%) $\frac{\text{Gross Operating Margin}}{\text{Revenue from Operations}}$

G.1 — (%) $\frac{\text{Net Cash-Flow}}{\text{Average Shareholders' Equity}}$

G.2 — (%) $\frac{\text{Net Cash-Flow}}{\text{Average Net Capital Employed}}$

G.3 — (%) $\frac{\text{Funds Generated by Operations}}{\text{Average Net Fixed Assets}}$

H.1 — (%) $\frac{\text{Net Profit}}{\text{Average Paid-In Share Capital}}$

H.2 — (%) $\frac{\text{Net Profit}}{\text{Stock Market Capitalization}}$

I. (years) $\frac{\text{Remunerated liabilities}}{\text{Resources Generated}}$

J. (ratio) $\frac{\text{Resources Generated}}{\text{Interest Expenses}}$

K. (%) $\frac{\text{Total Assets (less intangibles) - Liabilities}}{\text{Paid-In Share Capital at Year End}}$

creased in the coming years to place it at more acceptable levels, which will require continuing efforts to be made in this direction.

The trend mentioned above was appreciated by our shareholders and risk capital investors in the Company who, considering the support that these factors give to the dividend paid by

Telefónica, have continued to respond favourably to cash calls via capital increases, as mentioned in the preceding pages.

Furthermore, the return on capital has been reinforced: while the return on paid up share capital has been maintained, the stock market yield has fallen by 4 percentage points, demonstrating the improvement in the evaluation

INCOME								
(In millions of Pesetas)						Yearly Growth Rate % 1980/1984	Growth Rate % 1984/1983	Growth Rate % 1983/82
ITEM	1980	1981	1982	1983	1984			
	Amount	Amount	Amount	Amount	Amount			
Revenue from Services.....	168,454	204,855	244,925	296,883	349,226	20.0	17.6	21.2
Connection Fees and								
Others	13,953	16,299	17,225	17,072	17,020	5.1	(0.3)	(0.9)
Income from Investments.....	641	942	1,481	1,964	6,183	76.2	214.8	32.6
Other Income	6,944	7,625	7,902	8,665	8,802	6.1	1.6	9.7
Income	189,992	229,721	271,533	324,584	381,231	19.0	17.4	19.5
Itemisation of Revenue from Services								
Subscriber Service Charges	44,749	55,059	65,337	74,916	111,086	25.5	48.3	14.7
National Data Processing								
Charges	8,577	11,758	14,722	21,245	24,568	30.1	15.6	44.3
National Automatic Service								
Charges	83,648	102,295	122,054	148,023	149,646	15.6	1.1	21.3
Trunk Calls through								
Operator	2,129	2,252	2,554	2,201	2,217	1.0	0.7	(13.8)
International Service								
Charges	24,354	28,040	32,620	40,299	51,149	20.4	26.9	23.5
Mobile and Maritime								
Service Charges	649	772	983	1,087	1,437	21.9	32.2	10.6
Directories and Year Books	4,348	4,679	6,655	9,112	9,123	20.3	0.1	36.9

Telefónica had an income of 381,231 million pesetas in 1984, signifying a nominal growth of 17.4 percent as compared to 1983, demonstrating the important growth rate in real terms.

Under the heading of Income, the most significant item is Revenue from Services at 349,226 million pesetas, representing 91.6% of total 1984 income, with the same share of income as in 1983.

The following comments can be made on developments this year in comparison with previous years:

1. In the services included under the Revenue from Services, the most significant increase was for Subscriber Service Charges which had reached a figure of 111,086 million pesetas in 1984, an increase of 48.3% over 1983, mainly due to the change in the tariff structure in 1984.

Nevertheless, this has clearly been compensated for by the introduction of 140 free billing pulses per month for automatic calls, which has meant that income from the National Automatic Service has practically not grown in 1984 (1.1%) (with this being the major income item for Telefónica).

2. Behaviour of the other telephone and teleprocessing revenue items in 1984 is similar to the weighted growth of Revenue from Services. Most notable are: National Data Processing, which has generated 24,568 million pesetas. This increase, nearly 16%, is high but very much lower than that recorded in previous years, at the beginning of a spectacular potential growth that still has a medium-term outlook; and the Interna-

tional Service at 51,149 million pesetas, which increased by 26.9% over 1983, nearly three points higher than that obtained in that year (23.5%).

3. The trend in connection fees has stabilised with respect to 1983, due to the different bases for comparison, arising from the price reduction of March 25, 1983, with an acceptable nominal growth rate if the comparison is made on an homogeneous basis.
4. With respect to other income, the increase in income from investments is worthy of emphasis and is a result, as mentioned in the corresponding section, of the changes in Cash and Liquid Asset management.

EXPENSES

(Millions of Pesetas)						Yearly Growth Rate % 1980/84	Growth Rate % 1984/1983	Growth Rate % 1983/1982
ITEM	1980	1981	1982	1983	1984			
Operating Expenses	73,982	86,116	104,592	121,809	134,779	16.2	10.6	16.5
Interest Expense	33,672	47,180	53,654	65,090	77,655	23.2	19.3	21.3
Depreciation and Amortization	46,193	56,674	67,989	82,382	96,028	20.1	16.6	21.2
State Levy and Taxes	10,107	12,269	14,845	17,959	21,117	20.2	17.6	21.0
Transfer to Exchange Loss Provision	1,500	3,000	3,000	5,330	14,230	75.5	167.0	77.7
Transfer to Self-Insurance Provision	723	604	906	909	1,000	8.4	10.0	0.3
Transfer to Provision for Bad Debts	—	—	—	2,000	3,507	—	75.4	—
Transfer to Provision for Contingencies and Others	—	—	—	1,569	295	—	(81.2)	—
Total Costs and Expenses	166,177	205,843	244,986	297,048	348,611	20.3	17.4	21.2
Itemisation of Operating Expenses								
Salaries and Related Cost..	85,731	99,134	117,439	132,765	144,686	14.0	9.0	13.1
Outside Work, Supplies and Services	16,614	19,090	25,443	30,540	35,375	20.8	15.8	20.0
Other Operating Charges..	787	848	1,006	1,075	1,744	22.0	62.2	6.9
Provision for Accrued Expenses not accounted for	—	—	—	1,388	608	—	(56.2)	—
Investment Expenses	(29,150)	(32,956)	(39,296)	(43,959)	(47,634)	13.1	8.4	11.9
Total Operating Expenses	73,982	86,116	104,592	121,809	134,779	16.2	10.6	16.5

In the context of an expense rationalization and control policy, total expense growth in 1983 (which amounted to 348,611 million pesetas) has been 17.4%, i.e. 3.8% points less than the year before and 2.9% points less than the overall period considered.

The different expense items can be divided into two main groups: Firstly, that comprising items corresponding to the Company's regular activities and which it is possible to affect directly, applying specific policies for improving management and running; and a second group to cover those items basically determined by more independent external behaviour variables.

In the first group one may thus include operating expenses, interest expense, state levy and taxes and, to a certain extent, the transfer to the self-insurance provision and depreciation and amortization. All of these, with the exception of the transfer to the self-insurance provision, have grown at rates below those of 1983 and the five-year period overall.

The second group then includes the remaining transfers to provisions. In this group, with the exception of the provision for contingencies and others (which started from a very high base in 1983, the first year in which a provision was set up for this item, therefore involving a considerable sum), growth rates are very high, higher than previous years, reflecting policy criteria and maintaining the line marked out the year before of cost recognition and restructuring through the results.

The most outstanding aspects and items of greatest significance are commented on below (interest expenses are discussed in detail in the analysis of economic and financial activity included in this section):

The effort to rationalise expenses takes on a special importance in the item for operating expenses which, amounting to 134,779 million pesetas, only grew by 10.6%, nearly 6% points less than the 1983 increase. The main component, Salaries and Related Costs,

contributed 144,686 million pesetas, 9% more than in 1983.

Equally significant within this same item is the investment expenses heading, a negative component of operating expenses that represents the application of internal Company funds to investments. This increase has only been 3,675 million pesetas, or a growth of 8.4% over 1983, due mainly to two causes: improved construction management, and the reassignment of part of the employees normally engaged in this work to maintenance of new plant.

The depreciation charge has been 96,028 million pesetas, representing an increase of 16.6% with respect to 1983. The depreciation rate is 5.2% of average depreciable plant, in accordance with the technical studies on the useful life of plant.

The other components do not require special comment, except that the policy initiated the previous year relating to bad debt has been maintained, involving a provision of 3,507 million pesetas in 1984.

made of the Company by investors, in terms of the share price.

At a financial level the policy applied throughout 1984 has continued, with the already established objectives of 1983, generally improving on the achievements already made in that year.

The objectives of this policy, apart from the qualitative aspects already mentioned, can be summarised through the following aspects:

- To improve degree of the self-financing, establishing investment levels in accordance with the capacity of fixed assets used in operations to generate funds.
- To diminish relative borrowing levels, encouraging the expansion of risk capital and self-financing.

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STATEMENT OF CHANGES IN FINANCIAL POSITION FOR 1980-1984					
(Millions of Pesetas) (After Profit Distribution)					
	1980	1981	1982	1983	1984
Depreciation and Amortization	46,193	56,674	67,989	82,383	96,028
+ Net Variations in Reserves and Provisions	2,484	2,682	6,584	4,542	5,556
= Net Self-Financing (1)	48,677	59,356	74,573	86,924	101,584
+ Non-Reimbursable Contributions for Irrevocable Rights of Use.....	47	193	(30)	13	477
+ Capital Increase	—	13,351	—	33,644	22,387
+ Debentures and Bonds Issued...	28,000	35,092	34,384	30,537	47,280
+ Other Medium and Long-Term Loans	53,365	59,234	57,822	83,329	125,995
= Increase in Net Capital Employed (2)	81,412	107,870	92,176	147,523	196,139
Basic Finance (1+2)	130,089	167,226	166,749	234,447	297,723
+ Increase in Working Capital ...	12,712	—	24,314	—	—
= Total Sources and Applications..	142,801	167,226	191,063	234,447	297,723
+ Debentures redeemed	4,004	2,503	15,201	19,699	25,364
+ Amortization of Long and Medium-Term Loans	22,009	18,684	21,913	31,819	53,278
= Applications of Finance (3)	26,013	21,187	37,114	51,518	78,642
+ Investment in Fixed Assets	115,839	131,753	146,379	159,861	175,417
+ Other Investments	(865)	(3,069)	5,318	15,659	(14,835)
= Total Gross Investments (4) ...	114,974	128,684	151,697	175,520	160,582
+ Inventories for Fixed Assets (5).	1,814	1,955	2,252	4,256	4,538
= Basic Applications (3+4+5)	142,801	151,826	191,063	231,294	243,762
+ Increase in Working Capital ...	—	15,400	—	3,153	53,961

The difference between the increase in working capital as shown in this table and that audited is as follows:

• Increase in Working Capital	53,961
• Increase in Stocks	4,538
• Increase in 1984 Dividends	5,119
• Increased Stock Provision	(49)
TOTAL	63,569

BALANCE SHEETS FOR 1980/1984

(After Profit Distribution)

(In millions of Pesetas)

ITEMS	1980	1981	1982	1983	1984
Issued Share Capital	213,610	240,312	240,312	288,374	320,416
Revaluation Reserve	287,871	279,897	281,090	344,722	419,719
Other Reserves and Surplus	28,657	25,568	30,628	35,620	40,318
Provisions and others	6,611	6,594	47,664	50,307	52,090
Shareholders' Equity ...	536,749	552,371	599,694	719,023	832,543
Debentures and Bonds in Pesetas	203,313	222,479	247,942	255,529	277,445
Debentures and Bonds in Foreign Currency	—	4,092	11,598	19,356	19,743
Other Medium and Long-Term Debt	109,207	171,899	232,283	304,415	377,279
Medium and Long-Term Debt Finance	312,520	398,470	491,823	579,300	674,467
Net Capital Employed .	849,269	950,841	1,091,517	1,298,323	1,507,010
Fixed Assets	1,348,870	1,451,190	1,667,754	1,903,232	2,182,144
Accumulated Depreciation	(522,039)	(553,823)	(659,630)	(754,311)	(868,250)
Fixed Assets under construction	48,367	53,018	59,036	76,179	76,742
Advance Payments on Plant	10,705	5,663	9,988	14,531	12,756
Inventories for Fixed Assets	12,856	15,093	17,494	22,251	26,441
Net Fixed Assets	898,759	971,141	1,094,642	1,261,882	1,429,833
Net Intangible Assets	922	878	2,256	3,797	4,803
Investments	16,564	20,687	22,054	37,677	33,895
Deferred Charges	4,823	6,284	7,884	9,186	13,461
Unrealised Exchange Losses	9,515	20,855	54,378	75,972	58,164
Total Net Assets	930,583	1,019,845	1,181,214	1,388,514	1,540,156
Consumable Inventories ...	1,582	1,799	2,051	2,523	2,993
Subscriber Accounts Payable	37,954	43,494	52,022	61,587	65,895
Other Receivables	10,217	15,020	12,764	21,583	21,016
Cash and Banks	5,630	13,717	15,521	36,195	77,977
Short-Term Liabilities	136,697	143,034	172,055	212,079	201,027
Working Capital	(81,314)	(69,004)	(89,697)	(90,191)	(33,146)
Total Net Assets = Total Net Liabilities..	985,966	1,093,875	1,263,572	1,510,402	1,708,037

VALUE ADDED IN THE LAST FIVE YEARS

(Millions of Pesetas)

	1980	1981	1982	1983	1984
Total Income (1)	+219,142	+262,677	+310,829	+368,542	+428,865
Outside Work, Supplies and Services ...	16,614	19,090	25,443	30,540	35,375
Other Operating Charges	787	848	1,006	1,075	1,744
Total External Cost and Charges	— 17,401	— 19,938	— 26,449	— 31,615	— 37,119
Value Added	201,741	242,739	284,380	336,927	391,746
Salaries and Related Costs	85,730	99,134	117,439	132,765	144,686
Remuneration and Interest	56,609	69,917	79,142	90,885	108,031
— Remuneration to Shareholders (dividends)	23,497	23,497	26,434	27,095	32,214
— Interest Expense (on loans)	33,112	46,420	52,708	63,790	75,817
State Levy and Taxes	10,107	12,269	14,845	17,958	21,117
Upkeep of production facilities (depreciation charges, provisions, reserves, etc.)	49,295	61,419	72,954	95,319	117,912

(1) Includes work carried out by the Company on fixed assets.

The value added generated by Telefónica in 1984 amounted to 391,746 million pesetas, an increase of 16.3% in nominal terms and 7 points in real terms in relation to 1983.

The breakdown of value added and its change over the previous year demonstrates the facts that have been discussed in greater detail in the preceding pages, of which the following should be mentioned:

1. Productivity increases achieved, that allow greater value added generation per unit cost.

2. Action taken to reinforce and improve financial and asset balances.
3. Intensification of the policy of transfer to provisions and write-offs, in order to preserve asset quality.

Treasury payments, which increased by 17.6% in 1984, practically all correspond to the State Levy applicable to Telefónica's activities.

- To raise the degree of financial coverage of fixed assets and working capital, by a major rebalancing on the basis on better compensated guarantee, solvency, and current ratios, in order to improve financing capacity with respect to third parties.
- Lastly, to improve the resources generated/remunerated liabilities and resources generated/interest expenses ratios, in order to widen and improve the Company's real capacity for expansion.

The degree to which these objectives have been attained has been generally fully satisfactory, although further efforts are necessary in some cases. On the other hand, in other areas, the levels required have already been achieved.

Thus, working capital has been improved to a satisfactory level, if the high non-operating current liabilities with which Telefónica operates are taken into account. It could be stated in this sense that liquidity is already at a sufficient level to enable more qualitative elements to be incorporated into financial management, as occurred in 1984.

PAYMENTS TO THE TREASURY AND SOCIAL SECURITY

(Millions of Pesetas)

	1984	1983	Increase	
			Absolute	Relative %
I Payments to the Treasury	112,222	95,264	16,958	17.8
Due as taxpayer:				
— State Levy	20,846	17,678	3,168	17.9
— Tax on interests charged to affiliates and others	271	281	(10)	(3.6)
Taxes withheld as intermediary:				
— Tax on telephone use	58,533	48,732	9,801	20.1
— Income Tax	16,472	13,965	2,507	17.9
— Capital Tax	9,153	9,024	129	1.4
— Non-resident Corporation Tax	177	81	96	118.5
Indirect Taxes:				
— Turnover Tax	6,770	5,503	1,267	23.0
II Net Payments to Social Security Organizations...	17,159	15,994	1,165	7.3
Total Payments	129,381	111,258	18,123	16.3

Total payments by Telefónica to the Treasury and Social Security in 1984 have amounted to 129,381 million pesetas, an increase of 16.3% with respect to 1983.

The main items of this payment and their growth in 1984 are detailed in the corresponding table.

In this sense, it should be mentioned that this improvement has not involved major increases in total remunerated liabilities, but has been carried out by transforming short-term debts into long-term ones, without this transformation causing marginal increases in financial costs. Similarly, the greater diversification in the Company's financial current assets should be emphasised, new instruments, and a more rational management of traditional ones, being employed.

Furthermore, this has been carried out simultaneously with an improvement of the guarantee and solvency ratios, as shown in the table below. This result has seen the influence of the policy of increasing shareholders' equity and adapting the volume of investments, together with the depreciation rate in the former and self-financing in the latter.

Self-financing capacity, although improvement continues as mentioned earlier, must continue to increase in the future.

Gearing has been severely corrected, and now shows a clearly falling trend after having stabilised in 1983. This correction has been intensified at the short term level, with a positive effect on marginal financing costs.

On the other hand, although the present gearing is higher than in 1980, the different liquidity situation in these two years should be taken into account, with a better balanced situation existing at the present after correcting the considerable risk compensation in the early years of this five-year period.

Financial policy, in turn, on having been marked by the need to match debt to the real capacity for generating resources, has committed a substantial improvement in the capacity to repay debt, improving in several of these years, and also in the ratio of resources generated to interest expenses, where the former are almost double the latter.

With respect to revolving fund policies, the improvements initiated the year before have continued and a more compensated development has been achieved in the growth of net current assets from operations. With respect to net current assets other than from operations, the traditional tendency has continued, improving the management of these in line with the earlier comments for working capital.

All of this has enabled a major restructuring of the Company's financial balances, and thanks to the easier situation, it is now possible to initiate and intensify qualitative debt policies, without this meaning that the objectives indicated are not to be aimed at in the future.

It can therefore be stated that Telefónica's capacity has improved quantitatively and qualitatively, having a present growth potential greater than that of previous years.

This greater solvency and solidity, on the other hand, has been achieved while maintaining a positive rate of activity and real investment, substantially improving the return on assets employed in operations and other profitability ratios with the consequent benefit for the shareholder, both directly and through the rise in share prices that this has led to on the Stock Exchanges.

Auditing Shareholders' Report

MR. FERNANDO PEREZ OLIVARES HINOJOSA and MR. JOSE CARLES ABELLO, designated Auditors of the Accounts for the year of 1984 by the Annual General Meeting of Shareholders of the Compañía Telefónica Nacional de España, held on June 29, 1984, state that they have analysed the Balance Sheet, Statement of Profit and Loss, Statement of Changes in Financial Position, and Statement of Movement and Direct Applications to Reserves, together with the 25 Notes thereon and the external reports of the auditors and the Spanish statutory auditors, included in the Company's Annual Report and they have found them in accordance with the information requested by and provided to them, so that they consider that they give a true and fair view of the financial situation of the Company and consequently propose approval thereof by the Annual General Meeting.

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And in testimony of which, we sign this Report in Madrid on the 24th of May, 1985.

The image shows two handwritten signatures in black ink. The signature on the left is for Fernando Pérez-Olivares Hinojosa, featuring a large, stylized 'F' and 'O'. The signature on the right is for José Carles Abelló, written in a more fluid, cursive style.

Mr. Fernando Pérez-Olivares Hinojosa

Mr. José Carles Abelló

Independent Auditors' Report

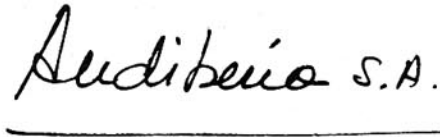
To the Board of Directors Compañía Telefónica Nacional de España Madrid

1. We have examined the balance sheet of Compañía Telefónica Nacional de España (TELEFONICA) at December 31, 1984, 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, as set out on pages 58 to 77. 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 TELEFONICA are submitted annually to the Spanish government for approval, with the prior intervention of the Government Delegate in the Company and agreement of the Prices Commission. Consequently, TELEFONICA 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. The employees of the Company are covered by a social benefit plan governed by the mutual pension fund "Institución Telefónica de Previsión" (ITP). The characteristics of this plan and the difficulties associated with its viability are explained in Note 23 to the financial statements. At present negotiations are in process between the interested parties in order to determine a new scheme of social benefits assumable by the parties involved.
In our independent auditor' report of May 31, 1984 with respect to the financial statements as at December 31, 1983, we qualified our opinion due to the uncertainty existing with respect to the potential liabilities, if any, that could have resulted for TELEFONICA as a consequence of the negotiations concerning the social benefits plan. Based upon the opinion of qualified independent legal counsel, which has confirmed TELEFONICA's compliance with all its contractual obligations to ITP, as well as its legal independence from ITP, we understand that there exists no other secondary responsibility of TELEFONICA to ITP than that expressed in Note 23 to the financial statements.

4. In our opinion, the financial statements referred to in paragraph 1 present fairly the financial position of Compañía Telefónica Nacional de España at December 31, 1984, 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 TELEFONICA'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.
(Member of Fox
Moore International)

Madrid, April 29, 1985

Spanish Statutory Auditors' Report

MR. PEDRO RODRIGUEZ SAN ROMAN and MR. ENRIQUE FERNANDEZ PEÑA, full members of the Institute of Spanish Statutory Auditors, in compliance with the mandate 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, 1984 together with the Statement of Profit and Loss corresponding to that year.

In the examination carried out we have jointly taken into account the work and reports prepared by the firms Price Waterhouse and Audiberia, S. A., which have audited the Company's accounts during 1984, all in accordance with Telefónica.

The said review has given rise to this Report 17/85 that is issued with the remarks and observations given below.

I. General remarks

- 1.1. The figures contained in the Balance Sheet and Statement of Profit and Loss audited come from the Company's general ledger and auxiliary books, in accordance with general account groupings, shown in detail in the annual accounts.
- 1.2. The Company's Balance Book number 3, legalized on May 30, 1973 under number 8,756 shows the Trial Balances on March 31, June 30, September 30 and December 31, 1984.
- 1.3. The Company's Day Book number 23, legalized on August 5, 1977 under the number 12,002, shows the summary of the entries made each month, in accordance with the account groupings mentioned in 1.1.

2. Remarks on the Balance Sheet

2.1. Fixed assets.

This item has increased by 175,417 million Pesetas in 1984, fundamentally corresponding to purchases, works contracted with third parties and direct imputations amounting to 151,426 million Pesetas, and on the other hand, to indirect investment costs of 17,662 million Pesetas and interest expenses charged to the works amounting to 6,329 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 expenses already charged.

The fixed assets have been revalued in accordance with Article 3 of the law of December 31, 1945 by 143,342 million Pesetas, credited to accumulated Depreciation for the year in 57,784 million Pesetas and charged to the revaluation surplus in 85,558 million Pesetas. This authorization, which the Company may carry out after obtaining prior approval from the Ministry of Finance, has been applied to the fixed asset inventory at December 31, 1983.

2.2. Accumulated depreciation and amortization of assets.

The relevant credit items charged to the 1984 results amount to 96,028 million Pesetas (95,427 million Pesetas of depreciation of fixed assets and 601 million Pesetas of amortization of intangible assets). The overall percentage of the average value of depreciable plant (without including the revaluation pending mentioned above) has been 5.20%.

2.3. Net shareholdings in companies.

Investments in the Telefónica group have been valued on the basis of the corresponding company balance sheets at December 31, 1983 and represent a reduction of 949 million Pesetas that had been charged to the Voluntary Reserve. The income received as dividends during 1984 from these shareholdings has amounted to 395 million Pesetas.

2.4. Loans to affiliates and associates.

In the balance on this account at the year end the most significant amount corresponded to the borrowings of Telefonía y Finanzas, S. A. (an affiliate in which Telefónica has a 100% interest), a stock exchange share dealing company permitted for this purpose by the Spanish Stock Exchanges (Article 41 of the Stock Exchange Regulations in force). This balance was practically settled in the first quarter of 1985.

2.5. Unrealized exchange losses.

The revaluation of foreign currency borrowings at the year end amounted to 58,164 million Pesetas. This amount is the future potential loss that the Company will have to withstand in the coming years if present exchange parities are maintained. In order to cover these losses the Coordinated Four Year Plan with the Government (1983/1986) includes this item in the tariff provision.

During 1984 the company has absorbed and charged to results 14,230 million Pesetas and 1,394 million compensated by positive exchange differences, corresponding to the collection of payment for services in foreign currency.

At the year end the Self-Insurance Provision for exchange losses had a balance of 21,598 million Pesetas, which reduces the above-mentioned risk of 58,164 million Pesetas.

2.6. Inventories.

The policy of not reflecting purchases carried out when the invoices are being processed at the year end continues: we have been informed that this policy will be modified in the future.

2.7. Accounts receivable.

The caption "Subscribers" includes ex-subscribers where debt collection is doubtful, amounting to a total of 3,961 million Pesetas, pending revaluation. There are provisions of 2,884 million Pesetas to cover this amount in the "Provision for bad-debt" item.

2.8. Share capital.

The company, thus authorized by the Annual General Meeting of Shareholders held on June 11, 1982, has carried out a capital increase of 32,042 million Pesetas on the basis of one new share for every one held, with 30% of the nominal value charged to the Reserves (14,419 million Pesetas).

2.9. Statutory reserve.

The balance in this account has increased by 400 million Pesetas due to the distribution of profits for 1983 with a balance of 6,905 million Pesetas at December 31, 1984.

2.10. Voluntary reserve and revaluation surplus.

These have been increased by 85,558 million Pesetas, as a result of net plant revaluation, and reduced by 9,012 million Pesetas due to the part charged to reserves of the capital in-

crease, and 949 million Pesetas as a consequence of the reduction in the valuation of shareholdings in group companies. Furthermore, this item includes the balance on the Share Premium Reserve account, amounting to 1,733 million Pesetas.

2.11. Technological development reserve.

The balance on this account has increased by 4,292 million Pesetas due to the difference between material recovered and dismantling costs.

2.12. Debentures and bonds.

Debentures amounting to 67,455 million Pesetas have been issued in 1984, of which 47,536 million Pesetas have been received. The total amount of the difference plus an extension of 5,000 million Pesetas were received in January, 1985. A total of 75,889 million Pesetas have been obtained via other financial instruments.

2.13. **Pensions.**

Telefónica employees are the beneficiaries of a social welfare scheme, with pensions that substitute and complement the Social Security. These pensions are provided by the Institucion Telefónica de Prevision (ITP), a pension fund with an independent legal status created in accordance with the law of December 6, 1941 and the regulations of May 26, 1943 relating to mutual benefit funds.

The circumstances and explanations of this matter are described in Note 23 to the Financial Statements. The latest calculations by actuaries show that, given the qualitative and quantitative importance of the services provided by this institution, the resources that it possesses and the contributions made by employees and Telefónica (4.3% and 9% of the regulatory salary, respectively) are insufficient to cover the obligations to beneficiaries in the future, both with respect to retired personnel and those in active service. For this reason negotiations have commenced between the interested parties, creating a tripartite Commission for this purpose (ITP, Trade Unions and Telefónica).

In our report of last year we qualified our opinion relating to the eventual liabilities that may arise for Telefónica as a result of these negotiations, announced in May, 1984.

This year, on the basis of an independent legal report demonstrating compliance with all contractual obligations with the ITP and the non-existence of legal responsibility for Telefónica, the said qualification on contingencies not reflected in the annual accounts is eliminated.

3. Remarks on the Statement of Profit and Loss

3.1. **Income.**

The estimate of income items for the year is considered to be correct. The estimate carried out the year before included insignificant variations on the final figures.

3.2. **Costs and expenses.**

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

On the basis of the verifications made, jointly with the work and reports of the firms Price Waterhouse and Audiberia, S. A., we hereby issue the following:

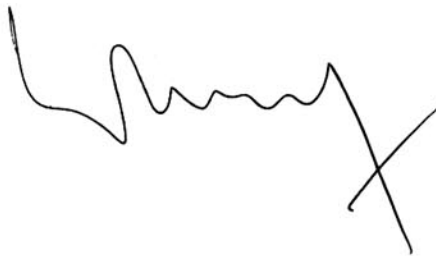
REPORT

As a result of the review carried out it is our professional opinion, that the Balance Sheet and the Statement of Profit and Loss of the Compañía Telefónica Nacional de España, S. A., attached, present a true and fair view of the financial situation of the Company at December 31, 1984 and that they have been prepared and submitted in accordance with generally accepted accounting principles in Spain and are substantially coherent with previous years, in accordance with the contracts and agreements in force with the Spanish authorities and subject to the considerations that we have indicated.

And considering our professional work as commissioned to have finished, we issue this document with one original and six copies, issued in six numbered pages of official paper from the Institute of Spanish Statutory Auditors, to which two appendices, also numbered, are attached and which we sign, seal, and paraph in Madrid on May 22, Nineteen hundred and eighty-five.



Enrique Fernández Peña



Pedro Rodríguez San Román

Balance sheet at December 31

(before distribution of profits)

(In millions of pesetas)

ASSETS	1984	1983
FIXED ASSETS (Note 3)	1,403,392	1,239,631
Land	30,914	30,290
Buildings and power equipment	141,170	129,361
Telephone installations	1,997,616	1,732,669
Other fixed assets	12,444	10,912
	2,182,144	1,903,232
Accumulated depreciation	(868,250)	(754,311)
	1,313,894	1,148,921
Fixed assets under construction:		
Work in progress	76,742	76,179
Advances to suppliers	12,756	14,531
	4,803	3,797
INTANGIBLE ASSETS (Note 4)	4,803	3,797
Research and development and others	5,882	4,923
Accumulated amortization	(1,079)	(1,126)
	33,895	37,677
INVESTMENTS (Notes 5 and 6)	33,895	37,677
Shares and others	22,238	20,536
Loans to group companies	9,162	14,924
Loans to employees	2,205	2,056
Guarantees and deposits	290	161
	13,461	9,186
DEFERRED CHARGES (Note 7)	13,461	9,186
UNREALIZED EXCHANGE LOSSES (Note 8)	58,164	75,972
	29,434	24,774
INVENTORIES (Note 9)	29,434	24,774
Inventories on hand	30,267	25,225
Obsolescence reserve	(833)	(451)
	78,038	75,155
ACCOUNTS RECEIVABLE	78,038	75,155
Subscribers (Note 10)	68,779	63,063
Provision for bad debts (Note 10)	(2,884)	13,985
Miscellaneous receivables	12,810	(1,476)
Provision for bad debts	(667)	(417)
	77,977	36,195
CASH AND BANKS (Note 11)	77,977	36,195
Unused facilities - cash and banks	44,209	32,538
Short term investments	31,171	—
Funds in transit and others	2,597	3,657
	23,761	20,333
OTHER CURRENT ASSETS AND PREPAYMENTS	23,761	20,333
Prepayments	8,873	8,015
Interim dividend	14,419	12,316
Debentures pending subscription	469	2
Total	<u>1,722,925</u>	<u>1,522,720</u>
MEMORANDUM ACCOUNTS (Note 25)	64,406	50,163

Notes 1 to 25 form an integral part of this statement.

LIABILITIES	1984	1983
SHAREHOLDERS' EQUITY	780,047	668,275
Share capital (Note 12)	320,416	288,374
Reserves: (Note 13)		
Statutory reserve	6,905	6,505
Voluntary reserve and revaluation surplus	422,286	347,289
Technological development reserve	30,372	26,080
Unappropriated profit	68	27
	459,631	379,901
NON-REIMBURSABLE CONTRIBUTIONS FOR RIGHTS OF USE AND OTHERS (Note 14)	2,768	2,291
PROVISIONS (Note 15)	49,322	48,016
Risk and exchange loss self-insurance	29,198	29,187
Other provisions	20,124	18,829
LONG TERM DEBT	674,936	579,302
Debentures and bonds (Note 16)	297,657	274,887
Loans and credit facilities (Note 17)	338,630	270,718
Loans from the Institución Telefónica de Previsión (ITP)	18,289	15,064
Notes payable to suppliers (Note 18)	13,818	13,875
Collective insurance for employees (Note 24).....	6,542	4,758
SHORT TERM DEBT	149,596	171,126
Loans and credit facilities (Note 17)	37,179	43,069
Suppliers (Note 18)	12,709	12,062
Notes payable to suppliers (Note 18)	21,891	41,710
Taxes payable (Note 19)	43,797	37,246
Social Security payable	4,242	4,533
Other creditors (Note 20)	21,947	19,307
Dividend payable (Note 21)	7,831	13,199
ACCRUALS (Note 22)	33,636	26,174
Accrued expenses and deferred income	30,412	24,024
Interest payable-ITP	3,224	2,150
PROFIT AND LOSS	32,620	27,536
Profit for the year	32,620	27,536
Total	1,722,925	1,522,720
MEMORANDUM ACCOUNTS (Note 25)	64,406	50,163

Notes 1 to 25 form an integral part of this statement.

STATEMENT OF PROFIT AND LOSS FOR THE YEARS ENDED DECEMBER 31

(In millions of pesetas)

	1984	1983
INCOME	365,779	313,422
Revenue from services	349,226	296,883
Connection fees	12,118	11,785
Suburban connection fees and others	1,966	1,814
Surcharges	1,842	1,953
Private exchange maintenance	374	842
Amortization of irrevocable rights of use	253	145
COSTS AND EXPENSES	320,340	273,408
Salaries and related costs	144,686	132,765
Outside work, supplies and services	34,279	30,189
Taxes	271	281
Provision for bad debts (subscribers)	3,206	2,000
Other charges	2,204	3,866
Exchange losses	14,230	5,330
Financial expenses	75,817	63,790
Sundry expenses	1,744	1,074
Depreciation of fixed assets	95,427	82,266
Amortization of intangible assets	601	116
Amortization of deferred charges	1,838	1,300
Internal expenditure capitalized in fixed assets:		
Labour, materials and overhead	(47,634)	(43,959)
Notional interest allocated to construction in progress	(6,329)	(5,610)
OPERATING PROFIT	45,439	40,014
OTHER INCOME	8,027	5,200
	53,466	45,214
STATE LEVY	(20,846)	(17,678)
NET PROFIT	32,620	27,536

Notes 1 to 25 form an integral part of this statement.

**STATEMENT OF CHANGES IN FINANCIAL POSITION
FOR THE YEARS ENDED DECEMBER 31**
(before distribution of profits)

(This statement has been prepared in accordance with the classification of short and long term debts, described in Note 2.2 k)

Millions of pesetas

	1984		1983
SOURCES			
Net profit for the year	32,620		27,536
Depreciation and amortization	97,866		83,682
Net movements in reserves and irrevocable rights of use	4,769		2,832
Self-insurance and exchange differences	16,433		8,615
FUNDS PROVIDED BY OPERATIONS..	151,688		122,665
Capital increase	22,387		33,644
Loans to affiliates	5,548		—
Debentures issued	47,280		30,537
Foreign currency loans	54,101		28,026
Other loans, credit facilities and notes payable...	71,894		55,920
TOTAL SOURCES	352,898		270,792
APPLICATIONS			
Dividends	27,095		26,434
Additions to fixed assets	175,417		159,861
Other additions:	8,175		24,189
Advances to suppliers of fixed assets	(1,775)	4,543	
Intangible assets	1,607	1,658	
Investments in affiliates	2,230	15,386	
Deferred charges	6,113	2,602	
Debentures redeemed	25,364		19,699
Amortization of foreign currency loans	25,610		10,411
Amortization of other loans, credit facilities and notes payable	27,668		21,408
TOTAL APPLICATIONS	289,329		262,002
NET MOVEMENTS	63,569		8,790
COMPOSITION OF NET MOVEMENTS:			
Increase in inventories	4,660		4,728
Increase in receivables	2,816		16,072
Increase in cash and banks	41,782		20,675
Increase in prepayments	858		5,054
Variation in short term debt	14,162		(32,990)
Increase in accruals	(8,180)		(7,524)
Variation in dividend accounts	7,471		2,775
Total	63,569		8,790

Notes 1 to 25 form an integral part of this statement .

STATEMENT OF MOVEMENTS AND DIRECT APPLICATIONS TO RESERVES FOR THE YEARS ENDED DECEMBER 31

(In millions of pesetas)

	1984	1983
Balance at the beginning of the year	379,901	311,607
Profit from preceding year	27,536	26,546
Dividend declared	(27,095)	(26,434)
Portion of capital increase charged to reserves (Note 12)	(9,612)	(14,419)
— Asset revaluation (devaluation):		
Fixed assets (Note 3)	85,558	80,344
Investments	(949)	(562)
— Direct operational applications:		
Technological development reserve (Note 2.2.b)	4,292	4,550
Provision for bad debts - prior years	—	(1,731)
Balance at the end of the year, before distribution of profits	<u>459,631</u>	<u>379,901</u>

Notes 1 to 25 form an integral part of this statement.

NOTES TO THE FINANCIAL STATEMENTS AT DECEMBER 31, 1984 AND 1983

NOTE 1 - ACTIVITY AND CONTRACT WITH THE STATE

1.1 Conditions of the Concession Agreement

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

Condition 2 of the contract defines the monopoly services that the Company can operate within the scope of the "Telephone System" which allows for the transmission of speech, independently of the procedure used.

TELEFONICA services were expanded under the Decree of December 21, 1970 and the Order of October 26, 1978, to include monopoly of port and coastal communication services and non-monopoly services for information and data transmission.

1.2 Fiscal status

The fiscal status of TELEFONICA is established in Condition 7, by which the State shares in the

Company's revenue and, consequently, as the most significant factor, has the right to receive annually a levy of 15% of the net profit of the Company, such amount never to be less than 6% of the Company's gross revenue from services, as defined by Condition 24 of the contract.

The amounts to be received by the State under the terms of Condition 7, are considered for all legal purposes as a tax. Also, 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, it being understood that the exemptions and exceptions from taxes, excise taxes and duties established in this condition will be fully effective, even if this is not specifically stated in the laws or stipulations regulating the levying of such taxes (Condition 26).

1.3 Tariff situation

The arrangement for authorizing tariffs for the services rendered is set out in Condition 19 of the Concession Agreement and in subsequent regulations. The tariffs will be reviewed, at the Company's request, when for two consecutive years they do not give a sufficiently high yield to cover all the operating expenses, allocate the required amount for the depreciation of the installations and properties of the company, accumulate and maintain the statutory reserve referred to in Condition 7 of the contract or any other required by law, and, obtain a surplus in each fiscal year of not less than 5% of the paid-in share capital plus reserves defined under heading e) of Condition 24.

PROPOSAL FOR DISTRIBUTION OF THE PROFIT FOR THE YEAR 1984

	Millions of pesetas
Unappropriated profit brought forward from previous year	68
Net profit for the year	32,620
Total available for distribution	32,688
PROPOSED DISTRIBUTION	
5% Interim dividend on shares N.º 1 to 576,748,073 payable as from November 11, 1984	14,419
6% Final dividend on the same shares pending approval	17,302
11% dividend on shares n.º 576,748,074 to 640,831,193 (proportional to the period paid-up) pending approval	493
Total dividends	32,214
To statutory reserve	400
Unappropriated profit carried forward	74
Total proposed distribution	32,688

63

NOTE 2 - BASES OF PRESENTATION AND SIGNIFICANT ACCOUNTING PRINCIPLES

2.1 Bases of presentation

- a) The financial statements have been prepared based on the accounting records of TELEFONICA of each year.
- b) The financial statements are presented before the proposed distribution of the profit for the year. The distribution of 1984 profits is subject to approval by the Shareholders' General Meeting.
- c) Due to the need to have a statement of profit and loss which shows as far as possible the direct and indirect results of service operations, certain operational concepts, which are considered as not forming part of distributable net profit, (such as, those corresponding to plant dismantling, corrections to the valuation of trade investments, and other extraordinary items) are applied directly to the Company's reserves. Consequently, the statement of profit and loss and the statement of movements and direct applications to reserves should be read and considered together.

2.2 Significant accounting principles

- a) Accounting standards
The accounting principles adopted in drawing up the financial statements are, in general, in accordance with generally accepted accounting

principles in Spain, together with others required or allowed under the conditions of concession and by virtue of the character of 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.

All amounts in the notes to the financial statements are expressed in MILLIONS OF PESETAS.

- b) Fixed assets and method of depreciation
TELEFONICA, with the approval of the Ministerio de Hacienda (Finance Ministry), can revalue its assets in order to bring them into line with the real value of its properties and installations (Condition 24). Should this revaluation give rise to an increase in asset values such increase will not be included in the basis for the calculation of the State levy.

In line with the above, fixed assets are valued at their estimated replacement cost, in accordance with the explanations given in Note 3. Revaluations at replacement value, net of the corresponding revaluation of depreciation funds, are credited to the revaluation surplus account. Additions are accounted for at their respective purchase price and installation cost, including direct labour and materials used, together with an allocatable share of the overheads and a notional interest allocation to the start-up date of the asset concerned.

Idle facilities (due to scrapping or dismantling of the plant) are deducted from the value of the corresponding fixed asset account. At the same time, an equivalent amount is deducted from the

value of the accumulated depreciation, on the overall assumption (periodically reviewed) that the facilities dismantled are the oldest and that these are fully depreciated. Furthermore, the residual value of dismantled facilities is charged to a corresponding inventory account and credited to the technological development reserve and this account, where applicable, is charged with the inherent cost of dismantling the plant.

The annual depreciation charge is calculated using the straight-line method, by applying coefficients, in line with the useful life of the assets, to the net revalued amounts.

- c) Maintenance and repair of fixed assets.
The amounts resulting from the maintenance and repair of fixed assets, when they do not relate to an increase or improvement, are charged to expenses in the year in which they are incurred.
- d) Intangible assets.
The items recorded by the company as intangible assets comprise labour costs and costs of outside services and supplies incurred in developing new product lines. Amortization is scheduled over a maximum period of 5 years from completion of the projects.
The rights acquired for the use of equipment and installations owned by others as a consequence of official concessions or irrevocable rights of use, are valued at their respective historical purchase cost and are amortized by the straight-line method over periods not exceeding the estimated term of recovery through revenue.
Intangible assets, when fully amortized, are cancelled.
- e) Investments - Net investments in companies
The financial statements do not present the consolidated financial position of TELEFONICA and its subsidiaries. Consolidation exercises have been carried out and the results reflect that there is no significant impact on the Company's financial statements.
The valuation of the Company's investments in other companies is annually adjusted against the Company's reserves, on the basis of the theoretical equity value of these companies, using the balance sheets as at December 31 of the previous fiscal year, as approved by the Annual General Meeting of Shareholders. Dividends are recorded as revenue when received.
- f) Deferred charges
Debenture issue expenses are amortized on a straight-line basis over the period of the issues. The remainder of deferred charges are amortized on the straight-line method over periods of between 5 and 10 years.

- g) Valuation of foreign currency accounts
Foreign accounts are valued at the end of the year at the official exchange rate ruling in the Madrid foreign exchange market. The differences are recorded each year in the "Unrealized exchange losses" account. These are charged to expenses each year, as realized, in accordance with the repayment of the foreign currency debt to which they relate. The fixing of tariffs of each year takes into consideration the recovery of these deferred expenses. Furthermore, the 4-year plan, agreed to with the Spanish Government, contemplates the recovery of these deferred expenses, for the period which it covers, through tariff charges.
- h) Inventories
Inventories are valued, in general, at their weighted average purchase cost, which is lower than the net replacement cost or realizable value.
- i) Invoicing and accounting for 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 recognise prepayments with respect to services invoiced bi-monthly in advance, and to accrue for unbilled services provided.
- j) Pensions and other social services
Retirement pensions of TELEFONICA employees are covered by the "Institución Telefónica de Previsión" (ITP), whose relationship with the Company is described in Note 23.
Contributions made by TELEFONICA to ITP are charged to expenses together with other payroll costs.
- k) Short and long term debts
For the purposes of the balance sheet, debts are classified according to the 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
Notwithstanding, the corresponding Notes disclose the maturities within the 12 months from balance sheet date, and those subsequent to 12 months.

NOTE 3 — FIXED ASSETS

3.1 The composition by type of fixed asset and movements during 1984 are as follows:

Items	Gross book value at 31-12-1983	Revaluation	Additions for the year	Dismantled plant and retirements	Gross book value at 31-12-1984
Land	30,290	—	630	(6)	30,914
Buildings and power equipment	129,361	4,099	8,066	(356)	141,170
Exchange equipment	577,449	50,757	45,488	(2,943)	670,751
Wire and cable transmission equipment	155,398	13,144	9,924	(2,079)	176,387
Radio and satellite communication transmission equipment	31,847	2,446	3,217	(460)	37,050
Local and trunk networks	737,149	64,998	58,071	(11,911)	848,307
Subscriber sets and other related installations	230,826	7,898	47,709	(21,312)	265,121
Furniture, office and other equipment	9,052	—	1,230	(217)	10,065
Other installations	1,860	—	519	—	2,379
Fixed assets in service	1,903,232	143,342	174,854	(39,284)	2,182,144
Work in progress	76,179	—	563	—	76,742
Gross additions			175,417		
Advances to suppliers for fixed assets.	14,531	—	(1,775)	—	12,756
Fixed assets	1,993,942	143,342	173,642	(39,284)	2,271,642

3.2 Service and operating conditions and the obligations of the Concession Agreement require TELEFÓNICA to maintain a permanent investment programme to ensure a service with the most up-to-date and efficient equipment.

The investment budget for 1985 amounts to Ptas 198,969 million, of which Ptas 191,215 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.

The fixed asset additions comprise the following:

	1984	1983
Labour	25,145	24,094
Material from stock	35,324	30,857
Suppliers	49,583	51,617
Contractors and other direct charges	41,374	32,480
Overhead and others	17,662	15,203
Interest allocation	6,329	5,610
Total	175,417	159,861

3.3. Condition 9 of the State Contract stipulates that those fixed assets of TELEFÓNICA related to telephones services cannot be mortgaged. In accordance with this, these assets at December 31, 1984 are not pledged under loan contracts, except for isolated operations involving insignificant amounts. At the same date assets amounting to Ptas 237,700 million, are subject to legal regulations (mainly inspection by the relevant authorities) derived from Decree Law 19/1961 and Law 61/1978, which regulates the benefits obtained for the reduction of withholding tax on interest on the loans and borrowings indicated in Notes 16 and 17.

3.4 The insurance policies contracted by TELEFÓNICA cover all of the assets owned by the Company, with the exception of the local and trunk networks and the subscriber sets to which corresponding self-insurance provisions are applied.

3.5 Revaluation of fixed assets.

The revaluations made to date, in accordance with the requirements of the conditions of the Concession Agreement mentioned in Note 2.2 b) have resulted in the following movements:

Year	Revaluation	Increased depreciation	Revaluation reserve
From 1946 to			
1978	338,895	162,674	176,221
1979	174,682	105,840	68,842
1980	188,544	120,647	67,897
1982	109,053	68,796	40,257
1983	134,420	54,076	80,344
1984	143,342	57,784	85,558
Total	1,088,936	569,817	519,119

The revaluation process comprises the valuation of the inventory of physical units at replacement prices of the previous year. These prices are obtained by applying the corresponding price increase index of the supplier or suppliers to the average historical prices, or by estimated values given by the Company's technical departments. In the latter case the total surplus is compared to that obtained by an indexing procedure, the lower of the two being applied. The same indexes used to revalue fixed assets are applied to revalue the accumulated depreciation.

3.6 Dismantled plant

During the year 1984 the fixed assets and accumulated depreciation accounts were reduced by Ptas 39,284 million, crediting the technological development reserve with Ptas 4,292 million being the net effect of costs and revenue arising from dismantling.

For the purposes of the above calculation, dismantled plant is considered to be the oldest plant, generally corresponding to fully depreciated equipment, in accordance with the criteria followed in accounting for dismantling (Note 2.2.b).

3.7 Accumulated depreciation of fixed assets

The composition of the accumulated depreciation and its movements during 1984 are as follows:

Group	Accumulated depreciation at 31-12-83	Revaluation	Transfer	Dismantled plant	Depreciation for the year	Accumulated depreciation at 31-12-84
Buildings and power equipment	37,280	1,678	408	(362)	3,981	42,170
Exchange equipment	213,192	17,876	(655)	(2,943)	23,140	251,918
Wire and cable transmission equipment..	84,000	6,908	32	(2,079)	9,422	98,220
Radio and satellite communication transmission equipment	18,430	1,447	(65)	(460)	1,643	21,124
Local and trunk networks	292,028	26,367	1,914	(11,911)	28,960	333,529
Subscriber sets and other related installations	103,804	3,508	(1,635)	(21,312)	27,168	114,803
Furniture, office and other equipment	5,385	—	13	(217)	1,076	6,257
Other installations	192	—	—	—	37	229
Total	754,311	57,784	12	(39,284)	95,427	868,250

3.8 TELEFONICA, each year revises the useful lives of its plant with the objective of adapting such lives to the effects of new investments and obsolescence. The results obtained from these revisions enable the Company to determine with greater accuracy, the rates of depreciation applicable to each fixed asset, taking into account not only its type, but also in each case, the conditions under which it is operating and other special factors which might affect its rate of depreciation.

The rate of depreciation applied during 1983 and 1984 has been an average of 5.2% of depreciable fixed assets.

The following table indicates the useful lives of the various types of fixed assets used by the Company, and which results in the overall average depreciation rate of 5.2%:

Group	Years
Buildings	40-50
Power equipment	21-24
Exchange equipment	23-24
Radio and transmission equipment.	15-16
Land-based infrastructure	44-48
Poles and wires	22-24
Cables	20-22
Subscriber sets	8-9
Subscriber sets installation	9-16
Booths, furniture, equipment, workshops, etc.	7
Other fixed assets	12
Finished projects not grouped .	22-23

NOTE 4 — INTANGIBLE ASSETS

These accounts are detailed as follows:

	Book value at 31-12-84	Book value at 31-12-83	% amortization
Research, studies and development projects	4,581	2,983	20
Allocations to systems and installations	—	646	10
Installation concessions	1,301	1,294	4
Gross intangible assets	5,882	4,923	
Less: Accumulated amortization	1,079	1,126	
Net intangible assets	4,803	3,797	

NOTE 5 — INVESTMENTS - SHAREHOLDINGS IN COMPANIES

5.1. The details at December 31 are as follows:

	1984	1983
Net interest in companies (Note 2.2 e)	16,637	15,791
Other investments	5,601	4,745
Total	22,238	20,536

5.2. Transactions during 1984 and 1983 between TELEFONICA and companies in which it has an interest have been as follows:

	Dividends received		Interest charged by TELEFONICA		Acquisitions of goods and services by TELEFONICA	
	1984	1983	1984	1983	1984	1983
Affiliates	217	102	2,238	904	22,601	16,625
Associates	178	79	3	1	64,072	56,278
Total	395	181	2,241	905	86,673	72,903

Interest charged to related companies has been at market rates.

5.3 .The information presented in the following tables under the titles "Income before taxes" and "Equity value at December 31, 1984" have been prepared based on the financial statements of Group companies at December 31, 1984. The calculation of the equity value takes into account audit adjustments required to present the best estimate of the share of net worth at the end of 1984.

5.4 Relevant data for TELEFONICA Group companies is as follows:

Company name	Share capital	TELEFONICA direct holding %	Book value	Equity value at December 31, 1984	1984 income before tax profit (loss)
Affiliates:					
Comercial de Servicios Electrónicos, S. A. (COSESA)	700	99.14	1,699	1,609	1
ENTEL, S. A.	350	100.00	385	572	61
Compañía Publicitaria de Exclusivas Telefónicas, S. A. (CETESA)	434	97.33	642	672	67
Hispano Radio Marítima, S. A.....	500	100.00	1,026	636	(373)
Gráficas de Burgos, S. A. (GRAFIBUR)	325	100.00	342	398	58
Electrónica Aragonesa, S.A. (ELASA)	300	100.00	323	384	128
Telefonía y Finanzas, S. A. (TELFISA)	500	100.00	1,235	399	(652)
Compañía Financiera de la Telefonía Española B.V.	1	100.00	1	1	—
Sistemas e Instalaciones de Telecomunicación, S.A. (SINTEL)	1,100	100.00	2,363	2,775	496
Amper, S. A.	800	87.50	396	598	138
Urbana Ibérica, S. A.	330	100.00	184	1	(104)
Telefónica Internacional	25	100.00	25	25	—
Control Electrónico Integrado, S.A.	80	55.00	11	44	—
			8,632	8,114	
Associates:					
Telettra Española, S. A.	800	51.00	1,568	1,331	101
Cables de Comunicaciones, S. A. (CCSA)	782	49.00	1,053	1,207	765
Industrias de Telecomunicación, S. A. (INTELSA)	2,600	49.00	1,283	2,151	1,305
Standard Eléctrica, S. A. (SESA)...	12,335	20.64	3,625	3,148	(650)
Sociedad Española de Telecomunicaciones, S. A. (SECOINSA)..	8,681	23.75	239	731	158
INDELEC	300	30.00	75	84	—
			7,843	8,652	
Others:			162	23	
Total			16,637	16,789	

NOTE 6 — INVESTMENTS - LOANS TO GROUP COMPANIES

The balances at December 31, represent financial advances given by TELEFONICA to group companies:

Company	1984	1983
Affiliates	8,710	14,679
Associates	38	19
Others	414	226
Total	<u>9,162</u>	<u>14,924</u>

The most important item included in affiliates relates to TELFISA, the treasury stock holding company. Balances with this company have been virtually settled at the beginning of 1985.

NOTE 7 — DEFERRED CHARGES

The balances at December 31 comprise the following:

	1984	1983
Debenture and bond issue expenses.	12,500	8,329
Capital increase expenses	895	737
Others	66	120
Total	<u>13,461</u>	<u>9,186</u>

Amortization criteria are described in Note 2.2 f); the amortization charge for 1984 was Ptas 1,838 million (1983 — Ptas 1,300 millions).

NOTE 8 — UNREALIZED EXCHANGE LOSSES

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

Debts in foreign currency are stated in the balance sheet at the closing exchange rate for the year in the Madrid Foreign Exchange Market.

The amortization calendar in function of the foreign exchange debt maturity, is as follows:

1985	5,680
1986	9,533
1987	8,698
Subsequent to 1987	34,253
Total	<u>58,164</u>

The amount of exchange losses realized in 1984, corresponding to repayment of debts and other payments was Ptas 15,624 million (1983—Ptas 6,934 million) of which Ptas 14,230 million (1983 — Ptas 5,330 million) were absorbed by charges against the year's profit and Ptas 1,394 million (1983 — Ptas 1,604 million) compensated by exchange gains generated by service charges in foreign currency.

NOTE 9 — INVENTORIES

The inventories in TELEFONICA warehouses or belonging to the Company and deposited in third parties' stores at December 31 are valued in accordance with the criteria described in Note 2.2.h) and are as follows:

	1984	1983
Installation materials	25,557	21,557
Maintenance materials and spare parts	3,571	2,525
Consumables	1,139	1,143
Obsolescence reserve	30,267	25,225
	(833)	(451)
Total	29,434	24,774

NOTE 10 — SUBSCRIBERS

The balances at December 31, comprise:

	1984	1983
Services billed:		
Private subscribers	8,293	5,317
Public entity subscribers	11,277	10,877
Ex-subscribers	3,961	3,219
Uncollectible and pending classification	84	143
	23,615	19,556
Unbilled services	45,164	43,507
	68,779	63,063
Provision for bad debts	(2,884)	(1,476)
Total	65,895	61,587

During 1984 the movement of the provision for bad debts account was as follows:

Balance of provision at beginning of 1984	1,476
Provision for 1984 charged to income	3,206
Cancellation of bad debts, net of telephone usage tax	(1,798)
Balance of provisions at close of 1984	2,884

NOTE 11 — CASH AND BANKS

- 11.1 In accordance with the procedures described in Note 17.4, the total of short and long-term credit facilities granted are registered under the classification "Unused facilities-Cash and Banks". At December 31, 1984 of the total balance of this classification, Ptas 43,680 million represent unused credit facilities (1983—23,807 million).
- 11.2 The heading "Short term investments" represents investments in liquid money market instruments.

NOTE 12 — SHARE CAPITAL

All of the shares of the Company on issue at December 31, 1984 have been fully subscribed and paid, and are bearer shares of Ptas 500 par value each; of these, 75% are not transferable to foreigners.

The State has a direct 32% shareholding, together with a further interest estimated at 15% through official institutions; the total number of shareholders is estimated to be approximately 700,000.

The table below reflects the movements of share capital:

Issue of November 15, 1983	
Balance December 31, 1983	
Issue of October 11, 1984	
Balance December 31 1984	
Issue of March 25, 1985	

NOTE 13 — RESERVES AND UNAPPROPRIATED PROFIT

13.1 Of the total of reserves and unappropriated profit of TELEFONICA, the statutory reserve is the only one specifically regulated by the State Contract (Condition 24); this contemplates its free distribution for any use as well as precludes the possibility to increase this reserve by charge against other reserves. With respect to the remainder, there do not exist any legal restrictions on the free distribution of the voluntary, technological development and revaluation reserves.

13.2 The movement on the Reserve accounts during 1984 has been as follows:

	December 31, 1983
Statutory reserve	6,505
Voluntary reserve:	347,289
— Revaluation surplus	433,561
— Share increase (discount)	(52,859)
— Share premium	1,733
— Allocations to extraordinary provisions	(39,196)
— Revaluations of investments	5,781
— Other	(1,731)
Technological development reserve	26,080
Unappropriated profit	27
Total	379,901

NOTE 14 — NON-REIMBURSABLE CONTRIBUTIONS FOR RIGHTS OF USE AND OTHERS

These items correspond to one-time payments received from third parties for leasing a certain number of circuits of a "Communication System" belonging to TELEFONICA and included in the Company's fixed assets. These amounts are credited to income on a straight-line basis over the period of the concession.

NOTE 15 — PROVISIONS

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

	1984	1983
Exchange losses	21,598	22,587
Self-insurance	5,928	4,928
Contingencies	1,672	1,672
	<u>29,198</u>	<u>29,187</u>
Secondary responsibility for complementary pensions of ITP	18,829	18,829
Others	1,295	—
	<u>20,124</u>	<u>18,829</u>
Total	<u>49,322</u>	<u>48,016</u>

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, such as:

- With respect to exchange losses, revenues (tariffs) in future periods will not allow the usual practice of absorbing the realized losses in each year.
- With respect to secondary responsibility with ITP, this provision is set-up, as an independent act by TELEFONICA, to cover the possibility that it could be necessary in the future to complement the cost of the complementary pensions of ITP.

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Number of shares	Face value	Ratio	Price	Paid-in
96,124,679	48,062	1 × 5	70%	33,643
576,748,073	288,374			
64,083,120	32,042	1 × 9	70%	22,430
640,831,193	320,416			
80,103,899	40,052	1 × 8	80%	32,042

Movements during 1984		December 31, 1984
Allocation	Application	
400		6,905
		<u>422,286</u>
85,558		519,119
—	(9,612)	(62,471)
—		1,733
—		(39,196)
—	(949)	4,832
—		(1,731)
4,292		<u>30,372</u>
41		68
<u>90,291</u>	<u>(10,561)</u>	<u>459,631</u>

NOTE 16 — DEBENTURES AND BONDS

16.1 Composition and movements:

	Balance 31-12-83	New issues	Repay- ments	Other movements	Balance 31-12-84
Debentures and bonds in pesetas:					
— Non-convertible	255,531	47,455	(25,364)	211	277,833
— Convertible and/or exchangeable.	—	20,000	—	—	20,000
Debentures and bonds in foreign currency	19,356	—	—	387	19,743
	274,887	67,455	(25,364)	598	317,576
Convertible bonds pending subscrip- tion	—	(19,919)	—	—	(19,919)
Total	274,887	47,536	(25,364)	598	297,657

16.2 Redemption

Year of redemption	1985	1986	1987	Subsequent	Total
Amount	34,663	38,467	48,772	175,755	297,657

16.3 Additional information:

	1984	1983
Interest expense	33,097	29,580
Accrued interest at December 31	12,474	11,218
Issues subject to fiscal benefits (Decree Law 19/1961 and Law 61/1978):		
Debentures in pesetas	205,047	230,411
Debentures in foreign cur- rency	18,669	18,310

The interest rate for debentures and bonds in circulation varies between 5.75% and 15% p.a.

16.4 Foreign currency debentures were issued for US dollars 50 million and Deutsche Mark 200 million and have been revalued at the official closing exchange rate of each currency at year end. The revaluation charged in 1984 to the unrealized exchange losses account amounts to Ptas 387 million (1983 — Ptas 2,221 million).

16.5 Issues have been subscribed at par value and interest due is paid periodically with the exception of an issue in 1984 of Zero Coupon Bonds for Ptas 3,000 million, which are optionally redeemable in the years 1989, 1991 or 1994 at respectively 200%, 264% or 400% of their par value.

16.6 In December 1984, an issue of exchangeable or convertible bonds for Ptas 20,000 million was placed in circulation. This issue was increased to Ptas 25,000 million in January 1985. At December 31, 1984, Ptas 81 million had been subscribed and paid up. The balance of the issue was subscribed during the first months of 1985. This issue is optionally convertible or exchangeable into shares of TELEFONICA from 1986 until 1988 or redeemable at par value after 1989. The Company has made the necessary arrangements to meet commitments in the case that holders of the bonds opt for the exchange into shares.

NOTE 17 — LOAN AND CREDIT FACILITIES

17.1 As mentioned in Note 2.2 k) 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:

	1984			1983		
	Long term	Short term	Total	Long term	Short term	Total
Loans in foreign currencies	213,697	1,219	214,916	186,662	7,745	194,407
Loans and credit facilities in pesetas	98,841	2,600	101,441	81,367	15,400	96,767
Other loans	3,125	1	3,126	2,689	4	2,693
Promissory notes (face value)	40,257	35,632	75,889	—	22,607	22,607
	355,920	39,452	395,372	270,718	45,756	316,474
Less:						
Deferred interest on promissory notes	17,290	2,273	19,563	—	2,687	2,687
Total	338,630	37,179	375,809	270,718	43,069	313,787

17.2 The maturities are as follows:

	Maturities				Total 31-12-84
	1985	1986	1987	Subsequent	
Loans in foreign currencies	14,586	23,453	23,029	153,848	214,916
Loans and credit facilities in pesetas	26,783	32,600	38,150	3,908	101,441
Other loans	—	—	—	3,126	3,126
Promissory notes	35,632	3,115	13,817	23,325	75,889
Total	77,001	59,168	74,996	184,207	395,372

17.3 Additional information:

	Financial charges		Interest accrual (deferral)		Interest rates	
	1984	1983	1984	1983	1984	1983
Loans in foreign currency	15,556	10,130	3,226	3,253	4.5-13%	4.5-11%
Loans and credit facilities in pesetas	9,084	12,679	1,979	1,951	14-17%	14-17%
Promissory notes	7,482	834			14-17%	14.5%
Long term			(17,290)			
Short term			(2,273)	(2,687)		

17.4 Credit facilities granted are accounted for as bank balances and as credits payable for the total amount of the limit granted (see Note 11.1). The disclosure of credit facilities not used at December 31, is as follows:

	1984	1983
Loans and credit facilities - long term	41,670	18,831
Loans and credit facilities - short term	2,010	4,976
	43,680	23,807

At December 31, 1984, there exist other credit facilities in addition to those included in the balance sheet, amounting to Ptas 45,000 million, represented by new loans not drawn down and by floating credit facilities which are accounted at the time they are utilized.

17.5 At December 31, 1984 of the total foreign currency loans, Ptas 146,996 million are covered by the fiscal benefits of Decree Law 19/1961 and Law 61/1978 (interests payable are subject to a withholding income tax at a minimal rate).

In accordance with the accounting criteria mentioned in Note 2.2 g), the amount of exchange differences arising from these loans in 1984 resulted in a credit to the account of unrealized exchange losses of Ptas 1,457 million (in 1983 there was a charge of Ptas 20,717 million).

The composition of foreign currency debt at December 31, 1984 is as follows:

Currency	Millions
US Dollars (US\$)	242.5
Deutsche Marks (DM)	1,014.1
Swiss Francs (SF)	1,305.9
Canadian Dollars (Can\$)	10.0
Swedish Crowns (SKR)	34.4
Dutch Florins (DFL)	50.0
Pounds Sterling (£)	74.0
ECU's	75.0

17.6 Promissory notes are accounted for as liabilities, at their face value, less interest deferred at December 31. Interest costs are accounted for over the period during which the notes are in force, with the charge to results being calculated using financial methods. Estimated charges attributable to expenses in future periods are as follows:

	1985	1986	1987	Subsequent	Total
Interest on promissory notes - long term	4,079	4,613	3,447	5,151	17,290
Interest on promissory notes - short term	2,273	—	—	—	2,273

At December 31, 1984, Ptas 3,780 million of promissory notes issued were still pending discount in the hands of the agent bank, for sale through the stock exchange. At the same date, there exist agreements on the part of various banking institutions, to place Ptas 14,840 million of promissory notes related to issues between January 1 and July 1, 1985.

NOTE 18 — SUPPLIERS AND NOTES PAYABLE TO SUPPLIERS

The balances at December 31 are as follows:

	Short term		Long term		Total	
	1984	1983	1984	1983	1984	1983
Suppliers	12,709	12,062	—	—	12,709	12,062
Notes payable to suppliers	21,891	41,710	13,818	13,875	35,709	55,585
Total	34,600	53,772	13,818	13,875	48,418	67,647

These balances at December 31, 1984 include Ptas 13,715 million corresponding to transactions with affiliated and associated companies, Ptas 7,495 million relating to transactions with suppliers in foreign currencies, and the remainder to Spanish suppliers and contractors.

	1985	1986	1987	Subsequent	Total
Repayment schedule of notes payable	26,378	4,931	1,910	2,490	35,709

NOTE 19 — TAXES PAYABLE

The balances, at December 31, comprise the following:

	1984	1983
State levy	20,846	17,678
Tax on telephone use and other	14,798	12,805
Payroll withholding tax	4,468	3,898
Tax withholdings on dividends and interest	3,685	2,865
Total	43,797	37,246

NOTE 20 — OTHER CREDITORS

These comprise the following groups of accounts:

	1984	1983
Staff bonus provision	7,807	7,109
Telephone service interchange	3,301	2,903
Guarantee and deposits	1,353	1,293
Imports on the Company's account .	1,383	1,965
Other creditors	8,103	6,037
Total	21,947	19,307

NOTE 21 — DIVIDENDS PAYABLE

At December 31, 1984, the net dividends payable amounted to Ptas 7,831 million after deducting 18% income withholding tax.

On November 11, 1984, TELEFONICA declared an interim dividend with respect to results of 1984, as detailed in the proposed distribution of the profit. In a calculation of the net worth of TELEFONICA, this interim dividend (included in the assets in the balance sheet) should be considered as a deduction of the profits pending distribution for the year.

NOTE 22 — ACCRUALS

22.1 Accrued expenses and deferred income
This item covers the following accounts:

	1984	1983
Accrued interest	17,679	16,422
Services billed in advance	7,737	5,186
Other	4,996	2,416
Total	30,412	24,024

22.2 Interest payable ITP:
This figure includes the interest corresponding to the ITP loan. In accordance with the existing agreement, the year's interest is payable on January 1st of the following year.

NOTE 23 — PENSIONS

23.1 TELEFONICA employees benefit from a social service system with substitutory and complementary pensions to those provided in Spain by the Social Security, and from a Group Endowment Insurance scheme (the latter as explained in Note 24).

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 Fund Law) of December 6, 1941 and the regulations pertaining thereto of May 26, 1943. In accordance with the above 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.

23.2 Benefits provided by ITP to its members are of various types, and are detailed in Article 4 of the Institute's Revised Text of Regulations, and mainly include retirement pensions, permanent disability, widowhood, orphanhood and other rights, pensions bonus payment and other auxiliary and subsidiary benefits. 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 retirement pension is Ptas 4.2 million per annum. The regulations of ITP provide for the revaluation of pensions based on the salary increases granted to personnel currently employed.

The members covered by this plan comprise approximately 8,900 retired personnel (pensioners) and 62,300 currently on the payroll, whose actual contributions represent 4.3% of their total gross salary (pension-base salary).

23.3 To meet the abovementioned combination of benefits ITP relies principally on the profits earned on its assets, and the contributions of TELEFONICA and those of its members. During 1984 the contributions of TELEFONICA amounted to Ptas 9,078 million and those of its employees to Ptas 4,337 million.

23.4 In addition, TELEFONICA has given ITP a guarantee of up to Ptas 8,000 million (included under Memorandum accounts of the balance sheet). This guarantee was authorised in 1977 in accordance with the guarantee required by Transitory Requirement 4, of the ITP Regulations, which reads: "TELEFONICA guarantees the effectiveness of the benefits to be satisfied by ITP during a period of 10 years".

For its part ITP, as principal respondent, is obliged, if the guarantee should not be renewed or whensoever it considers necessary, to readjust its revenue or the benefits granted or to be granted (article 19 and transitory stipulation 4 of the ITP's Regulations).

23.5 Furthermore, TELEFONICA has a provision of Ptas 18,929 million charged in 1982 against the revaluation surplus, and which, as indicated in Note 15, was set up considering the possibility that it could be necessary, in the future, to cover eventual shortages in the complementary pension benefits.

- 23.6 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. Based on actuarial studies carried out on ITP's situation, using a capitalization factor of 8%, the following matters are disclosed:
- a) Presently there is an underfunded liability of Ptas 41,583 million in order to comply with the aforementioned requirement.
 - b) If the actual required benefit levels were maintained, the contributions required to eliminate the deficit mentioned in a) above and establish and maintain the necessary funding levels, would be significantly greater than those currently paid.
 - c) However, the projections available indicate that, on the basis of current contributions and benefits, ITP will have sufficient funds and future net income to meet its obligations for the next 10 or 12 years.
- 23.7 In view of the problematic situation, negotiations between the interested parties have been commenced with a three party commission (ITP, TELEFONICA and Unions) having been formed, with the following objectives:
1. The study and analysis of the present position of ITP.
 2. Defining the position to be taken with respect to new situations or actions external to ITP which could affect it, and specifically, the possibility of the integration of the substitutory part of the pension benefits into the National Social Security Scheme.
 3. The viability study of the future of social benefits of TELEFONICA's employees.
- 23.8 It is probable that the previously mentioned integration of the substitutory part of social benefits into the National Social Security scheme will occur in the near future. In the opinion of the Company, the integration will not produce any impact on the net worth of the Company for the periods ended up to December 31, 1984.
- 23.9 At the same time, and as a consequence of the aforementioned, it is probable in the near future, that a new complementary pension plan will be defined, being established on sound financial bases. This plan should be structured on the basis of the new legal rules currently in force (Law 33/84 of Private Insurance and its future Regulations still pending announcement) or, where applicable, based on other legal foundations that could be announced shortly (for example, Regulation of Pension Funds). It is expected that these will incorporate the requirement to apply capitalisation systems in order to determine the financing schemes and the setting up of liabilities.
- 23.10 Any increase over the present costs of the social benefits system currently supported by TELEFONICA, that could derive from the circumstances outlined in this Note, will have its effect on future periods, being incorporated in the general situation as outlined in Note 2.2 a) as to the effect on future tariff structures. The guarantee which the Company has presently given to ITP (See Note 23.4) will be subject to the definitive solution adopted in the new plan previously referred to.

NOTE 24 — ENDOWMENT INSURANCE

TELEFONICA's employees have the right to receive a single payment for endowment insurance on reaching 65 years of age, whether still at work or retired. This payment is variable in each case, depending on the personal situation of each employee (labour position, collective insurance scale to which the employee belongs, etc.), with a variable limit.

Until December 31, 1982, the Company maintained a policy with an insurance company. During 1983, with effect from January 1 of that year, TELEFONICA changed this policy, modifying the contract to reduce capital, and agreeing with the insurance company that the accumulated mathematical reserves as at December 31, 1982 be applied in the future, to payments of benefits under the scheme, as they become due.

At December 31, 1984, the accumulated mathematical reserves of the insurance company relating to this policy amounted to Ptas 8,875 million.

To cover this concept, TELEFONICA, maintains a provision of Ptas 8,355 million of which Ptas 6,542 million are accounted for under long term debts and the balance (Ptas 1,813 million) under short term, having charged Ptas 4,473 million of additional provisions against profits in 1984.

As a result of the actuarial studies that have been carried out, and on the basis that the cost of the endowment insurance should be absorbed throughout the working life of the employees, it was concluded that:

- a) the annual charge for the year 1984, being approximately 4.2% of the overall payroll costs, is sufficient to cover this objective, and
- b) at December 31, 1984, the present value of the future commitments, calculated at an interest rate of 6% applied on actual salaries, amounts to approximately Ptas 76,000 million.

NOTE 25 — MEMORANDUM ACCOUNTS

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

	1984	1983
Guarantees of financial operations	2,975	4,016
Guarantee to ITP (see Note 23)	8,000	8,000
Guarantees granted to employees ..	4,906	4,312
IGTE (Turnover tax)	21,752	14,982
Promissory notes	20,740	14,270
Others	6,033	4,583
Total	64,406	50,163

The heading "Guarantees of financial operations" refers mainly to guarantees given by TELEFONICA to cover financial operations of affiliated and associated companies.

The heading "Turnover Tax" relates to the taxes paid by TELEFONICA to its suppliers for this concept as from October 1, 1979.

The heading "Promissory notes" includes the nominal value of underwritten promissory notes pending delivery to the agent bank for discount and the unused balances on credit facilities obtained to support the liquidity of the promissory notes.