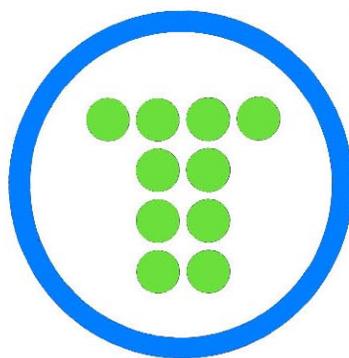


**Telefónica**

Annual Report for 1985





# Telefónica

Annual Report for 1985

Submitted to the General Meeting  
of Shareholders for approval

During 1985 D. LUIS DE USERA Y LOPEZ-GONZALEZ acted as Vice-chairman (resigning on May 29, 1985), being substituted by D. JOSE MARIA AMUSATEGUI DE LA CIERVA. Also during 1985 D. JOAN MAJO CRUZATE, D. RAMON SOLER AMARO and D. FRANCISCO JOSE GARCIA ZAPATA resigned as Directors representing Shareholders (all three on September 20), together with D. ALFONSO FIERRO VIÑA (on October 30). The vacancies left by Sres. Majó, Soler, García Zapata and Fierro were covered by appointing D. JAIME CLAVELL YMBERN, Dña. MARIA PAZ FERNANDEZ FELGUEROSO, D. ALVARO ESPINA MONTERO and D. EPIFANIO RIDRUEJO BRIEVA to the Board.

Furthermore, by Decree on October 23, 1985, D. FRANCISCO JAVIER MORAL MEDINA retired as a Director representing the Government, being replaced by D. PRUDENCIO GARCIA GOMEZ.

Finally, Royal Decree 1238/85, of July 24 designated D. JAVIER NADAL ARIÑO as Director General of Telecommunications and as the Government Delegate in Compañía Telefónica Nacional de España.

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**Editing and general design by:** SIRS/Publications Service, Valverde, 2 Madrid

**Photocomposition by:** Fuertes, Corredera Alta, 31. Madrid

**Printed by:** Mateu Cromo, S. A., Pinto (Madrid)

**Legal Deposit:** M-13.257/1986

# Board of Directors

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D. José María Concejo Alvarez

D. José María Amusátegui de la Cierva

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D. Diego Martínez Boudes

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D. Emilio Botín-Sanz de Sautuola y García de los Ríos

D. Jaime Carvajal y Urquijo

D. Jaime Clavell Ymbern

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D. Francisco Javier Eiroa Villarnovo

D. Alvaro Espina Montero

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Doña María Paz Fernández Felgueroso

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D. José Montes Fernández

D. Juan Manuel Rebollo Castrillo

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D. Miguel Martín Fernández

D. Saturnino Suanzes de la Hidalga

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D. Manuel María de Araluce y Araluce

## **VICE-SECRETARY**

D. Mariano Aldama Magnet

## **GOVERNMENT DELEGATE**

D. Javier Nadal Ariño

# Management Committee

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**Chairman:**

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**General Manager:**

D. José Antonio Adell García

**General Manager:**

D. Germán Ramajo Romero

**General Manager:**

D. Carlos Viada Fernández-Velilla

**Secretary:**

D. Luis Terol Miller

## Deputy General Managers

---

D. Heliodoro Alcazar García de la Barrera,  
**Labour Relations and Organization**

D. Juan Manuel Barreiro de las Llanderas,  
**Commercial Management**

D. Antonio Bertán Astola,  
**Internal Data Process and Systems**

D. José Caballero Guerrero,  
**Economic Control**

D. Jaime Comenge Puig,  
**International Coordination**

D. Juan Cruz Larrea Arechavala,  
**Managing Director's Office**

D. José Ignacio Esteve Espinosa,  
**Commercial Services**

D. José Luis Fernández Dopico,  
**Security**

D. Francisco Ferre Ferre,  
**External Plant**

D. José Luis Franganillo Asensio,  
**Procurement and Administration**

D. Víctor Goyenechea Fuentes,  
**Affiliates and Associates and Industrial**

D. Francisco Javier Monzón de Cáceres,  
**Finance and Control**

D. Luis Lada Díaz,  
**Network Management**

D. Antonio López-Barajas y García Valdecasas,  
**Technical Assistance**

D. Francisco Martínez Martínez  
**Expansion of Rural Telephone Services**

D. Crisanto Plaza Bayón,  
**Planning Office**

D. Faustino Rivero Morales,  
**Inspection**

D. Enrique Used Aznar,  
**Technology**

D. José María Vázquez Quintana,  
**Internal Plant**

D. Roberto Velázquez Martín,  
**Social Relations and Information Service (SIRS)**

## Area Managers

---

**Barcelona:**

D. Francisco Gómez Novella

**Madrid:**

D. Enrique Esparcia García

**Northeast:**

D. Manuel Badenes Moles

**Northwest:**

D. Augusto Serrano Santarromana

**Southeast:**

D. Manuel Conejos Valdés

**Southwest:**

D. José Luis García Arizti

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# CHAIRMAN'S LETTER

Dear shareholders,

**T**hanks to the efforts of employees and the savings of the shareholders, it has been possible to restructure the Company after several difficult years and it can now be stated that the results of these efforts are beginning to gather. Today, **Telefónica** is a financially stable, industrially active and innovative Company, providing the new services and demands of a modern country with a greater presence in the world than ever before. Statement of Profit and Loss and Balance Sheet trends, the progress of the Company's shares on the Stock Exchange and the number of telephones and new services in our country, are proof that the targets set by the present Company Management when appointed are being achieved.

We also have data showing that the general economy of our country is reflecting its improved situation on the telecommunications world; at the present time, telephone demand is much higher than in recent years. I should like the shareholders to know that **Telefónica** is presently ready for a new leap forward in its performance as a Company and in its efficiency as a public service.

A few figures will allow you to briefly understand why we can face up to the future with optimism, on the basis of the solid foundation that we have laid during these three years.

By the end of 1985 the number of telephones and lines was 14,258,928 and 9,340,458, respectively, as opposed to 12,820,190 and 8,017,695 in 1982. The number of telephones per 100 inhabitants rose from 34 to 36.6.

But qualitative changes have taken place, apart from purely quantitative developments. The degree of automation is 99.5%; there are 787,800 semielectronic and 184,320 electronic lines, not only improving quality but allowing new services to be offered, such as detailed billing, call waiting, three-way calling and a long list of other facilities.

Telematic services are spreading: point-to-point data transmission, transmission over the switched telephone network, coded alarms, telefax, teletex, dataphone, etc. with an increasing growth rate for the IBERPAC and X-25 public data transmission network, while business communications services and the IBERCOM multi-service and multi-user network are being defined.

At the same time, electronic exchanges and lines are becoming commonplace, optical fibre is starting to make an appearance for both trunk lines and submarine cables. There are presently 93 kilometres of overland optical fibre cable and over 125 kilometres of submarine cable, with the particularity that OPTICAN, laid between the two large Canary Islands, is the world's first submarine cable with repeaters in very deep water.

The appearance of optical fibre and satellites make it possible to transmit voice, data and video over the same channel and initiate a new stage with tremendous possibilities in the world of telecommunications.

**Telefónica** owns the world's third largest submarine cable network covering 31,000 Km. In 1984, Meridian was inaugurated and negotiations are in progress for the optical fibre submarine network to interconnect the Mediterranean and Atlantic submarine systems, for construction in the period 1990-92.

However, **Telefónica**, apart from being a utility company, is also the head of an industrial group. One consequence of this policy is the creation of joint ventures with AT&T to design and manufacture 1.75 micron custom chips, with Corning Glass to produce optical fibre, with Fujitsu to develop and manufacture computers; with SyScam, for digital mapping and with Philips, for mobile telephony.

Similarly, **Telefónica** is participating in the European Silicon Structures (ES 2) project, which will design and manufacture short production runs of custom integrated circuits.

Despite being the head of a major group of commercial and services companies, **Telefónica** has no ambition as an industrial holding company. The first sign of this policy took place with the offer of shares in AMPER to **Telefónica** shareholders at a price of 150%, together with the subsequent tender of a further package of shares on the Madrid Stock Exchange, at which shares were awarded to applications priced between 315% and 500%, with the resulting average price of 343.9%.

**Telefónica** is having major international successes with products employing national technology and some Group Companies are marketing Spanish patented products on international markets. This is the case of Tesys, the packet switching equipment, which has been sold in Argentina, Canada, U.S.A., U.K. and Tunisia, has been selected by the IBI and is being offered in various European tenders.

In order to be able to make its service, industry and technology policy a reality, the new **Telefónica** Management adopted strict financial restructuring measures, that can basically be summarised as follows:

- Cost restraint.
- Active financial policy, based on successive capital increases and debt diversification.
- Adaptation of depreciation rates to telephone plant life.
- Strong growth in the ratio of self-financing to investment, that will continue to increase in the future.

The improvement obtained in the latter demonstrates

the major effort made, rising from 50.9% in 1982 to 66.6% in 1985.

The result of this important growth in self-financing, together with the policy of successive capital increases has been that major repayments have enabled debt structure to be improved and working capital to be reorganised.

In order to reduce the effort requested of its shareholders and national savings and to transform debt into equity, **Telefónica** obtained listings on foreign Stock Exchanges in 1985, after complying with the strict controls on the external auditors and the Stock Exchanges themselves. **Telefónica** shares are presently listed on the Stock Exchanges of London, Tokyo, Frankfurt and Paris, with excellent turnover levels that in some cases even exceed turnover on the Spanish Stock Exchanges.

But I will not cease to emphasize that **Telefónica** has achieved these successes because its employees have made the effort, although many controversies remain

that are common to times of crisis, and shareholders have been capable of maintaining **Telefónica** investment activity with their savings. To all of them, now that the end of the long tunnel of the Spanish economic crisis is visible, I should like to express my gratitude and absolute confidence that the coming years will witness new successes for our Company and even greater improvements in our internal organization and presence in the world.



**Luis Solana**

Chairman of the Board of Directors  
of the **Compañía Telefónica**  
Nacional de España

## HIGHLIGHTS

ITEMS	1984	1985	% 85/84
Number of telephones	13,825,459	14,258,928	3.1
Telephones per 100 inhabitants	35.8	36.6	2.2
Lines in service	8,881,727	9,340,458	5.2
Applications pending	266,979	252,762	-5.3
Trunk calls (thousands of units)	2,565,816	2,819,679	9.9
Trunk calls per subscriber	288.7	301.9	4.6
Automatic trunk calls (%)	98.8	99.1	0.3
Outgoing international calls (thousands of units)	78,402	87,220	12.5
Automatic international calls (%)	97.2	97.4	0.2
Number of permanent staff	66,781	66,661	-0.18
Investment in fixed assets for the year (millions of pesetas)	175,417	187,881	7.1
Value of telephone equipment and installations (millions of pesetas)	2,258,886	2,525,314	11.8
Share capital (millions of pesetas)	320,416	360,468	12.5
Revenue from services (millions of pesetas)	349,226	393,506	12.7



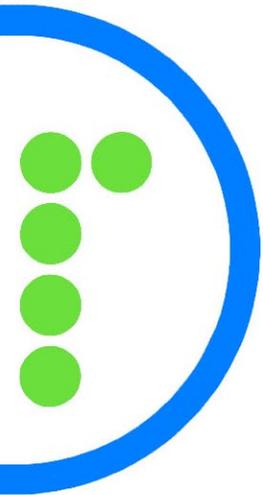
# PLANNING, NETWORKS AND SERVICES



*Facade of the  
Madrid-Colón building*

# TARGET YEAR 1990

10



In order to draw up a future strategy without forgetting present activities, **Telefónica** has considered a target year of 1990, defined by corporate objectives and lines of action, to create a flexible Company, capable of quickly responding to the demand for telecommunications services from a modern society.

The fast rate of technological change, social and economic trends with demand more orientated to business areas, E.E.C. membership, proposed modifications to legislation, etc. are some of the variables leading to an increasingly dynamic situation.



*With this poster, **Telefónica** joined in the Institutional Billboard Advertising Campaign programmed to celebrate Spain's membership of the E.E.C.*

In this respect the intention is to employ proper management facilities, taking the action necessary to appraise risks and exploit opportunities so as to ensure an acceptable profitability.

Consequently, it was necessary to define an overall corporate objective that, to ensure the required agility and flexibility, firmly place it in the market while continuing the financial restructuring policy already initiated and paying special attention to two basic aspects: improving the operating margin and the ratio of gross sales to total assets, while increasing the self-financing rate.

With this global approach, various objectives are developed for sectors of the different Organization Units, intercoordinated on the basis of a fundamental market-network-technology-industry action sequence, guided by parameters of flexibility, profitability, agility and service, and backed up by the suitability of financial and human resources.

The aim is to seek a dynamic market position, even anticipating demand for new services, thus contributing to the economic recovery and modernization of the country.

To achieve these goals the Company is necessarily promoting the incorporation of advanced technology in order to modernise infrastructures and adapt them to the future ranges of service demanded by users, while optimising existing ones. The foundation of this modernization will be the creation of major communications highways that will serve as a support for all kinds of information and will facilitate transmission to different points of the country. This modernization includes more intelligent terminals, suitable for any type of information, without forgetting expansion of the telephone service to rural areas, thanks to agreements with the relevant Authorities.

This set of objectives will be complemented with technical improvement in materials and procedures involved in the installation and maintenance of equipment, particularly the human resources, coordinating the progress of **Telefónica** with the training and greater integration of staff in corporate objectives.

The challenge of new technologies and new concepts of society, together with Spain's membership of the European Economic Community, ob-

liges the Company to have its own technology, that is competitive in other markets.

**Telefónica's** response to this challenge has been made obvious with the creation of the new Research and Development Centre, participation in projects such as RACE, ESPRIT, etc. and the signing of agreements with AT&T, Fujitsu, SysScan, Corning Glass and Pacific Telesis, to mention the major technological partners.

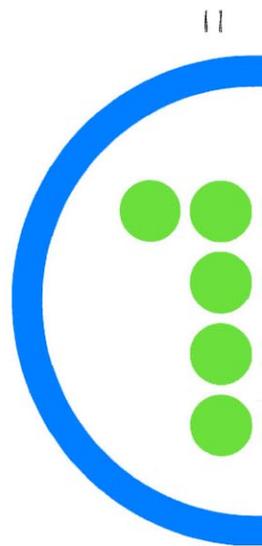
International projection is reinforced with the application for acceptance of the laboratories in the European homologation system and with the presence of **Telefónica** and its Group in the international market.

With respect to industrial policy, in its day, **Telefónica**, as a service company, sponsored an industrial sector that supported the availability of these services, thus boosting technological progress and making up for low private investment.

On completing this essential stage, future objectives are based on promoting an open participation policy and on managing procurement capacity in as diversified a way as possible.

This approach seeks to promote private investment in telecommunications technologies while catalysing the search for foreign markets for products developed with domestic technology, so as to strengthen market and product diversification in the industrial companies.

From the planning point of view, 1985 has been marked by the application of a new process, based on analysis of foreseeable variations to legal frameworks, technologies and demands for domestic and international services, that has meant incorporating strategic concepts to **Telefónica's** activities, in order to convert it into a flexible company capable of facing up to market challenges.

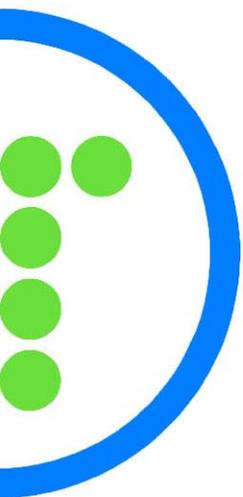


# MAIN PARAMETERS

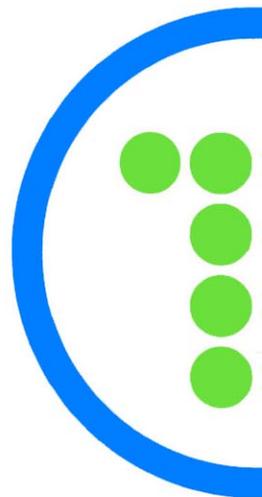
## I. TELEPHONE SERVICE

SERVICE PARAMETERS	31-12-84	31-12-85	31-12-90
No. of telephones/100 inhabitants	35.8	36.6	42.8
Lines in service (thousands)	8,881	9,340	11,529
— Automatic	8,814	9,290	11,529
— Manual	67	50	—
Applications pending (thousands)	266.9	253	120
Public Service Telephones (PST)	13,000	13,770	15,459
Telephone density, lines/100 inhab.	23.0	23.8	28.9
Degree of automation (%)	99.2	99.5	100
No. of homes with telephone (%)	49.8	52.2	64.6
New local zones to be formed			538*
Trunk calls (millions/year)	2,565.8	2,820	3,597
No. of trunk lines (thousands)	217.1	228.8	283.5
European automatic service connected subscribers (%)	99.6	99.7	100
Intercontinental service automation (%)	80	84	90
Public telephones (coin operated public and regular telephones)	51,466	63,923	128,026

\*Correspond to accumulated data for 1986-90



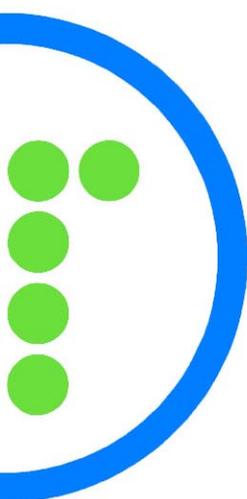
<b>INSTALLATIONS</b>	<b>31-12-84</b>	<b>31-12-85</b>	<b>31-12-90</b>
Local lines installed (thousands)	9,989.9	10,313	12,400
— Automatic (% of those installed)	9,912.0 (99.2)	10,263 (99.5)	12,400 (100)
— Electronic (% of automatic)	127.0 (1.3)	185 (1.8)	1,935 (15.6)
— Conventional and semi-electronic (% of automatic)	9,785.0 (98.7)	10,078 (98.2)	10,465 (84.4)
— Manual (% of those installed)	77.9 (0.8)	50 (0.5)	—



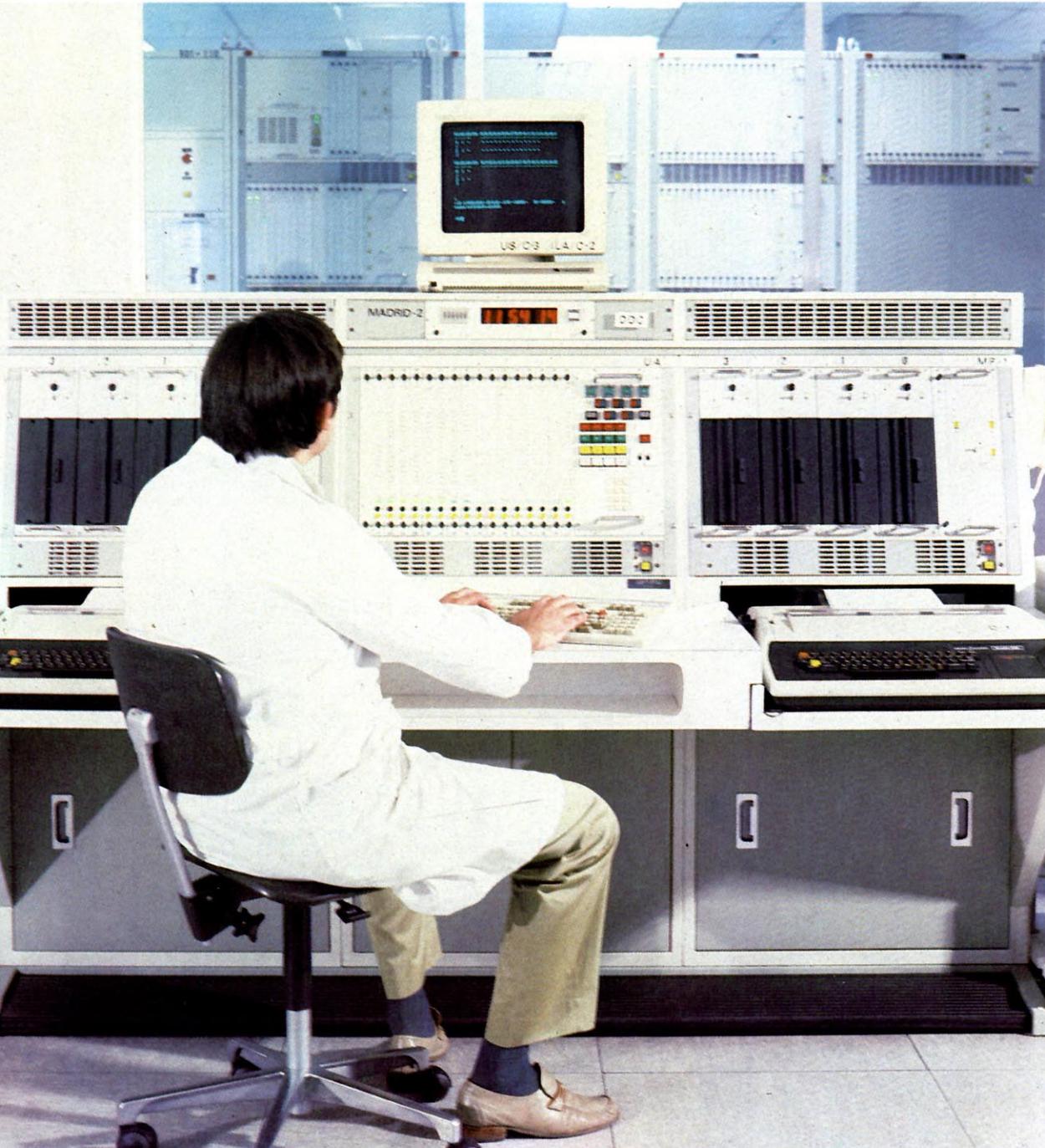
<b>BASIC INFRASTRUCTURE</b>	<b>31-12-84</b>	<b>31-12-85</b>	<b>31-12-90</b>
Coaxial cable (Km.)	9,933	10,112	10,394
Optical fibre (Km.)	—	93	8,677

## 2. TELEMATICS AND OTHER SERVICES

<b>TELEMATICS</b>	<b>31-12-84</b>	<b>31-12-85</b>	<b>31-12-90</b>
TELETEX terminals (in service)	—	225	13,629
VIDEOTEX terminals (in service)	121	244	18,060
DATAPHONE terminals (in service)	809	4,584	73,877
TELEFAX terminals (in service)	1,532	2,184	12,223
DATA TRANSMISSION CONNECTIONS:			
— Switched telephone network	7,955	9,811	17,361
— Telegraphy and telex	42,753	46,211	60,000
— Dedicated D/T circuits	25,125	27,484	46,000
Iberpac network connections	21,316	25,070	58,701
Telealarm connections	14,351	28,356	44,930
<b>OTHER SERVICES</b>	<b>31-12-84</b>	<b>31-12-85</b>	<b>31-12-90</b>
No. of Automatic Mobile Telephones (including Vehicle Automatic Telephones)	1,291	1,898	32,000
RADIO PAGING SYSTEM subscribers	—	—	34,380
MESSAGE PAGING SYSTEM subscribers	11,437	12,088	22,200
AUDIO CONFERENCING:			
— High quality rooms	—	—	315
— Standard rooms	—	—	7,785
Multiconferencing (rooms)	—	—	1,329
Video conferencing (rooms)	—	—	27
Detailed billing (thousands with access)	135	146	2,142
IBERCOM (Business Communications Services) (lines)	—	—	270,000

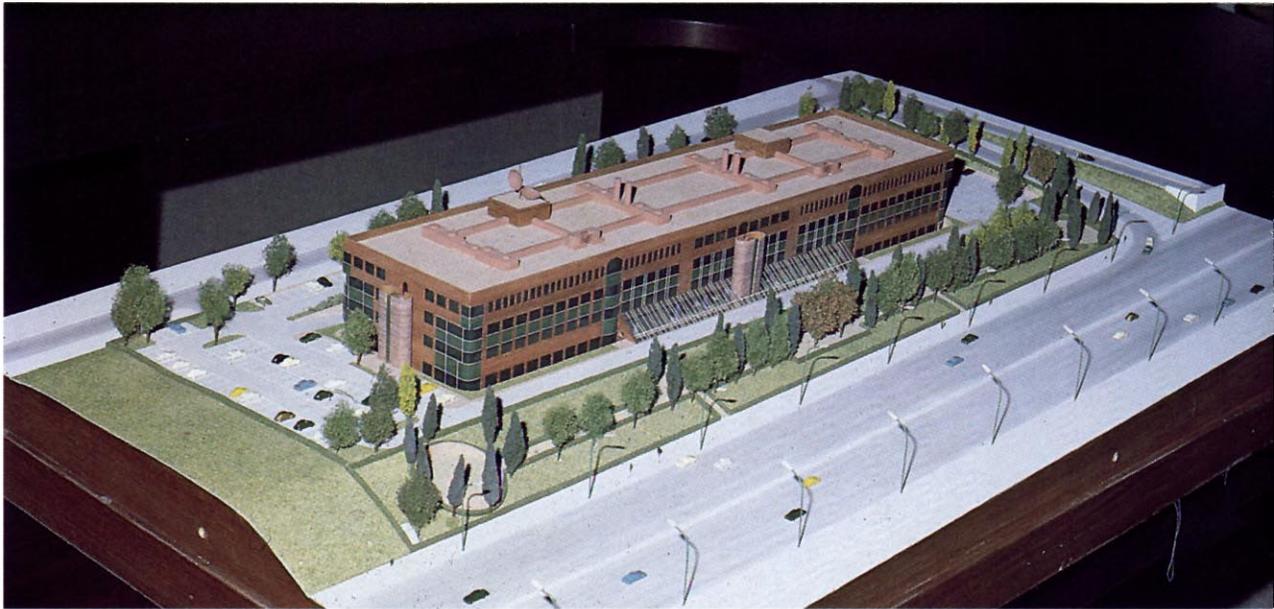
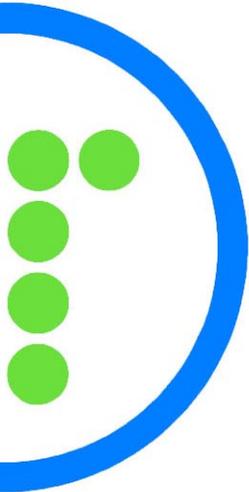


*Tesys-5 system console employing high technology developed by Telefonica, installed in the X-25 and RSAN Network*



# NETWORK MODERNIZATION

16



*Model of one of the new building projects for the R & D Centre to be built in Madrid*

*Integrated Circuit Design*



**T**he telephone equipment modernization process continued in 1985 with the incorporation of new digital switching and transmission systems and the installation of optical fibre cables, in order to satisfy the demand for new telecommunications services and to guarantee quality levels.

The modernization of management systems continued in order to respond better to users' requirements, decentralising activities relating to the definition of internal and external plant works, programming and supervision of execution, together with network assignment and services quality control to zones and provinces.

Under the heading of management improvement, the creation of 25 provincial maintenance centres for external plant should be mentioned; these centres include the organization of fault reporters and centralization of cable protection or pressurization system alarms. The provision of information technology facilities in design project offices is also worthy of mention, such as the installation of a **Computer Aided Design Graphics System** in Valencia, for the generation and up-dating of external plant records, while providing processed basic information for project execution.

## TECHNOLOGICAL INNOVATION

**I**n order to incorporate the most advanced research techniques and methods in **Telefónica, Pacific Telesis International** was commissioned at the end of last year with the design project for the Research & Development Centre. Execution of this project not only implies construction of a sophisticated building but also involves conceptual and detailed definition of working methods that will allow scheduled objectives to be achieved in this field.

Noteworthy developments include activities dedicated to subscriber terminals and equipment to assist operations, together with those relating to the **TESYS** system.

**Applied Research** activities are worthy of special consideration as, to a certain extent, they comprise the technological source for achieving the objectives that are later applied to state-of-the-art technical solutions.

Under this heading, word processing research should be emphasized, that is starting to result in experimental developments such as the fixed and variable message informer, various codecs, applications to voice recognition techniques and the interactive message recording station. On the other hand, image processing has led to development of a specific station that allows coding technique simulation.

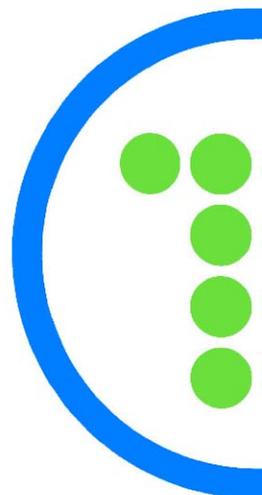
Furthermore, under this heading, the first work on artificial intelligence has been carried out, that will lead to the design of an Expert System.

The work carried out on millimetre wave technology, both by mechanical and photolithographic procedures, has been a fundamental element and support of all of the **R & D** activities.

Progressive adaptation to existing requirements, especially after the **E.E.C.** membership, and in order to place **Telefónica** in a privileged position with regard to standardization and qualifications, has led the Company to commence procedures for acceptance of the **Technological Planning Laboratories** for performance of tests and trials. Recently, the Ministry of Industry and Energy granted **Telefónica** the qualification of the calibration laboratories in electrical and frequency-time areas, and negotiations are in progress for official recognition of the Radio laboratory, as a recognised centre for radioelectrical measurements.

Within the area of **Switching**, the majority of the technical qualification tests finished, without real traffic, of the medium and high capacity local exchange **Sistema 1240**.

The **CDS 96/16 concentrator** was technically qualified, a unit that allows significant savings in subscriber networks. In regard to packet switching,



the future **TESYS System** generation was specified, having achieved availability of several products of elements of this family.

International support activities were of special importance, culminating in the commissioning of a network contracted with **CNCP, of Canada**, and the agreement reached on the **ARPAC Network** in Argentina.

A special effort was dedicated to video communications-related activities, having prepared various technical proposals on cable television, video conferencing and the digital coding of video signals.

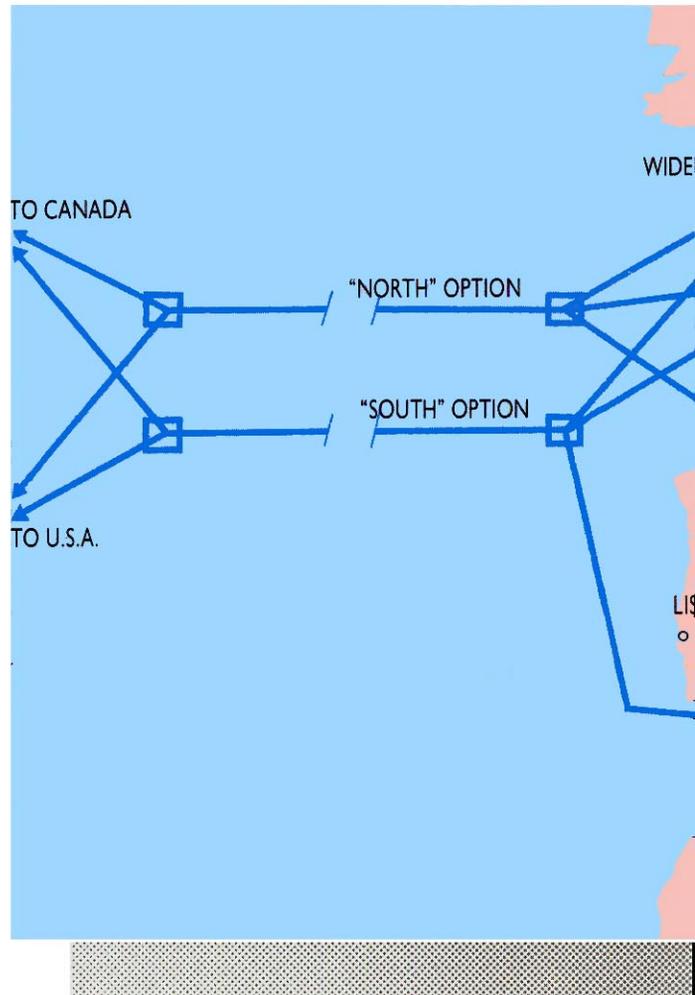
Laboratory experience commenced with the **Integrated Services Digital Network (ISDN)** with **ISDN Models of the AXE and 1240 Systems**. With respect to the **IBERCOM Network**, tests were completed that will allow the service to be opened shortly.

For the **Mobile Services**, the radio paging system was selected and defined, with active participation in the drawing up of an agreement between the Ministry of Industry and Energy and the Ministry of Transport and Communications, relating to the homologation procedure for terminals (on a free competition basis) of the **Automatic Mobile Telephony** service.

With regard to terminal equipment, the development of practically all multi-line equipment was completed and a new technique finalised to allow the **Teide Hands-free** development to be made available shortly.

The effort made in testing X-25 protocol terminals is noteworthy, that has involved connection of 30 different data terminal models to the **IBERPAC Network**.

Lastly, in relation with the European Economic Community, participation in several projects should be mentioned, including: the Inter-governmental Video Communications Project (**IVP**), the Research and Development on Advanced Communications Technologies (**RACE**) and the second generation of Cellular Mobile Telephones, together with two specific projects within the **ESPRIT** programme-fixed and moving image transmission coding and multi-point interactive audiovisual conference.



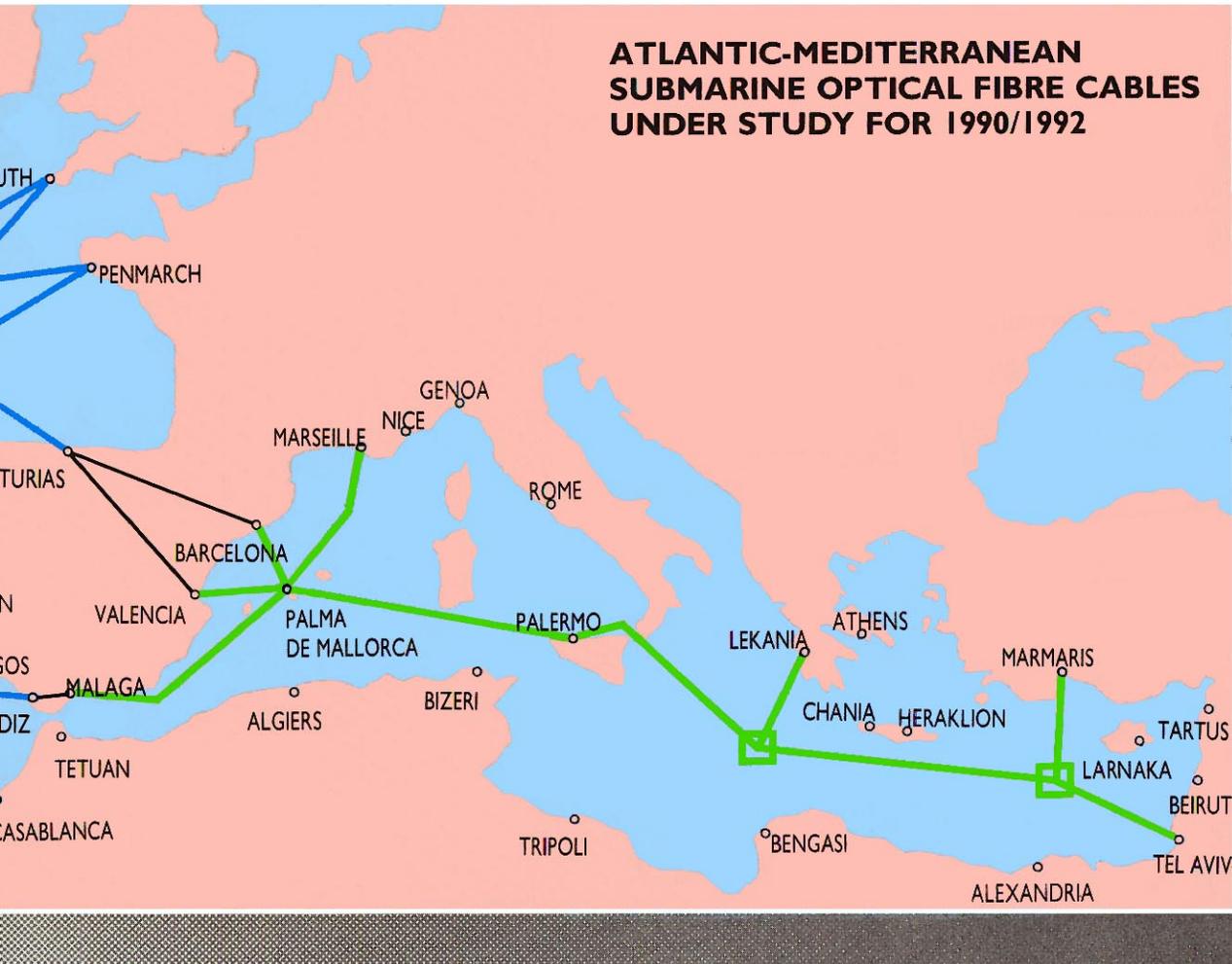


## SPANISH CABLE SHIP

The contract was signed in 1985 for building the Spanish cable ship between Telecomunicaciones Marinas, S. A. (TEMASA), affiliate of **Telefónica** with a 100% interest and Astilleros de Santander (ASTANDER), an affiliate of Astilleros Españoles.

This vessel when commissioned in 1987 will have the latest technology of its kind in the world. It has been designed by Spanish engineers for repairing and laying any type of submarine cable. Furthermore, it is designed for carrying out oceanographic studies with remote-controlled submersibles.

In June 1985, **Telefónica** managed to include this vessel in the Atlantic Cable Management Agreement-ACMA formed by 17 telecommunications administrations and entities owning submarine cables in the Atlantic. On entering into service, it will be incorporated into the International Consortium of the ACMA, remaining on standby at its base port in Spain, leaving port, when required, to repair any faults that arise in Atlantic cables, whether belonging to **Telefónica** or any other Administration. In addition, it will be able to tender internationally for any type of submarine cable work.



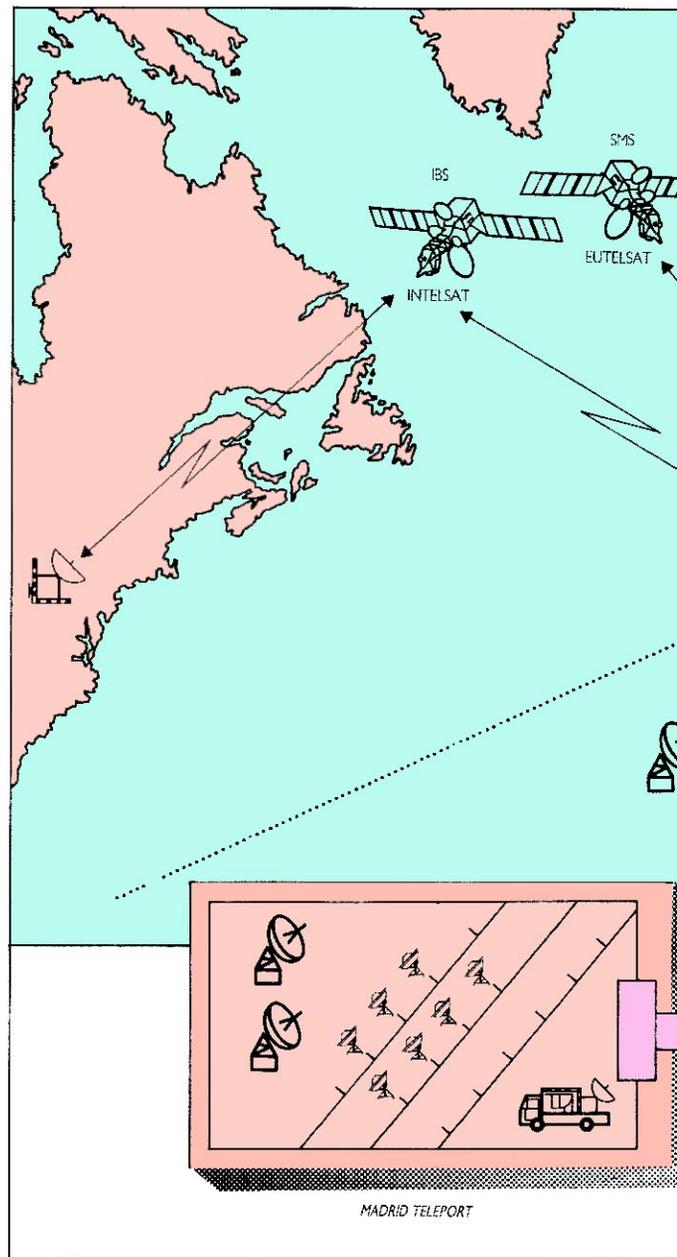
## NETWORK PLANNING AND INSTALLATIONS PROGRAMME

A great effort of definition was made last year for the planning of specific solutions for the network structures in order to adapt **Telefónica** networks in the coming years to a powerful digital infrastructure, on which the future **Integrated Services Digital Network** will be based.

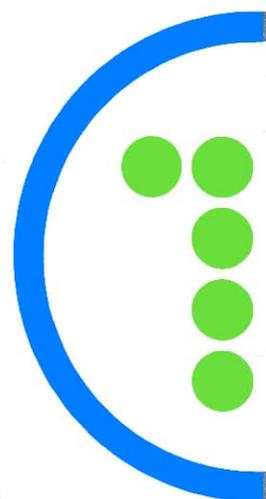
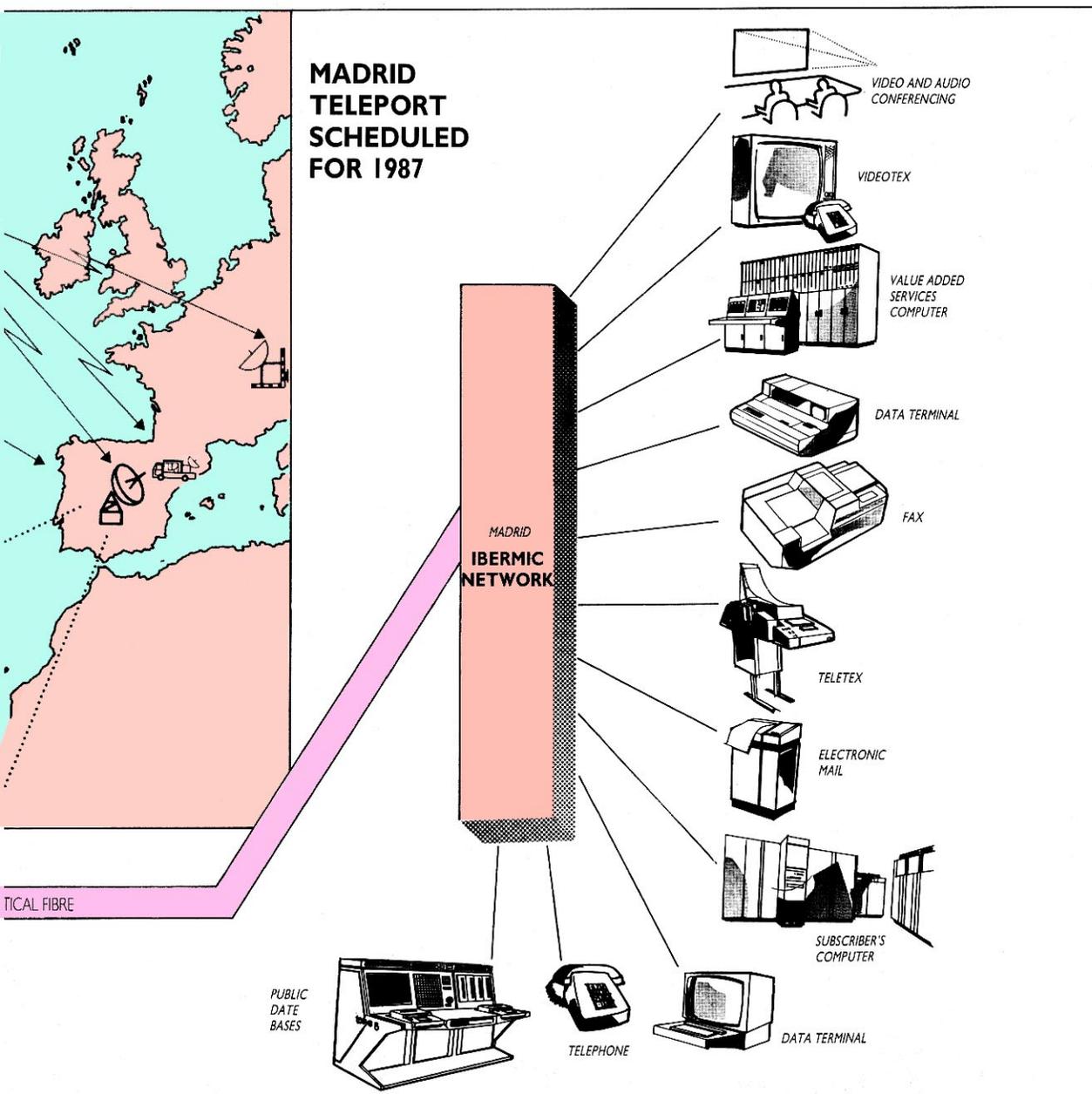
Consequently, development and modernization of the whole trunk transit structure of the telephone network up to complete digitalization was profiled; action to be taken on the international network, under the responsibility of **Telefónica**, was analysed, together with the digital infrastructure facilities to be installed throughout the country's large metropolitan areas, via the corresponding "digital rings". The intention is to facilitate digital connection over the relatively short term wherever the demand exists for new services. In this context, work has started on defining the evolution to which all access networks including rural areas must be subjected to achieve total digitalization.

In the **telematics** field, work continued on structural development of the **IBERPAC Network** and its associated services, that will allow a substantial capacity and flexibility increase for this network in order to handle the rise in demand for these services, with higher quality, while major efforts are being dedicated to the X-25 network.

In the business communications area, terminal structures were defined for potential multiple users of the **IBERCOM Network** which will include **Telefónica** itself, together with the interconnection structure of the **IBERMIC Network**, that will allow a preliminary offer of high transmission speed point-to-point digital carrier services to be made available.



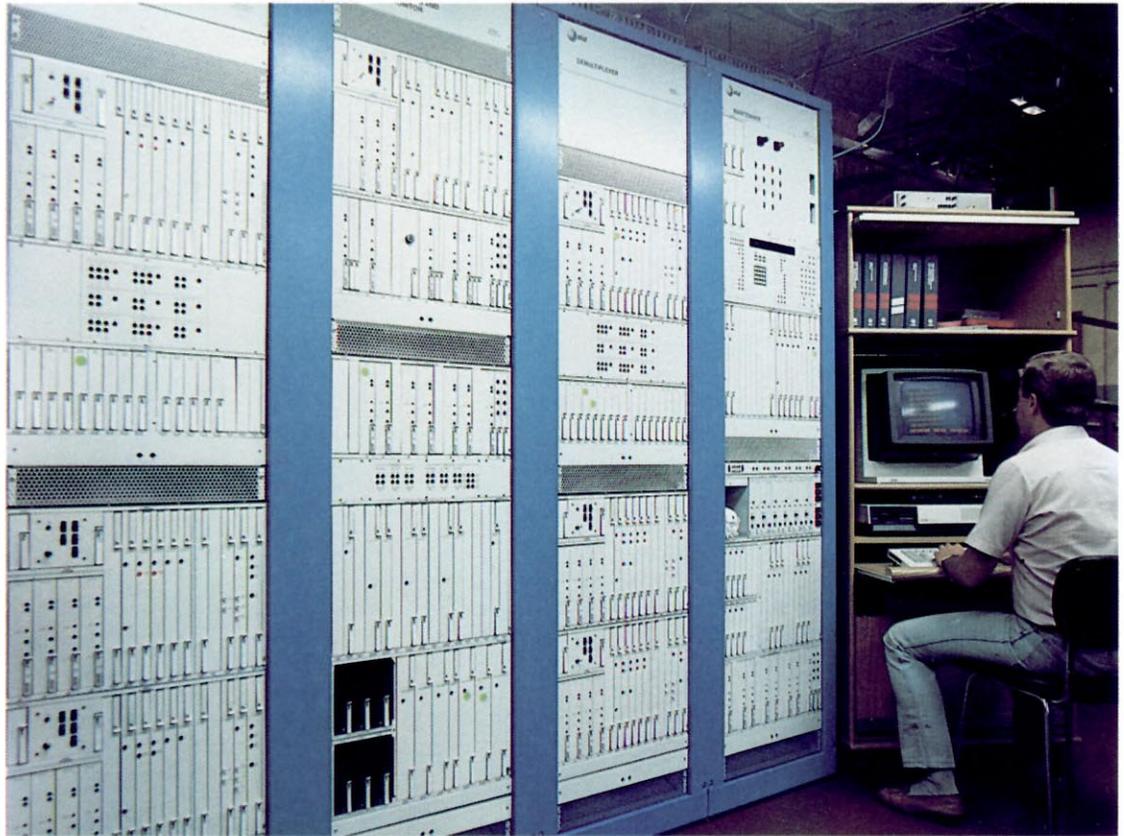
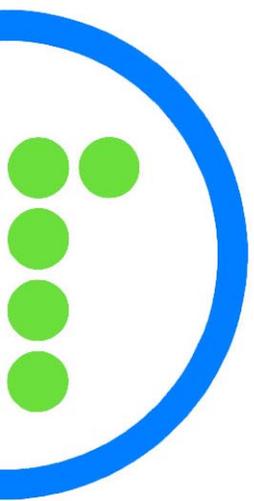
The use of solutions via satellite is also scheduled in the same area, fundamentally directed to the international provision of this type of service that, transcending the initial limited deployment of scattered installations to handle initial requirements, will give rise to the creation of "Teleports", the first of which is scheduled for the Madrid area in 1987 and the second, in the Barcelona area, in 1988. These will comprise fields of earth stations on which, via the **IBERMIC Network**, interconnection will be concentrated via satellite for



the provision of IBS and SMS services, from IN-TELSAT and EUTELSAT, respectively.

Together with the Automatic Mobile Telephony Expansion Plan that contemplates its gradual increase in scope to cover areas of the country with the heaviest demand, the **Radio Paging Service** was structurally defined for the simple numerical and alphanumeric warning modes, together with the **Automatic Message Paging, Message Broadcasting, Automatic Reverse Charge and Ibertex Services.**

As part of installation coordination and planning, 18 instrumental plans were drawn up that bring together the achievement of a specific objective of service, modernization and technological renewal of plant or management coordination. Continuation of this work in 1985 involved up-dating works planned and programmed for the 1986/7 two-year period, that was completed with the study and preparation of the 1987-90 Installations Plan, involving a firm boost to the networks and services modernization and expansion process.



*Terminal equipment of the OPTICAN optical fibre submarine cable, laid between the islands of Gran Canaria and Tenerife*



*Automatic mobile telephone (T.M.A.).*



*Short wave radio transmitter station.*

## PLANT DEVELOPMENT

**P**lant modernization continued throughout last year with the incorporation of switching equipment based on new technologies, that will allow the demand for new services to be handled. A total of 400,244 automatic lines were installed, of which 59,500 and 57,344 were semielectronic and electronic systems, respectively, accounting for 29.1% of all lines installed.

At the year end, the total advanced technology lines installed amounted to 972,120, representing 9.5% of automatic lines overall.

Simultaneously, 37,000 rotary switch system lines and 12,410 other conventional system lines were taken out of service.

Continuing the policy of caring for rural areas, 141,500 lines were installed, representing 35.4% of the total number installed. It should be mentioned that at the end of the year there were 50,325 annual lines, so that the degree of automation is 99.5%, with 19 provinces completely automated.

With respect to trunk switching, 53,914 links were installed, with the influence of electronic technology being more marked, as 30,498 electronic and 376 semielectronic links were installed, accounting for 57.3% of the total. At the year end, a total of 935,908 links were installed, of which 7.6% employed advanced technology.

The trunk network increased by 1,152 channel groups, of which 24 employed digital technology; 922 transmission systems were installed together with 66 new radio channels, with 176 transceivers.

Under this heading new installations were executed of special importance, given their service and technological significance; an 18 MHz (3,600 channel) system was installed in the Madrid-Seville coaxial route, a direct 140 Mb/s (1,920 channel) system on coaxial cable in the Armuña de Tajuña E.S.-Madrid route, was installed, together with the first 140 Mb/s system on optical fibre cable in the Barcelona/Can Serra-Barcelona/Corts route, with 1,800 channel radio links for Almería-Málaga and

Avila-Madrid. Furthermore, the installation of the First Front End Processor for **IBERCOM** and the **Madrid Terminal Network** for its first user, Iberia, L.A.E. is worthy of attention.

In the telematics field, 10,252 terminal connection gates have been installed for the **IBERPAC Network**. In RSAN, there was an increase of 255 **TESYS-1** and 14 **TESYS-5** units installed. Hardware and software improvements to these high technology units, belonging to **Telefónica** and, above all, the installation of the **TESYS-5**, have considerably influenced network quality improvement, apart from increasing switching speed.

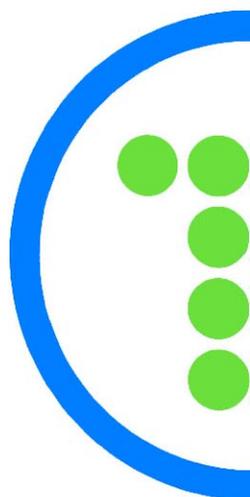
In X-25, the expansion of installed equipment has involved 132 **TESYS-1** and 6 **TESYS-5**.

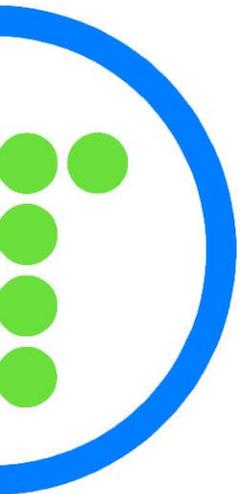
With respect to **Automatic Mobile Telephone Systems**, a total of 20 radio channels and 607 mobile units have been accepted. With respect to the **Maritime Mobile service**, installation of a management system in the National Radio Maritime Communications Centre should be noted, that allows radio telephony traffic to be routed in the shore-to-ship and ship-to-shore directions.

In order to handle service demand and improve quality, 1985 saw the installation of 1,849,700 Km. of subscriber network pairs, 178.7 Km. of coaxial cable, 93 Km. of optical fibre cable and 2,166.8 Km. of trunk pair cable, expanding the infrastructure for carrying these networks by 3,295 Km. of conduit and 2,919 Km. of pole lines.

Of the **coaxial cables** installed, those of Calahorra-Tudela and Gibraleón E.R.-Cristina Island should be emphasized, with a potential capacity of 3,840 circuits each, and the Huelva-Gibraleón E.R., with a capacity of 43,200 circuits. With regard to optical fibre cables, those installed in the Madrid links—36.9 Km. of 16 fibre cable— and Barcelona links—19.5 Km. of 16 fibre and 4.8 Km. of 8 fibre cable— should be mentioned, together with that installed between Cádiz-San Fernando-Puerto Real—29.5 Km. of 8 fibre and 3.3 Km. of 6 fibre cable. All of these cables have a capacity of 1,920 circuits per fibre pair.

The installation of the **optical fibre submarine cable** is worthy of special attention, which will join up the Islands of Gran Canaria and Tenerife,



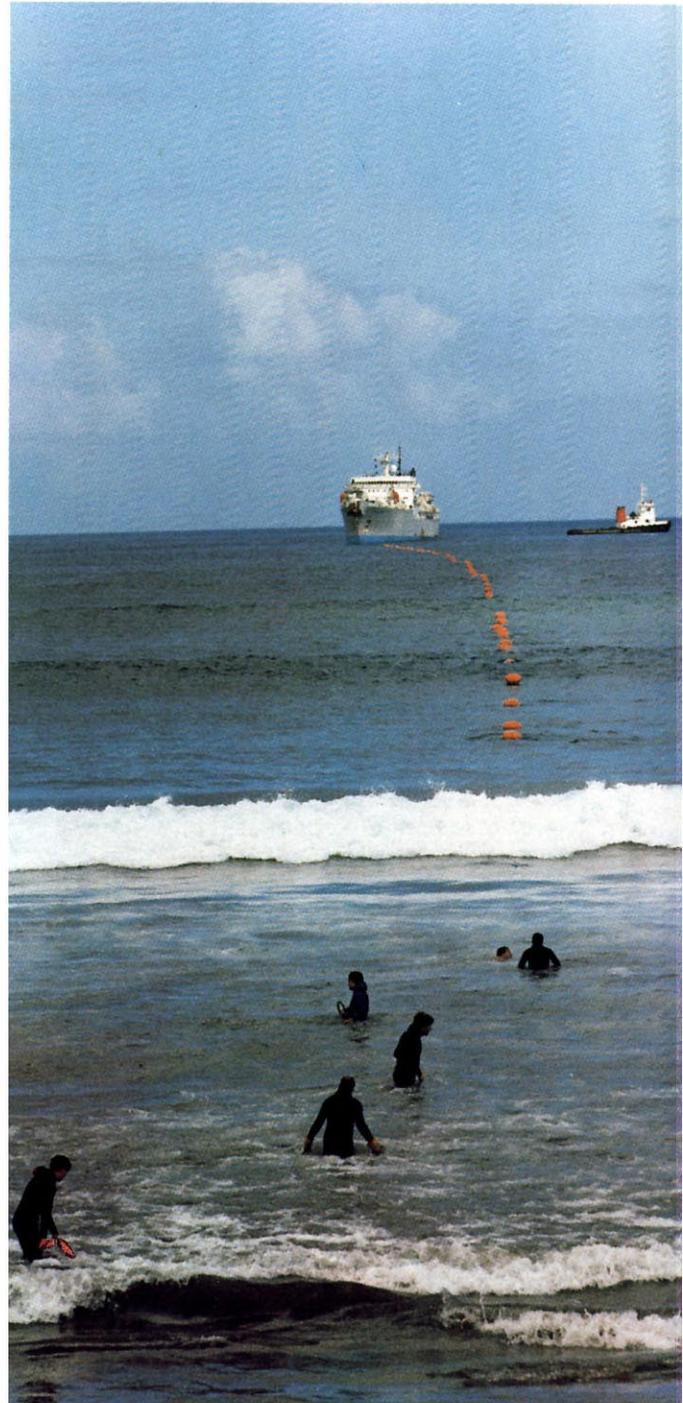


known as **OPTICAN**, the first of its kind with repeaters installed in the world. This cable will be 125 Km. long and on entering into service will have a final capacity of 7,860 circuits.

Furthermore, a **satellite communications earth station** entered into partial operation for T.V. signals near Armuña de Tajuña, located 23 Km. from Guadalajara, functioning within the framework of activities of International Organization with a European scope, **EUTELSAT**. It is fitted with an 18 m. diameter antenna and incorporates the latest and most sophisticated equipment using the most advanced digital technology. Official inauguration is scheduled for the first half of 1986.

Within the local subscriber networks, the task continued of gradually changing the present networks into "series networks". The new subscriber network structure is presently used in the majority of telephone administrations, as it is best able to handle new services.

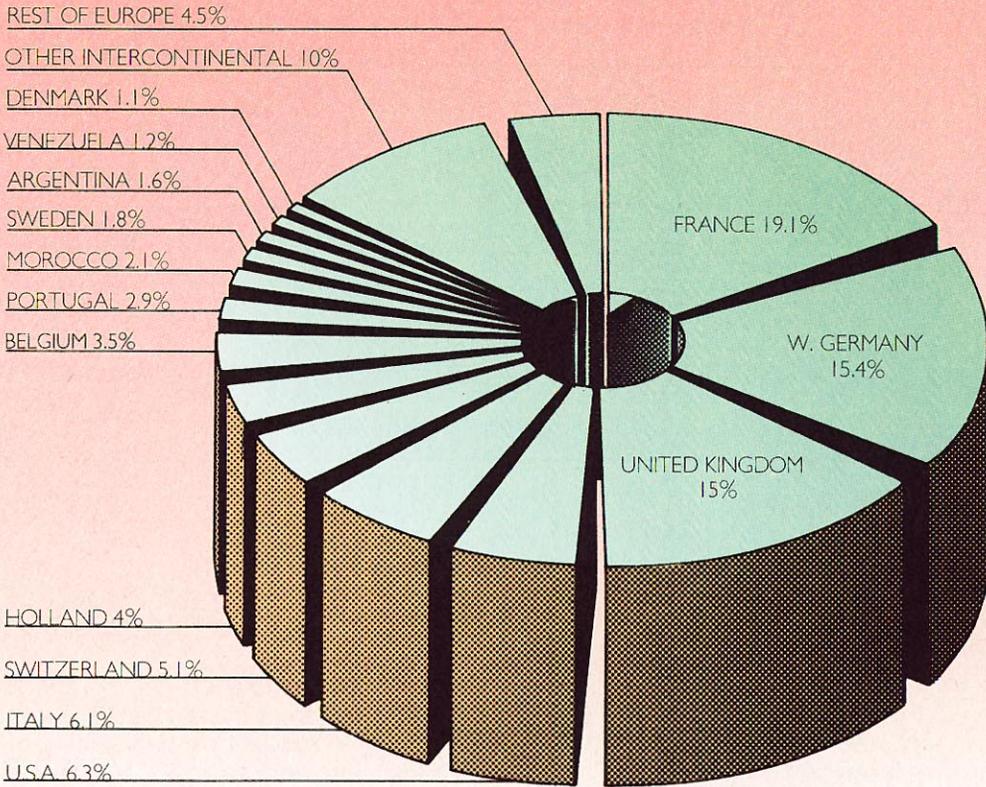
In order to expand the automatic telephone service into rural areas with a scattered population, not provided with a telephone infrastructure, four new multi-access systems were installed, having expanded two radio channels of this system.



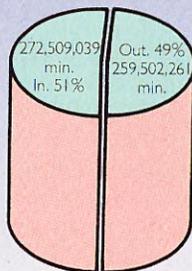
*Laying of the OPTICAN optical fibre submarine cable between Tenerife and Gran Canaria.*



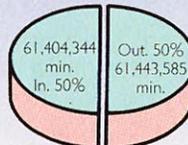
### INTERNATIONAL SERVICE DISTRIBUTION: TOTAL OUTGOINGS



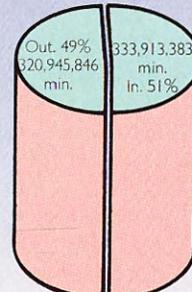
### INTERNATIONAL SERVICE VOLUME AND DISTRIBUTION



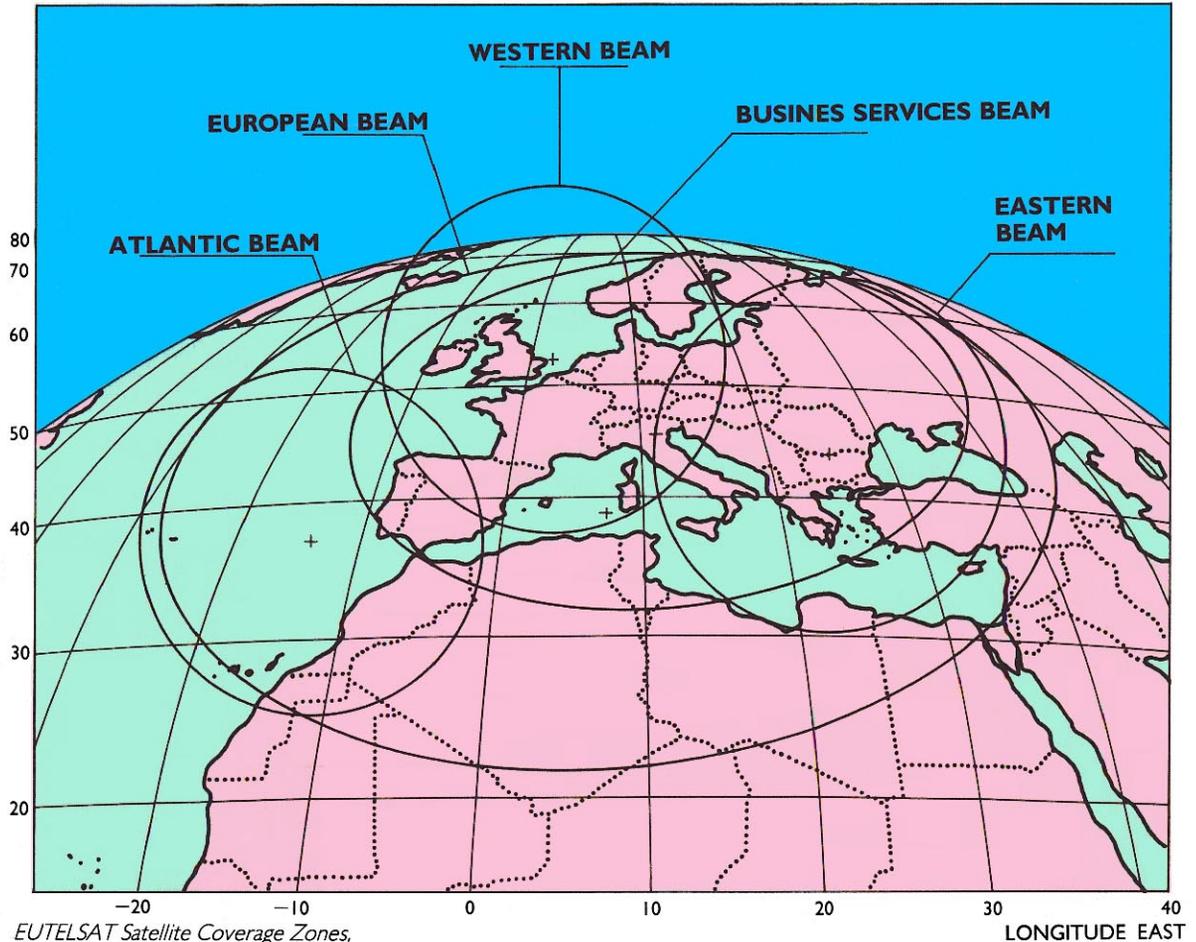
EUROPEAN



INTERCONTINENTAL



TOTAL



*EUTELSAT Satellite Coverage Zones, with which the Guadalajara earth station is connected.*

## NETWORK MANAGEMENT

In this area, the activity was oriented to improving information on the state and behaviour of telematic and telephone networks and the adoption of measures to obtain optimum performance, which has led to the quality of the automatic service to subscribers improving by 4.5%, measured as a percentage of plant faults on that 1984.

With respect to the **telematic network**, special attention was given to applying teletraffic criteria and obtaining network utilization data and degree of availability for the user.

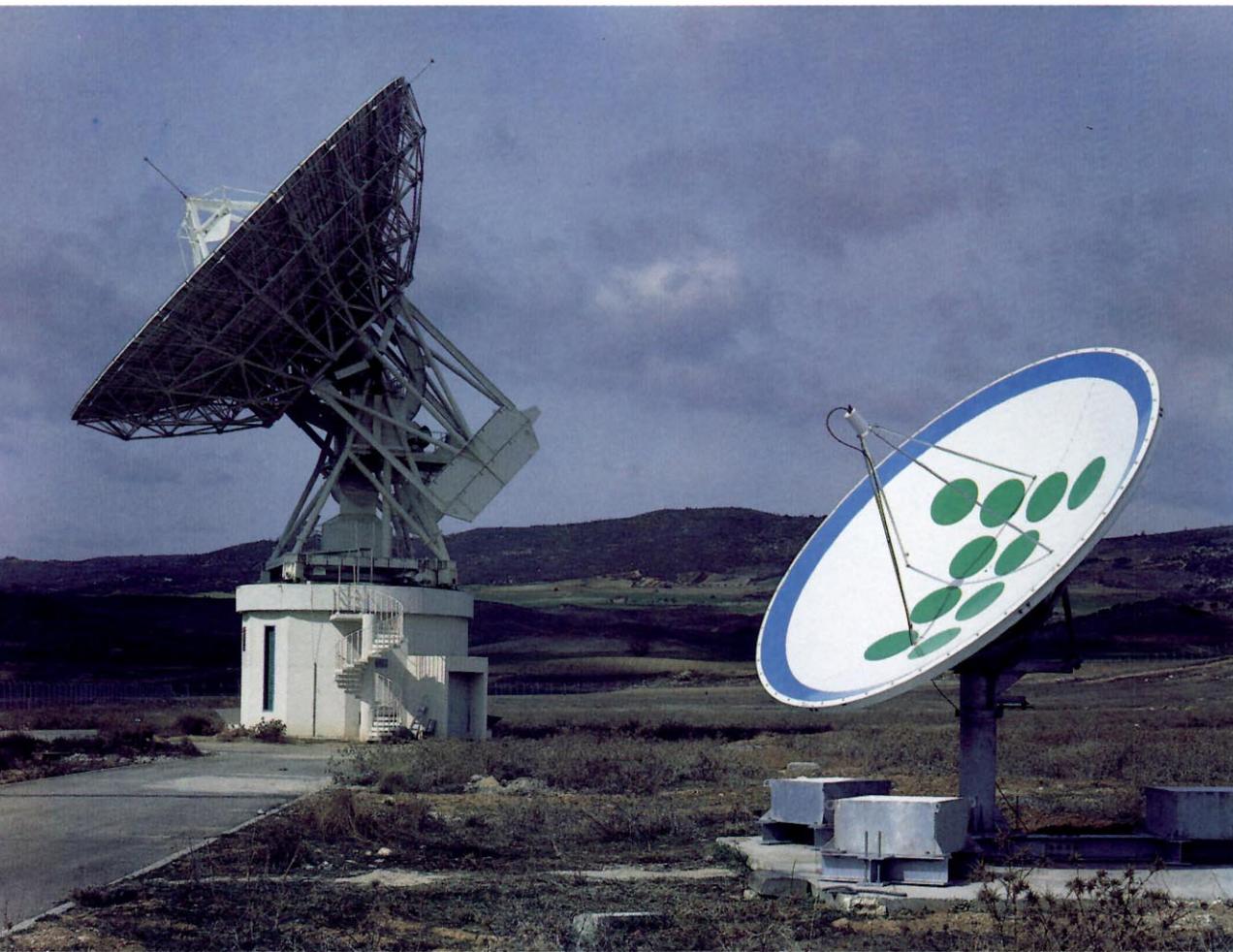
Simultaneously, measures were taken to comply with the network expansion programme, scheduled at 7,682, 11,689 and 404 automatic local, trunk and international network circuits, that totalled 447,262, 228,869 and 9,575 circuits, respectively. Of the latter, it should also be mentioned that 50%

were carried by submarine cable and 11% via satellite.

Work also commenced on defining the characteristics of the different management network centres for national and international telephony, data and TV, starting work on the international network at an information and coordination level.

With regard to **TV transmission** for the Peninsular-Canary Islands and International, 7,616 and 728 hours were carried, respectively, with a total of 2,739 programmes.

With respect to **international services** provided by **Telefónica**, these continue to expand, having incorporated four new countries into the direct telephone connection network and seven more, either by direct connection or via transit through other countries, to the data transmission network. Throughout the year, 21 local areas from provincial capitals and 31 primary areas were incorporated into the intercontinental type international automatic service, allowing an overall degree of automation of 97.6% for this service.

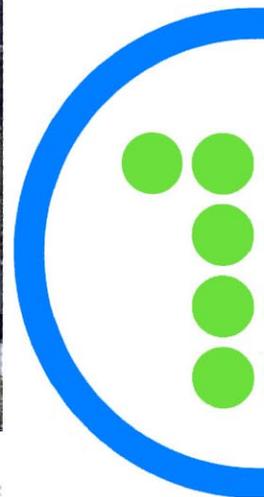


*Guadalajara telecommunications station*

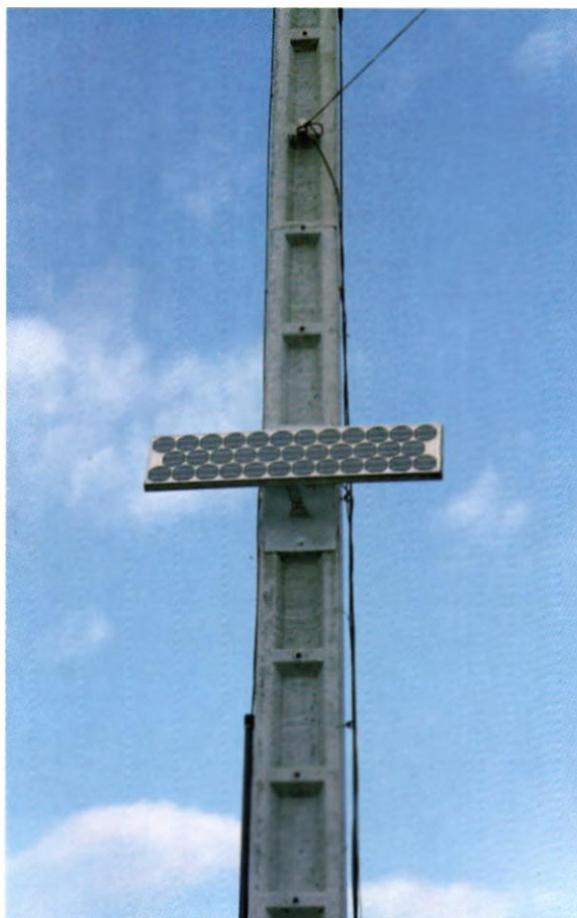
Finally, with respect to the transmission network, **Telefónica** actively participated in negotiations for constructing an optical fibre submarine cable in the 1990/92 period, that will connect up the future Mediterranean and Atlantic submarine systems via Spain, together with definition of the wide band transnational infrastructure of the European Economic Community (**TBB Project**).



*IBERCOM network terminal module*



# COMMERCIAL ACTIVITIES AND DEMAND



*Detail of rural telephony equipment.*

**T**he telephone service demand recorded in 1985 totalled 756,164 line requests that, as in the previous two years, has kept within the highest levels achieved by **Telefónica** over the last decade.

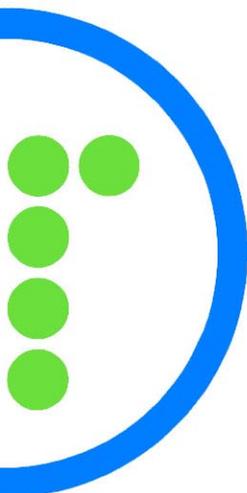
Nevertheless, despite this strong demand, there were 252,762 applications pending at the end of the year; this figure is again lower than that of previous years, confirming the effort being made to shorten the time taken to cover this demand.

At the year end Spain had a total of **9,340,458 telephone lines** in service and **14,258,928 telephones**, which represents a density of 36.6 telephones per 100 inhabitants.

When Royal Decree 2,248/84 of November 28 entered into force on January 1, 1985, concerning **Telephone Service Expansion into Rural Areas**, a major boost was undoubtedly given to the coverage of demand for telephones in rural areas. In application of this Royal Decree, conversations were initiated during the year with the different territorial authorities so that, by means of the corresponding collaboration agreements with **Telefónica**, action is taken to anticipate and intensify expansion of rural telephony in their respective areas. Already in the first year, as a result of these conversations, **8 Agreements were signed** with Provincial Authorities of the Castille and León Regional Government.

For its part, **Telefónica** installed 597 new **public service telephones** in towns lacking a telephone service in accordance with its annual plans on this subject for 1985, and also created 134 new local zones in the same number of towns, whose inhabitants will be able to enjoy a telephone in their homes with the application of the local tariffs in force.

With regard to **Public Use Telephones**, and as part of the new **Telefónica** policy, orientated to marketing public telephones serviced by their owners, a total of 21,666 telephones were contracted in the year, of which 12,970 were the so-called **Coin-Operated Regular Telephones (T.R.M.)**, where acceptance, due to their function-





*In accordance with the new corporate image design, all telephone box signs are being renewed and are incorporating the regional languages.*

ality, has meant that demand has outstripped all forecasts.

In the same field, **Telefónica** continues to promote the opening of telephone box facilities in the offices of large entities and organizations, to be serviced and managed by their owners in order to facilitate the telephone service to their clients and users. At the end of the year, there were already 95 telephone box facilities installed employing this method.

The telephone service continued to grow in 1985, with a total of **2,820 million** trunk calls and **87.2 million** international outgoing calls, meaning a growth of 9% and 12.5%, respectively, over the previous year's figures.

On the other hand, via the **Maritime Service** coastal stations, 680,888 radio calls were made, 320,940 radio telegrams and 2,710 radio telexes were sent, 2,786 radio medical services, 88,574 navigation aid reports and 136 rescue services were carried out.

As part of the **on-land mobile services**, the Message Paging Service increased the number of users, with a total of 12,088 subscribers and 1,056,878 messages sent at the end of the year.



*Teide 5/10/3 telephone set*



*Benjamín telephone, marketed during 1985*



*Dataphone demonstration in the Madrid-Colón Centre.*





## TELEMATICS SERVICES

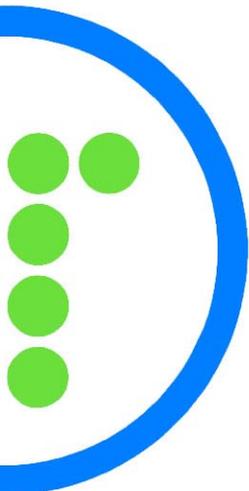
The **Telematics Services** have been the **Telefónica** activity with the most spectacular growth rate, in trying to satisfy the demand for a fully expanding market requiring the latest communications systems that new technology can now provide. Consequently, in 1985, there were **48,074 circuit applications**, representing a 43.7% increase over 1984, with a net plant increase of 31,272 circuits installed, as opposed to the 17,753 of the previous year. Broken down into different systems, the figures for the year are as follows:

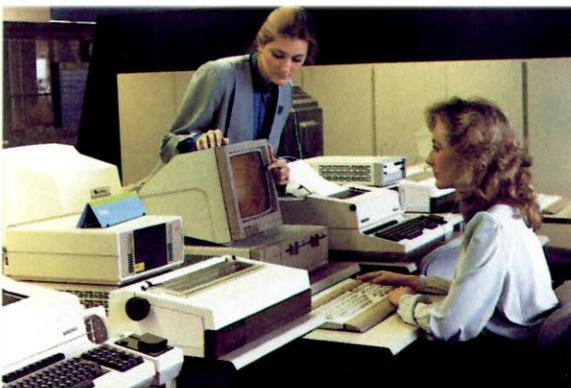
## NEW SUBSCRIBERS TO TELEMATICS SERVICES

Point-to-point data transmission .....	5,703
Switched Telephone Network	
Data Transmission.....	2,611
Coded Alarm Service.....	14,314
Dataphones .....	3,953
Telegraphy.....	486
Telefax.....	828
Private Videotex.....	151
Iberpac Network.....	5,240

In this table the considerable increase in the number of Dataphone and Coded Alarm Services should be noted, rising by 809 and 3,235 compared to 1984, respectively.

TELEPHONE DENSITY				
Year	No. of telephones	% year-on-year increase	Telephones per 100 inhabitants	Av. waiting time for a telephone. Months
1972	5,712,549	11.4	16.5	24
1973	6,331,474	10.8	18.1	25
1974	7,042,968	11.2	20.0	19
1975	7,835,970	11.3	22.0	16
1976	8,604,768	9.8	23.9	13
1977	9,527,781	10.7	26.2	14
1978	10,311,423	8.2	28.0	14
1979	11,107,624	7.7	29.4	13
1980	11,844,623	6.6	31.0	12
1981	12,384,656	4.6	32.9	11
1982	12,820,190	3.5	34.0	10
1983	13,345,332	4.1	34.9	9
1984	13,825,459	3.7	35.8	7
1985	14,258,928	3.1	36.6	7





*Different views  
of the Madrid-Colón  
Telecommunications  
Room.*

The new telephone directories have been designed with the new corporate image.



## USER AFFAIRS

32

Company activities continued in 1985 to improve the relationships with subscribers and users. In this respect, the entry into service of the **first 6 Mobile User and Information Offices** is worthy of emphasis, to bring **Telefónica** closer to rural areas, for which the results obtained over this short period confirm the excellent acceptance of this entity in these zones. Furthermore, deployment and development work continued for the new **Subscriber Offices** that integrate the different services most directly related with the users' requirements, to achieve greater efficiency and speed in these affairs.

Continuing with the aim of improving subscriber affairs by introducing information technology to management, introduction of the **MIGA Project** (Integrated Automation of Subscriber Management) continued, which now covers 28 provinces, and the preliminary phases of another similar project have been finalised, the **Computerised Circuit Management (G.M.C.)**, for nation-wide introduction in 1986.

Similarly, information technology continues to be provided to **billing management**, with a total of 66 Offices being completely computerised. On the other hand, with the incorporation of 18 new bank institutions to the billing system employing magnetic tape without direct bills, 93% of all direct debit bills were settled in this way by the end of the year.

Under the heading of information, a total of **17,746,000 copies of 90 Telephone Directories** were published in 1985, together with 95 Supplements with information on new subscribers and modifications occurring after the Directory closing data. It should be mentioned that this year's editions of the Telephone Directories corresponding to the provinces in Catalonia, Galicia, Valencia and the Basque country have the "information pages" inserted in Spanish and in their respective languages.

On the other hand, the **003 Information Service** handled over 80 million calls last year, of which 77% were carried out by computerised procedures. In this field, the commissioning in this service of a modern **direct access** system is worthy of special attention, as part of the **Telefónica** plan to introduce new technologies for the improvement of services.

A **Demonstration Centre** was inaugurated in Madrid, in which both Equipment and Services marketed by **Telefónica** are installed, with the most advanced communications technology, being highly useful for commercial management improvement as potential users can, at this Centre, check characteristics, real operating conditions, performance, etc. of the products that best comply with their requirements.

## NEW EQUIPMENT AND SERVICES

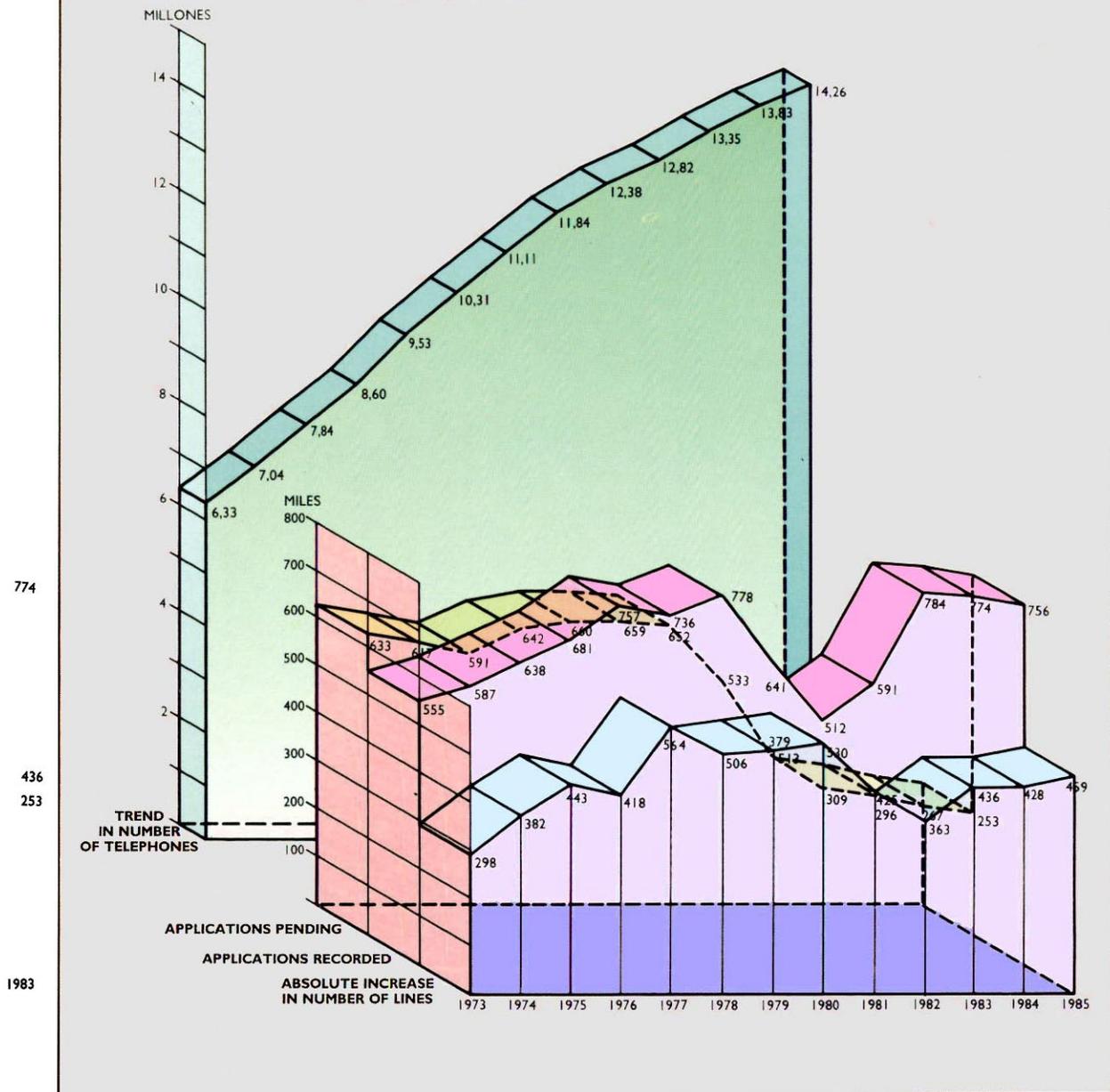
**T**en new products were commercially launched in 1985, between services and equipment. Of the services, **Teletex** and **Telefax** were put into service, representing a substantial advance in **Telefónica's** strategy, in line with offering Spanish Companies the same automated office innovations and facilities available in the most advanced countries.

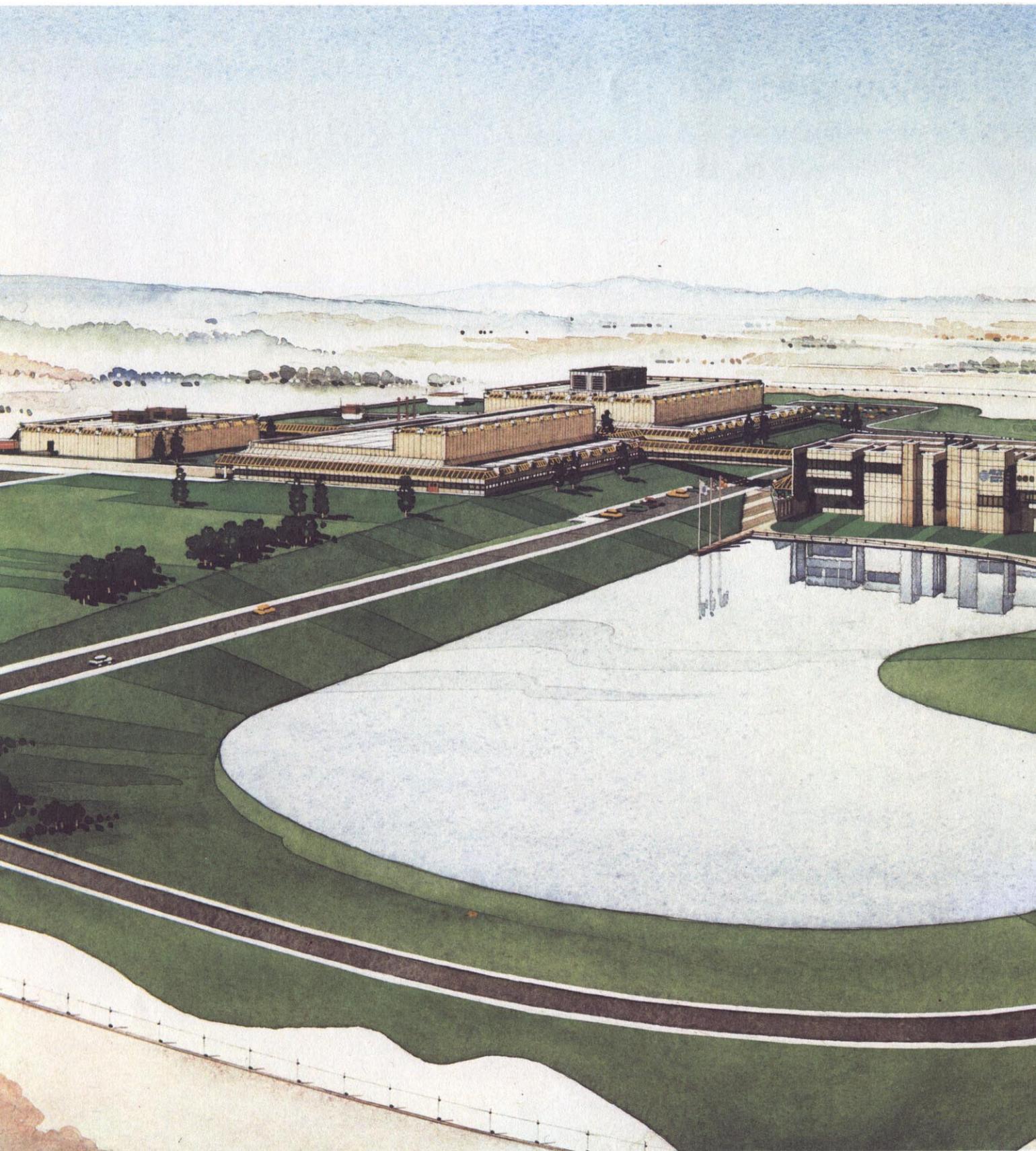
With respect to **telephone equipment**, sets made available to users range from the **BENJAMIN** telephone set, basically aimed at the home sector, to the **TEIDE 10 and 24**, that cover the telephone requirements of a wide range of businesses employing the most sophisticated technology in the TEIDE line. Telematics equipment was also launched, including the **Automatic Interface Switching Unit**, **Audible Response Modem** and **Single Channel Equipment**, that had been designed with the latest technology.



Mobile User and Information Office. The photo was taken in the Plaza Mayor of Chinchón (Madrid).

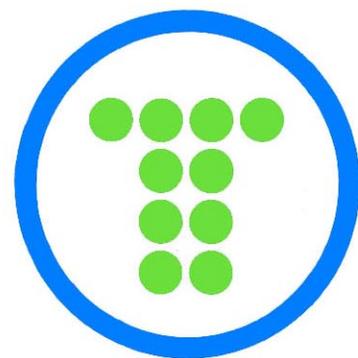
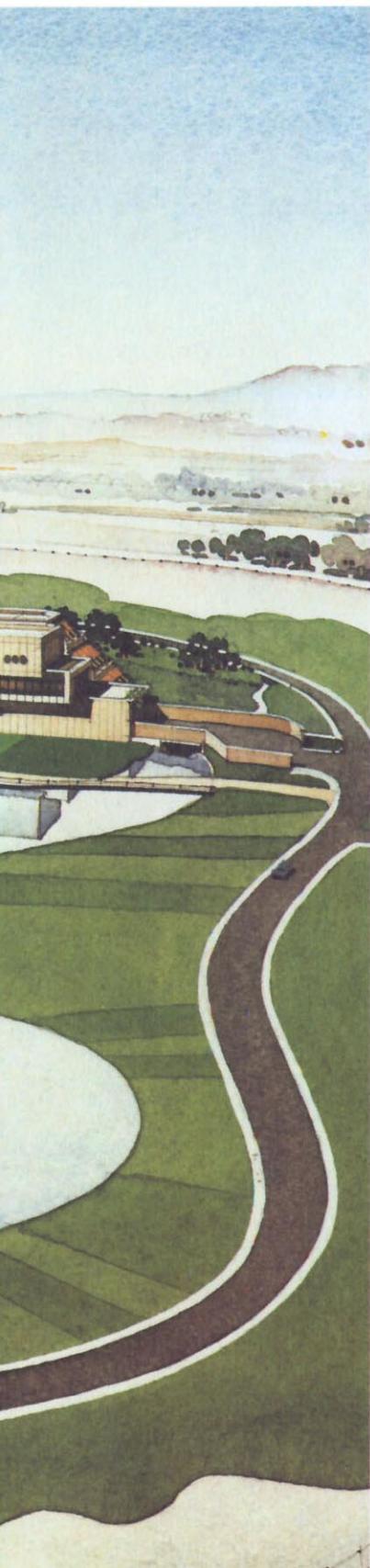
### SERVICIOS TELEFONICOS





# THE TELEFONICA GROUP

# 2



*The Telefónica-AT&T agreement was signed in Madrid during December 1985. The foundation stone of the factory being built near Madrid, shown in the picture, was laid in April 1986.*

# END OF AN ERA

## 1985

has seen the end of an era in the industrial policy that **Telefónica** used to implement. The achievements are basically a more homogeneous group of companies in profit for the second year running, more solid from the industrial and technological point of view and, finally, less dependent on purchases from **Telefónica** itself; i.e. with a more diversified activity structure.

Consequently, **Telefónica** maintains the objective of proper industrial procurement planning that, on being agreed with the suppliers, provides a platform allowing improved orientation of resources, investments and efforts towards other market segments, eliminating uncertainties.

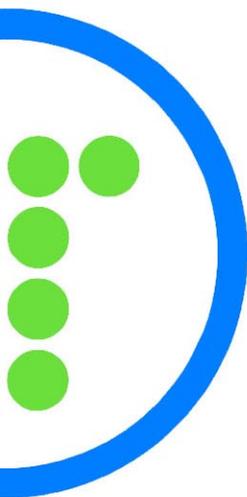
This progressive consolidation of the companies has in turn allowed **Telefónica** to open up the firm's supplies policy to the sector overall, favouring greater competitiveness in both developments and supplies.

In this way, the restructuring effect of industrial policy widens its scope to the sector overall and directly benefits **Telefónica's** procurement.

Business projects created in 1984 and directed to preexisting market gaps have commenced operations in 1985. This has happened with **Indelec**, having **Philips** as the technological partner and dedicated to mobile communications; with **THM**, specialised in electronic security systems, and **Telefónica y Datos**, as the second supplier of **Tesys** and advanced voice/data communication systems.

The appearance of new companies and the restructuring and development of existing ones has led to another series of initiatives aimed at coordinating activity between Group Companies, allowing the Group to make maximum use of existing synergy and complementary aspects. These actions, some of which are already implemented and others in the pipeline, include:

- **Telefónica Internacional, S. A.**, a company orientated to promotion abroad, complementing individual Company activities. It is basically directed at complex projects, coordinating global proposals from several companies, essentially in the area of Spanish-patented products.
- **Telefónica Sistemas, S. A.**, a systems and networks engineering company, specialising in large-scale complex projects, and contributing the value added of advanced design, multidisciplinary complexity and corporate coordination. Its objective is the domestic market outside the scope of **Telefónica: Advanced Business Communications, Defence, Institutional Sector**. Furthermore, as a consulting and engineering company, it provides technical backup to **Telefónica Internacional**.
- **Research and Development Centre**, at the service of **Telefónica** and the sector as a whole, basically in applied research and prospective development areas. The new technology policy is aimed at maximizing Spanish-patented products adapted to market requirements, while allowing a condition-free supply of exports. The **Research and Development Centre** construction agreement was signed in December with the company **Pacific Telesis**.
- **Cosesa-Telyco (Marketing Networks)**. The object is to create new modern distribution networks, which are the key for access to freely competitive markets. The maturity process of **Telefónica's** industrial companies runs parallel to that of conquering new markets for its prod-



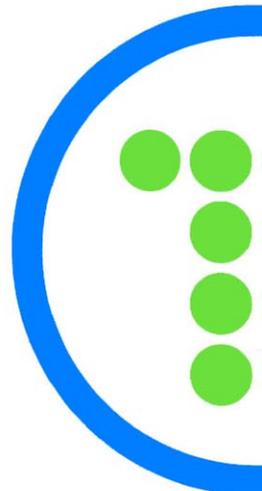
ucts. Activities presently in progress and others scheduled for the near future in an international context and with respect to the liberalization of equipment and terminals offer tremendous potential with an adequate commercial policy. **Cosesa y Telyco** offer the possibility of a combined commercial policy on the basis of a solid coherent strategy.

## NEW AGREEMENTS

In order to make up for capacities that the country lacks, although being of fundamental importance for guaranteeing and updating service quality, **Telefónica** has concluded a series of agreements in 1985 of transcendental importance for the future of the sector.

The outline of the negotiations has essentially been as follows:

- a) Fluid technology transfer without limitations but with guarantees of permanent updating. For this it has been necessary to negotiate R&D activities in Spain, implied in the global strategy of the R&D partner.
- b) An unrenounceable presence in international markets, with the double aim of achieving the critical mass necessary for business success (taking the small domestic market into account) and for an international comparison of competitiveness.
- c) A prospect of specialization towards production centre arrangements which, on generating mutual interdependence, provides a better guarantee of reciprocal commitments and technical and economic project viability.



## ATT MICROELECTRONICA ESPAÑA, S. A.

Deregulation of **ATT** in 1982 made this company turn to foreign markets, commencing a joint venture policy with international partners. In this context, **Telefónica** made the initial contacts in October 1983. From the beginning, the project with **Telefónica** was approached as a launching platform for **ATT's** new international strategy, essentially in relation to Spain and Europe. This allowed 80 or 90% of overall output from the future production facility to be scheduled for export, implying the possibility of achieving the economies of scale necessary to overcome the critical break-even point of the project.

The basic Agreement reached in July 1984 was defined in detail throughout 1985, signing the final Agreement on December 17, after fulfilling all official requirements for foreign investments in the country, aids scheduled for the new facility, etc.

Construction work has already started on the factory (located in Tres Cantos, in Madrid's Urgent Reindustrialization Zone) and production is planned to start in 1988.

The Company will have a share capital of 65 million dollars, 20% **Telefónica** and 80% **ATT**, and will specialise in manufacturing integrated circuits employing the most up-to-date technology available. Apart from producing one of the elements whose strategic value is increasingly more important, such as chips, and with high market growth forecasts, the most important aspect of this project is the local design capacity. It is an investment in training personnel to assimilate new technologies in our society and industry.

## FUJITSU ESPAÑA-SECOINSA

Secoinsa, with a majority INI and minority **Telefónica** and **Fujitsu** shareholding, had become the country's leading information technology company. The project, launched in 1974, basically rested on **TESYS** (which the firm helped develop). However, penetration in the information technology market was insufficient and, at the end of 1983, the accumulated losses made it necessary to strengthen the technology base.

**Secoinsa** owned a high quality factory in Málaga, had a wide based commercial structure and a certain market presence.

These factors were behind the negotiations with **Fujitsu**; on the one hand, **Telefónica** purchased the INI shareholding in **Secoinsa** and started to negotiate an increased commitment by **Fujitsu** in the Spanish project. **Fujitsu** is one of the world's leading manufacturers with an extensive range of large computers and has leading technology in semi-conductors and telecommunications, guaranteeing its presence in the professional electronics sector.

The negotiation has focussed on the following points: a) incorporation of the wide **Fujitsu** main-frame computer range into the new company; b) real technology transfer, both in systems engineering and manufacture, know-how and staff training; c) exports to enable the critical mass of the company to be overcome, opening up new markets; d) overall response to existing demand in the information technology, automated office and telematics sectors. The new factory will be the beachhead of **Fujitsu** products in Europe and Latin America.

The Company, formed with the name of **Fujitsu España**, is the result of the merger between **Fujitsu España** and **Secoinsa**. **Telefónica** will control 40% of the share capital of the new **Fujitsu España**, while **Fujitsu** will have a 60% interest. The share capital in 1986 is 6,000 million pesetas.



## COMPANÍA DE FIBRA OPTICA TELCOR, S. A.

Optical fibres undoubtedly already comprise the new future transmission medium, given their power, transmission quality and price. They offer a greater communications capacity at much lower cost than coaxial systems. This has led to a major increase in the manufacture of fibre and optical fibre cables, making spectacular progress in world markets: from 400 million dollars in 1982 to 4,500 million dollars forecast for 1990.

**Telefónica** logically plans to introduce this new material in its network. The first optical fibre cables were installed in 1985 and installation is scheduled in 1986 for the large local networks (Madrid, Barcelona), continuing to expand this type of installation up to subscriber networks in 1990.

As a result, a survey was carried out in 1984 for potential technological partners for joint optical fibre manufacture in Spain, with these efforts resulting in a memorandum of understanding with **Corning Glass** in January 1985.

A basic agreement was reached in December 1985, covering the following points:

- Transfer of leading OVD technology with a guarantee of creating and permanently updating the necessary R&D capacity in Spain.
- Repurchase and export commitments of around 35% of the total installed capacity.
- A **Corning Glass** shareholding of 65% and a **Telefónica** interest of 35%.
- Manufacturing capacity of around 100,000 kilometres per year of optical fibre.
- Investment of around 25 million dollars, employing 100 to 150 persons and a two-year implementation period.

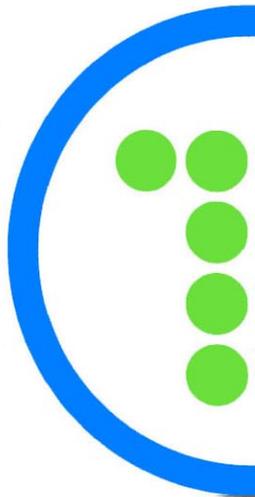
## EUROPEAN SILICON STRUCTURES (ES2)

**ES2** is a completely European project involving major EEC industrial partners, the object of which is the design and manufacture of custom integrated circuits with exceptionally short design and prototype production times in short production runs.

This serves to orientate the sector within the semi-conductor market that will enjoy strongest growth in the coming years: custom circuits.

**Telefónica**, together with a Spanish banking group, has a 3 million dollars interest, approximately equivalent to 5% of share capital. It will act as a broker for a group of 20 industrial companies, selected from the most suitable firms for this type of requirement. The main consequence is to facilitate access for small innovative companies to high technology custom circuits and the incorporation of a certain design capacity, all with a minimum response time at competitive prices.

This will basically facilitate greater price competitiveness in the industrial sector and an alignment with European trends relating to the incorporation of new technological designs.



## RESEARCH AND DEVELOPMENT CENTRE

A collaboration project was signed in December 1985 for building this Centre with **Pacific Telesis** (one of the companies formed on the breaking up of **AT & T**), an agreement that not only included the construction of the building, but also the installations, equipment and commissioning services.

The new building, involving a 6,400 million peseta investment, will cover 20,600 m<sup>2</sup>. This new infrastructure will allow the present **R&D** capacity to be doubled and, above all, will strengthen it.

The new Centre has the following basic objectives:

- a) Firstly, to achieve domestic products with in-house technology.
- b) To develop exploratory systems or equipment, i.e. to analyse the feasibility of new concepts or to define future trends.
- c) Applied research in collaboration with other centres to create and/or assimilate new technologies.

This Centre, in particular, will offer the Telecommunications sector world standard facilities and organization, with the aim of providing orientation in the field of new technologies.

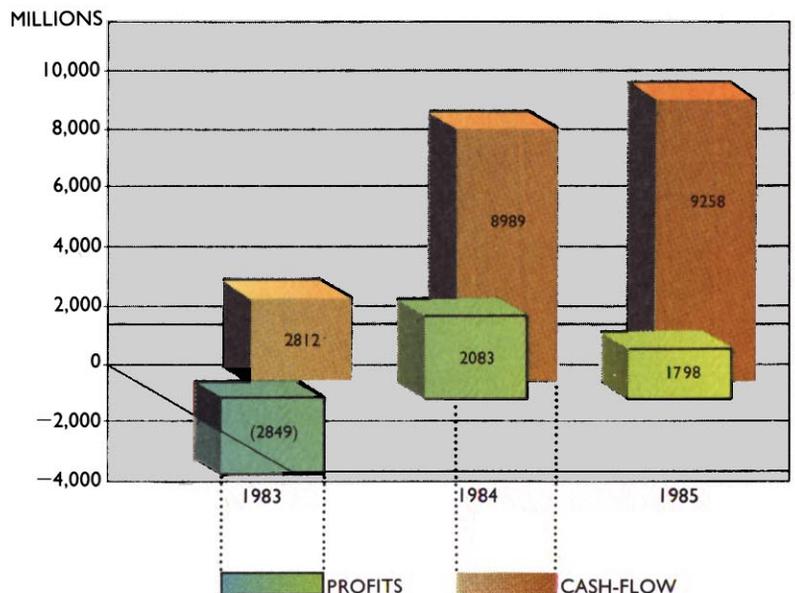
## DIGITAL MAPPING COMPANY, MAPTEL, S. A.

A memorandum of understanding was reached with the Norwegian Company **SysScan** in December. The aim is to create a digital mapping company providing general engineering and consultancy on graphics systems. This is a relatively unexplored area in our country, so that the Company's growth prospects and potential for a major market share are promising.

On the other hand, the mapping of the **Telefónica** network will allow for a major improvement in network management. The project is also aimed at other important markets: electrical, gas and water utilities, municipalities, land registry, etc.

The technological partner **SysScan** will have a minority interest (around 30%), with the rest corresponding to **Entel** (software) and qualified users.

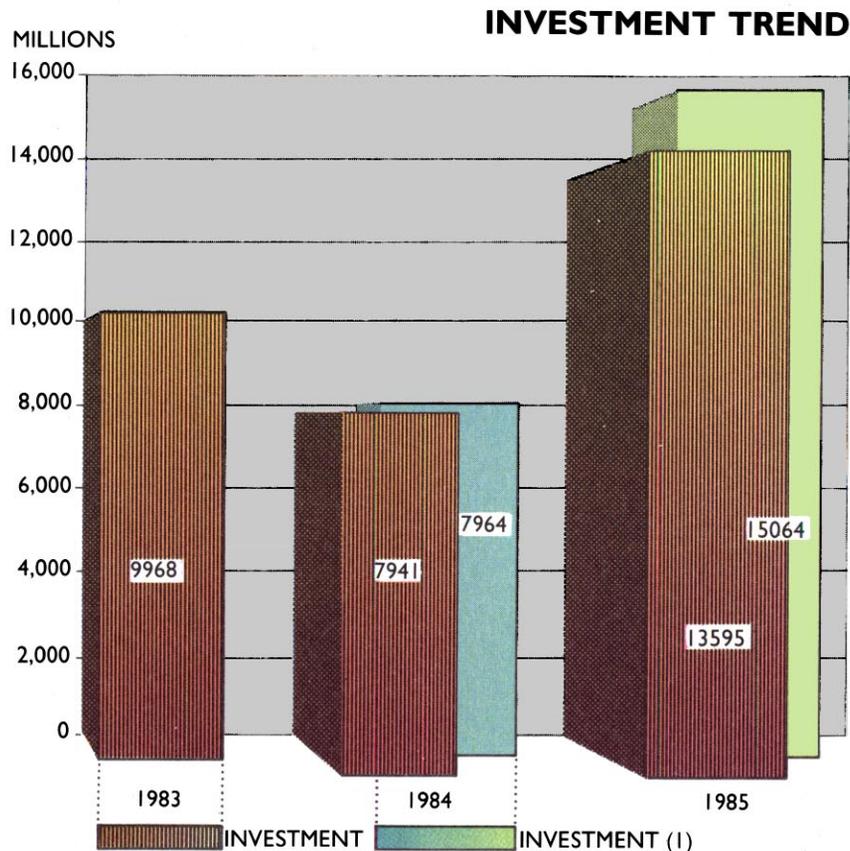
### PROFIT TREND



# TELEFONICA GROUP PROMOTION ACTIVITIES ABROAD

**T**elefónica's projection into international markets has been instrumented by forming **Telefónica Internacional de España, S. A.**, in 1985, to consolidate the Spanish telecommunications present world-wide, on three fronts:

- a) Consultancy to international Administrations employing experience acquired by us in the specific field of telecommunications.
- b) Promotion of **Telefónica Group** products. In 1985, **Telefónica** signed an important collaboration agreement with the Academy of Science of the Ministry of Post and Telecommunications in the Popular Republic of China, to supply Spanish-made products and technology, ranging from the complete installation of a telephone factory to the supply of rural multi-access networks and digital electronic exchanges.



(I) INCLUDING INVESTMENT IN COMPANIES FORMED

# Telefónica Group

Furthermore, negotiations are in progress to supply engineering services to Panama, Argentina and Ecuador.

**TESYS** equipment has been sold on a turnkey basis for packet switching data networks in Canada, U.S.A., U.K., Colombia and Tunisia and proposals have been submitted in a further ten countries that are under negotiation.

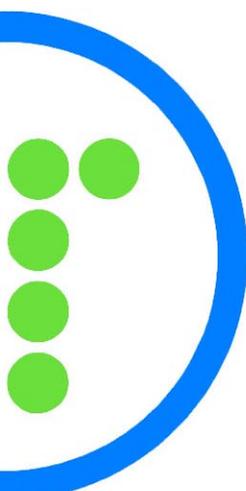
Firm contacts have also been made to supply telephone systems and equipment to a total of twelve countries, including the U.S.S.R., China, Kuwait and Portugal.

c) Creation of companies abroad.

The creation of **Telefónica Hispanoamericana, S. A.**, in Puerto Rico, in October—in which **Telefónica** has a 30% interest, **Compañía de Teléfonos de Puerto Rico** a 50% share holding and with the remainder distributed between three Spanish banks—marks the start of an activity that should become normal practice in the future. This factory, that presently repairs telephones, will be manufacturing with Spanish technology tomorrow.

Negotiations are now in progress with several countries on four continents to form other companies and export Spanish technology.

Culminating several contracts for operation and development and for the industrialization of a data-over-voice communications system signed by **Telefónica** with the American Company, **Barry Young**, a small shareholding was taken in that firm, equivalent to 4% of the shares issued. This will not only make it possible to manufacture the products that the system requires in Spain, but also to participate in international marketing of this system.



	AMPER	ATT Micro- electrónica	CCSA	ELASA	ENTEL
Communication exchanges	Telephony				
	data				
Switchboards and multilines	☎				
Concentrators	Telephony				
	Data				
Transmission equipment					
Modems	☎				
Subscriber equipment	Telephones	☎		☎	
	Telematic terminals	☎			
	Piscifoneas subscriber equipment	☎			
Cables			☎		
Components	☎	☎			
Local area networks					
Operation aid systems	☎			☎	
Computer equipment	Computers				
	Peripherals	☎			
Office automation equipment					
Data processing and telematic applications					☎
Mobile telephony					
Rural telephony					
Navigational aid systems					
Electronic security					
Power supply systems					
Installations and civil work			☎		
Systems engineering					☎

■ SUBSIDIARY COMPANIES  
■ ASSOCIATED COMPANIES



## INDUSTRIAL GROUP HIGHLIGHTS

**T**elefónica has a major interest in a total of 29 companies, without including the new high technology projects that have recently been signed. In 21 of these companies **Telefónica** has an interest exceeding 20% of capital, whereas it has an indirect interest in the other eight.

Given the importance of these firms and the breadth of activity diversification, ranging from circuit design and manufacture (printed, hybrid and integrated circuits), telematics and telephone terminals, packet switching and rural telephone systems to the manufacture of radio and transmission equipment, telephone exchanges, etc., the **Telefónica Group** comprises a major industrial conglomerate placing it among the leaders of our country's economic structure and undoubtedly occupying first place in the telecommunications sector.

Suffice it to say that total Group sales in 1985 amounted to 146,115 million pesetas; that, of the Group of Companies, five (**Standard, Sintel, Secoinsa, Intelsa** and **Telettra**) each had a turnover exceeding 10,000 million pesetas and, all of these plus **Amper**, figure amongst the 500 largest Spanish companies.

From an economic point of view, efforts made in recent years to improve the Group's development potential have been directed in the first place to restructure some companies (e.g. **H.R.M.** and **Standard**) and, in second place, to planning products and markets. The continuation of this policy in 1985 has been reflected in the main economic highlights, which demonstrate the three fundamental aspects that define Group evolution: growth, profit consolidation and an increasing investment effort.

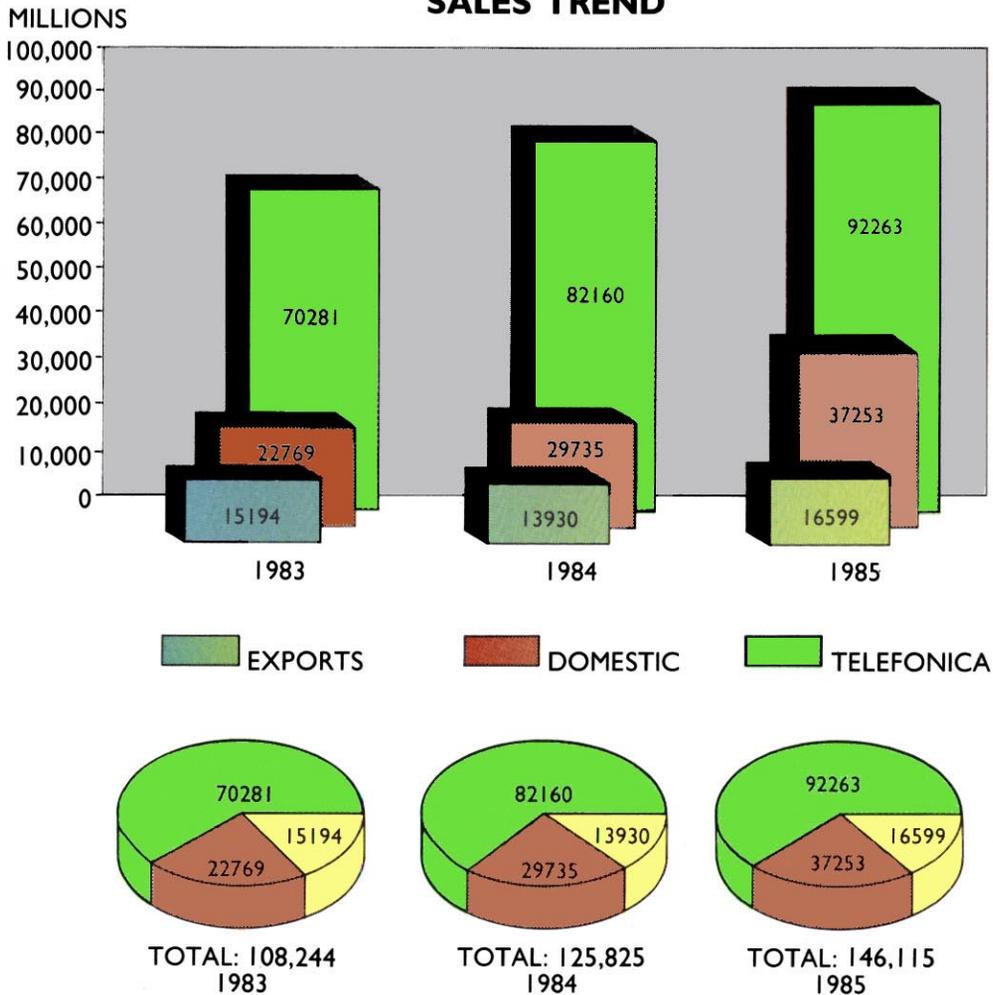
## Growth

Average annual sales growth was 16% over the last three years. But although this figure is significant, there are other important aspects that should be emphasized. Group Companies generally supply products and services to **Telefónica** but, thanks to becoming increasingly dynamic, they are increasing their specific weight in other domestic and international markets. Exports are growing at a rate of 19% and sales to the domestic market (other than **Telefónica**) are increasing by 24%.

## COMMERCIAL SERVICES, FINANCE AND OTHER COMPANIES

	Advertising	Marketing of Equipment and Systems	Publication of Telephone Directories	Civil Protection	Financial	Real Estate Activities
CETESA	●●●●		●●●●			
COSESA		●●●●				
GRAFIBUR			●●●●			
TELEFONICA INTERNACIONAL		●●●●				
TELFISA					●●●●	
TELYCO		●●●●				
TPSA				●●●●		
URBANA IBERICA						●●●●

## SALES TREND



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### Continued Profits

The profits obtained by the Companies overall, without taking the new Companies formed after 1984 into account, amount to 1,798 million pesetas.

Although this profit figure is less than in 1984, it should be taken into account that the policy has been to transfer a total of 1,301 million pesetas to technological innovation provisions.

When this fact is taken into consideration, the real cash-flow of the Group overall was 9,258 million pesetas, 3% higher than in 1984 and triple that obtained in 1983. In this sense, the profits undoubtedly can be considered to have been consolidated in 1985.

### Increased Investment Effort

The investment effort in 1985 has been much greater than in previous years: 90% more than in 1984 and 50% higher than in 1983.

This effort is not only due to the formation of new companies over the last two years, to which 1,469 million pesetas have been destined, but mainly to the other companies already operating as a result of the technological consolidation policy put into effect. In this major technological updating process, the following main industrial companies stand out: **Standard** (7,858 million), **Intelsa** (931 million), **Secoinsa** (909 million), **Amper** (720 million) and **Telettra** (643 million).

# TELEFONICA GROUP COMPANIES

## DIRECT SHAREHOLDINGS

COMPANY	SHARE CAPITAL (MILL. PTAS.)	% TELEFONICA	1985 PROFITS (MILL. PTAS.)	EMPLOYEES AT 31-12-1985
AMPER, S. A.	2,400	84.375	391	987
CABLES DE COMUNICACIONES, S. A.	782	49	(109)	395
CETESA	434	100 (1)	61	879
COSESA	700	100 (2)	(442)	385
ELASA	300	100	87	494
ENTEL, S. A.	350	100	157	718
GRAFIBUR, S. A.	325	100	(6)	104
H. R. M.	500	100	31	315
INDELEC	300	30	(86)	46
INTELSA	2,600	49	729 (4)	2,225
SECOINSA	3,125	92.857 (5)	307	1,133
SESA	17,604	20.99	138	15,127
SINTEL, S. A.	1,100	100	457	3,121
TELEFONICA INTERNACIONAL DE ESPAÑA, S. A.	200	100	1	3
TELEFONICA SISTEMAS, S. A.	100	100	(5)	22
TELETTRA ESPAÑOLA, S. A.	2,800	51	30	1,764
TEMASA (3)	600	100	—	2
TEPESA	100	63 (6)	(18)	31
T. H. M.	200	51.5 (6)	(68)	27
T. Y. D.	225	100	(78)	120
URBANA IBERICA, S. A. (4)	330	100	(33)	1

(1) A 2.67% shareholding through COSESA.

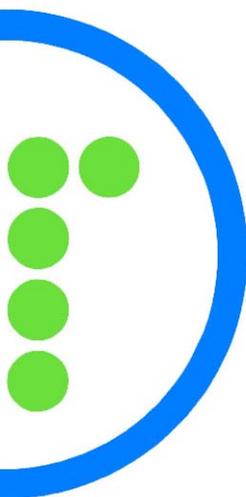
(2) A 0.86% shareholding through CETESA.

(3) Will not commence operations until the middle of 1987

(4) The profits shown do not include the effect of deferred corporation tax

(5) Includes direct and indirect interest (TELFISA)

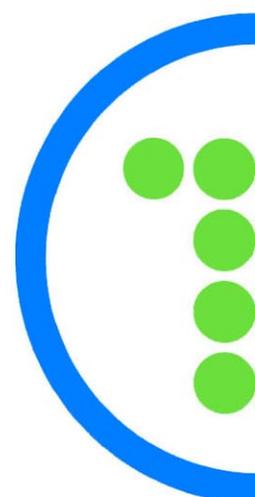
(6) Of paid-in share capital



## INDIRECT SHAREHOLDINGS

COMPANY	SHARE CAPITAL	% TELEFONICA (Indirect interest)
<b>CETESA</b> TELYCO	50 mill. ptas.	100
<b>COSESA</b> SAPEC	40 mill. ptas.	33
<b>ENTEL, S. A.</b>		
IBERMATICA, S. A.	210 mill. ptas.	35
SADIEL, S. A.	56 mill. ptas.	9.8
<b>SINTEL, S. A.</b> TECNITEL CORPORATION (Miami)	US \$ 10,000	100
<b>SECOINSA</b> SADIEL, S. A.	56 mill. ptas.	9.8
<b>T. I. TELEFONICA INTERNACIONAL DE ESPAÑA, S. A.</b> TELEFONICA INTERNATIONAL	1,750,000 D.M.	100
(1) COMPANIA FINANCIERA DE LA TELEFONICA ESPAÑOLA, B. V.	25,000 florins	100
(1) TELEFONICA HISPANO-AMERICANA	US \$ 600,000	30

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(1) A direct shareholding of TELEFONICA INTERNATIONAL

## COMPANIES IN THE PROCESS OF FORMATION

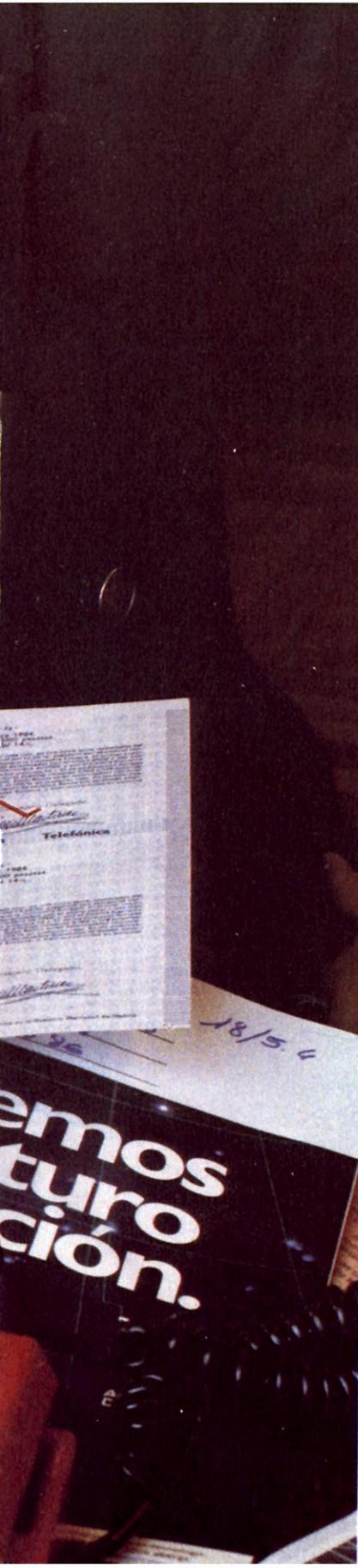
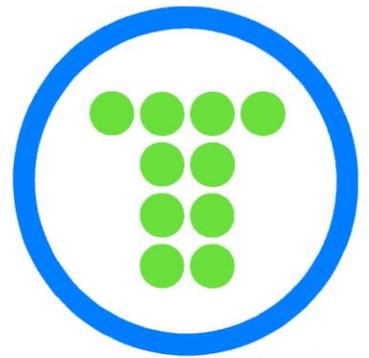
COMPANY	SHARE CAPITAL	% TELEFONICA
ATT MICROELECTRONICA ESPAÑA	US \$ 65 mill. (1)	20
TELCOR, S. A.	US \$ 6 mill. (1)	35
DIGITAL MAPPING, MAPTEL, S. A.	300 mill. ptas.	70

(1) Forecast share capital on completing the implementation period



# ECONOMY AND FINANCE

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*Favourable investment opinion on **Telefónica** shares in 1985 was best demonstrated during the capital increases carried out in March and December for a nominal amount of 80,104 million pesetas.*

# I. ECONOMIC ENVIRONMENT

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**D**espite an unfavourable world economic environment (lower growth rate for world trade) the Spanish economy has certainly had satisfactory results in 1985. Growth rates similar to and more balanced than those obtained in 1984 have been achieved, being comparable to

those obtained by the European economies. Simultaneously, basic economic data have continued to improve, particularly the change to the trend of increasing unemployment initiated in 1975.

The following figures demonstrate the results achieved:

- The **real growth rate** in G.D.P. terms was 2.1%, with the 2.5% growth in internal demand being most significant after (after falling by 1.1% in 1984).

This positive behaviour of internal demand has been sustained by the recovery in private consumption, fundamentally resting on the relative improvement in employment trends and the falling inflation rate. Investment, in turn, has staged a major recovery, due to the increase in business profits and from the fall in interest rates and an improving general economic climate.

- With regard to **finance and income generated**, the transfer of resources to profits and national savings has continued, although less intensely than in previous years. Gross profits have grown by 11.8% in 1985, compared to a growth rate for salaries and gross national income of 9% and 10.8%, respectively. The ratio of gross profits from operations in gross disposable income has risen from 43.5% in 1980 to 49.7% in 1985.

National savings have grown by 15% in 1985, continuing the trend of previous years. Their share in gross disposable national income reached 21.2% this year, when it was 18.8% in 1980.

This increase in national savings has not only allowed for a real investment growth rate of 5.5%, in open contrast to the previous year when investment fell, but has also allowed the position of net loans abroad to be maintained, improving the net position of the Spanish economy abroad compared to the rest of the world for the second year running.

- The **balance of payments on current account** has recorded a surplus of 2,847 million dollars, for the second year running, allowing a start to be made to early foreign debt repayment, expanding on the improvements that commenced in 1984 to the liquidity and solvency indicators of the Spanish economy.
- **Inflation**, measured with the annual average C.P.I., was 8.7% as opposed to 11.3% in 1984, which meant a price differential reduction with the E.E.C. of 1.6 percentage points and 2 points with respect to the OECD countries overall.
- With regard to **employment**, the fall in the working population has been detained for the first time since 1975, increasing by 53,000 persons, with a slow-down in the acceleration in the increase of the unemployment rate of previous years.
- In contrast to the above aspects, **budget deficit** trends have not been positive (at 6.2% of G.D.P.), although it should be considered that most factors indicated a lower negative impact in the future.

Overall, the results obtained by the Spanish economy in 1985, together with the encouraging international prospects, enable it to make maximum use of the benefits resulting from favourable international trends.

In this context, **Telefónica** has maintained and improved the activity levels of previous years. Good demand behaviour should be emphasized, on maintaining telephone line applications near the 1983 record and having increased telematic circuit applications by 43.7%, together with capacity utilisation trend of plant in service, recording an average consumption per line of 3.3% as opposed to 1.6% in 1984, with this level being the highest for the last six years.

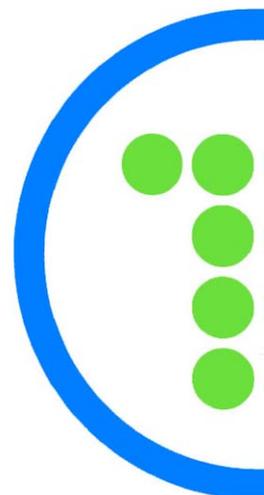
This behaviour of productive activity has enabled real growth of 7% to be achieved for the production of goods and services, maintaining growth rate differentials with the national economy and the services sector, as in previous years, showing greater growth potential, meaning that its weighting in the national economy continues to increase.

The price component of the production of goods and services was 6.2%, as opposed to 9% of the total output of the domestic economy, contributing to the major reduction in inflation.

With regard to employment although the policy of previous years of holding fixed employment stable has continued, new flexible labour contracting instruments have been used, in order to reinforce modernization policies for management instruments, hiring 2,551 people on a temporary basis.

While real investment growth continued, gross savings increased by 19%, allowing financing requirements to fall by 16%, which has now occurred for the third year running.

In conclusion, **Telefónica** is presently in a very solid financial situation, which allows the Company an adequate capacity for expansion in order to cover the new investments that it will be required to make in the future.



### SIGNIFICANT Telefónica-SPANISH ECONOMY VARIABLES 1984-1985 (Thousands of Millions of Pesetas)

	Telefónica		Spain		Telefónica/Spain	
	1984	1985	1984	1985	1984	1985
Total gross value added	371.8	422.1	25,401.6	28,270.0	1.46	1.49
Gross value added: Service sector	371.8	422.1	13,375.0	14,939.9	2.78	2.83
Gross capital formation	173.6	190.5	5,144.5	5,833.9	3.37	3.27
Employment (thousands)	66.8	69.3(1)	10,359.0	10,411.5	0.64	0.67
Employment in <b>Telefónica</b> and Industrial Group (Thousands)	94.6	97.4(1)	10,359.0	10,411.5	0.91	0.94

(1) Including 2,551 temporary employees on one-year training contracts.  
Figures in terms of National Accounts.

## 2. FINANCIAL ACTIVITY

The general trend of the Spanish economy described in the previous section allowed a looser monetary policy to be put into practice, within the gently restrictive approach adopted since 1983. This ensured that money markets did not suffer serious tensions, in a general climate of continually falling interest rates.

In this context, **Telefónica** continued with its finance activities, having the basic objectives of widening and diversifying its fund-raising sources, reinforcing capital raising channels, reducing foreign borrowings and making overall debt management more flexible.

These activities, initiated in preceding years, allowed the growth in financial expenses to be strongly contained, as announced in last year's annual report, while financial balances generally improved, as discussed in the following section in greater detail.

**Telefónica** has been present in practically all Spanish capital markets.

Two aspects of the raising of long-term funds are worthy of special mention:

- On the one hand, traditional bank financing instruments have been made flexible to allow complete adaptation to interest rate trends while extending average maturities.
- On the other hand, **Telefónica** has consolidated its presence in the bond markets achieving a major penetration that has allowed assimilation, at no detriment whatsoever, of the loss of institutional markets that traditionally comprised a basic source of fund raising for the Company due to changes in financial system regulations. The significant reduction in interest rates of the issues launched are worthy of attention, falling from 14% to 11.75%.

With regard to short and medium term fi-

### Telefónica-ISSUES OF FIXED INTEREST SECURITIES (Millions of pesetas)

Years	Total Issued	(1)		(2)		Net Placings	
		Total Placed	Redemptions	Saving Banks	Others Markets	Total (1)-(2)	
1980	28,000	25,600	4,000	20,900	700	21,600	
1981	31,000	20,400	2,503	15,095	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	
1985	40,000	59,919	34,662	(34,662)	59,919	25,257	

nance, several instruments available in the market continued to be used, enabling coordinated access to different money and capital markets, to ensure maximum cash management efficiency.

The appearance of the "Ley de Régimen Fiscal de Determinados Activos Financieros" (Law on

Taxation of Certain Securities) required the adaptation of **Telefónica** Promissory Note issues to the new legal framework, which, together with the abundant liquidity existing in the second half of the year, explains the reduction in the issue volumes of this instrument.

#### Telefónica -COMPANY PROMISSORY NOTES (Millions of pesetas)

	1983	1984	1985
Direct placing	17,843.5	26,136.5	11,660
Stock Exchange placing	4,743	7,999.5	921.5
<b>TOTAL PLACINGS IN THE YEAR</b>	<b>22,586.5</b>	<b>34,136.0</b>	<b>12,581.5</b>
<b>BALANCE OUTSTANDING AT DEC. 31</b>	<b>22,586.5</b>	<b>34,041.5</b>	<b>13,493</b>
<b>DISCOUNT RATES APPLIED (%)</b>			
Direct Placing	14.2-13.4	14.0-12.2	11.35
Stock Exchange Placing	14.0-13.2	14.0-11.0	10.8-10.0

With regard to **foreign borrowings**, as mentioned last year, **Telefónica's** policy has basically consisted in reducing this type of debt. An early repayment programme was therefore established for financial operations in foreign currencies, that was partially executed during the later half of 1985. Early repayments for an equivalent amount of 29,397 million pesetas were made, without any operations involving new borrowing in foreign currencies.

As a result, the weight of foreign borrowings in the Company's total liabilities has fallen from 14% in 1984 to 11% in 1985.

Simultaneously, part of the existing borrowings were replaced by new debt at lower interest rates and with longer maturities.

The intensification of these activities in 1986 will allow the weighting and conditions of this type of debt to be better adapted to the financial characteristics of **Telefónica**.

Lastly, as was normal practice, the structure of borrowings in foreign currencies continued to be adapted (by use of the multicurrency options or instruments such as swaps) to interest and exchange rate trends.

Although not reducing the importance of the previous aspects, the major protagonist of **Telefónica's** financial activity in 1985 was the **share market**. This was due to several reasons:

Firstly, due to positive of trend **Telefónica** share prices on the Spanish Stock Exchanges within a generally positive context and a recovery situation, with a strong increase in foreign investment.



One of the most relevant aspects of 1985 was the official listing of **Telefónica** shares on Stock Exchanges in London, Paris, Frankfurt and Tokyo. The photo shows the display panel at the presentation in the London Stock Exchange.

On the Madrid Stock Exchange, the average increase in share price was 35.78%, turnover has exceeded historic levels on increasing by 72.2% and the market capitalization of the listed share capital has grown by 31.2%; all of this has allowed the volume of shares issued to increase by 36.4%. This favourable trend has strongly attracted foreign investors. A highly significant presence of these foreign investors was consolidated on our Stock Exchanges in 1985, on having multiplied the volume of operations by foreign investors 7.5 times over the last two years, with their net purchases growing by 296% throughout 1985.

With regard to the developments of **Telefónica**, the following table shows the relevant major indicators. The figures speak for themselves and require no further comment.

#### STOCK EXCHANGE PARAMETERS OF Telefónica 1984/1985

	1984	1985
— Average share price increase	32.8 %	44.3%
— Effective overall return	50.7 %	51.3%
— Dealing frequency	100 %	100 %
— Increase in market capitalization	47.6 %	54.2%
— Percent of total Madrid Stock Exchange Capitalization	11.67%	15.2%
— Effective increase in turnover	66.4 %	410 %
— % <b>Telefónica</b> to total Madrid Stock Exchange turnover	7 %	20 %
— Liquidity	6.5 %	21.4%
— Price/Cash-Flow	1.8	2.5
— P.E.R.	8.4	11.5

The favourable opinion that investors have formed of **Telefónica** shares in 1985, demonstrated by the above figures, was best shown in the reaction to the capital increases carried out, the first of which was in March and the second in December 1985/January 1986, for a total nominal amount of 80,104 million pesetas and an effective value of 68,089 million pesetas. The price trend of share subscription rights and the turnover recorded throughout the subscription periods ratified the very favourable position of shareholders and investors with respect to the Company.

Another important aspect, although it finally materialised in 1986, was the offer in combination with the last capital increase for the purchase of shares in our subsidiary, AMPER, thus putting a new innovative industrial holding philosophy into practice, directly translating benefits generated by this activity to our shareholders.

Lastly, the most relevant factor of 1985 was the official listing of **Telefónica** shares on the London, Paris, Frankfurt and Tokyo Stock Exchanges, combined with a share placing in each of these markets totalling 47.5 million shares, equivalent at that time to 6.6% of the company's share capital, with a total market value of around 30,000 million pesetas. The placing was carried out between nearly 10,000 investors (more than 70% small investors and individuals) which gives an idea of the high degree of diversification achieved.

Apart from the novelty of this complex operation and its great success, the favourable trend that has been recorded on these Stock Exchanges since then should be emphasized. Consolidation of the presence of our shares on these markets has been achieved in all cases and wide-based liquid secondary markets have developed, with high dealing frequency and turnover levels.

From a general point a view, the positive appraisal of this process is reinforced. Therefore, looking to the future, the fundamental objective of



these operations was to diversify and expand the capital-raising bases and to widen and deepen the secondary markets in our shares, which has the benefit of improving market stability which is to the shareholders' gain, while properly channeling foreign demand for our shares, which has been occurring within the general context of a greater presence of foreign investors on the Spanish Stock Exchanges.

Of equal benefit to the shareholder was the international comparison involved with the listing on these foreign Stock Exchanges, not only in terms of price but also with regard to information at the strictest levels of requirements and transparency.

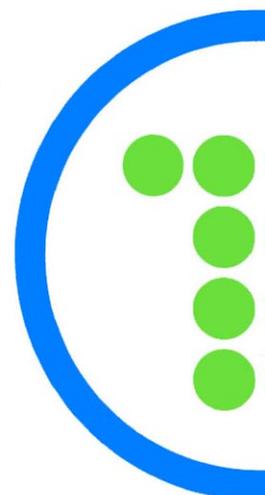
For the Company, there is the additional effect of improving and consolidating its rating as a prime risk at an international level.

### Telefónica AND WORLD BOURSES-1985

	Share Price/ Book Value	Share Price/ Cash-Flow	PER	Dividend Yield	Annual Index(*) (DEC.31-84=100)	Turnover/Stock Exchange Capit.
FRANKFURT	2.8	6.0	16.7	2.7	176.14	42.2
LONDON	1.5	6.8	12.1	4.4	118.81	21.4
NEW YORK	1.7	6.9	13.7	3.8	127.66	49.6
PARIS	1.6	4.3	15.3	3.4	146.53	22.7
TOKYO	2.7	9.0	25.9	1.0	114.72	35.3
ZURICH	1.7	7.4	14.4	1.9	152.38	—
MADRID	0.5	2.9	10.8	7.9	135.78	16.38
INTERNATIONAL INDICES FOR TELECOMMUNICATIONS SECTOR	1.5	5.0	12.5	5.2	137.1	—
<b>Telefónica-MADRID</b>	<b>0.5</b>	<b>2.57</b>	<b>11.5</b>	<b>8.6</b>	<b>144.28</b>	<b>21.42</b>

(\*) Local Indices

Source: Capital International Perspective



# 3. MANAGEMENT ANALYSIS

As a complement to the audited financial statements included herein and the notes attached thereto, management indicators and detailed data are given in this section for the last five years.

Without pretending to comment on them exhaustively, the main conclusions obtained from global analysis should be underlined, that ratify the favourable trend and improvement recorded by **Telefónica** in 1985.

From the economic management point of view:

- The improvement in the **Gross Operating Margin** recorded in previous years has been consolidated.
- Particularly worthy of attention is the very low growth rate in **financial expenses**, that breaks the trend of earlier years, as stated in 1984 (the growth rate was 3.1% in 1985 as opposed to 19.4% in the period 1981/1984), reducing its net weighting in revenue from services by more than 4 points.
- This has meant that costs continue to be strictly identified in the results and **provisions** are made at a high level employing criteria of maximum prudence, for similar amounts to those of last year.
- Furthermore, **depreciations** continue to be made as necessary to maintain productive assets at their proper net values, growing by 18.8% over 1984. The depreciation rate has increased to 5.3%, thus reducing the average period over which assets are depreciated. Fixed assets were 40.4% depreciated at December 31, 1985.
- As a result of the above, **self-financing** has continued to grow significantly, amounting to 66.6% of investment made. The accumulated annual growth rate for this variable from 1982 was therefore 19%.
- **Cash-flow** grew by 22.5% over last year, being translated into an improvement in operating profitability.

Financial management activities have led to a generally positive trend in basic financial data: **financial autonomy** improved very significantly. **Borrowings** were reduced both short and long term, also significantly, reaching the lowest levels of the last five years. **Fixed asset coverage** and the **current ratio** also improved, stabilising at adequate levels.

## RESULTS - PROFIT MARGINS 1981/1985 (In Millions of Pesetas)

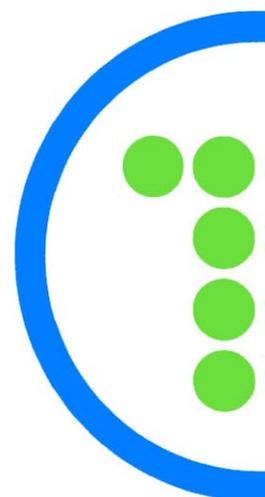
+ Revenue from services
— Levy and taxes
= Net revenue from services
+ Internal expenditure capitalised in fixed assets
— Salaries and related costs
— Other costs and expenses
= Gross operating margin
+ Connection fees
+ Nominal investment contributions and other
+ Surcharges
= Resources provided by operations
+ Other income
— Financial expenses
— Non-operating expenses
— Extraordinary items and others
— Exchange loss provisions
— Transfer to provisions
= Gross operating profit
— Depreciation of fixed assets
= Net operating profit



Lastly, two aspects should be emphasized that, as a consequence of the above, reflect the reinforcement of **Telefonica's** growth potential and expansion capacity on firm financial foundations:

- The **debt repayment capacity** improved by over 30%: whereas in the initial years of the five considered 5.5 years were necessary to repay the debt with costs, only 3.8 years were necessary in 1985.
- **Resources generated** presently cover 2.2 times financial expenses, whereas this was only 1.8 times at the start of the period; i.e. the degree of coverage has grown by 22%.

	1981	1982	1983	1984	1985	Yearly Growth Rate	GROWTH RATE %	
						1981/1985	1985/84	1984/83
	204,856	244,925	296,883	349,226	393,506	17.7	12.7	17.6
	12,269	14,845	17,959	21,117	23,710	17.9	12.3	17.6
	192,587	230,080	278,924	328,109	369,796	17.7	12.7	17.6
	32,956	39,296	43,959	47,634	51,863	12.0	8.9	8.4
	99,134	117,439	132,765	144,686	159,572	12.6	10.3	9.0
	20,340	27,004	33,637	38,346	43,491	20.9	13.4	14.0
	106,069	124,933	156,481	192,711	218,596	19.8	13.4	23.2
	11,914	11,925	11,785	12,118	13,922	4.0	14.9	2.8
	4,385	5,300	5,287	4,902	5,259	4.6	7.3	(7.3)
	1,852	1,805	1,953	1,842	2,274	5.3	23.5	(5.7)
	124,220	143,963	175,506	211,573	240,051	17.9	13.5	20.5
	6,714	7,578	8,676	13,143	14,257	20.7	8.5	51.5
	47,180	53,654	65,090	77,655	80,070	14.1	3.1	19.3
	202	351	275	381	1,019	49.9	167.5	38.5
	3,000	3,000	5,330	14,230	9,277	32.6	(34.8)	167.0
			3,569	3,802	10,690	n/a	181.1	6.5
	80,552	94,536	109,918	128,648	153,252	17.4	19.1	17.0
	56,674	67,989	82,382	96,028	114,103	19.0	18.8	16.6
	23,878	26,547	27,536	32,620	39,149	13.2	20.0	18.5



<b>INCOME</b> (In Millions of Pesetas)								
ITEM	1981	1982	1983	1984	1985	Yearly Growth rate 1981/1985	Growth rate %	
							1985/84	1984/83
Revenue from Services .....	204,855	244,925	296,883	349,226	393,506	17.7	12.7	17.6
Connection fees and others .....	16,299	17,225	17,072	17,020	19,181	4.2	12.7	(0.3)
Investment income .....	942	1,481	1,964	6,183	7,283	66.8	17.8	214.8
Other income .....	7,625	7,902	8,665	8,802	9,248	4.9	5.1	1.6
<b>INCOME</b> .....	<b>229,721</b>	<b>271,533</b>	<b>324,584</b>	<b>381,231</b>	<b>429,218</b>	<b>16.9</b>	<b>12.6</b>	<b>17.4</b>
<b>Breakdown of Revenue from Services</b>								
Subscriber service charges .....	55,059	65,337	74,916	111,086	126,834	23.2	14.2	48.3
National Telematic service .....	11,758	14,722	21,245	24,568	32,252	28.7	31.3	15.6
National Automatic Service .....	102,295	122,054	148,023	149,646	163,063	12.4	9.0	1.1
Trunk calls through operator .....	2,252	2,554	2,201	2,217	2,186	(0.7)	(1.4)	0.7
International service .....	28,040	32,620	40,299	51,149	57,505	19.7	12.4	26.9
Mobile and maritime Services .....	772	983	1,087	1,437	1,595	19.9	11.0	32.2
Directories and Year books .....	4,679	6,655	9,112	9,123	10,071	21.1	10.4	0.1

<b>EXPENSES</b> (In Millions of Pesetas)								
ITEM	1981	1982	1983	1984	1985	Yearly Growth Rate 1981/1985	Growth rate %	
							1985/84	1984/83
Operating expenses .....	86,116	104,592	121,809	134,779	150,719	15.0	11.8	10.6
Financial expenses .....	47,180	53,654	65,090	77,655	80,070	14.1	3.1	19.3
Depreciation and amortization .....	56,674	67,989	82,382	96,028	114,103	19.0	18.8	16.6
Levy and taxes .....	12,269	14,845	17,959	21,117	23,710	17.9	12.3	17.6
Transfer to exchange loss provision .....	3,000	3,000	5,330	14,230	9,277	32.6	(34.8)	167.0
Transfer to self-insurance provision and others .....	604	906	909	1,000	3,600	56.2	260.0	10.0
Transfer to bad debt provision .....	—	—	2,000	3,507	4,746	n/a	35.3	75.4
Transfer to provision for contingencies and others .....	—	—	1,569	295	3,844	n/a	n/a	(81.2)
<b>Total Costs and Expenses</b> .....	<b>205,843</b>	<b>244,986</b>	<b>297,048</b>	<b>348,611</b>	<b>390,069</b>	<b>17.3</b>	<b>11.9</b>	<b>17.4</b>
<b>Breakdown of Operating Expenses</b>								
Salaries and related costs .....	99,134	117,439	132,765	144,686	159,572	12.6	10.3	9.0
Outside work, Supplies and Services .....	19,090	25,443	30,540	35,375	41,240	21.2	16.6	15.8
Other operating charges .....	848	1,006	1,075	1,744	2,165	26.4	24.1	62.2
Provision for accrued expenses not accounted for .....	—	—	1,388	608	(395)	—	n/a	(56.2)
Investment expenses .....	(32,956)	(39,296)	(43,959)	(47,634)	(51,863)	12.0	8.9	8.4

## STATEMENT OF CHANGES IN FINANCIAL POSITION FOR 1981/1985

(Millions of Pesetas)  
(After Profit Distribution)

	1981	1982	1983	1984	1985
Depreciation and amortization .....	56,674	67,989	82,382	96,028	114,103
+ Net variations in reserves and provisions ....	2,682	6,584	4,542	5,556	11,151
= Net self-financing (1).....	59,356	74,573	86,924	101,584	125,254
Non-reimbursable contributions for irrevocable rights of use.....	193	(30)	13	477	(191)
+ Capital increase.....	13,351	—	33,644	22,387	32,084
+ Debentures and bonds issued .....	35,092	34,384	30,537	47,280	60,621 (a)
+ Other medium and long-term loans .....	57,170	51,252	74,569	93,085	89,573 (b)
= Increase in net capital employed (2).....	105,806	85,606	138,763	163,229	182,087
= Total source of funds (1+2).....	165,162	160,179	225,687	264,813	307,341
Debentures redeemed .....	2,503	15,201	19,699	25,364	34,662
+ Amortización of medium and long-term loans.....	18,684	21,913	31,819	53,278	112,827
= Applications of finance (3).....	21,187	37,114	51,518	78,642	147,489
Investment in fixed assets .....	131,753	146,379	159,861	175,417	187,881
+ Other investments.....	(3,069)	5,318	15,659	(14,835)	(6,117)
= Total Gross investments (4).....	128,684	151,697	175,520	160,582	181,764
Inventories for fixed assets (5).....	1,955	2,252	4,256	4,538	5,615
= Total Applications (3 + 4 + 5) .....	151,826	191,063	231,294	243,762	334,868
Variation .....	13,336	(30,884)	(5,607)	21,051	(27,527)
+ Variation in unused facilities .....	2,064	6,570	8,760	32,910	29,271
= Total variation .....	15,400	(24,314)	3,153	53,961	1,744

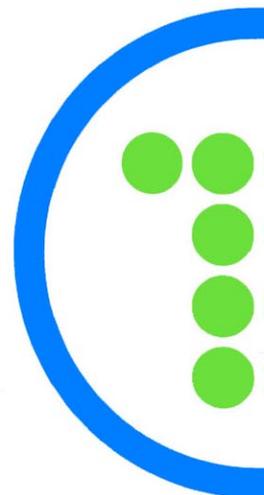
### NOTES

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

• Total variation .....	1,744
• Increase in inventories .....	5,615
• Increase in 1985 dividends.....	6,435
• Increased inventory provision .....	(2,031)
<b>TOTAL .....</b>	<b>11,763</b>

— These amounts (a and b) include time period adjustments for Promissory Notes and Zero Coupon bond expenses that figure in the audited statement of changes in financial position as self-financing, in accordance with the following breakdown:

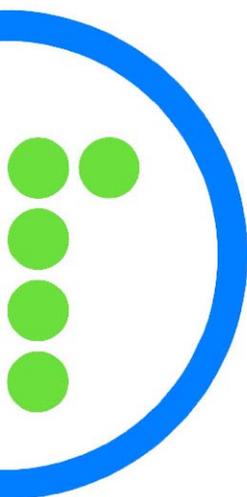
• Debentures and bonds.....	478
• Medium and Long Term Loans .....	4,123
<b>SUMA.....</b>	<b>4,601</b>



## BALANCE SHEETS 1981/1985

(After Profit Distribution)

ITEMS	1981	1982	1983	1984	1985
Paid-in share capital .....	240,312	240,312	288,374	320,416	360,468
Revaluation surplus .....	279,897	281,090	344,722	419,719	486,574
Other reserves and unappropriated profits	25,568	30,628	35,620	40,318	44,378
Provisions and others .....	6,594	47,664	50,307	52,090	56,384
<b>Shareholders' equity .....</b>	<b>552,371</b>	<b>599,694</b>	<b>719,023</b>	<b>832,543</b>	<b>947,804</b>
Debentures and bonds in pesetas .....	222,479	247,942	255,529	277,445	303,403
Debentures and bonds in foreign currency	4,092	11,598	19,356	19,743	22,299
Other medium and long-term debt .....	168,398	222,212	285,584	335,609	328,967
<b>Medium and long-term debt finance ..</b>	<b>394,969</b>	<b>481,752</b>	<b>560,469</b>	<b>632,797</b>	<b>654,669</b>
<b>Net capital employed .....</b>	<b>947,340</b>	<b>1,081,446</b>	<b>1,279,492</b>	<b>1,465,340</b>	<b>1,602,473</b>
Fixed assets .....	1,451,190	1,667,754	1,903,232	2,182,144	2,429,520
Accumulated depreciation .....	(553,823)	(659,630)	(754,311)	(868,250)	(982,606)
Fixed assets under construction .....	53,018	59,036	76,179	76,742	95,794
Advanced payments on plant .....	5,663	9,988	14,531	12,756	13,556
Inventories for fixed assets .....	15,093	17,494	22,251	26,441	29,991
<b>Net Fixed Asset .....</b>	<b>971,141</b>	<b>1,094,642</b>	<b>1,261,882</b>	<b>1,429,833</b>	<b>1,586,255</b>
Net intangible assets .....	878	2,256	3,797	4,803	5,042
Investments .....	20,687	22,054	37,677	33,895	32,987
Deferred charges .....	6,284	7,884	9,186	13,461	12,898
Unrealised exchange losses .....	20,855	54,378	75,972	58,164	66,132
<b>Total net assets .....</b>	<b>1,019,845</b>	<b>1,181,214</b>	<b>1,388,514</b>	<b>1,540,156</b>	<b>1,703,314</b>
Consumable inventories .....	1,799	2,051	2,523	2,993	3,650
Subscriber accounts payable .....	43,494	52,022	61,587	65,895	75,859
Other receivables .....	15,020	12,764	21,583	21,016	15,583
Cash and banks .....	5,565	2,592	12,388	34,297	7,981
Short-term liabilities .....	138,383	169,197	207,103	199,017	203,914
<b>Working capital .....</b>	<b>(72,505)</b>	<b>(99,768)</b>	<b>(109,022)</b>	<b>(74,816)</b>	<b>(100,841)</b>
<b>Total net assets .....</b>	<b>1,085,723</b>	<b>1,250,643</b>	<b>1,486,595</b>	<b>1,664,357</b>	<b>1,806,387</b>
Unused credit facilities .....	26,902	35,329	53,607	88,680	121,300



## FINANCIAL RATIOS

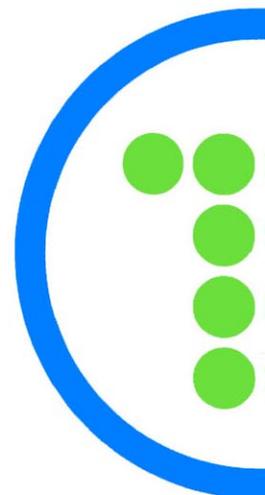
	1981	1982	1983	1984	1985
A — Gross Operating Margin Ratio .....	51.8	51.0	52.7	55.2	55.6
B — Self-Financing Capacity/Revenue from Services ..	41.1	40.2	40.8	42.5	44.4
C — Self-Financing Rate .....	45.1	50.9	54.4	57.9	66.6
D — Rate of Return from Operations					
1. On average shareholders' equity .....	15.6	17.3	18.6	19.3	19.6
2. On average net capital employed .....	9.5	9.8	10.3	10.8	11.4
3. On average fixed assets employed .....	12.5	13.4	14.0	15.0	16.0
E — Effective Rate of Return from Capital Employed	11.1	11.0	11.2	11.1	11.1
F — Financial Autonomy .....	79.6	76.2	77.3	82.4	92.3
G — Fixed asset coverage .....	54.2	50.8	51.8	54.1	55.6
H — Borrowing Ratio .....	41.3	43.3	42.9	40.8	37.2
1. Long-term .....	36.4	38.5	37.7	38.0	36.2
2. Short-term .....	4.9	4.8	5.2	2.8	1.0
I — Current Ratio .....	51.7	47.9	57.4	83.5	85.0
J — Debt repayment capacity .....	5.5	5.6	5.2	4.8	3.8
K — Resources generated/Financial expenses .....	1.8	1.8	1.9	1.9	2.2

### Definitions:

A — (%) $\frac{\text{Gross operating margin}}{\text{Revenue from services}}$	F — (%) $\frac{\text{Shareholders' equity}}{\text{Remunerated liabilities}}$
B — (%) $\frac{\text{Self-financing capacity}}{\text{Revenue from services}}$	G — (%) $\frac{\text{Shareholders' equity}}{\text{Net fixed assets}}$
C — (%) $\frac{\text{Annual self-financing}}{\text{Investment in fixed assets}}$	H — (%) $\frac{\text{M. and l.-term debts} + \text{short-term finance}}{\text{Total liabilities}}$
D.1 — (%) $\frac{\text{Net cash flow}}{\text{Average shareholders' equity}}$	H.1 — (%) $\frac{\text{Medium and long term debts}}{\text{Total Liabilities}}$
D.2 — (%) $\frac{\text{Net cash flow}}{\text{Average Net capital employed}}$	H.2 — (%) $\frac{\text{Short term finance} + \text{Company promissory notes}}{\text{Total Liabilities}}$
D.3 — (%) $\frac{\text{Funds generated by operations}}{\text{Average Net fixed assets}}$	I — (%) $\frac{\text{Current Assets}}{\text{Current liabilities}}$
E — (%) $\frac{\text{Net profit}}{\text{Average paid in share capital}}$	J (years) $\frac{\text{Remunerated external funds}}{\text{Resources generated}}$
	K (times) $\frac{\text{Resources generated}}{\text{Financial expenses}}$

### Self-financing capacity

Comprises net profit, depreciation and amortization (except deferred expenses), exchange loss and other provisions.



## VALUE ADDED IN THE LAST FIVE YEARS

(Millions of Pesetas)

	1981	1982	1983	1984	1985
Total income (1).....	+262,677	+310,829	+368,542	+428,865	+481,081
Outside work, supplies and services.....	19,090	25,443	30,540	35,375	41,240
Other operating charges.....	848	1,006	1,075	1,744	2,165
Total external costs and charges.....	-19,938	-26,449	-31,615	-37,119	-43,405
Value added.....	242,739	284,380	336,927	391,746	437,676
Salaries and related costs.....	99,134	117,439	132,765	144,686	159,572
Remuneration and interest.....	69,917	79,142	90,885	108,031	115,859
— Remuneration to shareholders (dividend).....	23,497	26,434	27,095	32,214	38,649
— Financial expenses (on loans).....	46,420	52,708	63,790	75,817	77,210
State levy and taxes.....	12,269	14,845	17,958	21,117	23,710
Upkeep of production facilities (depreciation charges, provisions, reserves, etc.).....	61,419	72,954	95,319	117,912	138,535

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

## ACCRUALS TO THE TREASURY, AUTONOMOUS GOVERNMENT TREASURY DEPARTMENTS AND SOCIAL SECURITY.

(Millions of Pesetas)

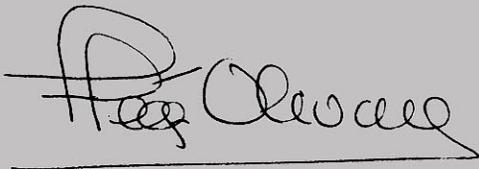
	1985	1984	Variation	
			Absolute	Relative
I. PAYMENTS TO THE TREASURY AND AUTONOMOUS GOVERNMENT TREASURY DEPARTMENTS.....	122,328	112,222	10,106	9
AS OBLIGOR.....	114,111	105,181	8,930	8.5
TAXPAYER				
— Levy.....	23,435	20,846	2,589	12.4
WITHHELD AS INTERMEDIARY				
— Tax on telephone use.....	64,233	58,533	5,700	9.7
— Income tax.....	18,036	16,472	1,564	9.5
— Capital tax.....	8,084	9,153	(1,069)	(11.7)
— Non-resident corporation tax.....	323	177	146	82.5
PAID BY OBLIGORS ACTING AS INTERMEDIARY FOR <b>Telefónica</b> .....	8,217	7,041	1,176	16.7
AS TAXPAYER				
— Turnover Tax.....	7,489	6,770	719	10.6
— Capital Tax.....	728	271	457	168.6
II. PAYMENTS TO SOCIAL SECURITY.....	19,307	17,159	2,148	12.5
— Net payments.....	19,307	17,159	2,148	12.5
TOTAL PAYMENTS.....	141,635	129,381	12,254	9.5

# 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 .....		1,806,387		1,679,245
MEMORANDUM ACCOUNTS (Note 20)				
Unused credit facilities .....		121,300		88,680
Other .....		55,004		64,406
		176,304		153,086

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

**(In millions of pesetas)**

	<b>1985</b>	<b>1984</b>
<b>INCOME</b> .....	<b>411,689</b>	<b>365,779</b>
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
<b>COSTS AND EXPENSES</b> .....	<b>357,090</b>	<b>320,340</b>
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)
<b>OPERATING PROFIT</b> .....	<b>54,599</b>	<b>45,439</b>
<b>OTHER INCOME</b> .....	<b>7,985</b>	<b>8,027</b>
Financial .....	4,419	4,955
Other .....	3,566	3,072
<b>PROFIT BEFORE STATE LEVY</b> .....	<b>62,584</b>	<b>53,466</b>
<b>STATE LEVY</b> .....	<b>( 23,435)</b>	<b>( 20,846)</b>
<b>NET PROFIT (Before distribution)</b> .....	<b>39,149</b>	<b>32,620</b>

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
<b>SOURCES</b>		
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
<b>Funds provided by operations .....</b>	<b>177,323</b>	<b>154,289</b>
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
<b>TOTAL SOURCES .....</b>	<b>359,599</b>	<b>330,059</b>
<b>APPLICATIONS</b>		
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
<b>TOTAL APPLICATIONS .....</b>	<b>377,107</b>	<b>289,329</b>
<b>VARIATIONS .....</b>	<b>( 17,508)</b>	<b>40,730</b>
Variation in unused credit facilities (**)	29,271	22,839
<b>NET VARIATIONS .....</b>	<b>11,763</b>	<b>63,569</b>
<b>COMPOSITION OF NET VARIATIONS:</b>		
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
<b>TOTAL .....</b>	<b>( 17,508)</b>	<b>40,730</b>

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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
<b>PROPOSED DISTRIBUTION</b>	
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
<b>Total .....</b>	<b>187,881</b>	<b>175,417</b>

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
<b>Total .....</b>	<b>1,212,744</b>	<b>618,351</b>	<b>594,393</b>

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
<b>Total .....</b>	<b>868,250</b>	<b>48,534</b>	<b>(45,261)</b>	<b>111,083</b>	<b>982,606</b>

- 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
<b>Total .....</b>	<b>25,869</b>	<b>22,238</b>

- 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
<b>Total affiliates .....</b>	<b>2,800</b>
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
<b>Total associates .....</b>	<b>.....</b>
<b>Total others .....</b>	<b>.....</b>
<b>Total Group .....</b>	<b>.....</b>

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.
	<b>10,890</b>	<b>14,087</b>		
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.
	<b>9,444</b>	<b>8,671</b>		
	<b>244</b>	<b>230</b>		
	<b>20,578</b>	<b>22,988</b>		

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: Debtentures .....	170,505	205,047
Debtentures 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-

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## 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 — OHER 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 1<sup>st</sup> 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
<b>Unused credit facilities:</b> (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>
<b>Total .....</b>	<u><b>176,304</b></u>	<u><b>153,086</b></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:

- The annual charge for the year 1985, being approximately 4.2% of the overall payroll cost, is sufficient to cover this objective, and
- 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>
<b>Net profit for the year as reported in the Spanish statutory accounts at December 31, 1985 .....</b>	<b>39,149</b>
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
<b>Profit for the year in accordance with IAS .....</b>	<b><u>45,358</u></b>

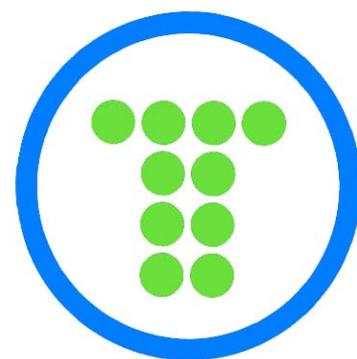
	<u>Millions of pesetas</u>
<b>Reserves as reported in the Spanish statutory accounts at December 31, 1985 .....</b>	<b>530,452</b>
Net profit for the year .....	39,149
	<u>569,601</u>
Dividends .....	(38,649)
	<u>530,952</u>
Adjustments for IAS purposes:	
Investments .....	(4,423)
Research and development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

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

 **Telefónica**



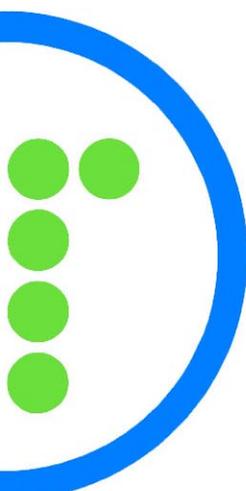
# HUMAN RESOURCES AND LABOUR RELATIONS



*Main Entrance  
of the Madrid-Colón  
Building*



# OBJECTIVES



The main human resource management objective in 1985 has been adaptation to the new technological, organizational and service environment in the Company. In this sense, on the basis of a more solid organization and information policy, priority was given to optimum human resource assignment as a function of Company objectives and increasing staff motivation and integration.

Progress was made in this context for planning the improvement, expansion and systematization of the information bases. The **1986-1990 Human Resource Plan** articulates a set of ambitious actions and a guideline framework for staff trends on the basis of strategic objectives for the five-year period, to face up to the challenges that the immediate future holds.

PRODUCTIVITY TREND	
YEAR	Revenue from services/employee (millions of Pesetas)
1981	3.38
1982	3.97
1983	4.73
1984	5.56
1985	6.27

Within the framework of the Social and Economic Agreement (AES), the **XIII Collective Wage Agreement** was signed on March 1, 1985, covering two years and constituting a major step in modernizing labour relations, technifying evaluation procedures and selecting and reducing rigidity in contracting mechanisms and the functional adjustment of labour groups.

The most outstanding aspects of this XIII Collective Wage Agreement are summarised below:

### Economic Aspects

- 7.5% increase in overall wages and salaries in 1985, with a review clause for possible deviations in the R.P.I. forecast which, at the end, of the year, was translated into an additional increase of 1.18%. A proportional increase was established for 1986 for all staff levels as a function of the forecast R.P.I. for that year. The character of these salary increases will impede the gradual closing of the salary range and facilitate adaptation to market conditions.
- Freezing of the accumulated seniority bonus, applying the amount that would have been assigned to increase this item to the basic salaries, in order to promote a professional approach among staff.
- Rationalization of expenses and implementations of a single level for all staff categories.

### Employment

- Maintenance of the level of employment, involving the creation of as many permanent jobs as retirements.
- Introduction of new "training" and "industrial experience" contract modes, as established in the Social and Economic Agreement (AES). To this end an Agreement with the Ministry of Work and the National Employment Institute (INEM) was signed, in which the company undertook to accept 5,103 people applying for their first job, in the con-



tract modes mentioned. In the first phase, covered in 1985, 2,512 contracts have been signed for different staff categories throughout the company's area of operations.

- Increased flexibility in high level staff contracts by including a clause to this effect in the Agreement.
- Collaboration commitment on searching for solutions to the employment problem in the sector. This commitment was instrumented with the ITT-**Telefónica**-Government-UGT Agreement by which a number of employees from the ITT Group of Companies were provided with a means of access to **Telefónica**.

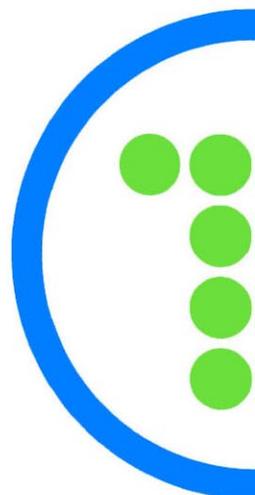
### Labour Groups

The need to adapt human resources to new service and technology requirements and to promote commercial management, made it recommendable to create new labour categories with better qualifications and wider ranging characteristics. The new labour categories established are: Commercial Promoter, Sales Agent, Auxiliary Plant and Network Technician.

STAFF EXPENSES TREND	
YEAR	% of Revenue from Services
1981	48.0
1982	47.1
1983	44.2
1984	41.3
1985	39.9

As a summary of our staff characteristics and of human resource management in general, the following headings could be mentioned:

- At the beginning of the year, the Company's staff comprised **62,817 employees in service**. Throughout the year, 1,005 direct permanent jobs were created to cover retirements that took place, giving a final number of employees of 62,790, basically similar to the initial figure. Temporary job contracts under the Social and Economic Agreement (AES) modes mentioned above are not included in this figure.
- The staff increased its level of **qualification** with the substitution of retirements and promotions in some relatively unqualified groups by people with medium and high level qualifications. At the year end, the University-Qualified Staff and the Auxiliary and Technically-Qualified Staff represented 8.3% of total employees, as opposed to 7.4% the year before.
- Average staff age is **38.9 years old** with a seniority of 16.6 years, which guarantees us a young staff with experience arising from their stability in the Company.
- There was a **37.5 hour working week** for all labour groups and categories.
- Absenteeism fell again in 1985 to **11.8 working days lost** per employee and year; the lowest figure for the last five years.
- Productivity, expressed as gross revenue from services per employee, was **6.27 million pesetas**, a considerable increase over 1984.
- The ratio of staff expenses to revenue from services continued to fall, at **39.9%**.





The main activities of the Training Department in 1985 are as follows, expressed in figures in the corresponding table.

### a) Diagnosis and Selection Activities

The following selection processes have been carried out:

- Notices under the Annual Employment Plan.
- **Telefónica**-INEM (National Institute of Employment) Agreement.
- **Telefónica**-ITT Agreement.
- Temporary Contracts.
- Functional Scale of experts.
- 4th Clause (XIII Collective Wage Agreement).

Furthermore, a collaboration project has been implemented with the Complutense University for Selection model design and validation.

### b) Training Activities

An effort has been made to cover priority requirements with the resources available, emphasizing the following aspects within a general increase in activity compared to the previous year:

- 1.º **The systematization** initiated in 1985 for Management training.
- 2.º **The development** of basic levels that allow evaluation of different training activities to be instrumented.
- 3.º **The increase** in courses given and pupils trained by **Telefónica** for Advanced Technologies, when compared to other companies.
- 4.º **The development** of education technology with respect to Computer-Assisted Training and Audiovisual Facilities.

Furthermore, a collaboration project has been implemented with the University to validate and implement a home study methodology, developing the concept in preparatory courses for access to

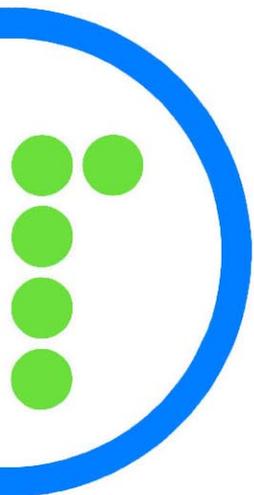
the Auxiliary Plant and Network Technician Labour Group.

Under the heading of Social Affairs, in 1985 the policy of rationalizing auxiliary staff services has been intensified, on the basis of profitability and equality criteria.

The following services have been negotiated:

- Social, cultural and sports activities.
- Holiday plans.
- Company shops and membership of consumer organizations.
- Study Aids and Assistance.
- Guarantees and assistance for housing purchase.

ABSENTEEISM INDEX	
YEAR	Working Days Losts per Employee
1981	13.2
1982	12.9
1983	13.5
1984	12.2
1985	11.8



## TELEFONICA STAFF DISTRIBUTION

By Departments	1985	By Labour Categories/Groups	No. of Employees Dec./1984	No. of Employees Dec./1985	Average Basic Salary in 1985 (Pesetas)
Basic Equipment	13,428	Office managers	478	576	2,023,786
Special Equipment	1,157	Unyversity-Qualified Staff	1,695	1,945	2,525,033
Manual Services and Cont. C.	3,560	Auxiliary and Technically-Qualified Staff	2,959	3,241	1,979,005
External Plant	5,608	Draughtsmen and photographers	232	254	1,477,936
Internal Switching Plant	8,285	Technical Operators and Plant Supervisors	7,331	7,278	1,609,437
Construction	4,801	Mechanical Fitters	4,616	4,329	1,407,623
Real Estate	2,199	Network Group and Gang Foremen	2,515	2,656	1,606,828
Subscriber management	4,741	Linesmen, Spicers and Drivers	19,971	19,399	1,404,745
User Information	1,640	Administrative Supervisors	1,091	1,102	1,686,778
External Plant Engineering	1,293	Subscriber Ser. Represent. and Supervisors	2,566	2,656	1,487,460
Billing	1,512	Administrative Staff	8,680	8,677	1,407,271
Internal Transmission Plant	3,366	Operation Supervisors and Managers	730	686	1,499,074
Procurement and Supplies	1,320	Operators	5,488	5,337	1,391,126
Labour Relations	1,130	Warehouses, Trades and Vehicle Maintenance	1,185	1,252	1,329,956
Operations (I. T.)	1,443	Auxiliary Staff	1,219	1,219	1,267,690
Other Departments	7,307	Radioteleg., Radioteleph., Telegraph Operators	52	45	1,455,004
<b>TOTAL STAFF IN SERVICE</b>	<b>62,790</b>	Categories being phased out	20	19	1,657,020
Staff Temporarily off work (on leave, illness, etc.)	3,871	Systems Analysists and Engineers	122	141	2,365,127
		Programmer-Analysts and Programmers	257	264	1,897,457
<b>TOTAL EMPLOYEES</b>	<b>66,661</b>	I. T. Operators and Assistants	1,610	1,714	1,505,261

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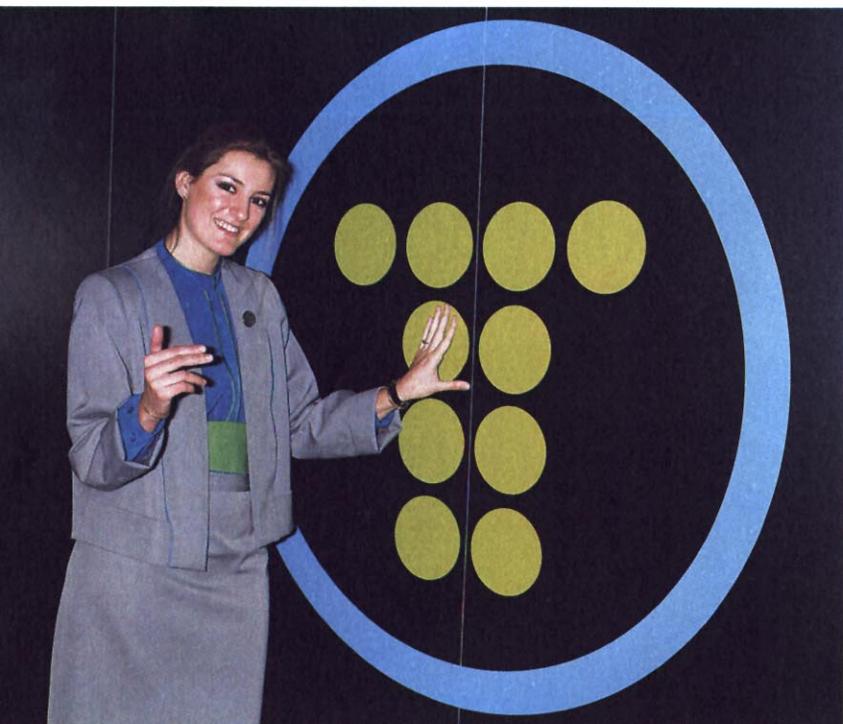


Training Activities		
TYPE OF COURSE	No. OF COURSES	No. OF PUPILS
Recycling and Perfectioning	4,074 (1)	43,326 (1)
Initial Training and Promotion	104	3,572
Management	22	326
Languages	—	242
Advanced Technologies:		
• Switching Area	85	784
• External Plant and Transmission Area	13	194
• Telematics Area	13	176
<b>TOTAL</b>	<b>4,311 (2)</b>	<b>47,620</b>

(1) Two staff training compaigns have been carried out in 1985 for Technical Assistance on Basic equipment with 20,897 pupils.

(2) Including courses given by Consultancy Companies.

# GENERAL INFORMATION ON THE COMPANY



*In compliance with the requirements of Ministry Orders dated November 17, 1981 and February 26, 1982.*

1. Compañía Telefónica Nacional de España has its registered offices in Madrid, Gran Vía, 28.
2. The Company was incorporated by a public document authorised by the Notary Public of the Illustrious College of Madrid, Mr. Alejandro Roselló y Pastors, on April 19, 1924, entered with number 141 in his official records and inscribed in the Madrid Register of Companies in Volume 152, page 122, sheet 5083, inscription I. By public document authorised in Madrid on April 28, 1953 by the Notary Public of Madrid, Mr. Alejandro Bérnago Lladrés, entered with number 1333 in his official records, the Articles of Association of Compañía Telefónica Nacional, S. A. were adapted to the Law on S. A. Companies (Spanish Companies Act) of July 17, 1951. This public document was inscribed in the Madrid Register of companies in Volume 818, book 368 of the 3rd section of the Book of Companies, page 102, sheet 5083, inscription 135.
3. In accordance with the provisions of Article 4 of the Articles of Association in force, "the object of this Company is the installation, repair, improvement, purchase, sale, operation and administration of all classes of telephone services, lines and networks and of any other telecommunications procedure used at present or that may be discovered in the future; the provision of other auxiliary telecommunications services; the purchase, sale and mortgaging of all classes of goods and chattels, buildings and real estate, rights and concessions and the manufacture, agreement, purchase or sale, negotiation, importation and operation of suitable materials, machines and tools, with no exception whatsoever, that may be useful for carrying out the functions described".  
In accordance with the stipulations of Condition I I of the Contract of Concession approved by the Decree of October 31, 1946, Compañía Telefónica Nacional de España, S. A., is committed to establish, develop and operate a comprehensive and homogenous local and trunk telephone system throughout the Península, adjacent is-

lands and areas of Spanish sovereignty, with the appropriate complementary and auxiliary services. The Company is also committed, in accordance with Condition 15 of the Contract of Concession and to the extent that service requirements make this necessary, to successively install the most up-to-date equipment and materials.

4. Interested persons may consult the Articles of Association and the accounting and financial statements in the Shareholders' Offices that this Company has opened to the public in its registered offices. In the same office, anybody may request the brochures on the increases in capital and debentures issued over the last three years.
5. Article 16 of the Articles of Association establishes that the Annual General Meetings shall be held every year prior to June 30 in the place and on the day and hour fixed by the Board of Directors. Extraordinary General Meetings shall be held after giving prior notice that describes the cause thereof, and includes the agenda, either on the initiative of the Board of Directors itself or when the Board of Directors is so requested, in accordance with the relevant procedures and clearly expressing the objective thereof, by shareholders that can demonstrate a minimum holding of 1/10 of the paid-in share capital.

#### Information on Share Capital

1. As at January 15, the share capital is 400,519,495,000 pesetas, being fully paid in and subscribed.
2. The General meeting of shareholders held in Madrid on June 17, 1985, authorized the Board of Directors in the most wide-ranging and effective way and to the extent that business requirements in their opinion made this necessary, to increase the share capital without requiring the holding or later agreement of the General Meeting, issuing new shares for this purpose once the amount of previous issues

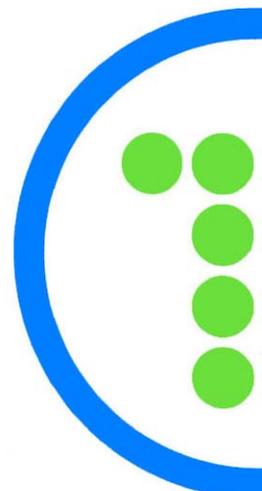
has been completely paid in, until the share capital of the Company reaches the amount of 540,701,318,000 pesetas.

Similarly, the General Meeting of Shareholders authorized the Board of Directors to issue debentures of any kind, including convertible debentures, up to the maximum authorized by the legislation in force at the time of issue, said authorization being in turn transferrable to the Executive Committee.

3. All of the shares forming the share capital of Compañía Telefónica Nacional de España are 500 pesetas nominal value bearer shares.
4. Article 6 of the Articles of Association requires that, if the new share issues were to exceed the maximum authorized for the Board of Directors in order to carry out new capital increases without the need of agreement from a General Meeting, the limit of which is at present that the share capital of the Company may reach the sum of five hundred and forty thousand seven hundred and one million three hundred and eighteen thousand pesetas, agreement to this shall be by the General Meeting and by the majority of the share capital, determined in accordance with the applicable legislation in force.
5. The share capital at December 31, 1983 was 288,374,036,500 pesetas and at December 31, 1985 amounted to 360,467,545,500 pesetas.

Since 1983 the following capital increases have taken place:

Year	Ratio	Type	Payment by Shareholder	Nominal Amount in Millions of Pesetas
1983	1 x 5	At par	70%	48,062.3
1984	1 x 9	At par	70%	32,041.6
1985	1 x 8	At par	80%	40,051.9
1985/86	1 x 9	At par	90%	40,051.9



Compañía Telefónica Nacional de España is the parent Company of the Group of 18 Companies listed earlier in the Annual Report with a 100% shareholding.

The Spanish State holds a 31.51% interest in the share capital of the Company.

The associate and affiliate companies hold a total interest of 0.77% in the capital of the Company.

As the shares in the Company are not registered, it is impossible to find out the number of shares held by the members of the Board of Directors or Managers of both the company and the affiliate and associate Companies.

#### COMPANY POLICY ON STAFF BENEFITS AND PARTICULARLY ON ALL CLASSES OF PENSIONS

On March 1, 1985 the XIII Collective Wage Agreement was signed, the basic contents of which are as follows:

The basic salaries agreed are given in the **Telefónica** Staff Table on page 96.

Bonus payments were increased by 6.5%.

Payments for child and school assistance were increased by 6%.

Other extra and compensation payments were increased by 5.5%.

A single level of expenses was established for all labour categories and groups, set at 2,150 and 3,200 pesetas for travel within and between provinces, respectively.

Social welfare funds were established at a total of 587 million pesetas.

Furthermore, **Telefónica** contributed 5,251 million pesetas to the Collective Endowment Insurance Scheme and 9,902 million pesetas to the ITP.

All of the expenses from the above items in 1985 are included in the Statement of Profit and Loss under the corresponding heading.

During 1985 the Company also granted advances of the following month's salary and advances of three months' salary, to be paid back over 24 months. These advances are interest-free and figure in the Company's Balance Sheet under the caption of Investments, in the "Loans to Employees" item.

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We would not like to finish without paying our respects to the memory of our companions who lost their lives in accidents at work:

- Mr. Andrés Aparicio Marazuela.
- Mr. Balbino Borreguero Labajos.
- Mr. Rafael Castro Cascón.
- Mr. Eugenio Cubero Ruiz.
- Mr. Enrique Parra Arteaga.
- Mrs. M.<sup>a</sup> Angeles Ribas Budios.
- Mr. Marino del Río de Blas.

And to whose families we reiterate our condolences.

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