

Audited financial statements

Auditing Shareholders' Report

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

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



Fernando Pérez



Javier Salaverri

Spanish Statutory Auditors' Report

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

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

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

1. General comments

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

2. Comments on the Balance Sheet

2.1. Fixed assets.

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

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

2.2. Accumulated depreciation and amortization of assets

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

2.3. Net Shareholdings in Companies.

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

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

2.4. Deferred Exchange Losses

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

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

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

2.5. Accounts Receivable

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

2.6. Share Capital.

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

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

2.7. Statutory Reserve

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

2.8. Voluntary Reserve and Revaluation Surplus

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

2.9. Technological Development Reserve

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

2.10. Debentures and bonds

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

2.11. Pensions

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

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

3. *Comments on the Statement of Income*

3.1. Income

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

3.2. Costs and Expenses

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

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

REPORT

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

Madrid, April 29, 1987



Pedro Rodríguez San Román



Enrique Fernández Peña

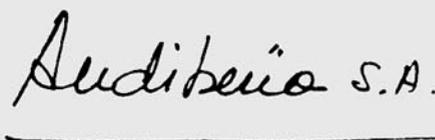
Independent Auditors' Report

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

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



Price Waterhouse



Audiberia, S. A.

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

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

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

LIABILITIES AND SHAREHOLDERS' EQUITY

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

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

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

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

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

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

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

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

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

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

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

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

COMPAÑIA TELEFONICA NACIONAL DE ESPAÑA, S. A.

PROPOSAL FOR DISTRIBUTION OF THE NET INCOME FOR THE YEAR 1986

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

COMPAÑIA TELEFONICA NACIONAL DE ESPAÑA, S. A.

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

NOTE I - ACTIVITY AND CONTRACT WITH THE STATE

I.1 Conditions of the State Contract

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

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

I.2 Fiscal status

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

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

I.3 Regulation of tariffs

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

NOTE 2 - BASES OF PRESENTATION AND SIGNIFICANT ACCOUNTING PRINCIPLES

2.1 Bases of presentation

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

2.2 Significant accounting principles

a) Accounting standards.

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

b) Fixed assets and method of depreciation.

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

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

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

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

c) Intangible assets and amortization.

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

d) Investments - net shareholdings in companies.

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

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

e) Deferred charges

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

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

f) Valuation of foreign currency accounts.

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

g) Inventories and stocks for fixed assets.

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

h) *Revenue from services.*

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

i) *Retirement pensions and endowment insurance.*

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

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

j) *Short and long-term debts.*

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

Short-term - Maturity up to 18 months.

Long-term - Maturity over 18 months.

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

NOTE 3 - FIXED ASSETS

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

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

3.2 *Annual variations were as follows:*

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

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

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

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

NOTE 4 - INVESTMENTS - Net shareholdings in companies

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

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

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

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

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

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

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

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

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

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

NOTE 5 - DEFERRED EXCHANGE LOSSES

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

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

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

NOTE 6 - SUBSCRIBERS

The balances at December 31, comprise the following:

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

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

NOTE 7 - SHARE CAPITAL

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

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

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

The table below reflects the movements of share capital:

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

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

NOTE 8 - RESERVES AND UNAPPROPRIATED PROFIT

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

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

NOTE 9 - PROVISIONS

The composition of the provisions is as follows:

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

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

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

NOTE 10 - DEBENTURES AND BONDS

10.1 Composition and movements:

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

10.2. Redemption:

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

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

10.3 Additional information:

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

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

NOTE 11 - LOANS AND CREDIT FACILITIES

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

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

- 11.2 The maturities are as follows:

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

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

- 11.3 Additional information:

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

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

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

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

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

NOTE 12 - SUPPLIERS AND NOTES PAYABLE TO SUPPLIERS

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

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

NOTE 13 - TAXES PAYABLE

The balances at December, 31 comprise the following:

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

NOTE 14 - OTHER CREDITORS

These comprise the following groups of accounts:

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

NOTE 15 - ACCRUED EXPENSES AND DEFERRED INCOME

These are disclosed as follows:

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

NOTE 16 - PENSIONS

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

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

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

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

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

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

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

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

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

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

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

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

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

NOTE 17 - ENDOWMENT INSURANCE

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

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

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

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

NOTE 18 - MEMORANDUM ACCOUNTS

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

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

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

NOTE 19 - SUBSEQUENT EVENTS

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

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

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

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

The most significant of these accounting practices are summarized bellow:

Presente practice for Local Spanish purposes

Treatment for IAS purposes

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

Treatment for US GAAP purposes

- | | |
|--|--|
| 5. Property, plant and equipment (See Notes 2.2 b) and 3)* | Revaluation of fixed assets is not permitted. Property, plant and equipment and related accumulated depreciation are stated at historical cost values. |
| 6. Investments (See Notes 2.2.d) and 4)* | Investments in subsidiaries should generally be accounted for as follows:
— More than 50% holding: consolidated or equity method of accounting.
— Between 20 and 50% holding: Equity method of accounting.
— Less than 20% holding: At the lower of cost or net realizable value. |
| 7. Costs of new equity capital (See Note 2.2. e)* | US GAAP require expenses of raising equity capital to be deducted from the proceeds of the new capital. |
| 8. Income per share is not required to be in the financial statements nor in any other obligatory financial information. | Per share computations are required to be shown. |
| 9. Endowment insurance (See Note 2.2 i)* | Past service costs were actuarially computed at December 31, 1986. Unit credit method was used based on current salary with a 40 year amortization of prior service obligations, retroactively applied to January 1, 1967. |

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

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

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

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

Board of Directors

CHAIRMAN

Luis Solana Madariaga*

VICE-CHAIRMEN

Pablo Garnica y Mansi*

José María Concejo Alvarez*

José María Amusátegui de la Cierva*

MANAGING DIRECTOR

Diego Martínez Boudes*

DIRECTORS (Representing shareholders)

Juan Antonio Blanco-Magadán Amutio

Emilio Botín-Sanz de Sautuola y García de los Ríos

Jaime Carvajal y Urquijo

Luis Delso Heras

Francisco Javier Eiroa Villarnovo**

Alvaro Espina Montero

Eugenio Estévez Cepeda

María Paz Fernández Felgueroso*

Jesús González del Yerro Martínez**

Julio González Sabat*

José Montes Fernández

Juan Manuel Rebollo Castrillo

Epifanio Ridruejo Brieva*

DIRECTORS (Representing the Government)

Prudencio García Gómez*

Saturnino Suanzes de la Hidalga

José María García Alonso*

SECRETARY

Manuel María de Araluce y Araluce**

VICE-SECRETARY

Mariano Aldama Magnet

GOVERNMENT DELEGATE

Javier Nadal Ariño*

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

Management Committee

Chairman:

Luis Solana Madariaga

Members:

Diego Martínez Boudes

José Antonio Adell García

Germán Ramajo Romero

Enrique Used Aznar

Carlos Viada Fernández-Velilla

Secretary:

Luis Terol Miller

Changes recorded after year-end

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

General Managers

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

Deputy General Managers

Heliodoro Alcaraz García de la Barrera,
Legal Services

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

José Caballero Guerrero,
Economic Control

Jaime Comenge Puig,
International Coordination

Juan Cruz Larrea Arechavala,
Managing Director's Office

José Luis Fernández Dopico,
Security

Guillermo Fernández Vidal,
Marketing (Major Customers)

Francisco Ferre Ferre,
Outside Plant

José Luis Franganillo Asensio,
Labour Relations, Administration and Procurement

Rafael Hernández García,
Operations

Luis Lada Díaz,
Network Management, Planning and Technology

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

Francisco Martínez Martínez,
Expansion of Rural Telephone Service

Francisco Javier Monzón de Cáceres,
Finance and Holdings

Crisanto Plaza Bayón,
Planning Office

Faustino Rivero Morales,
Inspection

Luis Terol Miller,
Secretary and Management Committee

José María Vázquez Quintana,
Inside Plant

Roberto Velázquez Martín,
Corporate Relations and Communications

Provincial Managers

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

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

Area Support Managers

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

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

Share Capital

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

Capital increases since 1982 are as follows:

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

* Conversion.

Share Listings

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

Market prices

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

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

Turnover on the Madrid Stock Exchange (MSE)

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

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

* % Cumulative annual average rate.

Stock Market Capitalisation

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

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

* % Cumulative annual average rate.

Dividend Policy

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

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

Recent dividends were:

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

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

Principal shareholders of Telefónica

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

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

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

Notice of the General Meeting of Shareholders

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

Time: 12.00 h.

Place: Paseo de la Castellana, 259

Shareholder Information

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

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

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