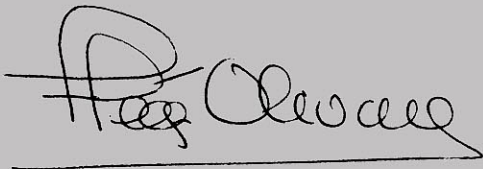


FINANCIAL STATEMENTS


Auditing Shareholders' Report

Mr. Fernando Pérez-Olivares Hinojosa and Mr. Isidoro Jiménez Gómez designated Auditors of the Accounts for 1985 by the Annual General Meeting of Shareholders of Telefónica, held on June 17, 1985, have examined the independent auditors' report, issued by the firms Price Waterhouse and Audiberia, S. A., and the report of the Spanish Statutory Auditors and propose that the Annual General Meeting approve the Annual Report, Balance Sheet, Statement of Profit & Loss, Statement of Changes in Financial Position and Statement of Movements and Direct Applications to Reserves for 1985 of the Compañía Telefónica Nacional de España, S. A.

And in testimony thereof, we sign this Report in Madrid, on the twenty-eighth of May nineteen eighty-six.



Fernando Pérez-Olivares Hinojosa



Isidoro Jiménez Gómez

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, 1985 together with the Statement of Profit and Loss corresponding to that year and the corresponding Notes thereto. In the examination carried out, we have jointly taken into account the working reports prepared by the firms Price Waterhouse and Audiberia, S. A., which have audited the Company's accounts during 1985, all in accordance with Telefónica.

The said review has given rise to this report 14/86, which 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, legalised on May 30, 1973 under the number 8,756, shows the trial Balances for the year.

1.3 The Company's Day Book number 23, legalised on August 5, 1977 under the number 11,882, 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 187,881 million pesetas in 1985, fundamentally corresponding to purchases, works contracted with third parties and direct imputations amounting to 163,156 million pesetas and, on the other hand, to indirect investment costs of 18,273 million pesetas and interest charged to the works of 6,452 million pesetas. Interest has been calculated at 9% by applying a rate of 0.75% per month on the balance of the work in progress at the end of the previous month, without including interest already charged.

Fixed assets have been revalued in accordance with Article 3 of the Law of December 31, 1945 by 123,808 million pesetas, credited to Accumulated Depreciation in 48,534 million pesetas and charged to the Revaluation Surplus in 75,274 million pesetas. This revaluation, which the Company carried out after obtaining

prior approval from the Ministry of Finance, has been applied to the fixed asset inventory at December 31, 1984.

2.2 Accumulated Depreciation and amortization of Assets.

The relevant credit items charged to the 1985 results amount to 114,103 million pesetas (111,083 million pesetas of depreciation of fixed assets and 3,020 million pesetas of amortization of intangible assets).

The overall percentage of the average value of depreciable plant (without including the revaluation mentioned above) was 5.3%.

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, 1984 and represent a reduction of 409 million pesetas that have been charged to the voluntary reserves.

As explained in detail in Note 4.3, it is estimated that there will be a positive revaluation in 1985 as a function of the net equity value at December 31, 1985.

The income received as dividends from these shareholdings in 1985 was 466 million pesetas.

2.4 **Deffered Exchange Losses**

The revaluation of foreign currency borrowings at the year end amounted to 66,132 million pesetas. Of this amount, 11,840 million pesetas correspond to deferred charges, and the remainder is the future potential loss that the Company must bear in the coming years if present exchange rates are maintained. These concepts differ on the basis of Telefónica's particular situation as a regulated company, the repercussion of which is incorporated into its tariff structure.

As in previous years, in 1985, the Company absorbed and charged to results all exchange losses attributable to the year, in accordance with paragraph 2.2.f of Note 2, amounting to 9,277 million pesetas together with 660 million pesetas compensated by positive exchange rate differences, corresponding to the collection of payment for services in foreign currencies.

At the year end, the Self-Insurance Provision for exchange losses had a balance of 21,598 million pesetas, the purpose of which is explained in Note 11.

2.5 **Accounts Receivable**

The caption "Subscribers" includes ex-subscribers where debt collection is doubtful, where the total balance amounts to 3,485 million pesetas, pending revaluation. There are 3,827 million pesetas in the "Provision for Bad Debt" Account to cover this amount, with the surplus covering other accounts receivable pending classification.

2.6 **Share Capital**

The Company, as authorised by the General Meetings of Shareholders, increased the share capital by 40,052 million pesetas on the basis of one new share for every eight held, with 20% of the nominal value charged to reserves (8,010 million pesetas).

In November 1985, the Board of Directors approved a new capital increase on the basis of agreements made at the General Meeting of Shareholders held on June 17, 1985. The subscription period was December 15, 1985 to January 15, 1986 and was accounted for on completion.

2.7 **Statutory Reserve**

The balance in this account increased by 400 million pesetas due to the distribution of profits for 1984, with a balance of 7,305 million pesetas at December 31, 1985.

2.8 **Voluntary Reserve and Revaluation Surplus**

These have increased by 75,274 million pesetas as a result of net plant revaluation, and reduced by 8,010 million pesetas due to the part charged to reserves of the capital increase, and in 409 million pesetas as a consequence of the reduction in the valuation in Group Company shareholdings.

2.9 **Technological Development Reserve**

The balance in this account has been increased by 3,560 million pesetas due to the difference between material recovered and dismantling costs.

2.10 **Debentures and bonds**

Debentures amounting to 40,000 million pesetas have been issued in 1985 of which payment of 245 million pesetas is pending. Furthermore, 19,919 million pesetas have been paid on convertible bonds and debentures issued during December 1984/January 1985.

2.11 **Unused Credit Facilities**

The accounting procedure for credit facilities was favourably modified

in 1985, adopting the criterion of including unused credit in the memorandum accounts. The loans and credit facilities caption in the liabilities therefore only reflects the drawn down amount of credit facilities obtained.

2.12 Pensions

Telefónica employees benefit from a social service system with substitutory and complementary pensions to those provided in Spain by the Social Security. These pensions are covered by the "Institución Telefónica de Previsión (ITP)", a mutual pension fund that has an independent legal status created under the Law of December 6, 1941 and the Regulations pertaining thereto of May 26, 1943 on Social Service Mutual Funds.

The circumstances and explanations relating to this matter are described in Note 18 to the Financial Statements.

On the basis of independent legal opinion issued in 1985 and recently updated, demonstrating compliance by Telefónica with all of its contractual obligations to ITP and the non-existence of legal responsibility for Telefónica, we consider that the situation existing up to the date of our previous report remains unchanged.

3. Remarks on the Statement of Profit and Loss

3.1 Income

The estimates of income at the end of 1984 and 1985 are correct.

3.2 Costs and Expenses

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

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

REPORT

As a result of the review carried out it is our professional opinion that the Balance Sheet and Statement of Profit and Loss of the Compañía Telefónica Nacional de España, S. A. and the Notes thereto, attached, present a true and fair view of the financial situation of Telefónica at December 31, 1985 and the results of its operations, in accordance with generally accepted accounting principles in Spain, without substantial variations in their application with those of the preceding year, in accordance with the contracts and agreements in force with the Spanish Authorities and subject to the considerations that we have indicated.

We sign this document, with one original and six copies, issued in six numbered pages on official paper from the Institute of Spanish Statutory Auditors, to which appendices are attached, numbered and sealed, in Madrid, on May twenty-two, nineteen hundred and eighty-six.

Pedro RODRIGUEZ SAN ROMAN

Enrique FERNANDEZ PEÑA

Independent Auditors' Report

To the Board of Directors Compañía Telefónica Nacional de España, S. A. Madrid

1. We have examined the balance sheet of Compañía Telefónica Nacional de España, S. A. (Telefónica) at December 31, 1985, 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 70 to 87. Our examination was made in accordance with generally accepted auditing standards.
2. As indicated in Note 1 to the financial statements, tariffs corresponding to the services provided by Telefónica are submitted to the Spanish government for approval, with the prior intervention of the Government Delegate in the Company and agreement of the Prices Commission. Consequently, Telefónica falls within the group of regulated entities whose peculiarities permit that income and expenses may be attributable to each period not only on the accrual basis but also when the related specific concepts of revenue and cost are computed as part of the approved tariffs. On this basis, the recovery of the amounts invested or deferred in the assets of the Company, particularly deferred exchange losses, will depend upon the adequate future consideration, in tariffs, of these concepts.
3. Notes 18 and 19 to the financial statements include a detailed explanation on the characteristics of the social benefit scheme by which the employees of Telefónica are covered through the mutual pension fund "Institución Telefónica de Previsión" (ITP), as well as the current going concern problems, the negotiations held and the Company's position in this respect.

Based upon the opinion of qualified independent legal counsel, recently updated in view of the events occurred in 1985 and up to date, which confirms Telefónica's compliance with all its contractual obligations to, as well as its legal independence from ITP, we understand that the situation as explained in our independent report on the financial statements as at December 31, 1984 remains unchanged, as no secondary responsibility of Telefónica to ITP exists other than that expressed in the above-mentioned Note 18.

4. In our opinion, the financial statements referred to in paragraph 1 present fairly the financial position of Compañía Telefónica Nacional de España, S. A. at December 31, 1985, 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, except for the change, with which we concur, in the presentation of unused credit facilities, as detailed in Note 13. 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. See additional note for international purposes.



Price Waterhouse



Audiberia, S. A. *

Madrid, May 5, 1986

Balance sheet at december 31

(before distribution of profits)

(In millions of pesetas)

ASSETS	1985	1984
FIXED ASSETS (Note 3)	1,556,264	1,403,392
Land	30,989	30,914
Buildings and power equipment	173,265	141,170
Telephone installations	2,209,192	1,997,616
Other fixed assets	16,074	12,444
	<u>2,429,520</u>	<u>2,182,144</u>
Accumulated depreciation	(982,606)	(868,250)
	<u>1,446,914</u>	<u>1,313,894</u>
Fixed assets under construction:		
Work in progress	95,794	76,742
Advances to suppliers	13,556	12,756
	<u>109,350</u>	<u>89,498</u>
INTANGIBLE ASSETS	5,042	4,803
Research and development and others	8,581	5,882
Accumulated amortization	(3,539)	(1,079)
	<u>5,042</u>	<u>4,803</u>
INVESTMENTS (Note 4)	32,987	33,895
Net investments in other companies	25,869	22,238
Loans to Group companies	4,164	9,162
Loans to employees	2,462	2,205
Guarantees and deposits	492	290
	<u>32,987</u>	<u>33,895</u>
DEFERRED CHARGES (Note 5)	12,898	13,461
DEFERRED EXCHANGE LOSSES (Note 6)	66,132	58,164
INVENTORIES (Note 7)	33,641	29,434
Inventories on hand	36,505	30,267
Obsolescence reserve	(2,864)	(833)
	<u>33,641</u>	<u>29,434</u>
ACCOUNTS RECEIVABLE	86,078	78,038
Subscribers (Note 8)	79,686	68,779
Provision for bad debts (Note 8)	(3,827)	(2,884)
Miscellaneous receivables	12,549	12,810
Provision for bad debts	(2,330)	(667)
	<u>86,078</u>	<u>78,038</u>
CASH AND BANKS	7,981	34,297
Cash and banks	1,034	529
Short term investments	2,168	31,171
Funds in transit and others	4,779	2,597
	<u>7,981</u>	<u>34,297</u>
OTHER CURRENT ASSETS AND PREPAYMENTS	5,364	23,761
Prepayments	5,364	8,873
Interim dividend	—	14,419
Debentures pending subscription	—	469
	<u>5,364</u>	<u>23,761</u>
Total	<u>1,806,387</u>	<u>1,679,245</u>
MEMORANDUM ACCOUNTS (Note 20)		
Unused credit facilities	121,300	88,680
Others	55,004	64,406
	<u>176,304</u>	<u>153,086</u>

Notes 1 to 21 form an integral part of this statement.

LIABILITIES	1985		1984	
SHAREHOLDERS' EQUITY		890,920		780,047
Share capital (Note 9)	360,468		320,416	
Reserves: (Note 10)				
Statutory reserve	7,305		6,905	
Voluntary reserve and revaluation surplus	489,141		422,286	
Technological development reserve	33,932		30,372	
Unappropriated profit	74		68	
	530,452		459,631	
DEFERRED INCOME				
Non-reimbursable contributions for rights of use and others ..		2,577		2,768
PROVISIONS (Note 11)		53,807		49,322
Risk and exchange loss self-insurance	33,698		29,198	
Other provisions	20,109		20,124	
LONG TERM DEBT		654,669		633,266
Debentures and bonds (Note 12)	325,702		297,657	
Loans and credit facilities (Note 13)	270,317		296,960	
Loans from the Institucion Telefónica de Previsión (ITP)	35,623		18,289	
Notes payable to suppliers (Note 14)	12,082		13,818	
Collective insurance for employees (Note 19)	10,945		6,542	
SHORT TERM DEBT		129,522		147,586
Loans and credit facilities (Note 13)	13,534		35,169	
Suppliers (Note 14)	25,681		12,709	
Notes payable to suppliers (Note 14)	4,707		21,891	
Taxes payable (Note 15)	46,448		43,797	
Social Security payable	5,243		4,242	
Other creditors (Note 16)	25,559		21,947	
Dividend payable	8,350		7,831	
ACCRUALS (Note 17)		35,743		33,636
Accrued expenses and deferred income	31,442		30,412	
Interest payable-ITP	4,301		3,224	
PROFIT AND LOSS		39,149		32,620
Profit for the year	39,149		32,620	
Total		<u>1,806,387</u>		<u>1,679,245</u>
MEMORANDUM ACCOUNTS (Note 20)				
Unused credit facilities		121,300		88,680
Other		55,004		64,406
		<u>176,304</u>		<u>153,086</u>

**STATEMENT OF PROFIT AND LOSS FOR THE YEARS
ENDED DECEMBER 31**

(In millions of pesetas)

	1985	1984
INCOME	411,689	365,779
Revenue from services	393,506	349,226
Connection fees	13,922	12,118
Suburban connection fees and others	1,632	1,966
Surcharges	2,274	1,842
Private exchange maintenance and other	355	627
COSTS AND EXPENSES	357,090	320,340
Salaries and related costs	159,572	144,686
Outside work, supplies and services	38,148	34,279
Taxes	275	271
Provision for bad debts (subscribers)	3,870	3,206
Other charges	7,925	2,204
Exchange losses	9,277	14,230
Financial expenses	77,209	75,817
Sundry expenses	2,165	1,744
Depreciation of fixed assets	111,083	95,427
Amortization of intangible assets	3,020	601
Amortization of deferred charges	2,861	1,838
Internal expenditure capitalized in fixed assets:		
Labour, materials and overhead	(51,863)	(47,634)
Notional interest allocated to construction in progress	(6,452)	(6,329)
OPERATING PROFIT	54,599	45,439
OTHER INCOME	7,985	8,027
Financial	4,419	4,955
Other	3,566	3,072
PROFIT BEFORE STATE LEVY	62,584	53,466
STATE LEVY	(23,435)	(20,846)
NET PROFIT (Before distribution)	39,149	32,620

Notes 1 to 21 form an integral part of this statement.

**STATEMENT OF CHANGES IN FINANCIAL POSITION
FOR THE YEARS ENDED DECEMBER 31
(BEFORE DISTRIBUTION OF PROFITS) (*)**

(In millions of pesetas)

	1985	1984
SOURCES		
Net profit for the year	39,149	32,620
Depreciation and amortization	116,964	97,866
Net movements in reserves and irrevocable rights of use	3,369	4,769
Self-insurance, exchange differences and other ...	17,841	19,034
Funds provided by operations	177,323	154,289
Capital increase	32,084	22,387
Investments in affiliates	4,599	5,548
Debentures issued	60,143	47,069
Foreign currency loans	14,897	54,101
Other loans, credit facilities and notes payable ...	70,553	46,665
TOTAL SOURCES	359,599	330,059
APPLICATIONS		
Dividends	32,214	27,095
Additions to fixed assets	187,881	175,417
Other additions:	9,523	8,175
Advances to suppliers of fixed assets	800	(1,775)
Intangible assets	1,778	1,607
Investments in affiliates	4,647	2,230
Deferred charges	2,298	6,113
Debentures redeemed	34,662	25,364
Amortization of foreign currency loans	60,687	25,610
Amortization of other loans, credit facilities and notes payable	52,140	27,668
TOTAL APPLICATIONS	377,107	289,329
VARIATIONS	(17,508)	40,730
Variation in unused credit facilities (**)	29,271	22,839
NET VARIATIONS	11,763	63,569
COMPOSITION OF NET VARIATIONS:		
Inventories	4,208	4,660
Receivables	8,081	2,816
Cash and banks	(26,316)	21,909
Prepayments	(2,012)	858
Short term debt	18,596	11,196
Accruals	(5,127)	(8,180)
Dividend accounts	(14,938)	7,471
TOTAL	(17,508)	40,730

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Notes 1 to 21 form an integral part of this statement.

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

(**) Corresponds to a lower utilization of medium and long-term credit facilities.

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

(Millions of pesetas)

	1985	1984
Balance at the beginning of the year	459,631	379,901
Profit from preceding year	32,620	27,536
Dividend declared	(32,214)	(27,095)
Portion of capital increase charged to reserves (Note 10)	(8,010)	(9,612)
Asset revaluation (devaluation):		
Fixed assets (Note 3)	75,274	85,558
Investments	(409)	(949)
Direct operational applications:		
Technological development reserve (Note 2.2 b)	3,560	4,292
Balance at the end of the year	<u>530,452</u>	<u>459,631</u>

Notes 1 to 21 form an integral part of this statement.

**NOTES TO THE FINANCIAL
STATEMENTS AT
DECEMBER 31, 1985 AND 1984**

**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, S. A. (**Telefónica**). The contract regulating the conditions of the concession was approved by Decree of October 31, 1946. For this reason **Telefónica** is a limited company regulated by the specific rules of this contract.

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

1.2. Fiscal status

The fiscal status of **Telefónica** is established in Condition 7 of the contract with the State, by which the State participates in the Company's revenue and, consequently, as the most significant factor, has the right to receive annually a levy of 15% of the Company's net profits which, under no circumstances, will be less than 6% of the Company's gross revenue from services (Condition 24).

The amounts to be received by the State under the terms of Condition 7 are considered for all legal purposes as a tax. For

this reason, and by virtue of the national scope of the Company's services, it is exempt from all other taxes or contributions, excise taxes or duties of any kind, 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 Law and Stipulations regulating the levying of such taxes (Condition 26).

1.3. Tariff situation

Condition 19 of the contract and additional regulations describe the tariff authorization system, according to which tariffs will be reviewed at **Telefónica's** request when, for two consecutive years, they do not give a sufficiently high yield to cover all operating expenses, allocate the required amount for depreciation of Company installations and properties, 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.

**NOTE 2 — BASES OF PRESENTATION
AND SIGNIFICANT ACCOUNTING
PRINCIPLES**

2.1 Bases of presentation

a) The financial statements have been prepared on the basis of the accounting records of **Telefónica** for each year prior to the distribution of profits. The distribution of 1985 profits is therefore subject to approval by the Shareholders' General Meeting.

PROPOSAL FOR DISTRIBUTION OF THE PROFIT FOR THE YEAR 1985

(Millions of pesetas)

Unappropriated profit brought forward from previous year	74
Net profit for the year	39,149
Total available for distribution	39,223
PROPOSED DISTRIBUTION	
5% Interim dividend on shares No 1 to 640,831,193 payable as from January 15, 1986	16,021
5% Interim dividend on shares No 640,831,194 to 720,935,091 (proportional to the period paid-in) payable as from January 15, 1986	1,547
6% Final dividend on shares No 1 to 640,831,193 pending approval	19,225
6% Final dividend on shares No 640,831,194 to 720,935,091 (Proportional to the period paid-in) pending approval	1,856
To dividends	38,649
To statutory reserve	500
Unappropriated profit carried forward	74
Total proposed distribution	39,223

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- b) In order to present a statement of profit and loss that responds to service operation as far as possible, certain items, such as those corresponding to the results of plant dismantling and trade investment valuation, are applied directly to the Company's reserves; consequently, they do not form part of the distributable profit. These items and their meaning are presented in the attached statement of movements and direct applications to reserves.
- c) As mentioned in Note 13.4, the 1985 balance sheet shows the credit facilities as the amount drawn down at December 31. The 1984 figures have been modified for comparability.
- d) All amounts shown in the Notes to the financial statements are expressed in millions of pesetas.

2.2 Significant accounting principles

a) Accounting standards

The accounting standards adopted in drawing up the financial statements are in accordance with generally accepted accounting principles in Spain, together with others required or allowed under the Conditions of Concession and by virtue of being a regulated enterprise, especially those referring to the revaluation of fixed assets and investments, treatment of exchange differences, the self-insurance fund and plant dismantling.

b) Fixed assets and their method of depreciation

Telefónica, in accordance with Article 3 of the Law of December 31, 1945 and 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. 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.

Consequently, fixed assets are valued at replacement cost, as explained in Note 3. The net revaluation is accounted for by crediting the revaluation surplus. Additions are accounted for at their respective purchase price and installation cost, including direct labour and materials used, together with an allocatable share of overheads and interest accrued up to the time of start-up of the asset concerned.

The annual depreciation charge is calculated using the straight line method as a function of the useful life of the assets.

The gross book value of elements removed from plant is deducted from the corresponding fixed asset account and, simultaneously, the equivalent amount is deducted from the accumulated depreciation on the assumption, reviewable on occasions, that dismantled plant is the oldest and is therefore fully depreciated. On the other hand, the residual value of dismantled plant is charged to the corresponding inventory account and credited to the Technological Development Reserve and this account, where applicable, is charged with the inherent costs of dismantling the plant.

Fixed asset maintenance and repair costs, when they do not relate to an increase or improvements, are charged in the year in which they are incurred.

c) Intangible assets and their method of amortization

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

Intangible assets, when fully amortised, are cancelled.

d) Investments - net investments in other companies

The financial statements do not present the consolidated financial position of **Telefónica** and its affiliates. Consolidation exercises have been carried out, the results of which show no significant impact on the Company's financial statements. The valuations of the Company's investments in other companies are adjusted against the revaluation surplus, 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 Shareholders at their Annual General Meeting. Dividends are recorded as revenue when received.

e) Deferred charges

Debenture issue expenses are amortised as a function of the respective capital outstanding at the year end. Capital increase expenses are amortised on a straight-line basis over ten years, from the date of each capital increase.

f) Valuation of foreign currency accounts

Foreign currency 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 "Deferred Exchange Losses" account. These are charged to expenses each year, as realised, in accordance with the repayment of the foreign currency debt to which they relate, or, when early repayment exists, at the time at which exchange losses should have been charged to expenses in accordance with the initial maturity schedule. In the latter case the procedure is congruent with the former, given the nature

and characteristics of **Telefónica** as a regulated price and services company and the tariff review mechanisms described in Note 1.3. The fixing of tariffs each year takes into consideration the recovery of these deferred expenses.

g) Inventories

Inventories are generally valued at their weighted average purchase cost. Provisions are made each year to reduce the value of these assets, in order to cover technical obsolescence for some materials.

h) Revenue from services

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

i) Pensions and other employee benefits

Retirement pensions of **Telefónica** employees are covered by the Institución Telefónica de Previsión (ITP), whose relationship with the Company is described in Note 18.

j) Short and long-term debts

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

Short-term - Maturity up to 18 months

Long-term - Maturity over 18 months.

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

NOTE 3 — FIXED ASSETS

3.1 The composition by type of fixed asset and movements during 1985 are as follows:

Items	Gross book value at 31-12-1984	Revaluation	Additions for the year	Dismantled plant	Gross book value at 31-12-1985
Land.....	30,914	(266)	341	—	30,989
Buildings and power equipment.....	141,170	24,972	7,398	(275)	173,265
Exchange equipment.....	670,751	74,197	34,257	(7,962)	771,243
Wire and cable transmission equipment..	176,387	6,339	13,139	(1,358)	194,507
Radio and satellite communication transmission equipment.....	37,050	16,208	2,387	(134)	55,511
Local and trunk networks.....	848,307	2,358	53,514	(8,586)	895,593
Subscriber sets and other related installations.....	265,121	—	54,081	(26,864)	292,338
Furniture, office and other equipment..	10,065	—	3,401	(82)	13,384
Other installations.....	2,379	—	311	—	2,690
Fixed assets in service.....	2,182,144	123,808	168,829	(45,261)	2,429,520
Work in progress.....	76,742	—	19,052	—	95,794
Gross additions.....			187,881		
Advances to suppliers for fixed assets ..	12,756	—	800	—	13,556
Fixed assets.....	2,271,642	123,808	188,681	(45,261)	2,538,870

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 1986 amounts to Ptas. 212,078 million, of which Ptas. 209,228 million is to be invested in fixed assets and the remainder largely in companies. The continuous and long-term nature of **Telefónica's** investments mean that a part of this budget is related to the completion of projects initiated in previous years.

The gross fixed additions comprise the following:

	1985	1984
Labour	27,296	25,145
Material from stock	43,463	35,324
Suppliers	51,039	49,583
Contractors and other direct charges	41,358	41,374
Overhead and others	18,273	17,662
Interest allocation	6,452	6,329
Total	187,881	175,417

3.3 **Telefónica's** fixed assets related to telephone services cannot be mortgaged (Condition 9). In accordance with this, these assets at December 31, 1985 are not pledged under loan contracts. At the same date, assets amounting to Ptas. 253,942 million are subject to legal regulations (mainly inspection by the relevant authorities) derived from Decree Law 19/1961 and Law 61/1978, which regulate the benefits obtained for the reduction of withholding tax on interest on the loans and borrowings indicated in Notes 12 and 13.

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

3.5 A physical inventory of fixed assets at December 31, 1984 has been taken in 1985, except part of the local and trunk networks, that will be completed in 1986. This inventory has demonstrated the existence of equipment not connected to the network, most of it fully depreciated, amounting to Ptas. 35,568 million, that, when applicable, will enter into the plant dismantling processes scheduled by the Company.

3.6 The revaluation figure shown in paragraph 3.1 has been calculated on the basis of replacement costs at December 31, 1984 for the assets inventoried referred to in the previous paragraph. It is estimated that the amount corresponding to revaluation of elements still in process of inventory will not significantly affect the asset situation of **Telefónica**.

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	Fixed assets	Accumulated 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
1985	123,808	48,534	75,274
Total	1,212,744	618,351	594,393

3.7 With respect to dismantled plant, during 1985 the fixed assets and accumulated depreciation accounts were reduced by Ptas. 45,261 million, crediting the Technological Development Reserve with Ptas. 3,560 million, being the net effect of costs and revenue arising from dismantling (see Note 2.2 b).

3.8 The accumulated depreciation breakdown and movements in 1985 are as follows:

Group	Accumulated depreciation at 31-12-84	Revaluation	Dismantled plant	Depreciation for the year	Accumulated depreciation at 31-12-85
Buildings and power equipment	42,170	5,436	(275)	4,740	52,071
Exchange equipment	251,918	31,010	(7,962)	29,733	304,699
Wire and cable transmission equipment	98,220	3,030	(1,358)	11,519	111,411
Radio and satellite communication transmission equipment	21,124	9,361	(134)	1,914	32,265
Local and trunk networks	333,529	(303)	(8,586)	38,957	363,597
Subscriber sets and other related installations	114,803	—	(26,864)	22,979	110,918
Furniture, office and other equipment	6,257	—	(82)	1,213	7,388
Other installations	229	—	—	28	257
Total	868,250	48,534	(45,261)	111,083	982,606

- 3.9 The useful lives of the different elements of **Telefónica** fixed assets are calculated in line with technical studies carried out by the Company, periodically reviewed on the basis of technological progress and the dismantling rate. These useful lives are distributed as follow:

Group	Years of useful life
Buildings	40-50
Power equipment	19-24
Exchange equipment	23-24
Radio and transmission equipment	15-16
External plant	20-24
Subscriber sets	8- 9
Subscriber sets installation	9-16
Booths, furniture, equipment, workshops, etc.	7- 8
Other fixed assets	12
Finished projects not grouped	22-23

The depreciation rate applied to the average depreciable plant was 5.3% in 1985 (5.2% in 1984).

NOTE 4 — INVESTMENTS

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

	1985	1984
Associated companies	20,578	16,637
Other investments	5,291	5,601
Total	25,869	22,238

- 4.2 The information presented in the following table under the titles "Equity value at December 31, 1985" and "Income before tax" have been prepared on the basis of Group Companies financial statements at December 31, 1985. The equity value calculation takes into account audit adjustments required to present the best estimate of the share of net worth at the end of 1985. The accounting principles are described in Note 2.2 d).

Company name	Share capital
Comercial de Servicios Electrónicos, S. A. (COSESA)	700
ENTEL, S. A.	350
Compañía Publicitaria de Exclusivas Telefónicas (CETESA)	434
Hispano Radio Marítima, S. A.	500
Gráficas de Burgos, S. A. (GRAFIBUR)	325
Electrónica Aragonesa (ELASA)	300
Telefonía y Finanzas, S. A. (TELFISA)	500
Sociedad Española de Telecomunicaciones (SECOINSA)	3,125
Sistemas e Instalaciones de Telecomunicación (SINTEL)	1,100
Amper, S. A.	2,400
Urbana Ibérica, S. A.	330
Telefónica Internacional de España, S. A.	200
Control Electrónico Integrado	200
Telefónica Sistemas, S. A.	100
Telefonía y Datos, S. A.	225
Telecomunicaciones Marinas, S. A. (TEMASA)	600
T.P. Servicios Integrales de Protección Civil, S. A.	100
Total affiliates	2,800
Telettra Española, S. A.	2,800
Cables de Comunicaciones, S. A. (CCSA) ..	782
Industrias de Telecomunicación, S. A. (INTELSA)	2,600
Standard Eléctrica, S. A. (SESA)	17,604
INDELEC	300
Total associates	300
Total others	300
Total Group	300

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

Telefónica holding %	Telefónica book value	Equity value at December 31-1985	1985 income before tax profit (loss)	Activity
99.14	1,585	1,068	(442)	Marketing of electronic equipment and services for telecommunication.
100.00	473	722	157	Development and implementation of projects in data processing.
97.33	647	706	61	Promotion of advertising services for directories, telephone booths and others.
100.00	649	679	31	Marketing and maintenance of electronics marine communication equipment and navigation aids.
100.00	362	364	(6)	Printing telephone directories.
100.00	395	442	87	Manufacture and repair of telephones.
100.00	196	2,660	2,178	Investment management.
23.75	575	937	307	Data transmission and data processing equipment.
100.00	2,606	2,954	457	Telecommunication cable and line laying and equipment installation.
84.38	2,478	2,845	391	Development, manufacture and repair of telephone and telematic terminals. Manufacture of components (hybrid and flexible circuits).
100.00	81	1	(33)	Real estate activities.
100.00	120	121	1	Export of telecommunication equipment and resources.
51.50	42	8	(68)	Security systems engineering
100.00	100	57	(5)	Systems engineering.
100.00	225	178	(78)	Telephone sets repair.
100.00	300	300	0	Surveying, laying and repairing submarine cables.
63.00	56	45	(18)	Education and training in fire, safety and civil protection techniques.
	10,890	14,087		
51.00	2,061	1,742	30	Development, manufacture and installation of electronic telecommunication equipment, especially in transmission and radio.
49.00	1,172	1,087	(109)	Installation and sale of cables for telecommunications and electrical applications.
49.00	1,828	2,360	685	Manufacture and installation of telecommunication equipment, especially public and private switchboards and defence systems.
20.99	4,302	3,438	138	Manufacture of telephone and telegraph transmission and exchange systems
30.00	81	44	(86)	Manufacture of portable and mobile communication equipment.
	9,444	8,671		
	244	230		
	20,578	22,988		

The total **Telefónica** shareholding in SECOINSA at December 31, 1985 amounted to 92.86% as Telefonía y Finanzas, SA held 69.11% of its share capital at that date. Agreements exist with Fujitsu Limited under which its Spanish affiliate, Fujitsu España, SA, will take over SECOINSA, leaving Fujitsu Limited and **Telefónica** with 60 and 40 percent, respectively, of the share capital in the new company.

4.4 Group Companies have increased capital by Ptas. 4,590 million in 1985. SECOINSA reduced its share capital by Ptas. 5,556 million by charging accumulated losses.

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

	Dividends received		Purchase of goods and services by Telefónica	
	1985	1984	1985	1984
Affiliates	275	217	37,771	22,601
Associates	191	178	54,531	64,072
Total	466	395	92,302	86,673

Financial advances granted by **Telefónica**, mainly to its affiliates, are included under the heading "Loans to Group Companies".

NOTE 5 – DEFERRED CHARGES

The balances at December 31 comprise the following:

	1985	1984
Debtenture and bond issue expenses.....	11,375	12,500
Capital increase expenses.....	1,511	895
Others.....	12	66
Total	12,898	13,461

Amortization criteria are described in Note 2.2 e).

NOTE 6 – DEFERRED EXCHANGE LOSSES

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

The balance breakdown and amortization schedule are as follows:

	Maturities				Balance 31-12-85
	1986	1987	1988	Subsequent	
Unrealised exchange losses (subject to exchange rate fluctuation)	5,009	6,514	8,570	34,199	54,292
Deferred exchange losses - (corresponding to loans repaid ahead of schedule).....	4,077	2,858	2,525	2,380	11,840
Total	9,086	9,372	11,095	36,579	66,132

The amount of exchange losses realised in the year corresponding to repayment of loans and other debts was Ptas. 9,937 million (1984-15,624 million), of which Ptas. 9,277 million (1984 - 14,230 million) were absorbed by charges against the year's profit and Ptas. 660 million (1984 - 1,394 million) compensated by exchange gains generated by service charges in foreign currency.

NOTE 7 – INVENTORIES

Inventories are valued in accordance with the criteria described in Note 2.2 g). At December 31, the value of inventories in **Telefónica** warehouses or belonging to the Company and deposited in third parties' stores are as follows:

	1985	1984
Installation materials.....	32,807	25,557
Maintenance materials and spare parts.....	2,803	3,571
Consumables.....	895	1,139
	36,505	30,267
Obsolescence reserve.....	(2,864)	(833)
Total.....	33,641	29,434

The purpose of this account is principally to maintain a control procedure for warehouse telephone service materials, mainly applied to fixed-assets and, residually, to the maintenance expense accounts.

NOTE 8 – SUBSCRIBERS

The balances at December 31, comprise:

	1985	1984
Services billed:		
Private subscribers.....	7,809	8,293
Public entity subscribers.....	15,622	11,277
Ex-subscribers.....	3,485	3,961
Uncollectible and pending classification	130	84
	27,046	23,615
Unbilled services.....	52,640	45,164
	79,686	68,779
Provision for bad debts.....	(3,827)	(2,884)
Total.....	75,859	65,895

During 1985 the movement of the provision for bad debts account was as follows:

Balance of provision at beginning of 1985.....	2,884
Provision for 1985 charged to income.....	3,870
Cancellation of bad debts, net of Telephone Usage Tax.....	(2,927)
Balance of provision at close of 1985	3,827

NOTE 9 – SHARE CAPITAL

All of the shares of the Company on issue at December 31, 1985 have been fully subscribed and paid in, and are bearer shares of Ptas. 500 par value each.

Telefónica shares are listed on the four Spanish Stock Exchanges and, since 1985, also on the Stock Exchanges of Frankfurt, London, Paris and Tokyo.

The State has an approximate 32% direct shareholding, together with a further interest estimated at 15% through official institutions; the total number of shareholders is estimated to be approximately 700,000. Under the Spanish legislation, foreign shareholdings, in total, cannot exceed 25% of the share capital.

The table below reflects the movements of share capital:

	Number of shares	Face value			
			Ratio	Price	Paid-in
Balance December 31, 1984.....	640,831,193	320,416			
Issue of March 25, 1985.....	80,103,898	40,052	1×8	80%	32,042
Balance December 31, 1985.....	720,935,091	360,468			
Issue of January 15, 1986.....	80,103,899	40,052	1×9	90%	36,047

The shares corresponding to the January 15, 1986 capital increase enjoy the same rights as those already in circulation and will participate in dividends charged to 1986 profits from January 1, 1986 onwards.

NOTE 10 — RESERVES AND UNAPPROPRIATED PROFIT

10.1 The reserves and unappropriated profit of **Telefónica** are regulated by the State contract (Condition 24), so the Company may make free use of the statutory reserve, whenever operating or financial requirements make this necessary. Said Condition 24 prohibits transfers thereto charged to other reserves.

The availability of the voluntary, technological development reserve and revaluation surplus is not regulated by specific legislation for the Company, it being understood that **Telefónica** may employ them on the same basis as regulated for the statutory reserve.

10.2 The table below shows the movement on the reserve accounts during 1985:

	December 31, 1984	Movements during 1985		December 31, 1985
		Allocation	Application	
Statutory reserve	6,905	400	—	7,305
Voluntary reserve.....	422,286	75,274	(8,419)	489,141
Revaluation surplus	519,119	75,274	—	594,393
Share increase (discount)	(62,471)	—	(8,010)	(70,481)
Share premium.....	1,733	—	—	1,733
Allocations to extraordinary provisions	(39,196)	—	—	(39,196)
Revaluations of investments	4,832	—	(409)	4,423
Others	(1,731)	—	—	(1,731)
Technological development reserve	30,372	3,560	—	33,932
Unappropriated profit.....	68	74	(68)	74
Total	459,631	79,308	(8,487)	530,452

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NOTE 11 — PROVISIONS

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

	1985	1984
Exchange losses	21,598	21,598
Self-insurance	7,428	5,928
Contingencies	4,672	1,672
	33,698	29,198
Secondary responsibility for complementary pensions of ITP.....	18,829	18,829
Others	1,280	1,295
	20,109	20,124
Total	53,807	49,322

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 was set up unilaterally on considering the possibility that it could become necessary, in the future, to cover eventual shortages in the complementary pension benefits (see Note 18).

NOTE 12 — DEBENTURES AND BONDS

12.1 Composition and movements:

	Balance 31-12-84	New issues	Repayments	Revaluations and other movements	Balance 31-12-85
Debentures and bonds:					
Non-convertible	277,833	35,000	(34,662)	477	278,648
Convertible and/or exchangeable ...	20,000	5,000	—	—	25,000
Debentures and bonds in foreign currency	19,743	—	—	2,556	22,299
	317,576	40,000	(34,662)	3,033	325,947
Bonds pending subscription	(19,919)	—	—	—	(245)
Total	297,657	—	—	—	325,702

12.2 Redemption

	Maturities				Total 31-12-85
	1986	1987	1988	Subsequent	
Amount	38,467	48,772	36,767	201,696	325,702

Maturities in 1987 include Ptas. 14,455 million corresponding to debentures and bonds whose year of redemption will be 1991, although they are also redeemable by option in 1987.

12.3 Additional information:

	1985	1984
Interest expense	37,648	33,097
Accrued interest at December 31	13,327	12,474
Issues subject to fiscal benefits:		
Debentures	170,505	205,047
Debentures in foreign currency	21,086	18,669

llion have been subjected to a swap operation for financial Belgian Francs 3,183 million.

These obligations were revalued at the official closing exchange rate of each currency at year end. The revaluation charged in 1985 to the unrealised exchange losses account amounted to Ptas. 2,556 million (1984-387 million).

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

12.6 In the last quarter of 1985, Ptas. 35,000 million of bonds were issued. At December 31, Ptas. 245 million were pending subscription (see 12.1).
These bonds will be redeemed at the subscriber's option in 1990 or 1992 and, finally, in 1995.

12.7 Of the debenture issue convertible on December 31, 1984, conversion options have been exercised in January, 1986 for an amount of Ptas. 1,463 million.

12.4 Foreign currency debentures were issued for US dollars 50 million and Deutsche Marks 200 million. The US dollars 50 mi-

NOTE 13 — LOANS AND CREDIT FACILITIES

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

	1985			1984		
	Long term	Short term	Total	Long term	Short term	Total
Loans in foreign currencies	180,975	—	180,975	213,697	1,219	214,916
Loans and credit facilities	58,859	41	58,900	57,171	590	57,761
Others loans	3,393	1	3,394	3,125	1	3,126
Promissory notes (face value)	40,257	13,841	54,098	40,257	35,632	75,889
	283,484	13,883	297,367	314,250	37,442	351,692
Less:						
Deferred interest on promissory notes	13,167	349	13,516	17,290	2,273	19,563
Total	270,317	13,534	283,851	296,960	35,169	332,129

13.2 The maturities are as follows:

	Maturities				Balances 31-12-85
	1986	1987	1988	Subsequent	
Loans in foreign currencies	9,870	15,305	25,168	130,632	180,975
Loans and credit facilities	4,352	19,340	19,208	16,000	58,900
Other loans				3,394	3,394
Promissory notes	16,956	13,817	82	23,243	54,098
Total	31,178	48,462	44,458	173,269	297,367

Telefónica made early repayments of foreign currency loans in 1985 amounting to Ptas. 29,397 million.

13.3 Additional information:

	Financial charges		Interest accrual (deferral)		Interest rates	
	1985	1984	1985	1984	1985	1984
Loans in foreign currency	16,415	15,556	2,928	3,226	4.5-13%	4.5-13%
Loans and credit facilities	6,629	9,084	1,465	1,979	11-18%	14-17%
Promissory notes	7,470	7,482			10-17%	14-17%
Long term			(13,167)	(17,290)		
Short term			(349)	(2,273)		

13.4 In 1985, **Telefónica** modified the accounting procedure for credit facilities, adopting the criterion of including unused facilities in the memorandum accounts. The loans and credit facilities accounts, therefore, reflect only the drawn down part of the credit facilities obtained.

	1985	1984
Loans and credit facilities-long term	70,941	41,670
Loans and credit facilities-short term	1,459	2,010
	<u>72,400</u>	<u>43,680</u>

The disclosure of unused credit facilities at December 31, is as follows:

At December 31, 1985, there exist other credit facilities amounting to Ptas. 48,900 million (1984 - 45,000 million) represented by new loans not drawn down and by floating credit facilities (see Note 20).

13.5 At December 31, 1985, of the total foreign currency loans, Ptas. 125,418 million are covered by the fiscal benefits of Decree Law 19/1961 and Law 61/1978.

In accordance with the accounting criteria mentioned in Note 2.2 f), the amount of exchange differences arising from

these loans in 1985 resulted in a credit to the account of unrealized exchange losses of Ptas. 13,068 million (in 1984 there was a credit of Ptas. 1,457 million).

The composition of foreign currency debt is shown below although, as a function of the multicurrency clause, their composition may undergo changes throughout their life in accordance with expectations at any given time:

	Millions	
	1985	1984
US Dollars (US\$)	530.5	242.5
Deutsche Marks (DM)	273.8	1014.1
Swiss Francs (SF)	652.7	1305.9
Canadian Dollars (Can \$)	10.0	10.0
Swedish Crowns (SKR)	23.2	34.4
Dutch Florins (DFL)	50.0	50.0
Pounds Sterling (£)	50.0	74.0
ECU's	75.0	75.0
Yens	10,000.0	0.0

13.6 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. The charges attributable to expenses in future periods are as follows:

	1986	1987	1988	Subsequent	Total
Interest on promissory notes - long term	4,607	3,409	3,381	1,770	13,167
Interest on promissory notes - short term	349	—	—	—	349

NOTE 14 — SUPPLIERS AND NOTES PAYABLE TO SUPPLIERS

The balances at December 31 are as follows:

	Short term		Long term		Total	
	1985	1984	1985	1984	1985	1984
Suppliers	25,681	12,709	—	—	25,681	12,709
Notes payable to suppliers	4,707	21,891	12,082	13,818	16,789	35,709
Total	<u>30,388</u>	<u>34,600</u>	<u>12,082</u>	<u>13,818</u>	<u>42,470</u>	<u>48,418</u>

These balances at December 31, 1985 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.

	1986	1987	1988	Subsequent	Total
Repayment schedule of notes payable	9,099	3,265	1,967	2,458	16,789

NOTE 15 — TAXES PAYABLE

The balances at December, 31 comprise the following:

	1985	1984
State levy	23,435	20,846
Telephone Usage Tax and other	17,142	14,798
Payroll withholding tax	4,753	4,468
Tax withholdings on dividends and interest	1,118	3,685
Total	46,448	43,797

NOTE 16 — OTHER CREDITORS

These comprise the following groups of accounts:

	1985	1984
Staff bonus provision	8,630	7,807
Telephone service interchange	3,992	3,301
Guarantees and deposits	1,408	1,353
Imports on the Company's account ..	1,278	1,383
Others creditors	10,251	8,103
Total	25,559	21,947

NOTE 17 — ACCRUALS

- 17.1 Accrued expenses and deferred income. This items cover the following accounts:

	1985	1984
Accrued interest	17,720	17,679
Services billed in advance	9,496	7,737
Other	4,226	4,996
Total	31,442	30,412

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

NOTE 18 — PENSIONS

- 18.1 **Telefónica** 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 19).

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.

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

The members covered by this plan comprise approximately 9,050 retired persons (pensioners) and 61,530 members currently on the payroll, whose actual contributions represent 4.3% of their total gross salary (pension-base salary).

To meet the abovementioned combination of benefits ITP relies principally on the profits earned on its assets, and the contributions of **Telefónica** and those of its members. During 1985 the contributions of **Telefónica** amounted to 9,902 million pesetas and those of its employees to 4,731 million pesetas.

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

- 18.2 **Telefónica's** commitments to the ITP comprise the obligation to make the annual payments determined in the ITP regulation, together with a guarantee of up to 8,000 million pesetas, included under memorandum accounts. This guarantee was granted in 1977 for the purposes indicated by Transitory Stipulation 4 of the ITP Regulations, which read; "**Telefónica** guarantees the effectiveness of the benefits to be satisfied by the ITP during the period of ten years..."
For its part, as principal respondent, ITP is obliged, should the guarantee 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 Regulations).

- 18.3 Independently of the above, **Telefónica** has a provision of 18,829 million pesetas charged in 1982 against the revaluation surplus and which, as indicated in Note 11, was set up unilaterally on considering the possibility that it could become necessary, in the future, to cover eventual shortages in the complementary pension benefits.

- 18.4 **Telefónica** had shown its willingness to collaborate in the configuration of a future scheme that would make its workers' social service system viable. Consequently, negotiations have been held in 1985 and in the first quarter of 1986, that resulted in an agreement for future viability of the Company's workers' complementary social service system being reached, with a majority of the workers' representatives, who made implementation conditional on express conformity being given by the workers. As this has not occurred, said agreement has not been signed.

The agreement, that would have become effective from January 1, 1986, included a new survival assurance substituting the Group Endowment Insurance referred to in Note 19 below, which contemplated splitting the ITP, in accordance with the provisions of Law 33/84 Regulating Private Insurance into two entities: substitutory and complementary. The former would be integrated into the general Social Security system, and the latter would grant a series of new complementary services, for which the necessary contributions from **Telefónica** and its workers were established on a balanced actuarial model based on a capitalization system.

The commitments undertaken by **Telefónica** as a result of this agreement did not involve modification to its financial situation at December 31, 1985 or a significant impact on its prospective future profitability.

18.5 As the new system covered by this agreement has not been put into practice, the commitments of **Telefónica** are those described in part 18.2 of this note, and there are no alterations with respect to previous years. Should a new future viability agreement be reached, **Telefónica** will not accept as a consequence thereof and also considering the contributions that it may have to make as compensation for integrating its workers in the Social Security, obligations that involve a significant modification to its financial situation for the years closed to December 31, 1985 or that compromise its prospective future profitability.

NOTE 20 — MEMORANDUM ACCOUNTS

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

	1985	1984
Unused credit facilities: (Note 13.4)		
Available credit - long-term	70,941	41,670
Other long-term credit facilities	48,900	45,000
Available credit - short-term	1,459	2,010
	<u>121,300</u>	<u>88,680</u>
Guarantee of financial operations	4,419	2,975
Guarantee to ITP	8,000	8,000
Guarantees granted to employees	5,137	4,906
IGTE (Turnover tax)	29,240	21,752
Promissory notes		20,740
Others	8,208	6,033
	<u>55,004</u>	<u>64,406</u>
Total	<u>176,304</u>	<u>153,086</u>

The heading "Guarantees of financial operations" refers mainly to guarantees given by the Company involving bank guarantees to cover financial operations of affiliate and associate companies.

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

NOTE 19 — ENDOWMENT INSURANCE

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

To cover payment of these benefits, funds have been constituted in a insurance company and in **Telefónica** that, at December 31, 1985, amounted to Ptas. 7,421 million and Ptas. 13,142 million, respectively; of the latter, 2,197 are shown in short-term balance sheet liabilities. The company has charged Ptas. 5,251 million (4,473 million in 1984) of additional provisions against profits in 1985.

As a result of the actuarial calculations that have been carried out on the basis of integrally absorbing these benefits throughout the working life of the employees, the conclusion is that:

- a) The annual charge for the year 1985, being approximately 4.2% of the overall payroll cost, is sufficient to cover this objective, and
- b) At December 31, 1985, the present value of the future commitments, calculated at an interest rate of 6% applied on actual salaries amounts to approximately Ptas. 88,926 million (76,000 million in 1984).

NOTE 21 — VALUE ADDED TAX

Implementation of this tax from January 1, 1986 has modified the indirect taxation applicable to the services provided by **Telefónica**. From this date onwards, the old Telephone and surcharges have been revoked, applying Value Added Tax at the general rate of 12% to all services provided by **Telefónica**.

The Company, in accordance with Section IX of the Value Added Tax Law and its regulation and as a result of the investments made to purchase goods for its fixed assets in 1985 and inventoried at December 31, 1985, has applied to the Ministry of Finance for an overall deduction amounting to 6,844 million pesetas under the transitory rules.

ADDITIONAL NOTE FOR INTERNATIONAL PURPOSES

Certain accounting practices applied by **Telefónica** in its financial statements prepared for use in Spain, together with other required or allowed under the Conditions of Concession of **Telefónica** as a regulated entity (Note 2.2. a), may not conform with International Accounting Standards (IAS).

The most significant of these accounting practices are summarized below:

Present practice for local Spanish purposes

1. Intangible assets (See Note 2.2. c).
2. Technological development reserve (See Note 2.2. b).
3. Short and long term debt (See Note 2.2. j)
4. Foreign currency accounts (See Notes 2.2. f) and 6)

Treatment for IAS purposes

Research and development costs are expensed as incurred. The effect is shown below.

Net effect of costs and revenue arising from dismantling should be taken into the profit and loss account. The effect is shown below.

Short and long term debt is classified on the basis of twelve months from the balance sheet date. Notes 12 to 14, show the classification on this basis.

IAS No. 21 establishes a different treatment. However in view of **Telefónica's** special position as a regulated entity, the treatment in the accounts is considered appropriate.

The total effect on the profit and loss account and on the statement of movements in reserves is as follows:

	<u>Millions of pesetas</u>
Net profit for the year as reported in the Spanish statutory accounts at December 31, 1985	39,149
Adjustments for IAS purposes:	
Research and development expenses -	
Net effect between prior write-offs and current amortization	1,164
Release of technological development reserve	3,561
Self-insurance and other	1,484
Profit for the year in accordance with IAS	<u>45,358</u>

	<u>Millions of pesetas</u>
Reserves as reported in the Spanish statutory accounts at December 31, 1985.....	530,452
Net profit for the year.....	39,149
	<u>569,601</u>
Dividends	(38,649)
	<u>530,952</u>
Adjustments for IAS purposes:	
Investments.....	(4,423)
Research and development written-off	(4,398)
Release of provisions set up in prior years not required under IAS.....	46,624
Reserves in accordance with IAS	<u>568,755</u>

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

 **Telefónica**

