



# **Audited financial statements**



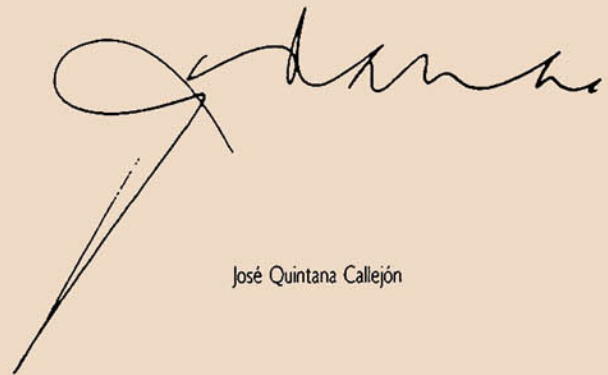
# Auditing Shareholders' Report

Mr. Fernando Pérez-Olivares Hinojosa and Mr. José Quintana Callejón, designated Auditors of the 1987 accounts by the Annual General Meeting of Shareholders held on May 22, 1987, 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 Movement and Direct Applications to Reserves for 1987 of the Compañía Telefónica Nacional de España, S. A.

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

A handwritten signature in black ink, appearing to read 'Fernando Pérez Olivares', written in a cursive style with a long horizontal stroke at the bottom.

Fernando Pérez Olivares

A handwritten signature in black ink, appearing to read 'José Quintana Callejón', written in a cursive style with a long diagonal stroke extending downwards and to the left.

José Quintana Callejón

# 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 the Compañía Telefónica 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 1987, all in accordance with **Telefónica**.

The said review has given rise to this Report 8/88, which is issued with the remarks and observations given below.

## 1. General remarks

- 1.1. The figures contained in the Balance Sheet and Statement of Income audited, come from the general ledger and auxiliary books of **Telefónica**, 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, number 24, legalised on November 17, 1983 under the number 28,608, shows 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 increased by 265,567 million pesetas in 1987. This figure includes charges for work carried out on the Company's own fixed assets (labour, materials and other) amounting to 57,571 million pesetas plus interest charged to the works of 8,373 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 the **Telefónica** Tax Law of July 30, 1987 and in application of article 3 of the Law of October 31, 1945, by 133,135 million pesetas, with 47,804 million pesetas credited to Accumulated Depreciation and 85,331 million pesetas charged to the Revaluation Surplus. This revaluation was applied to the Fixed Asset inventory at December 31, 1986.

### 2.2. Accumulated depreciation and amortisation of assets.

The relevant credit items charged to the 1987 results amount to 161,178 million pesetas (153,501 million pesetas for depreciation of fixed assets and 7,677 million pesetas for amortisation of intangible assets). The overall percentage of the average value of depreciable plant (without including the revaluation mentioned above) was 5.8 %.

### 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, 1986, and represent a reduction of 1,278 million pesetas, that has been charged to the voluntary Reserves.

Income received as dividends from these shareholdings in 1987 amounted to 393 million pesetas.

### 2.4. Deferred exchange losses.

The revaluation of foreign currency borrowings at the year end amounted to 28,984 million pesetas. Of this amount 27,237 million pesetas correspond to deferred realised exchange losses; the remainder is the future potential net loss that the Company must bear in the years to come if current exchange rates remain constant. 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 1987 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 6, which amounted to 9,404 million pesetas for the repayment of loans and 890 million pesetas differences relating to services charged in foreign currencies.

As the risk had been substantially reduced, at the year end the total balance of the exchange loss self-insurance provision had also been reduced by 20,367 million pesetas and was credited to the revaluation surplus, to which it had been charged in 1982.

### 2.5. Accounts receivable.

The caption "Subscribers" includes ex-subscribers where debt collection is doubtful, where the total balance amounts to 4,222 million pesetas, pending revaluation. There are 6,258 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.

**Telefónica**, as authorised by the General Meetings of Shareholders, increased share capital by 3,575 million pesetas of face value, for an effective amount of 5,411 million pesetas, to cover bond conversions.

2.7 Statutory reserve.

The balance on this account increased by 600 million pesetas to 8,405 million pesetas at December 31, 1987, due to the distribution of 1986 profits.

2.8 Voluntary reserve and revaluation surplus.

These increased by 84,053 million pesetas as a result of net plant revaluations and by (1,278) million pesetas due to the valuation placed on shareholdings in group companies. There was a further 20,367 million pesetas increase due to cancellation of this amount in the exchange loss self-insurance provision set up in 1982, as this risk has fallen considerably.

The share issue premium was increased by 1,836 million pesetas due to the capital increase caused by conversion of bonds to shares. The Voluntary Reserve was increased by 40,766 million pesetas, because of the transfer to this reserve of the account previously denominated the technological development reserve.

2.9 Debentures and bonds.

Debentures amounting to 35,000 million pesetas were issued in 1987. Payment of 28,539 million pesetas was also received in the year for the last issue of 1986, for which the payment period for subscriptions ended on January 10.

2.10. 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 Telefónica 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 to 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 1986 and 1987 are correct.

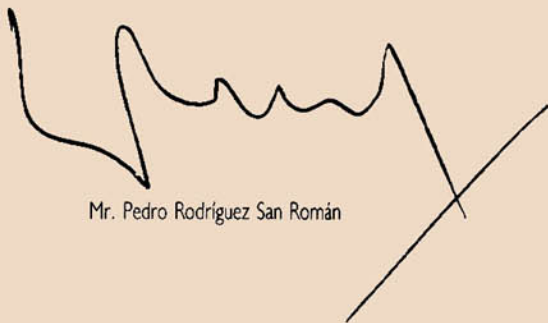
3.2. Costs and expenses.

The costs and expenses attributed by the Company are those accounted for.

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. (**Telefónica**) and the Notes thereto, attached, present fairly the financial position of **Telefónica** at December 31, 1987 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 laws specific to the company.



Mr. Pedro Rodríguez San Román



Mr. Enrique Fernández Peña

Madrid, March 22, 1988

# 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, 1987, 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 52 to 67. 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 held 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 nonexistence 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, 1987, 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.

Madrid, March 22, 1988

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

<b>ASSETS</b>	<b>1987</b>	<b>1986</b>
<b>FIXED ASSETS (Note 3)</b>	1,928,340	1,731,182
Land	38,336	31,387
Buildings and power equipment	235,477	187,290
Telephone installations	2,653,012	2,449,411
Other fixed assets	24,039	18,697
	2,950,864	2,686,785
Accumulated depreciation	(1,234,045)	(1,097,404)
	1,716,819	1,589,381
Fixed assets under construction:		
Construction in progress	159,088	92,353
Advances to suppliers	17,079	19,478
Stocks for fixed assets	35,354	29,970
<b>INTANGIBLE ASSETS (Note 4)</b>	718	3,997
Research and development and others	14,760	10,447
Accumulated amortization	(14,042)	(6,450)
<b>INVESTMENTS</b>	51,859	38,755
Net shareholdings in companies (Note 5)	27,000	27,553
Loans to Group companies	20,997	7,894
Loans to employees	3,087	2,578
Guarantees and deposits	775	730
<b>DEFERRED CHARGES</b>	10,722	12,424
<b>DEFERRED EXCHANGE LOSSES (Note 6)</b>	28,984	48,839
<b>INVENTORIES</b>	4,146	5,692
<b>ACCOUNTS RECEIVABLE</b>	114,882	100,010
Subscribers (Note 7)	99,308	85,219
Provision for bad debts (Note 7)	(6,258)	(5,245)
Miscellaneous receivables	23,873	22,678
Provision for bad debts	(2,041)	(2,642)
<b>CASH AND BANKS</b>	2,772	2,332
Cash and banks	550	722
Funds in transit and others	2,222	1,610
<b>OTHER CURRENT ASSETS AND PREPAYMENTS</b>	4,259	5,562
Prepayments	4,259	5,562
<b>Total</b>	<u><u>2,146,682</u></u>	<u><u>1,948,793</u></u>
<b>MEMORANDUM ACCOUNTS (Note 18)</b>		
Unused credit facilities	92,789	97,965
Others	26,051	26,994
	<u><u>118,840</u></u>	<u><u>124,959</u></u>

Notes 1 to 19 form an integral part of these statements.

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

<b>LIABILITIES</b>	<b>1987</b>	<b>1986</b>
<b>SHAREHOLDERS' EQUITY</b>	1,130,558	1,015,596
Share capital (Note 8)	415,368	411,793
Reserves: (Note 9)		
Statutory reserve	8,405	7,805
Revaluation surplus and other voluntary reserves	706,697	559,675
Technological development reserve	0	36,249
Unappropriated profit	88	74
	<u>715,190</u>	<u>603,803</u>
<b>DEFERRED INCOME</b>	2,339	2,412
Non-reimbursable contributions for rights of use and others	<u>2,339</u>	<u>2,412</u>
<b>PROVISIONS (Note 10)</b>	80,226	71,394
Risk and exchange loss self-insurance	61,397	50,876
Other provisions	<u>18,829</u>	<u>20,518</u>
<b>LONG TERM DEBT</b>	683,186	632,056
Debentures and bonds (Note 11)	331,651	320,808
Loans and credit facilities (Note 12)	272,399	238,554
Loans from the Institución Telefónica de Previsión (ITP)	50,744	48,516
Notes payable to suppliers	4,304	5,719
Collective insurance for employees (Note 17)	<u>24,088</u>	<u>18,459</u>
<b>SHORT TERM DEBT</b>	160,678	142,947
Loans and credit facilities (Note 12)	41,543	43,627
Suppliers	43,025	30,717
Notes payable to suppliers	1,966	2,948
Taxes payable (Note 13)	37,770	36,543
Social Security payable	5,168	4,640
Other creditors (Note 14)	25,080	24,432
Dividend payable	<u>6,126</u>	<u>40</u>
<b>ACCRUALS (Note 15)</b>	36,448	39,136
Accrued expenses and deferred income	<u>36,448</u>	<u>39,136</u>
<b>NET INCOME</b>	53,247	45,252
Net income for the year	<u>53,247</u>	<u>45,252</u>
<b>Total</b>	<u><u>2,146,682</u></u>	<u><u>1,948,793</u></u>
<b>MEMORANDUM ACCOUNTS (Note 18)</b>		
Unused credit facilities	92,789	97,965
Other	26,051	26,994
	<u>118,840</u>	<u>124,959</u>

Notes 1 to 19 form an integral part of these statements.

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

	1987	1986
<b>INCOME</b>	<b>540,727</b>	<b>468,011</b>
Revenue from services	520,405	449,798
Connection fees and other	20,322	18,213
<b>COSTS AND EXPENSES</b>	<b>476,175</b>	<b>409,342</b>
Salaries and related costs	192,687	176,095
Subcontractors, supplies and services	47,082	39,930
Taxes	382	324
Provision for doubtful accounts (subscribers)	3,500	3,624
Provision for contingencies	26,702	15,180
Other charges	10,499	5,106
Exchange losses (Note 6)	10,294	11,050
Financial expenses	84,094	77,781
Sundry expenses	2,437	2,140
Depreciation of fixed assets:		
Amortization of intangible assets	153,501	131,987
Amortization of deferred charges	7,677	2,910
Internal expenditure capitalized	3,264	3,307
In fixed assets:		
Labour, materials and overhead	(57,571)	(53,512)
Notional interest allocated to construction in progress	(8,373)	(6,580)
<b>PROFIT BEFORE OTHER INCOME</b>	<b>64,552</b>	<b>58,669</b>
<b>OTHER INCOME</b>	<b>19,770</b>	<b>13,439</b>
Financial	7,598	5,228
Other	12,172	8,211
<b>INCOME BEFORE STATE LEVY</b>	<b>84,322</b>	<b>72,108</b>
<b>STATE LEVY</b>	<b>(31,075)</b>	<b>(26,856)</b>
<b>NET INCOME (before distribution)</b>	<b>53,247</b>	<b>45,252</b>

Notes 1 to 19 form an integral part of these statements.

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

	December 31, of 1986	Movements during 1987			December 31, of 1987
		Allocation	Application	Transfers	
Statutory reserve	7,805	600	—	—	8,405
Revaluation reserve	549,360	84,053	—	20,367	653,780
Revaluation of fixed assets	659,872	85,331	—	—	745,203
Issuance of share capital	(74,486)	—	—	—	(74,486)
Allocations to extraordinary provisions	(39,196)	—	—	20,367	(18,829)
Revaluation of investments	5,735	(1,278)	—	—	4,457
Other	(2,565)	—	—	—	(2,565)
Other voluntary reserves	10,315	1,836	—	40,766	52,917
Share premium	9,481	1,836	—	—	11,317
Voluntary reserve	834	—	—	40,766	41,600
Technological development reserve (Notes 2.1 b and 9)	36,249	13,081	(8,564)	(40,766)	—
Unappropriated profit	74	88	(74)	—	88
<b>Total</b>	<b>603,803</b>	<b>99,658</b>	<b>(8,638)</b>	<b>20,367</b>	<b>715,190</b>

Notes 1 to 19 form an integral part of these statements.



**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)**

	1987	1986
<b>SOURCES</b>		
Net income for the year	53,247	45,252
Depreciation and amortization	164,442	138,204
Net movements in reserves and deferred income	4,444	2,157
Self-insurance, exchange differences and other	43,404	33,081
	<hr/>	<hr/>
Funds provided by operations	265,537	218,694
Issuance of share capital	—	36,047
Investments in affiliates	5,168	2,986
Debentures issued	63,394	51,704
Foreign currency loans	10,795	35,976
Other loans, credit facilities and notes payable	98,760	112,006
	<hr/>	<hr/>
<b>TOTAL SOURCES</b>	<b>443,654</b>	<b>457,413</b>
<b>APPLICATIONS</b>		
Dividends	44,638	38,649
Additions to fixed assets	262,582	205,592
Other additions:	28,839	18,685
Advances to suppliers of fixed assets	(2,399)	5,922
Intangible assets	4,398	1,866
Investments in affiliates	19,976	8,037
Stocks for fixed assets	5,384	27
Deferred charges	1,480	2,833
	<hr/>	<hr/>
Debentures redeemed	43,988	39,849
Repayment of foreign currency loans	13,377	138,520
Repayment of other loans, credit facilities and notes payable	52,970	27,165
	<hr/>	<hr/>
<b>TOTAL APPLICATIONS</b>	<b>446,394</b>	<b>468,460</b>
<b>NET VARIATION</b>	<b>(2,740)</b>	<b>(11,047)</b>
<b>COMPRISING:</b>		
Inventories	(1,546)	1,994
Accounts receivable	14,872	13,567
Cash and banks	440	(5,649)
Prepayments	(1,424)	176
Short term liabilities	(11,684)	(22,013)
Accruals	2,688	(7,432)
Dividend accounts	(6,086)	8,310
	<hr/>	<hr/>
<b>TOTAL</b>	<b>(2,740)</b>	<b>(11,047)</b>

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

Notes 1 to 19 form an integral part of these statements.

# COMPAÑIA TELEFONICA NACIONAL DE ESPAÑA, S. A.

## PROPOSAL FOR DISTRIBUTION OF THE NET INCOME FOR THE YEAR 1987

	Millions of pesetas
Unappropriated profit brought forward from previous year .....	88
Net income for the year .....	53,247
Total available for distribution .....	<u>53,335</u>
<b>PROPOSED DISTRIBUTION</b>	
5 % Interim dividend on shares No 1 to 823,585,478 payable as from January 8, 1988 .....	20,590
5 % Interim dividend on shares No 823,585,479 to 823,947,787, rights to dividend as from January 10, 1987, payable as from January 8, 1988 .....	9
5 % Interim dividend on shares No. 823,947,788 to 823,531,329, rights to dividend as from January 15, 1987, payable as from January 8, 1988 .....	134
5 % Interim dividend on shares No. 829,531,330 to 830,735,713, rights to dividend as from July 15, 1987, payable as from January 8, 1988 .....	14
6 % Final dividend on shares No 1 to 823,585,478, pending approval .....	24,707
6 % Final dividend on shares No. 823,585,479 to 823,947,787, rights to dividend as from January 10, 1987, pending approval .....	11
6 % Final dividend on shares No. 823,947,788 to 829,531,329, rights to dividend as from January 15, 1987, pending approval .....	161
6 % Final dividend on shares No. 829,531,330 to 830,735,713, rights to dividend as from July 15, 1987, pending approval .....	<u>17</u>
To dividends .....	45,643
To statutory reserve .....	7,600
Unappropriated profit carried forward .....	<u>92</u>
Total proposed distribution .....	<u><u>53,335</u></u>

### NOTES TO THE FINANCIAL STATEMENTS AT DECEMBER 31, 1987 AND 1986

#### NOTE I - ACTIVITY AND CONTRACT WITH THE STATE

##### 1.1 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.

##### 1.2 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 profit 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 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.

##### 1.3 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 required by law and obtain an amount of net income in each fiscal year of not less than 5 % of the paid-in share capital plus reserves as defined in the State Contract.

##### 1.4 New legal and fiscal regimes

The Telecommunications Law, dated December 18, 1987, stipulates that **Telefónica** will continue to provide the basic communication services (final and transmission) on a monopoly basis during an initial concession of 30 years. A new contract with the State will be signed before the end of fiscal year 1988, the actual contract continuing in force until such time.

On July 30, 1987 the **Telefónica** taxation Law was enacted, abolishing, as from January 1, 1988, the special regime established under the State Contract and subject the Company as from that date to the general Spanish taxation law as imposed by the central Government. The law also provides that **Telefónica** will be subject to certain specific local property taxes ("Contribución Territorial Rústica y Urbana") substituting all other local taxes by a yearly cash compensation equivalent to two per cent of gross revenues from invoicing.

## 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 1987 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 significance are presented in the Statement of Movements and Direct Applications to Reserves.
- c) 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 current State Contract for **Telefónica** as a regulated enterprise, especially those referring to the revaluation of fixed assets and investment, 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, and as explained in Note 3, property, plant and equipment are valued at replacement cost. 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 lives 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 stock for fixed assets account and credited to the technological development reserve.

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

- c) Intangible assets and amortization intangible assets comprise the costs of rights to the use of equipment and installation owned by others as a consequence of official concessions or irrevocable rights of use. These assets are amortised on a straight-line basis over 25 years, this being the estimated recovery period.

In 1987 the balance of costs incurred in developing new product lines has been fully amortized (until 1986, 5 years).

#### 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 carrying values of shareholdings in subsidiary and associated 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 Meetings. Dividends are recorded as revenue when received, and capital gains obtained from sales of investment are recorded as income when received.

#### e) Deferred charges

Debenture issue expenses are amortised based on the respective capitals outstanding at each year end, whereas issuance expenses of bonds converted to share capital and expenses related to the issuance of share capital are amortised on a straight line basis over five years from the date of each share capital increase.

#### 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. Stocks for fixed assets include subscribers sets which, in accordance with the Ministry Order dated December 2, 1987, are liberalized and available for sale.

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 asset and accumulated depreciation, incorporating their corresponding revaluations, is as follows:

	1987	1986	Years of useful life
Land	38,336	31,387	
Buildings	176,406	134,546	40
Accumulated depreciation	(52,678)	(38,748)	
Power equipment	59,071	52,744	19-21
Accumulated depreciation	(31,388)	(27,099)	
Exchange equipment	930,481	845,800	22-24
Accumulated depreciation	(387,925)	(334,967)	
Transmission equipment	301,922	275,406	15-18
Accumulated depreciation	(167,495)	(148,265)	
Local and trunk networks	1,275,208	1,009,434	20-24
Accumulated depreciation	(521,915)	(392,622)	
Subscriber sets and other related installations	145,401	318,771	6-10
Accumulated depreciation	(61,996)	(146,671)	
Furniture, office and other equipment	24,039	18,697	8-12
Accumulated depreciation	(10,648)	(9,032)	
Fixed assets in service	2,950,864	2,686,785	
Accumulated depreciation	(1,234,045)	(1,097,404)	
Net book amount	1,716,819	1,589,381	
Construction in progress	159,088	92,353	
Advances to suppliers of fixed assets	17,079	19,478	
Stocks for fixed assets	35,354	29,970	
Total net book amount	<u>1,928,340</u>	<u>1,731,182</u>	

3.2 Annual variations were as follows:

	1987	1986
Revaluations for the year:		
— Gross book value	133,135	109,439
— Accumulated depreciation	47,804	43,960
Additions for the year	265,567	211,542
Dismantled plant (Note 2.2 b)	64,663	61,150
Depreciation charge for the year	153,501	131,987
Average rate of depreciation applied	5.8 %	5.6 %
Stocks for fixed assets:		
Reserve for obsolescence	6,295	4,542
Provision for obsolescence	6,920	2,180

- 3.3 As at December 31, 1987, of the total balance of "Subscriber sets and other related installations", sets amounting to Ptas. 19,836 million (Ptas. 12,496 million net of accumulated depreciation) are subject to liberalization in accordance with the Ministry Order dated December 2, 1987. In 1987 fixed assets relating to subscriber related installations amounting to Ptas. 162,063 million have been transferred to the classification "Local and trunk networks".
- 3.4 Service and operating conditions 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 1988 amounts to Ptas. 335,000 million, of which Ptas. 330,000 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.
- 3.5 According to the State Contract, **Telefónica's** fixed assets used to provide telephone services cannot be mortgaged.
- 3.6 At December 31, 1987, assets amounting to Ptas. 288,952 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 loans and borrowings indicated in Notes 11 and 12.
- 3.7 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 corresponding self-insurance provisions are applied.
- 3.8 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
1987	133,135	47,804	85,331
Total	<u>1,455,318</u>	<u>710,115</u>	<u>745,203</u>

The 1987 revaluation has been made in accordance with the stipulations of the **Telefónica** taxation law dated July 30, 1987 and by applying Article 3 of the law of December 31, 1945. Consequently, fixed assets are valued at replacement cost up to December 31, 1987.

- 3.9 The useful lives of the different elements of Telefónica's fixed assets are calculated 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 - INTANGIBLE ASSETS

As indicated in (Note 2.2 c), the effect of the change in the basis of amortization of costs incurred in developing new product lines amounts to Ptas. 2,140 million.

#### NOTE 5 - INVESTMENTS

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

	1987	1986
Group companies .....	23,623	23,284
Other investments .....	3,377	4,269
Total .....	<u>27,000</u>	<u>27,553</u>

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

5.2 The information presented in the following table under the titles "Equity value at December 31, 1987" and "Income before tax" have been prepared on the basis of Group Companies financial statements at December 31, 1987. 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 1987. The accounting principles are described in Note 2.2 d).

Company name	Share capital	Telefónica holding %	Telefónica book value
Sistemas e Instalaciones de Telecomunicación (SINTEL)	1,100	100	2,935
Telefonía y finanzas, S. A. (TELFISA)	500	100	2,099
Comercial de Servicios Electrónicos, S. A. (COSESA)	700	99.14	1,246
ENTEL, S. A.	650	100	1,179
Compañía Española de Tecnología (COMET)	1,000	100	825
Compañía Publicitaria de Exclusivas Telefónicas (CETESA)	434	97.33	696
Hispano Radio Marítima, S. A.	500	100	692
Telecomunicaciones Marinas, S. A. (TEMASA)	600	100	550
Telefónica Internacional de España, S. A.	200	100	200
Cabinas Telefónicas (CABITEL, S. A.)	200	100	200
Seguros de Vida y Pensiones (ANTARES, S. A.)	320	100	160
Control Electrónico Integrado	320	81.25	156
Telefónica Investigación y Desarrollo	50	100	50
Teleinformática y Comunicaciones (TELYCO)	50	100	25
Urbana Ibérica, S. A.	330	100	14
Telefónica North América Inc.	1	100	1
<b>Total subsidiaries</b>			<b>11,028</b>
Alcatel Standard Eléctrica, S. A.	25,975	20.99	3,229 (*)
Fujitsu España, S. A.	6,000	40	2,700
Telettra Española, S. A.	2,800	51	2,040
Cables de comunicaciones, S. A. (CCSA)	782	49	1,211
INDELEC	600	30	150
<b>Total associates</b>			<b>9,330</b>
ATT Microelectrónica, S. A.	8,481	20	1,696
Amper, S. A.	2,400	12.45	850
European Silicon Structures	7,968	3.429	436
Other			279
<b>Total others</b>			<b>3,261</b>
<b>Total group</b>			<b>23,619</b>

(\*) Alcatel restructuring costs recognised in Telefónica financial statements in 1986, have been charged Alcatel's profit and loss account in 1987.

Equity value at December 31 1987	1987 income before tax profit (loss)	ACTIVITY
3,142	543	Telecommunication cable and line laying and equipment installation.
2,218	119	Investment management.
1,001	(251)	Marketing of electronic equipment and services for telecommunications.
1,482	337	Development and implementation of projects in data processing.
808	(17)	Promotion and investment in new companies.
745	51	Promotion of advertising services for directories, telephone booths and others.
718	22	Marketing and maintenance of electronic marine communication equipment and navigation aids.
558	(18)	Surveying, laying and repairing submarine cables.
356	196	Export of telecommunication equipment and resources.
356	196	Collection, cleaning and maintenance of public telephones.
160	—	Life insurance and pension funds.
163	6	Security systems engineering.
50	—	Research and development.
278	233	Promotion and marketing of telephone and telematic equipment.
1	(44)	Real estate activities.
1	—	Financial mediation.
12,037		
3,330	(7,569)	Manufacture of telephone and telegraph transmission and exchange systems.
3,090	202	Data transmission and data processing equipment.
2,531	590	Development, manufacture and installation of electronic telecommunication equipment, especially in transmission and radio.
1,793	1,832	Installation and sale of cables for telecommunications and electrical applications.
228	202	Manufacture of portable and mobile communication equipment.
10,972		
1,696	—	Design, manufacture, assembling and marketing of high technology integrated circuits.
966	2,716	Development, manufacture and repair of telephone and telematic terminals. Manufacture of components (hybrid and flexible circuits).
436	—	Manufacture and marketing of integrated circuits.
279	—	
3,377		
26,386		

5.3 In 1987 **Telefónica** sold its interest in Gráficas Burgos, Electrónica Aragonesa, Telefónica Sistemas, Telefonía y Datos, Electrónica Básica, Servicios integrales de Protección Civil e Industrias de Telecomunicación. The profit on sale of Ptas. 3,813 million is included in "Other income - Other".

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

	Dividends received		Purchase of goods and services by <b>Telefónica</b>	
	1987	1986	1987	1986
Subsidiaries .....	91	140	28,992	28,525
Associates .....	302	178	90,489	78,811
Total .....	393	318	119,481	107,336

Balances of suppliers and notes payable to suppliers include Ptas. 15,533 million corresponding to intercompany transactions. (1986, Ptas. 15,665 million).

#### NOTE 6 - 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 31-12-87	Balance 31-12-86
	1988	1989	1990	Subsequent		
Unrealised exchange losses (subject to exchange rate fluctuation) .....						
— Deferred unrealized losses .....	2,546	1,850	235	6,090	10,721	20,642
— Deferred unrealized gains .....	—	—	—	(8,974)	(8,974)	(2,232)
	2,546	1,850	235	(2,884)	1,747	18,410
Deferred realized exchange losses (corresponding to early repayment of loans) .....	8,271	6,282	5,359	7,325	27,237	30,429
Total .....	10,817	8,132	5,594	4,441	28,984	48,839
Details of the charge to expenses for the year are as follows:					1987	1986
Repayment of loans and other debts .....					9,404	10,140
Services charges in foreign currency and other .....					890	910
Total .....					10,294	11,050

#### NOTE 7 - SUBSCRIBERS

The balances at December 31, comprise the following:

	1987	1986
Subscribers services billed:		
Private subscribers .....	5,106	6,778
Public entity subscribers .....	22,033	16,749
Ex-subscribers .....	4,222	4,252
Uncollectible and pending classification .....	504	201
	31,865	27,980
Unbilled services .....	67,443	57,239
	99,308	85,219
Provision for bad debts .....	(6,258)	(5,245)
Total .....	93,050	79,974

During 1987, cancellation of bad debts amounted to Ptas. 2,488 million (1986, 2,206 million).



## NOTE 8 - SHARE CAPITAL

All of the outstanding shares of the Company at December 31, 1987 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, as well as the Stock Exchanges of Frankfurt, London, Paris and Tokyo and, since June 1987, also on the New York Stock Exchange.

At December 31, 1986, the State has an approximate 30,4 % direct shareholding, together with a further interest estimated at 2,4 % 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 the share capital.

The table below reflects the movements of share capital:

	Numer of shares	Par value	Price as a percentage of par value	Paid-in
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
Issue of July, 1987*	1,204,384	602	165.225 %	995
Balance December 31, 1987	830,735,713	415,368		
Issue of January, 1988*	30,514,914	15,257	129.666 %	19,784
Issue of January, 1988*	628,543	314	144.921 %	455

\* Share capital issued in connection with conversion of convertible bonds.

## NOTE 9 - RESERVES

The reserves 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. At December 31, 1987 the Reserve for Technological Innovation has been reclassified as Voluntary Reserves.

## NOTE 10 - PROVISIONS

The composition of the provisions is as follows:

	1987	1986
Exchange losses	1,230	21,598
Self-insurance	4,500	9,428
Contingencies	55,667	19,850
	61,397	50,876
Possible contributions to the employee benefit systems (Note 16.3)	18,829	18,829
Others	—	1,689
	18,829	20,518
Total	80,226	71,394

Due to the decrease of the exchange risks, the provision for exchange losses created in 1982, amounting to Ptas. 20,367 million, has been reverted to the Revaluation Reserve. Also Ptas. 7,425 million from the self-insurance provision and the balance of Others have been transferred to the Provision for contingencies.

## NOTE 11 - DEBENTURES AND BONDS

### 11.1 Composition and movements:

	Balance 31-12-86	New issues	Repayments	Revaluations and other movements	Balance 31-12-87
Debentures and bonds:					
Non-convertible .....	265,729	35,000	(34,949)	711	266,491
Convertible and/or exchangeable .....	59,601	—	(8,104)	—	51,497
Debentures and bonds in foreign currency .....	24,017	—	(10,640)	286	13,663
	349,347	35,000	(53,693)	997	331,651
Bonds pending subscription .....	(28,539)				—
	<u>320,808</u>				<u>331,651</u>

### 11.2 Redemption:

	Maturities				Total 31-12-87
	1988	1989	1990	Subsequent	
Amount .....	<u>36,767</u>	<u>75,235</u>	<u>74,000</u>	<u>145,649</u>	<u>331,651</u>

### 11.3 Additional information:

	1987	1986
Interest expense .....	39,496	39,078
Accrued interest at December 31 .....	13,347	12,742
Issues subject to fiscal benefits:		
Debentures .....	103,970	136,163
Debentures in foreign currency .....	12,979	22,712

11.4 Foreign currency debentures amount to Deutsche Marks 200 million. In 1987 the US dollars 50 million issue, which had its contractual maturity date on January 1991, was preamortized.

Outstanding debentures are valued at the official closing exchange rate of each currency at year end. The exchange differences charged in 1987 to the unrealised exchange losses account amounted to Ptas. 286 million (1986-1,718 million).

11.5 In January 1988, debentures and bonds convertible in debentures, amounting to Ptas. 30,000 million and Ptas. 1,200 million, respectively, were issued. Their subscription period ended on January 26, 1988, the issue being totally subscribed.

11.6 Conversion and exchange options of convertible bonds were exercised in January, 1988 in the amount of Ptas. 22,753 million, of which Ptas. 3,806 million correspond to the December 1984 issue, and Ptas. 19,778 million to the December 1986 issue, leaving Ptas. 16,749 million and Ptas. 10,222 million of the respective issues outstanding.

## NOTE 12 - LOANS AND CREDIT FACILITIES

12.1 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:

	1987			1986		
	Long term	Short terms	Total	Long term	Short term	Total
Loans in foreign currencies .....	62,226	—	62,226	71,023	—	71,023
Loans and credit facilities .....	186,415	13,417	199,832	134,114	5,276	139,390
Other loans .....	5,584	—	5,584	4,651	—	4,651
Commercial paper (face value) .....	23,325	28,972	52,297	37,364	40,299	77,663
	<u>277,550</u>	<u>42,389</u>	<u>319,939</u>	<u>247,152</u>	<u>45,575</u>	<u>292,727</u>
Less:						
Deferred interest on commercial paper .....	(5,151)	(846)	(5,997)	(8,598)	(1,948)	(10,546)
Total .....	<u>272,399</u>	<u>41,543</u>	<u>313,942</u>	<u>238,554</u>	<u>43,627</u>	<u>282,181</u>

12.2 The maturities are as follows:

	Maturities				Balances
	1988	1989	1990	Subsequent	31-12-87
Loans in foreign currencies .....	6,968	6,935	608	47,715	62,226
Loans and credit facilities .....	55,511	25,453	23,860	95,008	199,832
Other loans .....	—	—	—	5,584	5,584
Commercial paper .....	29,053	23,244	—	—	52,297
Total .....	91,532	55,632	24,468	148,307	319,939

**Telefónica** made early repayments of foreign currency loans in 1987 amounting to Ptas. 5,768 million.

12.3 Additional information:

	Financial charges		Interest accrual (Deferral)		Interest rates	
	1987	1986	1987	1986	1987	1986
Loans in foreign currency .....	5,064	8,976	1,187	1,157	5.50 -12.50 %	5.25-13 %
Loans and credit facilities .....	20,609	12,405	2,838	3,010	11.125-17 %	10 -17 %
Commercial paper:	6,898	5,970	—	—	10.50 -17 %	8.80-17 %
Long term .....			(5,151)	(8,598)		
Short term .....			(846)	(1,948)		

12.4 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).

12.5 At December 31, 1987, of the total foreign currency loans, Ptas. 58,810 million are covered by the fiscal benefits of Decree Law 19/1961 and Law 61/1978.

12.6 In accordance with the accounting criteria mentioned in Note 2.2 f), the amount of exchange differences arising from these loans in 1987 resulted in a credit to the account of unrealized exchange losses of Ptas. 6,216 million (in 1986 there was a credit of Ptas. 8,853 million).

12.7 The composition of foreign currency debt is shown below:

	Millions	
	1987	1986
US Dollars (US\$) .....	325.0	295.7
Deutsche Marks (DM) .....	50.0	50.0
Swiss Francs (SF) .....	150.0	215.0
Swedish Crowns (SKR) .....	1.7	12.0
Dutch Florins (DFL) .....	30.0	40.0
Yens .....	10,000.0	10,000.0

12.8 Loans denominated in foreign currencies include:

— A multiple financing operation amounting to US dollars 250 million represented as at December 31, 1987 by euro commercial paper amounting to US dollars 220 million with maturities of less than six months and by a subsidiary credit line amounting to US dollars 30 million. When they become due, the Company may opt to:

- issue new euro commercial paper
- use the credit facility stipulated in the contract for the amounts due
- repay the notes without using such credit facility.

— A loan agreement with the subsidiary Telefónica North America, Inc, up to a limit of US dollars 125 million. As at December 31, 1987 US dollars 75 million were drawn down. This loan derives from a commercial paper program, supported by a subsidiary credit line issued by the US subsidiary and guaranteed by **Telefónica**.

12.9 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:

	1988	1989	Total
Interest on commercial paper - long term .....	3,381	1,770	5,151
Interest on commercial paper - short term .....	846	—	846

## NOTE 13 - TAXES PAYABLE

The balances at December, 31 comprise the following:

	1987	1986
State levy .....	31,075	26,856
Value Added Tax .....	872	1,242
Payroll withholding tax .....	3,327	5,671
Tax withholdings on dividends and interest .....	2,496	2,774
Total .....	<u>37,770</u>	<u>36,543</u>

## NOTE 14 - OTHER CREDITORS

These comprise the following groups of accounts:

	1987	1986
Staff bonus provision .....	9,998	9,657
Telephone service interchange .....	5,084	4,856
Guarantees and deposits .....	2,733	1,690
Other creditors .....	7,265	8,229
Total .....	<u>25,080</u>	<u>24,432</u>

## NOTE 15 - ACCRUED EXPENSES AND DEFERRED INCOME

These are disclosed as follows:

	1987	1986
Accrued interest .....	17,377	16,909
Services billed in advance .....	11,425	10,435
Deferred income - Value Added Tax (transitory rules) .....	3,852	5,778
Other .....	3,794	6,014
Total .....	<u>36,448</u>	<u>39,136</u>

## 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 Fund 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. 4.4 million per annum.

The members covered by this plan comprise approximately 10,260 retired persons (pensioners) and 63,300 members currently on the payroll, whose current contributions represent 4.3 % of their total gross salary (pension-base salary).

To meet the above-mentioned 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 1987 the contributions of **Telefónica** amounted to Ptas. 11,960 million and those of its employees Ptas. 5,715 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.

- 16.2 On January 28, 1987 a guarantee of up to Ptas 8,000 million, granted in January 1977 by **Telefónica** to ITP, matured and, consequently, was cancelled. Therefore, **Telefónica's** commitments to the ITP are reduced to the obligation to contribute annual payments as determined in the ITP regulation.
- 16.3 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 10, was originally 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 net by ITP.

16.4 **Telefónica** has shown its willingness to collaborate in the configuration of a future scheme that would make 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, 1987 and 1986.

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 workers in the Social Security, any obligation that would involve any modification to its shareholders' equity at December 31, 1987 nor a significant impact on its prospective future profitability.

#### NOTE 17 - ENDOWMENT INSURANCE

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

To cover payment of these benefits, funds have been constituted and placed both with an insurance company and in **Telefónica** that, at December 31, 1987, amounted to Ptas. 4,091 million and Ptas. 24,087 million, respectively. In 1987 the Company has provided these funds, including interests accrued on capitals constituted, with a total of Ptas. 7,797 million charged against income (1986, Ptas. 7,513 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 1987, 4.9 % of the overall payroll cost, is sufficient to cover this objective.

b) At December 31, 1987, the present value of the future commitments, calculated at an interest rate of 8 % applied on current salaries, amounts to approximately Ptas. 81,000 million (74,000 million in 1986).

#### NOTE 18 - MEMORANDUM ACCOUNTS

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

	1987	1986
Unused credit facilities: (Note 12.4)		
Available credit - long-term .....	46,626	53,965
Floating rate credit facilities .....	32,000	42,500
Available credit - short-term .....	14,163	1,500
	<u>92,789</u>	<u>97,965</u>
Guarantees of financial operations .....	2,951	3,294
Guarantee to ITP (Note 16) .....	—	8,000
Guarantees granted to employees .....	4,429	4,667
Others .....	18,671	11,033
	<u>26,051</u>	<u>26,994</u>
Total .....	<u>118,840</u>	<u>124,959</u>

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

In January 1988 **Telefónica** sold its interest in Cables de Comunicaciones, S. A. for Ptas. 1,764 million, resulting in a profit of Ptas. 549 million.

Also, in February and March 1988 negotiations have been held with the Italian company Telettra, S.p.A. in order to reach an agreement which would eventually involve a share swap by which **Telefónica** will transfer to Telettra, S.p.A. its share in Telettra Española, S. A. amounting to a 51 percent of the share capital, and will receive a proportionate interest in the share capital of the Italian company.

## RECONCILIATION OF NET INCOME AND SHAREHOLDERS' EQUITY AS REPORTED IN THE SPANISH STATUTORY ACCOUNTS WITH NET INCOME AND SHAREHOLDERS' 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, including, since the middle of 1987 the New York Stock Exchange, the Company is requested to adjust its net income and shareholders' equity based on different accounting principles.

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)\*
5. Property, plant and equipment (See Notes 2.2 b) and 3)\*
6. Investments (See Notes 2.2 d) and 5)\*
7. Costs of new equity capital (See Note 2.2 e)\*
8. Income per share is not required to be in the financial statements nor in any other obligatory financial information.
9. Endowment insurance (See Note 2.2 i)\*

### Treatment for IAS purposes

Research and development cost are expenses 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 II and 12, show the classification on this basis.

IAS N.º 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

Revaluation of fixed assets is not permitted. Property, plant and equipment and related accumulated depreciation are stated at historical cost values.

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.

US GAAP require expenses of raising equity capital to be deducted from the proceeds of the new capital.

Per share computations are required to be shown.

Past service costs were actuarially computed at December 31, 1987. 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 statement of income and on the statement of changes in shareholders' equity is as follows  
(in millions of pesetas):

	1987	1986
Net income for the year as reported in the Spanish statutory accounts at December 31	53,247	45,252
Adjustments for IAS purposes:		
Research and development expenses - Net effect between prior write-offs and current amortization	3,254	1,140
Release of technological development reserve	4,518	2,317
Self-insurance and other	2,497	2,000
Approximate net income for the year in accordance with IAS	63,516	50,709
Adjustments for US GAAP purposes:		
Reversal of depreciation on revalued portion of fixed assets	65,750	55,126
Reversal of amortization of costs of new equity capital	472	501
Adjustment of investments to net equity value	(879)	(2,449)
Adjustment of endowment insurance cost	1,401	1,150
Approximate net income for the year in accordance with US GAAP	130,260	105,037
Write down of customer premises equipment at market prices	(16,510)	—
After write down, net income	113,750	105,037
Approximate net income per share in accordance with US GAAP	140.14	132.2
Shareholders' equity as reported in the Spanish statutory accounts at December 31.	1,130,558	1,015,596
Net income for the year	53,247	45,252
	1,183,805	1,060,848
Adjustments for IAS purposes:		
Investments	(3,073)	(5,735)
Research and development written-off	(4)	(3,257)
Release of provisions set up in prior years not required under IAS	30,754	48,624
Approximate shareholders' equity in accordance with IAS	1,211,482	1,100,480
Adjustment for US GAAP purposes:		
Reversal of net effect of revaluation of fixed assets related accumulated depreciation	(478,020)	(452,706)
Costs of new equity capital	(1,200)	(693)
Adjustment of investments to equity value	(18,847)	(6,788)
Accrual of past service cost of endowment insurance	200	(1,201)
Approximate shareholders' equity in accordance with US GAAP	713,615	639,092

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

\* Notes in brackets refer to the financial statements on pages 56 to 67 of this Annual Report.

## Board of Directors

As it stood on May 27, 1988

### CHAIRMAN

Luis Solana Madariaga

### VICE-CHAIRMEN

José María Concejo Alvarez  
Pablo Garnica y Mansi  
José María Amusátegui de la Cierva

### MANAGING DIRECTOR

Carlos Viada Fernández-Velilla

### DIRECTORS (Representing shareholders)

Juan Antonio Blanco Magadán Amutio  
Emilio Botín-Sanz de Sautuola y García de los Ríos  
José Luis Bozal González  
Jaime Carvajal y Urquijo  
Miguel Cruz Amorós  
Alvaro Espina Montero  
Antonio Flos Bassols  
María del Carmen Mestre Vergara  
José Montes Fernández  
Juan Manuel Rebollo Castrillo  
Epifanio Ridruejo Brieva  
Isabel Nieves Rodríguez Pérez  
José Teófilo Serrano Beltrán

### DIRECTORS (Representing the Government)

Prudencio García Gómez  
Enrique Martínez Robles  
Saturnino Suanzes de la Hidalga

### SECRETARY

Heliodoro Alcaraz y García de la Barrera

### VICE-SECRETARY

Mariano Aldama Magnet

### GOVERNMENT DELEGATE

Javier Nadal Ariño

## Executive Committee

As it stood on May 27, 1988

### CHAIRMAN

Luis Solana Madariaga

### VICE-CHAIRMEN

José María Concejo Alvarez  
Pablo Garnica y Mansi  
José María Amusátegui de la Cierva

### MANAGING DIRECTOR

Carlos Viada Fernández-Velilla

### DIRECTORS

José Luis Bozal González  
Prudencio García Gómez  
Enrique Martínez Robles  
M.<sup>a</sup> del Carmen Mestre Vergara  
Epifanio Ridruejo Brieva

### SECRETARY

Heliodoro Alcaraz y García de la Barrera

### GOVERNMENT DELEGATE

Javier Nadal Ariño

---

### Changes recorded in the Board of Directors after the end of 1987 financial year.

DIEGO MARTINEZ BOUDES retired as Managing Director on February 24, 1988; JULIO GONZALEZ SABAT, LUIS DELSO HERAS and JOSE MARIA GARCIA ALONSO retired as Directors on March 23, 1988 and March 29, 1988, respectively. On ending his term of office JAIME CARVAJAL Y URQUIJO also retired from the Board of Directors.



# Management Committee

## CHAIRMAN

Luis Solana Madariaga.—**Chairman of the Board of Directors.**

## MEMBERS

Carlos Viada Fernández-Velilla.—**Director/General Manager.**

German Ramajo Romero.—**General Manager.**

Enrique Used Aznar.—**General Manager.**

Francisco Javier Monzón de Cáceres.—**General Manager.**

## SECRETARY

Heliodoro Alcaraz y García de la Barrera.—**General Secretary.**

# Deputy General Managers

Juan Manuel Barreiro de las Llanderas.—

## **Data Processing**

José Caballero Guerrero.—

## **Accounts and Control**

José Luis Fernández Dopico.—

## **Security**

Guillermo Fernández Vidal.—

## **Sales and Marketing**

Francisco Ferre y Ferre.—

## **Basic Network Services**

José Luis Franganillo Asensio.—

## **Administration and Procurement**

Jesús Guerra Romero.—

## **Industrial Promotion**

Rafael Hernández García.—

## **Operations Coordinator**

Félix Paúl Ivorra Cano.—

## **Business Communications**

Luis Lada Díaz.—

## **Planning and Technology**

Oscar Maraver Sánchez-Valdepeñas.—

## **Personnel Management**

Crisanto Plaza Bayón.—

## **Economic Analysis**

Faustino Rivero Morales.—

## **Inspection**

Margarita Sánchez López.—

## **Holdings**

Ignacio María Santillana del Barrio.—

## **Finance**

Luis Terol Miller.—

## **International Affairs**

José María Vázquez Quintana.—

## **Plant**

D. Roberto Velázquez Martín.—

## **Corporate Relations and Communication**