



# Telefónica de España

1987 Annual Report



# 1987 Annual Report\*

Established in 1924, today **Telefónica** is Spain's leading corporation in terms of total assets, market capitalisation and net income. Our core business is to supply a wide variety of telecommunications services, ranging from domestic and international telephone services to integrated business communications; from mobile land and maritime services to high-speed data transmission.

The Spanish telephone network is the ninth largest in the world with 15.4 million telephones linked through 10.2 million lines in service. In addition, Iberpac —our public packet switching data network— is one of the most advanced in Europe. We are also involved, through a number of subsidiaries and joint ventures, in designing, manufacturing and marketing a wide array of Information Age services and products.

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\* Submitted for approval to the General Meeting of Shareholders.

### Head Office:

TELEFONICA DE ESPAÑA

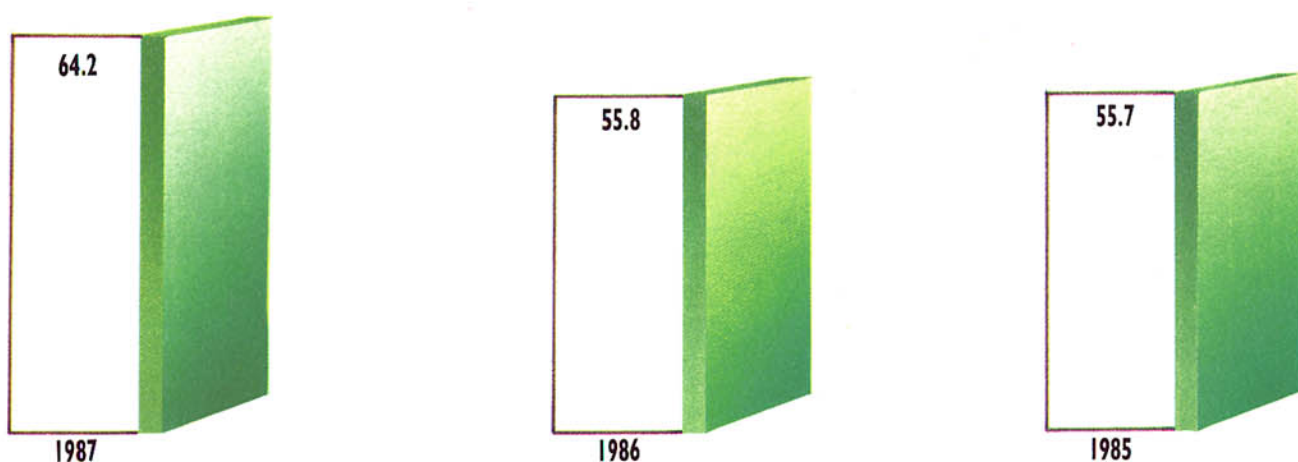
Gran Vía, 28 — 28013 MADRID

## HIGHLIGHTS

	1987	1986	1985
• Demand for new lines	1,135,406	963,037	756,164
• % Average growth in line usage	8.2	5.0	3.4
• Lines per 100 inhabitants	26.1	25.3	24.3
• Capital expenditure per year in fixed assets	260,183	211,514	188,681
• Employees	63,311	63,021	62,790
• Lines in service per employee	161.7	155.2	148.7
• Gross cash-flow	268,684	218,416	177,580
• Net income	53,247	45,252	39,149
• Earnings per share (ptas.)	64.2	55.8	55.7
• Operating revenue	540,727	468,011	409,415
• Debt ratio (%)	43.1	44.1	47.5

Amounts expressed in millions of pesetas, unless otherwise stated.

## EARNINGS PER SHARE (Ptas.)





# Letter to Shareholders

Dear Shareholder,  
1987 will be remembered as a turning-point in the history of our industry, brought about by the enactment of the Telecommunications Bill (LOT) which heralds the start of a new era for **Telefónica**.

The telecommunications industry worldwide is undergoing a far-reaching transformation of its institutions and technologies. If we are to protect the interests of shareholders and employees it is essential that the legal framework within which we operate keep pace with this transformation. Therefore, far from decrying this new legislation, we welcome the fact that the government has introduced a new Law, passed by Parliament, which clearly defines the regulatory environment for our industry. This in turn will ensure that the efforts of management and workers, aided by new technologies and financial resources, will continue to bear fruit.

The new Bill and its consequences for Spain and for **Telefónica** itself, clearly reflect the changes that are currently taking place throughout the industrial world. By the year 1992, when Spain finally becomes a full member of the European Economic Community, a freely competitive market will be a harsh reality and those companies which are ill-prepared to compete in it will be hard hit.

Fortunately, the new legislation ensures that by that date **Telefónica** will be ready and waiting to meet the challenge from our European neighbours head-on.

Naturally, we are not just sitting back and letting things happen. In fact, even before the new legislation came into force, **Telefónica**'s management was already planning to give the Company a corporate facelift to meet the new era. Enhancing marketing and selling techniques, decentralising operations, encouraging technological innovations, expanding globally, redefining industrial group activities and, above all, significantly increasing capital expenditures; these are the main features of **Telefónica**'s new corporate strategy.

Perhaps the two concepts which best sum up **Telefónica**'s situation today are consolidation and expansion. A solid financial base, a regularized fiscal framework, an explosive surge in demand and especially, the benefits we are reaping from our forward-looking strategy, all bear witness to this definition.

A sweeping transformation is also taking hold of our traditional industrial policy. We are gradually breaking old ties by selling off our shareholdings in telecommunications equipment manufacturing companies and starting to use our purchasing power as a basic tool to create new enterprises and support technological innovation and

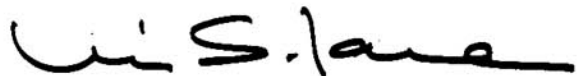
research. These steps are evidence of our whole-hearted commitment to a national industrial policy, which in no way detracts from our active participation at the forefront of the major European telecommunications groups.

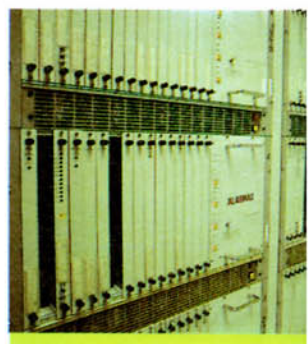
It will come as no surprise that an integral part of the consolidation process is to expand **Telefónica**'s global presence as a network administrator in line with the new international focus of the telecommunications sector. We have already made significant inroads on the international front and will continue to extend our global horizons.

In conclusion and as a final indication of the extent to which the new era has made its presence felt, **Telefónica** is keeping up with the times even in name: we are no longer the old *Compañía Telefónica Nacional de España* but are now the new **Telefónica de España, S. A.**

I trust that as shareholders you will continue to support and follow with interest the joint efforts of us all to lead our Company successfully into the future.

**Luis Solana**  
Chairman of the Board of  
**Telefónica de España.**





## 1987: The year in focus

1987 was a record year for **Telefónica**, which produced excellent results. The rise in growth rate over previous successful years was reflected both in demand for lines and in the increased usage per line of telephone and datacom services.

The positive trend in demand for services led to equally positive financial results for the company. Net income rose to 53,247 million pesetas, a 17.7 % increase over 1986. All in all, funds generated from operations grew by 23 %, from 218,416 million pesetas the previous year to 268,684 million in 1987. These healthy results were clearly reflected in the significant 15 % rise in earnings per share, which in fiscal 1987 stood at 64.16 pesetas per share, compared to 55.76 pesetas in 1986. 1987 represented a landmark in the history of Spain's telecommunications. On September 12th, the 15th million telephone was connected at the same time as the 10th million line went into operation.

Applications for new lines rose to 1,135,406, an increase of 18 % over 1986 demand. There was also a significant increase in telephone usage, with average usage per line rising by 8.2 %, compared to 5 % in 1986.

Our Public Telephone Service which represents 2.6 % of total plant, accounted for 12.7 % of revenue, 24 % up over the previous year. By the end of fiscal 1987, there were over 270,000 Public Telephones in operation, with 15,000 of them serving the rural community. The upward trend in demand was likewise recorded in the area of advanced communications services.

There were 10,587 new applications for connection to the Iberpac data transmission network, which represents a 75 % increase over 1986. Demand for the Ibercom Integrated Business Communications service also grew by 182 %, with 42,243 applications. In addition, there were major increases during the year in demand for other services, such as Automatic Mobile Telephony and Telefax.



**I**n 1987 we achieved many of our goals. At the same time fresh challenges sprung up, which we are set to meet at Telefónica with firm determination.

**Telefónica** met this outstanding boost in demand with a record number of installations. 601,643 new lines were installed during 1987, that is 33.8 % more than the year before. For the first time in our history, almost half of these lines were digital, thus enabling us to offer customers a much broader range of top quality communication services.

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**elefónica is continually striving to enhance the quality of public telephone equipment and diversify methods of payment. Card phones are becoming an increasingly wide-spread feature of the service.**



Firm evidence of our achievements throughout the year can be seen in the figure of 26.1 lines per 100 inhabitants at year end, representing 10,236,408 lines and 15.4 million telephones in service.

These accomplishments, which were witnessed in all areas of the Company, would not have taken place without the major transformation in **Telefónica's** corporate culture and the extensive decentralisation measures, which greatly enhanced management efficiency. Other contributing factors were the substantial increases in productivity and the rigorous cost containment policy implemented by the Company.

During 1987 our progress was further encouraged by expanding **Telefónica's** presence globally. As well as signing agreements with various leading telecommunications companies abroad, we continued our revolving holding company policy, bringing new companies into the group.

One of the highlights of the year on the international front, was the listing of **Telefónica's** shares in the New York Stock Exchange. In addition, the agencies Standard & Poor's and Moody's awarded our Company the maximum ratings for **Telefónica's** European and U.S. commercial paper program.







# Ready to meet the commercial challenge

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he recent introduction of the Telecommunications Bill (LOT), heralds the start of a new competitive era, which Telefónica's management and workers are ready to meet. In the photograph are general managers German Ramajo, Enrique Used, Carlos Viada and Francisco Javier Monzón (left to right).

In 1987 the Spanish Parliament passed the new Telecommunications Bill (LOT) and hence announced the start of a new era for **Telefónica**.

Henceforward our task is both to meet the fresh challenges brought about by the new legislation and also to make the necessary preparations for the year 1992—a year of vital significance for Spain and Europe.

This is a crucial time for **Telefónica** and we are facing it fully aware of the key role we play in Spain's economic arena. Our Company is wholly committed to supplying a wide array of top quality services to satisfy our customers demands.

With a vibrant economy and a healthy growth potential, Spain is in her prime. Following suit, **Telefónica** is ready to face the challenge set by both the new legislation and by the ever-increasing demand for telecommunications services.

We are moving away from a monopoly towards a free market, no longer supplying the subscriber but rather serving the customers and these changes will affect the company through and through. We are finely tuning our new market-focused corporate organisation which will enable us to satisfy the diverse needs of the various market segments.

Our ambitious capital expenditure program is an appropriate response both to the new commercial



challenges facing us and to the surge in the demand for lines, together with the rapidly growing use of the telephone and other telecommunications services.



Informa



## Meeting demand

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he rising demand in the Spanish telecommunications market is being met by Telefónica with a major capital expenditure program, which will provide the country with an advanced telecommunications network. Fibre optics cables are a vital part of the new telecommunications infrastructure.

A rapidly expanding market such as Spain's demands a dual purpose major capital expenditure program, aimed at upgrading and expanding traditional telephone services as well as keeping up with the latest technologies.

During 1987, we stepped up investment in the telecommunications infrastructure and networks. Capital expenditure in fixed assets rose by 23 % over the previous year to 260,183 million pesetas, compared to a 9.5 % average annual growth during the 1982-85 period and 12.1 % in 1986.

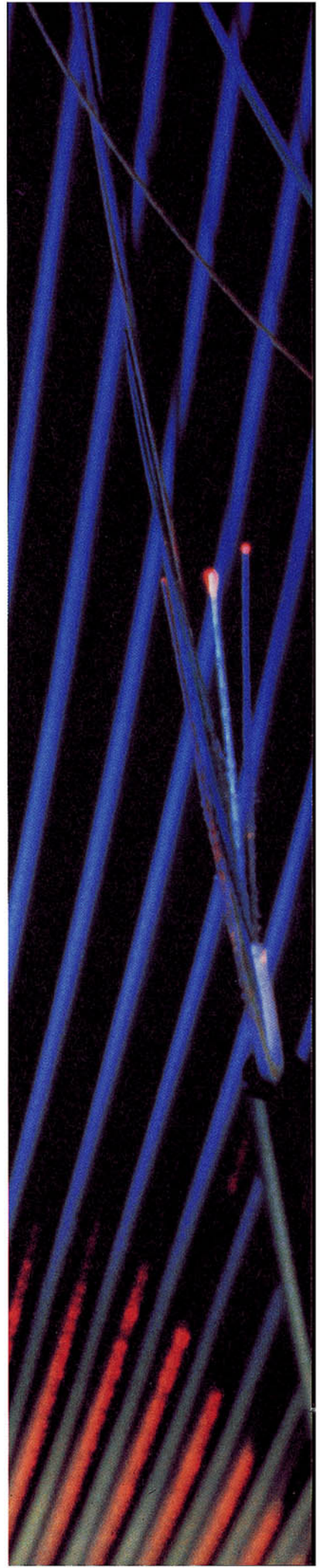
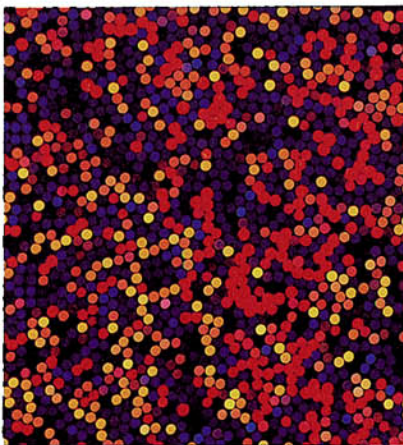
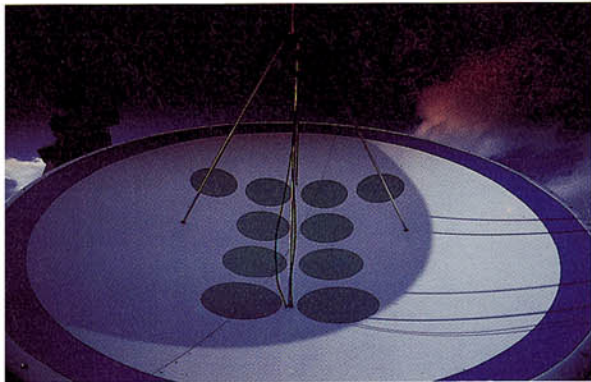
These expenditures went primarily towards meeting the increasing demand for new lines but also contributed to strengthening our infrastructure and enhancing the quality, convenience and versatility of **Telefónica's** products and services.

During the next four years, with our sights set on meeting the challenge of the year 1992, **Telefónica** will undertake an extensive investment program, designed to tackle four fundamental areas:

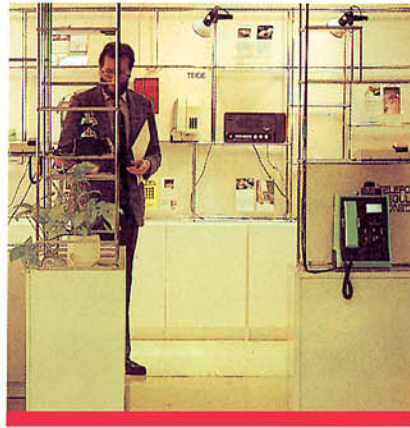
- Meet customer demand.
- Launch new telecommunications services.
- Enhance and upgrade the quality of the service.
- Modernize and digitize the network.

According to our capital expenditure program estimates, by 1992 telephone penetration will have doubled since 1982 to 86 lines per 100 households. There will also be 6.2 million local digital lines, that is 40 % local network digitization, compared to 43,000 lines in 1982; By the same year we plan to have laid 13,308 kms of fibre optics cable, a huge increase over the 1,504 kms existing in 1987. Finally, by 1992 our trunk network will have 1.6 million digital links representing 72 % of the total installed.

Our current program foresees that by 1992 we shall have 15 million lines in service and shall have passed the 20 million mark before the year 2000. This surge in network expansion will go hand in hand with an extensive changeover from analog to digital networks and together will bring about record levels in installations, with 10 million equivalent telephone lines to be installed in the period 1988-1992.







## A new market in terminals

Competition is now the name of the game; market orientation is **Telefónica's** way to win.

The lengthy parliamentary debate, prior to the passing of the Telecommunications Bill, gave **Telefónica** ample opportunity to get ready for

the new competitive environment. On December 2nd, 1987, a new commercial strategy was unveiled for supplementary, complementary and extension terminal equipment, the main features of which are outlined below:

- 1.°—The main telephone will continue to be rented out to the subscriber.
- 2.°—Additional telephones, extensions and complementary equipment will be offered for purchase.
- 3.°—Subscribers already renting this equipment will have the option of purchasing them.
- 4.°—A Network Connection Point will be installed to separate the public network and the subscriber's premises internal network.

An intensive sales and advertising campaign is already underway to stimulate subscriber purchases of additional phones and complementary equipment. Quality is our key selling point. By supplying top quality products we aim to become the leaders in the telephone terminals market.

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**elefónica's subscribers now have the chance to purchase certain telephone terminals equipment. This includes supplementary equipment which could previously only be rented.**







# Advanced telecommunications services

## Iberpac

1987 was a decisive year in the life of our data communications product, the Iberpac network. Demand for the X-25 protocol rose by 75.2 % over the previous year with 10,587 applications for connection. Last year Iberpac X-25 was connected up to 36 public packet switching data networks. We plan to expand the Iberpac network from around 30,000 ports installed in 1987 to 300,000 by 1992. One of the latest features of the X-25 network is the SITO project which



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he Madrid Stock Exchange is just one of the many institutions and associations enjoying the benefits of the Ibercom Integrated Business Communications service. Likewise, in 1987 the Iberpac network had over 30,000 ports and by 1992 we hope to have increased this figure to 300,000.

facilitates interbank clearing operations.

Of the datacom services transmitted over the Iberpac X-25 network, 1987 witnessed a great leap forward in our videotex service, Ibertex. In addition, the X-28 service was finally launched on the market and by the end of the year held a network capacity of 2,150 terminals, spread over 32 provinces.

## Electronic funds transfer

There are excellent growth prospects for our Dataphone Electronic Funds Transfer service which enjoyed a healthy boost in sales throughout the year, from 7,857 to 10,154 connections.

## Ibercom - integrated business communications service

In 1987 we achieved our sales target for the Ibercom service, designed for the corporate customers market. The launching of the Ibercom VOICE + DATA service has made important inroads towards consolidating the integration of communications services. By the end of fiscal 1987, 20,924 lines had been installed and 62,195 contracted, which is clear evidence of the warm welcome the product has received in the market. Last year 55 corporate customers joined the Ibercom network and **Telefónica** remains wholeheartedly committed to further expansion of the service.

Plans are in the pipeline to connect the Ibercom network to Iberpac, which will bring us nearer to our goal of an Integrated Services Digital Network (ISDN).

## **Ibermic, high speed data transmission**

In 1987 the first Ibermic infrastructures were installed. In the near future we aim to be providing a digital network which will give access to a host of high speed carrier and final services.

The Ibermic infrastructure will also include earth stations to carry satellite data communications with the rest of Europe (SMS) and with other continents (IBS). These single user or multiuser earth stations will be housed either in the Teleports or, where necessary, in the customer's own building.

## **Satellite communications**

By year end we had three Satellite Communications Complexes in operation supplying telegraph, telephone, television and data transmission services.

To meet the demands of 1992, **Telefónica** plans to increase the number of earth stations and build three new Satellite Communications Complexes, setting in motion a new communications structure for business and mobile services.

## **Towards an Integrated Services Digital Network (ISDN)**

In 1987 **Telefónica** began extensive testing of the new Integrated Services Digital Network, thus setting in motion an ambitious plan to incorporate the system into the Spanish telecommunications network. We aim to have the first experimental ISDN lines on the road by the beginning of 1989.

Furthermore, in 1988 we shall be piloting a new supplementary telephone services project, which by 1990 will be offering the following services:

- Integrated voice-data communications via the telephone line.
- Call waiting.
- Pre-programmed dialling.
- Billing information.
- Call re-routing.

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**Telefónica's policy of both modernising the earth stations network and building new installations will enable us to offer our customers a wide array of advanced satellite communications services. In 1987, on behalf of the SER radio broadcasting company, we installed the first permanent, nationwide hi-fi satellite link.**





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## Mobile communications

Our Automatic Mobile Telephony service (TMA) made significant advances throughout the year. The TMA network was extended to 11 provinces with a 10,500 user capacity. In 1988 our target is to provide the service to 31 provinces with a network capacity of 31,000 users.

To ensure that future demand continues to be met, **Telefónica** signed an agreement with most of the European countries to install a new cellular mobile system to cover the whole continent. This will enable a vehicle to keep in touch via the telephone while travelling throughout Europe. The coming years will also see substantial developments in our radiopaging and maritime satellite services.

## Intelligent network services

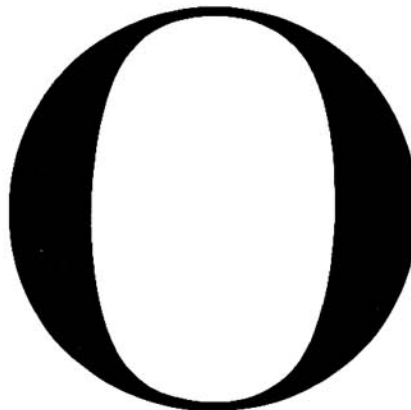
We have recently begun marketing the automatic reverse charge 900 service (Freephone), which will

shortly be providing an international service. The 900 line is specially tailored for companies to facilitate calls from potential customers.

Those advanced services which cannot be supplied by **Telefónica's** network, will be transmitted via a superimposed intelligent system capable of dynamic management of real-time communications.

Below are some of the services which will be on offer by the year 1990:

- Advanced multiaddress credit calling.
- Advanced automatic reverse charge calling.
- Personal telephony.
- Digital centrex.
- Supplementary centralised services.



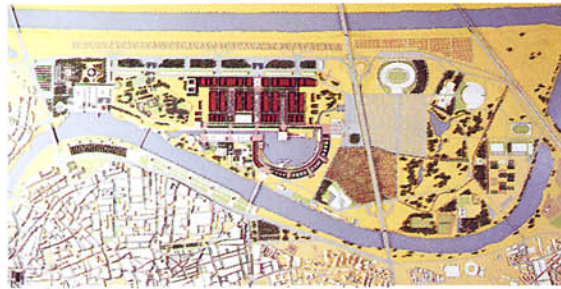
One of the aims of our Automatic Mobile Telephone service is to enable vehicles on the move to keep in touch with any part of Spain. Our Automatic reverse charge 900 Service recently hit the market. This service provides companies with a first-class tool to facilitate calls from potential customers.

## A key role in 1992

**Telefónica** is devoting special attention to the important events of 1992, a year of key significance for Spain with the Olympic Games in Barcelona coinciding with the World Expo in Seville and the Fifth Centenary of the Discovery of America. In the same year Spain faces the challenge of full membership in the newly European Single Market.

Preparations for these events are already in progress, with studies currently underway to assess the forthcoming demands of the market.

The following are some of the major steps we will be taking:



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he year 1992 is an important milestone for all Spain. Telefónica will be making a vital contribution to the success of the Olympic Games in Barcelona, and the World EXPO in Seville. Thanks to our telecommunications network, millions of people from all around the globe will have the chance to follow these two major events.



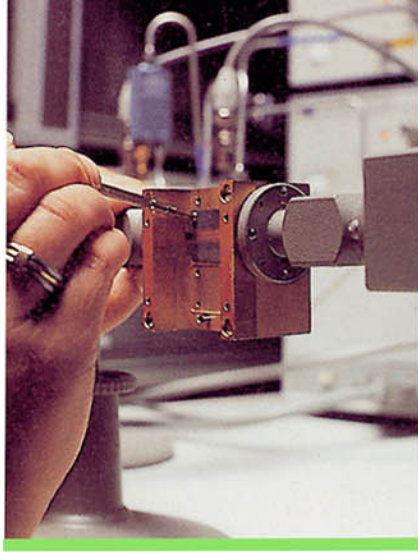
—The first commercial ISDN lines will be installed in 1990.

—The first Broadband infrastructure as part of the RACE project, will be in service in 1992.

—Tesy B, the new generation of our packet switching system, will be incorporated into the Iberpac network by the early 90's.

On a final note, by 1992 there will be three new satellite communications complexes and two teleports together with a major videocommunications carrier system.





The main objectives of **Telefónica** I+D are the following:

- To define new network services, architectures and applications, including telecommunications systems engineering solutions.
- To develop products and systems of key strategic value.
- To provide **Telefónica** with the latest hardware and software development technologies.

During 1987 there was further collaboration with EEC R&D projects, particularly the COST and RACE programs, with six new projects, and the ESPRIT program. We also continued our involvement in European Space Agency programs.

Optimizing network management and maintenance is still the chief objective of R&D activities. During the year, work continued on development of the Operations and Maintenance Structure (EOC), with a first prototype of the Operating and Maintenance System (SOC) already completed.

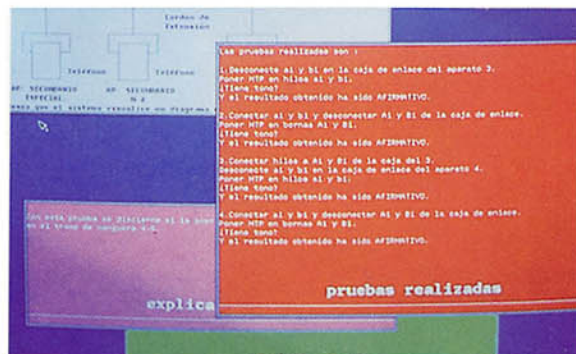
Development continued of a new packet switching system known as Tesys B. This will take over from Tesys A and Tesys AX as leaders in this field.

The results of research in terminals and adaptors for the ISDN and of the millimetric waveband radiolink, have been transferred to the industry. Work is also in progress on the first broadband ISDN, as part of the SABADO project (Broadband Optical Distribution User System). The aim of the project is to provide solutions to future user optical loops and to switching and local distribution.

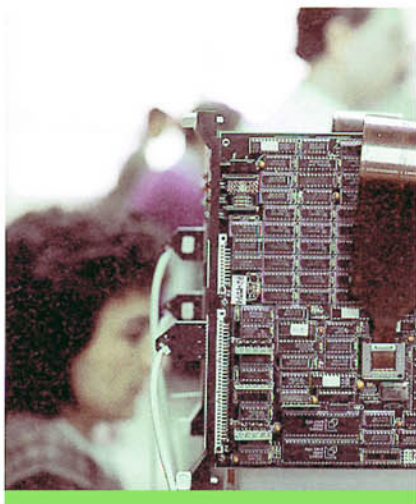
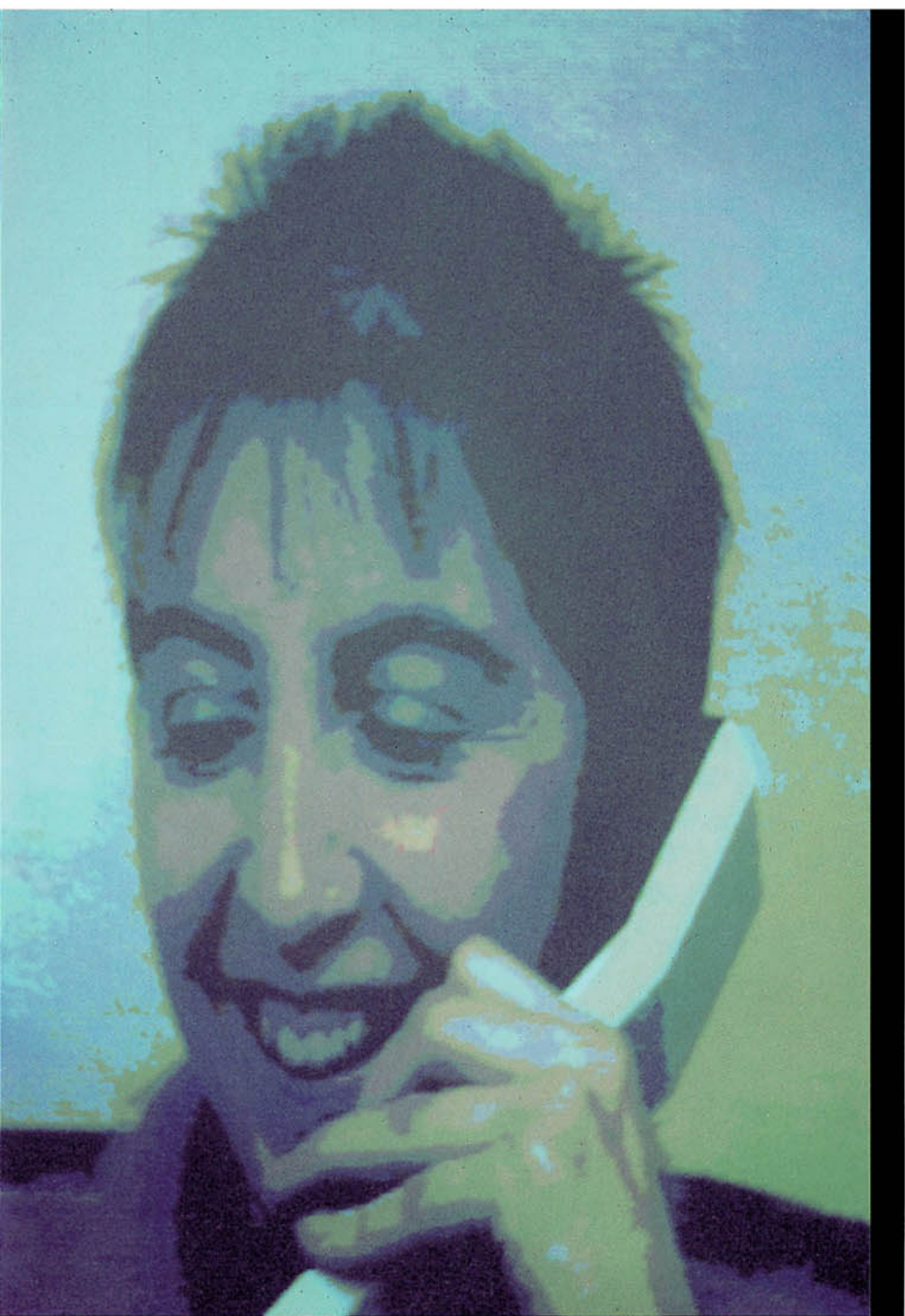


## Research and innovation

A new subsidiary company —**Telefónica** INVESTIGACION Y DESARROLLO S. A.— has taken over responsibility for Research and Development. Its aim is to encourage innovation in services and networks, applying high-quality, advanced technologies and thus ensure **Telefónica**'s strong position in the increasingly competitive marketplace.







**T**elefónica Investigación y Desarrollo, our Research and Development subsidiary, is striving to supply new, high-tech services and

networks of the finest quality. Current developments include a 50 GHz millimetric waveband communications system (top left), integrated circuits design work stations (left) and the integration of software of the Operations and Maintenance Structure (E.O.C.) (top right).

# Management decentralisation

Enhancement of **Telefónica's** management operations is vital if we are to succeed in the new competitive environment. Further decentralisation measures are an essential part of this enhancement process. The setting up of Provincial Units, which began in autumn 1986, was finally completed. From now on each province is responsible for meeting customers' needs and responding with greater efficiency to market demands.

The provincial budgeting process, together with the creation of Provincial Controller Reports, have enabled us to keep careful track of provincial management performance. Each province is regarded as a fully-fledged management body strengthening **Telefónica's** capacity to meet the demands of the new competitive environment.

In 1988 we will reach our goal of full decentralisation. Management at local level will be the responsibility of the market-focused provincial units, directly answerable to the Company's Executive Committee.

Parallel to this market-oriented strategy and in order to optimize management performance, we aim to further increase efficiency by fully computerising provincial management operations.



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**elefónica's** decentralisation program involves the setting up of provincial management units. We are continuing to work in close collaboration with various local authorities to expand the telephone service throughout the rural communities.





an efficient tool in expanding basic telephony to remote, sparsely populated regions. This policy has enabled us to set up 220 new local zones in 1987, 13 % more than the previous year. We also

installed 711 public service telephones, 18 % more than in 1986. Public service was expanded to a further 118 hamlets of under 50 inhabitants and telephone service was extended to 10,786 new subscribers outside local zones.

The healthy progress made in this field is largely due to the 16 cooperation agreements signed with Regional and Provincial Authorities and to the 386 smaller contracts drawn up with city councils and private bodies. Further steps were taken to convert outlying areas to an automatic service. By 1987 year end there were no more than 16,000 manually operated lines still in service and these will be replaced during 1988 by automatic equipment. Hence the completion of full network automatization will take place at the same time as the ISDN enters the arena.

## **Rural communications**

Our ongoing commitment to meeting the telecommunications needs of the rural community stands firm. The Royal Decree 2248/84, which defines the participation of public and private bodies, has proved to be

## Optimising human resources

A careful strategy of promotion, training and recycling of human resources is essential if we are to keep up with the ever-changing technological developments of the industry.

By 1987 year-end **Telefónica** had 63,311 employees, with graduates and technically qualified staff accounting for 16 % of the workforce.



**K**eeping up with the future means constantly upgrading our human resources pool. Telefónica's personnel policy is therefore a combination of training, promotion and highly qualified new recruitment.

In 1987, after negotiation, management and workers reached an agreement on pay levels for the next two years. In the first financial year salaries went up 5.48 % plus two productivity bonuses totalling 1.1 %, while a 3.9 % pay rise was agreed upon for 1988.

Our staffing policy is a combination of in-service training and recruitment of highly qualified personnel. Last year 1,091 graduates joined the company, representing an increase of 16 %.

The company has continued to expand its ambitious training program, which involves constant replacement of certain posts. Last year over 3,800 employees took part in initial training and promotion courses and 63,109 in refresher courses. In all, our training programs accounted for 1.65 % of total personnel costs.

In 1987 the Internal Communication Plan went into operation. The Plan is an important contributing factor towards our becoming a streamlined, market-focused, competitive enterprise.

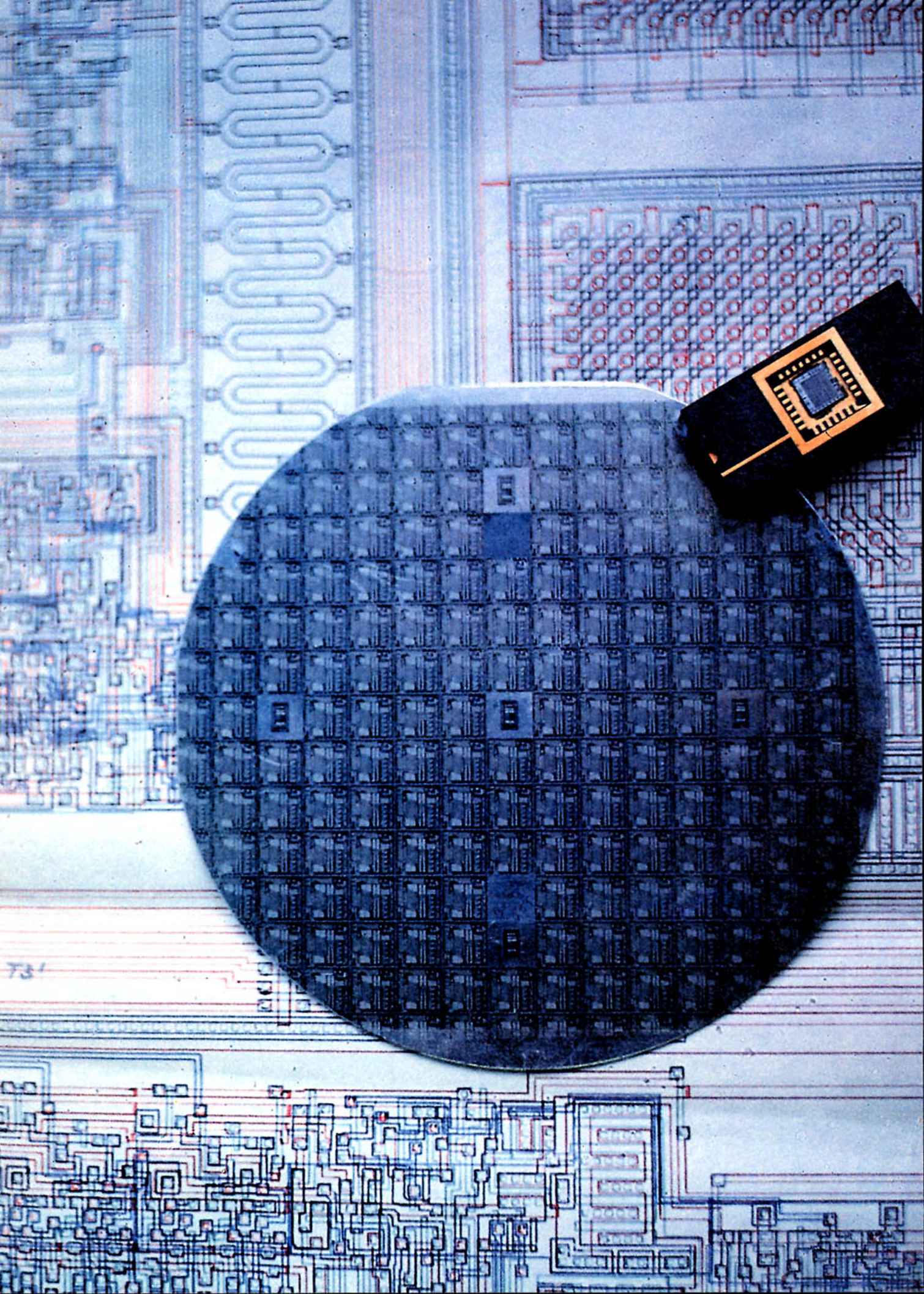
Our efforts to create a highly-trained, specialised workforce have borne fruit. Productivity increased by 7 % and major improvements in operating efficiency have enabled us to deal promptly with the rapid growth in the company's activities.

The number of lines in service per employee rose by 24.3 % during the 1982-87 period. At the same time the number of lines installed per employee went from 149.3 to 175.1 and revenue per employee grew from 4.21 to 8.54 million pesetas.

A factor which contributes to profitability growth is the downward trend in the ratio of personnel costs to revenue from services. This has fallen by 3.6 %, dropping from 0.48 in 1981 to 0.371 in 1987. Finally, absentee rates resembled those of the previous year.







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# Global perspectives

1987 saw a steady expansion in **Telefónica's** presence globally. This was due in part to our strong position as one of the nation's leading companies but also to the overall growth in Spain's economy and to our membership of the European Economic Community. International operations took place on several fronts.

The company's shares have spread further afield and are currently present in the major world stock markets. In 1987 we secured our share base by placing 54 million shares on the New York Stock Exchange.

Our activities in South America, USA, Europe, Africa and Asia bear witness to our global commitment. In an increasingly inter-dependent world, keeping up with the constant evolution of the global telecommunications market is central to our strategy. One way to ensure this is to participate in joint ventures with other major telecommunications companies.

In line with this policy, at the end of the year, the joint venture between **Telefónica** and AT & T, named AT&T Microelectrónica de España, started operations. The company, situated in the Tres Cantos suburb of Madrid, designs and manufactures 1.25 micron high-tech, custom integrated circuits and brings to Spain a wealth of technological expertise. In 1991, annual revenue will reach the figure of 20,000 million pesetas.

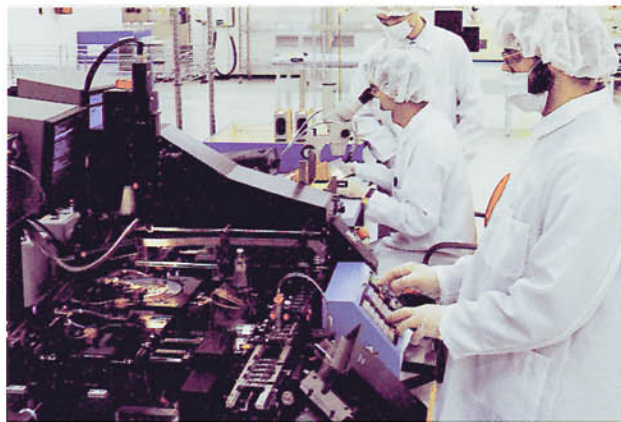
Throughout the year **Telefónica** was involved in promoting a new joint venture, APT-ESPAÑA, consisting of Amper and the European telecommunications consortium APT. The activities of this concern will cover the research, design, manufacture and installation of switching equipment and intelligent networks, together with digital transmission equipment and systems for the Integrated Services Digital Network.

**Telefónica** also signed an agreement in 1987 with the American company Electronic Data Systems (EDS) to set up a joint enterprise called TDS. This firm will operate worldwide, marketing and installing data transmission networks based on **Telefónica's** own Tesys packet switching system. The Tesys system is either already functioning or is on order throughout Spain, Canada, Argentina, Greece, Tunisia and Thailand. Over the next five years, we will strive to meet our sales target of 18,000 million pesetas spread across the five continents.

Having competed with the major companies in the sector, **Telefónica** Internacional won the contract with the Greek Telecommunications Administration to provide and install Hellaspac, the public packet switching data transmission network.

On January 18th, the first Spanish-Soviet enterprise was set up. This was also the first telecommunications joint venture ever undertaken in the USSR. The Spanish partners, **Telefónica** and Amper, hold 49 % of the share capital.

The factory will begin production of 500,000 Spanish designed "Tarsis" telephones and will eventually increase manufacturing capacity to one million units.



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**elefónica's activities on the international front are constantly spreading. A recent example is the manufacture of micro-chips by our joint venture ATT Microelectrónica de España.**

## A revolving holding company

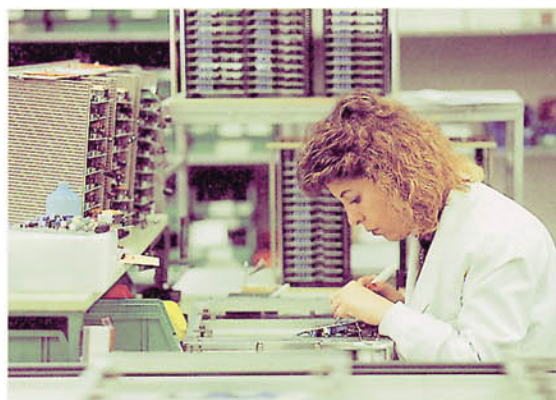
**Telefónica's** revolving holding policy remains central to its group strategy. In 1987 further measures were taken to reorganise, rationalise and simplify our participation in subsidiary and affiliated concerns, while still maintaining an energetic and flexible holding policy. Outlined below are some of the main objectives of our holding group program:

- Bring together under one umbrella all those companies involved in similar types of activities, in order to optimize exploitation of resources, technologies, markets and distribution channels.
- Sell off certain companies in order to make available resources with which to finance new business ventures.
- Draw up a strategy for future activities and new projects in order to strengthen **Telefónica's**

position as a keen competitor and technological leader in the world marketplace.

The following are a summary of the recent operations carried out in this field:

- Manufacturing is now the chief responsibility of Amper.



# T

**elefónica's revolving holding policy involves selling off our stake in some companies in order to take on new ventures. This strategy helps to sharpen our competitive edge in the market and provides a constant source of new business opportunities. In the photograph, SINTEL technicians discuss a project for the new joint venture "TDS".**

This company underwent a complete overhaul the previous year and today heads a widespread group of concerns involved both in electronics and terminal equipment and in the public telecommunications sector, following agreements with APT via Marconi.

—Sintel is the core company of both installations and systems engineering group, following the purchase of **Telefónica** Systemas. Particularly significant is the agreement reached with Electronic Data Systems (EDS) to market data networks.

—Computer and software activities centre around ENTEL, who are also preparing to compete in the Value Added Services market.

—Research and Development has now been handed over to the recently formed **Telefónica** Investigación y Desarrollo (TIDSA).

—Finally, there is the Services group which operates in areas closely related to marketing and financing. This group includes commercial concerns such as TELYCO (Terminal Equipment Sales), CETESA (Yellow Pages) and CABITEL (Telephone Booths). Financial enterprises include the newly formed **Telefónica** North America and notably two new subsidiary companies: Life insurance and pensions ANTARES, S. A. and CASIOPEA RE, S. A. The former is concerned with personal risk while the latter is a Risk Management tool, whose role is to protect risks which were hitherto self-insured by **Telefónica**.

Other recent enterprises of interest include the formation of COMET, concerned with venture capital projects in high profit, high technology business undertakings. And finally SEVA, formed in association with IBM and other Spanish firms, whose purpose is to evaluate the market potential of Value Added Services.





## TELEFONICA 83-87: SELECTED OPERATING DATA

### TELEPHONE SERVICE

Service parameters	31-12-87	31-12-86	31-12-85	31-12-84	31-12-83
Local lines in Service (thousands)	10,236.4	9,780.0	9,304.5	8,881.7	8,453.7
Degree of automation (%)	99.9	99.7	99.5	99.2	98.9
Automatic trunk circuits (thousands)	257.0	244.3	228.8	217.1	205.8
International service automation (%)	88.5	86	84	80	79
<b>Plant</b>					
Telephones (thousands)	15,476	14,782.2	14,258.9	13,825.5	13,345.3
Local lines installed (thousands)	11,085	10,645	10,313	9,990	9,630
Automatic	11,069	10,616	10,263	9,912	9,526
(% of those installed)	(99.9)	(99.7)	(99.5)	(99.2)	(98.9)
Digital	635	345	184	127	78
(% of automatic)	(5.7)	(3.3)	(1.8)	(1.3)	(0.8)
Conventional and semi-electronic	10,434	10,271	10,079	9,785	9,448
(% of automatic)	(94.3)	(96.7)	(98.2)	(98.7)	(99.2)
Manual	16	29	50	78	105
(% of those installed)	(0.1)	(0.3)	(0.5)	(0.8)	(1.1)

### BASIC INFRASTRUCTURE

	31-12-87	31-12-86	31-12-85	31-12-84	31-12-83
Coaxial cable (Km.)	10,454	10,379	10,112	9,933	9,514.2
Fibre-optics cable (Km.)	1,159	227	93	—	—
Trunk pair cable (Km.)	49,040	46,095	44,979	44,086	43,085
Subscriber networks (pair Km., thousands)	38,295	35,465	33,626	32,067	30,450

### TRENDS IN USAGE PER LINE AND DEMAND FOR NEW LINES

	31-12-87	31-12-86	31-12-85	31-12-84	31-12-83
AVERAGE GROWTH IN USAGE PER LINE	8.2	5.0	3.4	1.8	2.5
DEMAND FOR NEW LINES	1,135,406	963,037	756,164	773,812	783,867
(% Annual growth rate)	17.9	27.4	(2.3)	(1.3)	32.6

### TRENDS IN DATA TRANSMISSION SERVICES

	31-12-87	31-12-86	31-12-85	31-12-84	31-12-83
DATA TRANSMISSION CIRCUITS	32,715	31,152	28,950	26,651	24,001
Year-on-year growth (%)	5.0	7.6	8.6	11.0	11.2
TELEPHONE NETWORK CONNECTIONS FOR DATA TRANSMISSION	77,090	58,175	45,080	24,792	19,451
Year-on-year growth (%)	32.5	29.0	81.8	27.4	28.4
IBERPAC NETWORK CONNECTIONS	34,059	27,632	23,810	20,056	14,302
Year-on-year growth (%)	23.3	16.0	18.7	40.2	14.0

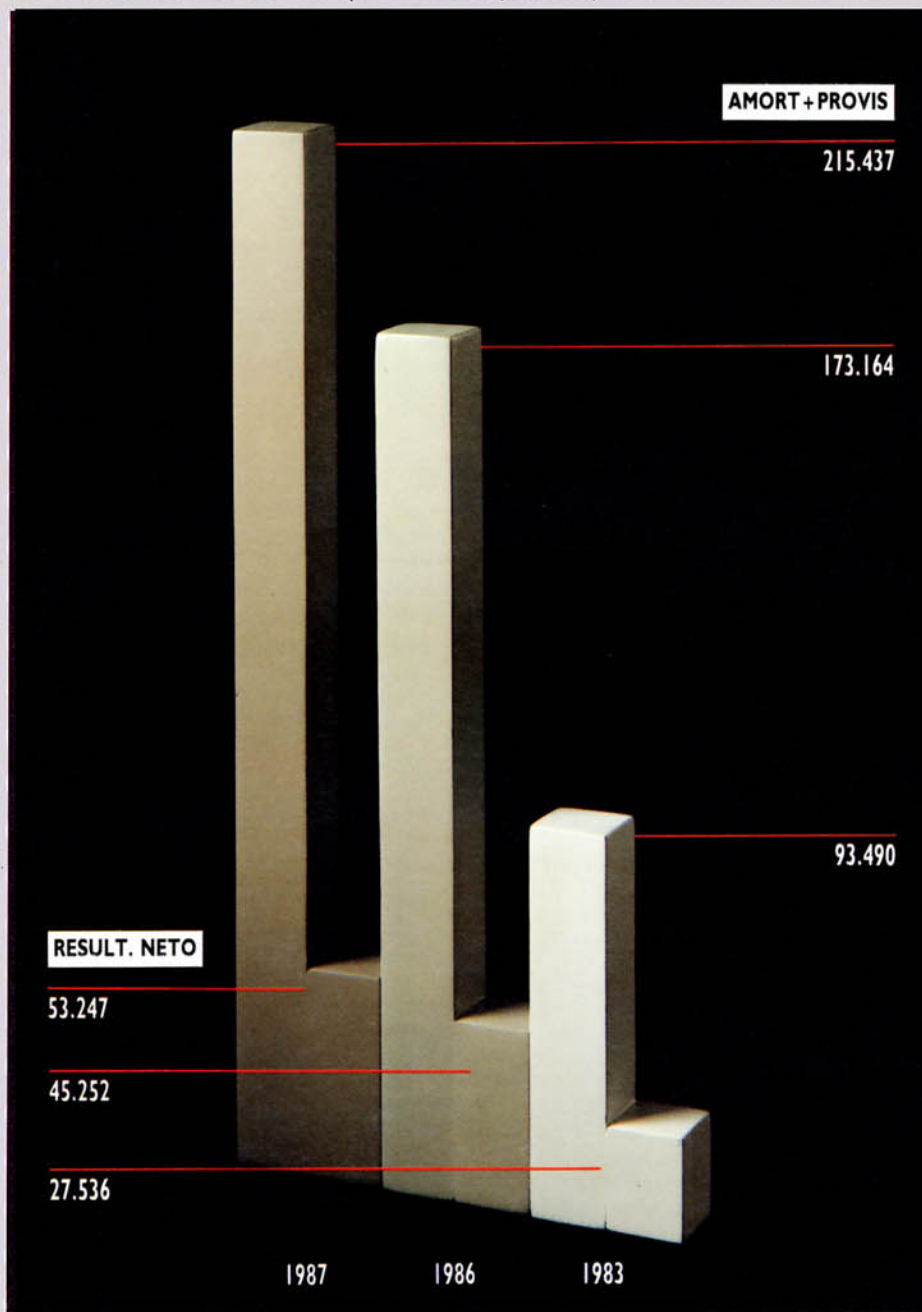


# Financial Review



## FUNDS GENERATED FROM OPERATIONS

(Millions of pesetas)



# Financial Review

## CONTENTS

- Selected financial data
- Telefónica and the Spanish economy
- Management's discussion

## SELECTED FINANCIAL DATA

(In millions of Ptas., unless otherwise stated)

	1987 (\$)	1987	1986	1985	1984	1983
Operating revenue	4,954.6	540,727	468,011	409,415	363,937	311,469
Operating expenses	1,673.0	182,580	162,837	148,601	133,143	120,897
Financial expenses	770.5	84,094	77,781	77,209	75,817	63,790
Depreciation and amortization	1,506.8	164,442	138,204	116,964	97,866	83,682
Net income	487.9	53,247	45,252	39,149	32,620	27,536
Gross cash flow	2,461.9	268,684	218,416	177,580	149,518	121,026
Share capital	3,806.0	415,368	411,793	360,468	320,416	288,374
Shareholders' equity	11,185.4	1,220,727	1,090,016	947,804	832,543	719,023
Medium and long term debt	6,260.0	683,186	632,056	659,545	636,528	562,994
Capital expenditures	2,384.0	260,183	211,514	188,681	173,642	164,404

Exchange rate (31-12-87): 1 \$ = 109.136 pts.

# Telefónica and the Spanish economy

1987 was another prosperous year for Spain's economy with performance notably exceeding EEC and OECD averages. Of particular significance, was the 5.2 % growth in real terms in GDP and the 15.9 % real increase in investment. In addition, there was a promising decline in the rate of inflation to 4.6 % and a reduction in public sector deficit to 3.8 % of GDP. On the exterior front, foreign reserves had risen by year end to 30,000 million dollars. There was a relative rise in the value of the peseta against the major world currencies and Spain became one of the world's creditor nations.

On the whole, the financial performance of Spanish companies showed a strong improvement. There was a rise in the ratio of internally generated funds to capital expenditures and a strengthening of their financial position, both enhanced by productivity gains and labour cost control.

In line with the rise in domestic markets, **Telefónica** registered an 8.2 % boost in average usage per line and a 17.9 % rise in demand for new lines. There was a real increase in **Telefónica's** value added of 11 %, representing 1.57 % of the national total. The substantial 10.7 % rise in labour productivity helped improve **Telefónica's** participation in Spain's gross operating profits from 1.89 % in 1986 to 2.07 %. Finally, the 33.1 % increase in the Company's gross savings enabled us to cover the 23.2 % expansion in capital expenditures over the year, with no significant rise in borrowing.

## Telefónica AND THE SPANISH ECONOMY (as a % of the national total)

	1987	1986	1985	1984	1983
Gross value added	1,57	1,50	1,51	1,47	1,46
Wages and related benefits	1,18	1,21	1,23	1,22	1,19
Gross operating profit	2,07	1,89	1,85	1,78	1,79
Gross savings	2,72	2,29	2,38	2,19	2,11
Gross capital formation	3,45	3,34	3,47	3,50	3,47

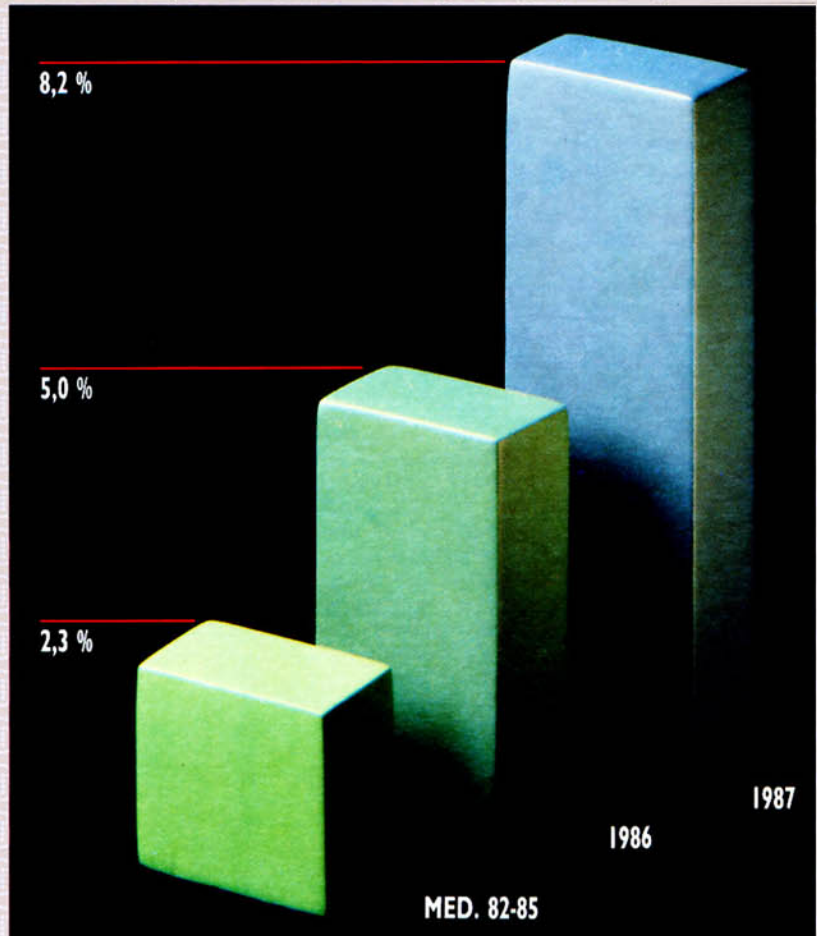
# Management's discussion

## TELEPHONE USAGE (% Increase in average usage per line)

Fiscal 1987 was a highly successful year for the Company as a whole. The boost in productivity together with enhanced management efficiency brought about a healthy increase in gross cash flow and earnings per share, which in turn has encouraged a vigorous capital expenditure program.

Once again there was an outstanding growth in demand. Over 1,135,000 applications for new lines had been recorded by the end of the fiscal year, representing a 17.9 % increase over 1986, when in turn there was a 27.4 % rise over 1985.

Particularly noteworthy was the sharp 8.2 % rise in average usage per line and the impressive 11.2 % leap in international service usage.

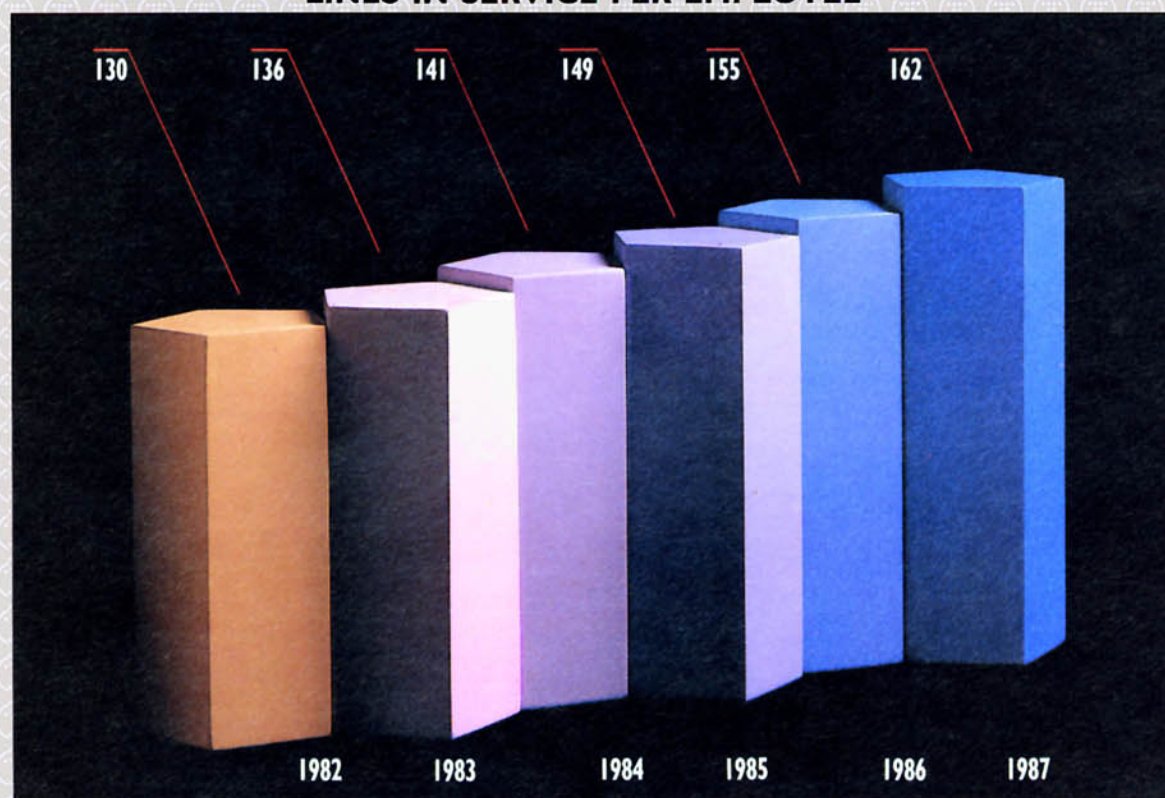


## OPERATING REVENUE (In millions of Ptas., unless otherwise stated)

Description	1987 \$ in millions	1987	1986	1985	1984	1983	% Increase	
							over 86	83-87 cum. av.
Subscriber Service Charges	1,439.2	157,073	141,894	126,834	111,086	74,916	10.7	20.3
Data and facsimile transmission	394.5	43,052	35,859	32,252	24,568	21,245	20.1	19.3
Domestic Automatic Service	2,166.9	236,491	196,526	163,063	149,646	148,023	20.3	12.4
Trunk calls through operator	14.6	1,597	1,882	2,186	2,217	2,201	(15.1)	(7.7)
International Service	668.4	72,948	61,787	57,505	51,149	40,299	18.1	16.0
Mobile land and maritime services	15.1	1,646	1,634	1,595	1,437	1,087	0.7	10.9
Directories and yearbooks	69.6	7,598	10,216	10,071	9,123	9,112	(25.6)	(4.4)
<b>REVENUE FROM SERVICES</b>	<b>4,768.3</b>	<b>520,405</b>	<b>449,798</b>	<b>393,506</b>	<b>349,226</b>	<b>296,883</b>	<b>15.7</b>	<b>15.1</b>
Connection fees and other items	186.3	20,322	18,213	15,909	14,711	14,586	11.6	8.6
<b>OPERATING REVENUE</b>	<b>4,954.6</b>	<b>540,727</b>	<b>468,011</b>	<b>409,415</b>	<b>363,937</b>	<b>311,469</b>	<b>15.5</b>	<b>14.8</b>

Exchange rate (31-12-87): 1 \$ = 109.136 ptas.

## LINES IN SERVICE PER EMPLOYEE



The upward trend in demand for data transmission services continued, with a 47.2 % increase over 1986. There was an especially heavy demand for the Iberpac network (75.2 %), and for the Telefax and Ibertex data transmission services through the switched telephone network (130.1 %).

Operating revenue grew by 15.5 % against an average 3.99 % increase in service charges. These figures provide firm evidence of the boost in real demand for telephone and datacom services.

The 1987 positive results were reinforced by improved management efficiency to cope with the increase in demand and by a strict cost containment policy.

Although workforce numbers remained stable, there was a notable improvement in productivity. The number of lines in service per employee reached the figure of 161.7, compared to 155.2 the previous year.

The relatively moderate increase in operating expenses led to a rise in the operating margin to 66.2 %, which is a clear reflection of the excellent progress achieved

in productivity and operating efficiency during fiscal 1987.

A prudent financial policy was responsible for keeping down financial costs and further cementing **Telefónica's** solid financial structure.

Consequently, the rate of increase in net financial expenses continued to fall with only a 3.3 % rise registered in 1987, compared to 3.9 % in 1986 and 6.3 % between 1983-85.

There was also a reduction in the ratio of net financial expenses to operating revenue, which fell by 1.5 points against the previous fiscal year.

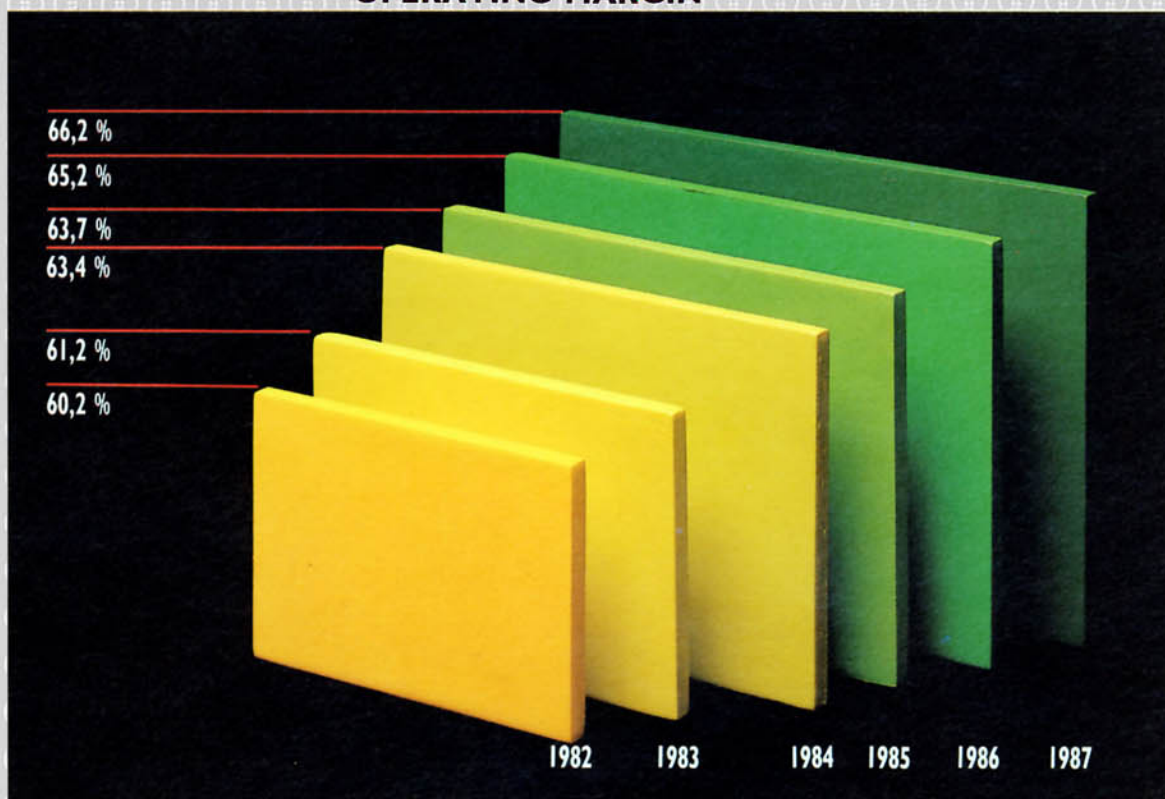
We should also mention that during fiscal 1987 financial management strategies led to adjustments and greater flexibility in domestic and foreign debt and general improvements in the Company's term financing structure.

The following are some of the most significant features of fiscal 1987 results:

—Transfer to provisions, in line with a provident poli-



## OPERATING MARGIN



cy of maximum prudence, representing 9.4 % of fiscal year revenue. This figure was in spite of the reduction in transfer to exchange losses resulting from the strength of the peseta and the current low level of foreign currency debt.

—Increase in the average annual depreciation rate, which was set at 5.5 % the last financial year, applying replacement cost accounting principles. If the historic cost value of assets is considered, the 153,501 million pesetas represent an 11.25 % average annual rate of depreciation of fixed assets. This figure compares favourably to that of the international telecommunications sector.

—Income before tax rose to 84,322 million pesetas. It is the last time that the 6 % state levy will be applied to gross operating revenue.

From January 1st 1988, the special tax regulations laid down in the State Contract, will cease to exist. Under the new fiscal regulations (Ley de Tributación de **Telefónica**), **Telefónica** will be subject

to general Corporate Tax law and Real Estate local taxation. All other local taxes will be replaced by an annual 2 % levy of gross operating revenue.

The change in fiscal regulations together with the enforcement of the new Telecommunications Bill (LOT) as from January 1st 1988, have encouraged the Company to take certain measures. These in no way affect the income statement but rather aim to anticipate the whole write down of customer premises equipment, thus preparing ourselves to meet the ongoing terminals deregulation process.

These adjustments are reflected in the reconciliation of net income and shareholders' equity to international (IAS) and United States (US GAAP) accounting systems. (See pages 68 and 69).

Further evidence of the positive trend within the Company can be found in the 17.7 % rise in net income to 53,247 million pesetas. Earnings per share grew by 15.1 % over the previous year to 64.2 pesetas.

This successful figure enabled us to meet our target

of offering an 11% dividend over par value to shareholders, with the rest going to the Company's reserves. Consequently, pay-out level was 85.7% as opposed to 99% in past years.

Our strategy, designed to boost productivity and enhance efficiency, together with the steps to control operating and financial expenses, have led to further upgrading in the quality of our assets and a 23% increase in gross cash flow.

**Telefónica's** excellent 1987 financial results are recorded in the balance sheet ratios where the accomplishments of our active financial managerial approach are faithfully reflected.

There were improvements in the fixed assets coverage ratio (from 59.4% in 1986 to 60.4%) and in the

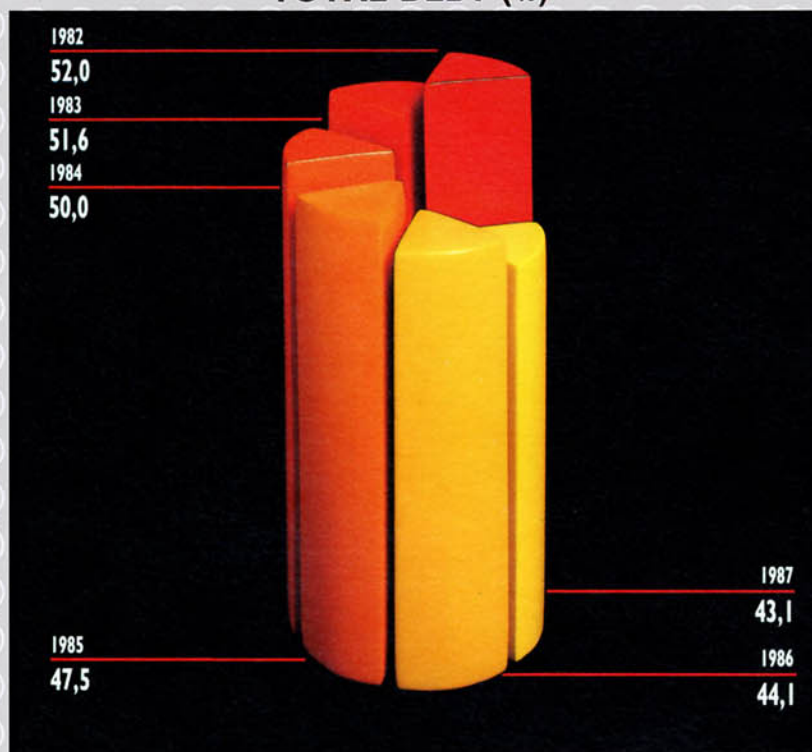
## FINANCIAL RATIOS

	1987	1986	1983
Operating margin/ operating revenue (%)	66.2	65.2	61.2
Net financial expenses/ operating revenue (%)	12.6	14.1	18.0
Transfer to provisions/ operating revenue (%)	9.4	7.5	3.1
Operating margin/Av. net plant (%)	19.6	18.4	16.2
Fixed assets coverage (%)	60.4	59.4	51.8
Guarantee ratio (%)	64.1	63.3	56.1
Total debt (%)	43.1	44.1	51.6
Debt repayment capacity (years)	2.7	3.1	5.2
Gross cash flow/net financial expenses (years)	3.9	3.3	2.2

## RESULTS - PROFIT MARGINS

Description	1987 \$ In millions	1987		1986		1985		
		Amount	% Struct.	Amount	% Struct.	Amount	% Struct.	Amount
+ Revenue from operations	4,954.6	540,727	100.0	468,011	100.0	409,415	100.0	363,937
— Operating expenses	1,673.0	182,580	(33.8)	162,837	(34.8)	148,601	(36.3)	133,143
= Operating margin	3,281.6	358,147	66.2	305,174	65.2	260,814	63.7	230,794
— Net financial expenses	624.2	68,123	(12.6)	65,973	(14.1)	63,474	(15.5)	63,600
— Exchange losses	94.3	10,294	(1.9)	11,050	(2.4)	9,277	(2.2)	14,230
— Depreciation and amortization	1,506.8	164,442	(30.4)	138,204	(29.5)	116,964	(28.6)	97,866
= Gross operating income	1,056.3	115,288	21.3	89,947	19.2	71,099	17.4	55,098
— Other provisions and charges	372.9	40,701	(7.5)	23,910	(5.1)	12,190	(3.0)	4,802
± Net extraordinary items	89.2	9,735	1.8	6,071	1.3	3,675	0.9	3,170
= Income before state levy	772.6	84,322	15.6	72,108	15.4	62,584	15.3	53,466
— State levy	284.7	31,075	(5.7)	26,856	(5.7)	23,435	(5.7)	20,846
= Net income	487.9	53,247	9.9	45,252	9.7	39,149	9.6	32,620
+ Net income	487.9	53,247	9.9	45,252	9.7	39,149	9.6	32,620
+ Depreciation and amortization	1,506.8	164,442	30.4	138,204	29.5	116,964	28.6	97,866
+ Provisions and charges	467.2	50,995	9.4	34,960	7.5	21,467	5.2	19,032
= Gross cash flow (funds generated from operations)	2,461.9	268,684	49.7	218,416	46.7	177,580	43.4	149,518

## TOTAL DEBT (%)



guarantee ratio—the relation between shareholders' equity and net capital employed—which reached 64.1 %, an 0.8 % increase over the previous year.

Debt ratios also experienced a positive development.

Total Debt ratio was down from 44.1 % in 1986 to 43.1 %.

On a final note, the fact that gross cash flow was 3.9 times greater than net financial expenses (3.3 in 1986), and total debt only 2.7 times gross cash flow, is a clear indication of the healthy expansion capacity achieved in 1987, which overtook that of the year before.

Two important events accompanied these outstanding financial results:

On 12th June 1987, the international diversification of **Telefónica's** investor base reached a highpoint, marked by the start of the listing of our shares on the New York Stock Exchange.

Almost simultaneously, the U.S. agencies, Standard & Poor's and Moody's, awarded the Company "A-1+" and "P-1" ratings respectively, for our U.S. and European commercial paper program.

These two events provide firm confirmation internationally of both **Telefónica's** performance and future prospects. Furthermore, they clearly show the solid foundations of the Company's financial position and the strong fundamentals of our stock in the eyes of the discerning international investor.

## 983/1987 (In millions of Ptas.)

% Struct.	1983		Increase	
	Amount	% Struct.	Over 86	83-87 cum. av.
100.0 (36.6)	311,469 120,897	100.0 (38.8)	15.5 12.1	14.8 10.9
63.4 (17.5) (3.9) (26.8)	190,572 56,216 5,330 83,682	61.2 (18.0) (1.7) (26.9)	17.4 3.3 (6.8) 19.0	17.1 4.9 17.9 18.4
15.2 (1.3) 0.8	45,344 4,478 4,348	14.6 (1.5) 1.4	28.2 70.2 60.4	26.3 73.6 22.3
14.7 (5.7)	45,214 17,678	14.5 (5.7)	16.9 15.7	16.9 15.1
9.0	27,536	8.8	17.7	17.9
9.0 26.8 5.2	27,536 83,682 9,808	8.8 26.9 3.2	17.7 19.0 45.9	17.9 18.4 51.0
41.0	121,026	38.9	23.0	22.1

## BALANCE SHEETS 1983/1987

(After profit distribution, in millions of Ptas., unless otherwise stated)

ITEMS	1987 \$ in millions	1987	1986	1985	1984	1983
Fixed assets	18,514.7	2,020,623	1,835,197	1,703,265	1,540,156	1,388,514
Property, plant and equipment	28,976.6	3,162,385	2,828,586	2,568,812	2,298,083	2,016,193
Depreciation of fixed assets	11,307.4	(1,234,045)	(1,097,404)	(982,606)	(868,250)	(754,311)
Property, plant and equipment - net	17,669.2	1,928,340	1,731,182	1,586,206	1,429,833	1,261,882
Net intangible assets	6.6	718	3,997	5,042	4,803	3,797
Investments	475.2	51,859	38,755	32,987	33,895	37,677
Deferred charges	98.2	10,722	12,424	12,898	13,461	9,186
Unrealised exchange losses	265.5	28,984	48,839	66,132	58,164	75,972
Current assets	1,155.1	126,059	113,596	103,122	124,201	98,081
Consumable inventories	38.0	4,146	5,692	3,699	2,993	2,523
Accounts receivable	1,052.6	114,882	100,010	86,078	78,038	75,155
Cash and banks	25.4	2,772	2,332	7,981	34,297	12,388
Other current assets and prepayments	39.1	4,259	5,562	5,364	8,873	8,015
Assets = Liabilities and shareholders' equity	19,669.8	2,146,682	1,948,793	1,806,387	1,644,357	1,486,595
Shareholders' equity (1)	11,185.4	1,220,727	1,090,016	947,804	832,543	719,023
Paid-in share capital	3,806.0	415,368	411,793	360,468	320,416	288,374
Reserves and provisions	7,379.4	805,359	678,223	587,336	512,127	430,649
Medium and long term debt (2)	6,260.0	683,186	632,056	659,545	636,528	562,994
Debt in pesetas	5,531.6	603,694	532,927	450,717	400,374	369,393
Debt in foreign currencies	728.4	79,492	99,129	208,828	236,154	193,601
Net capital employed (1 + 2)	17,445.4	1,903,913	1,722,072	1,607,349	1,469,071	1,282,017
Current liabilities	2,224.4	242,769	226,721	199,038	195,286	204,578
Short term debt	1,890.5	206,321	187,585	168,171	165,381	180,929
Accruals	333.9	36,448	39,136	30,867	29,905	23,649
Unused credit facilities (In memorandum accounts)	850.2	92,789	97,965	121,300	88,680	53,607

Exchange Rate 31-12-87: 1 \$ = 109.136 Ptas.

## STATEMENT OF CHANGES IN FINANCIAL POSITION

(After profit distribution, in millions of Ptas., unless otherwise stated)

	1987 \$ en millions	1987	1986	1985	1984	1983
Gross cash flow	2,461.9	268,684	218,416	177,580	149,518	121,026
Reserves	40.7	4,444	2,157	3,369	4,769	4,563
Share capital increases	—	—	36,047	32,084	22,387	33,644
M & L.T. Debt	1,622.1	177,028	204,803	154,267	151,510	105,714
— Domestic	1,518.4	165,710 (a)	168,827	139,370	97,409	72,151
— Foreign	103.7	11,318	35,976	14,897	54,101	33,563
Total sources and applications of funds	4,124.7	450,156	461,423	367,300	328,184	264,947
Capital expenditures and investments	2,609.3	284,773	218,458	195,726	175,549	185,797
— Capital expenditures in fixed assets	2,384.0	260,183	211,514	188,681	173,642	164,404
— Intangible assets	40.3	4,398	1,866	1,778	1,607	1,658
— Investments in affiliates	135.7	14,808	5,051	48	(3,318)	15,386
— Stocks for fixed assets	49.3	5,384	27	5,219	3,618	4,349
Deferred charges	(72.9)	(7,959)	(7,307)	(5,882)	(9,511)	(4,628)
Applications of provisions	611.6	66,752	61,774	55,056	50,770	36,851
Repayment and redemption of M. & L.T. debt	1,011.0	110,335	205,534	147,587	78,642	51,518
— Domestic	822.4	89,758	67,014	86,900	53,032	41,107
— Foreign	188.6	20,577	138,520	60,687	25,610	10,411
Variation in working capital	(34.3)	(3,745)	(17,036)	(25,187)	(32,734)	(4,591)
Variation in unused credit facilities	(50.7)	(5,533)	(16,976)	29,271	22,839	8,760

Exchange rate 31-12-87: 1 \$ = 109.136 ptas.

### NOTES

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

Total variation .....	(3,745)
Increase in 1987 dividends .....	1,005
<b>TOTAL .....</b>	<b>(2,740)</b>

(a) This amount includes time period adjustments for Promissory Notes and Zero Coupon Bonds, that figure in the audited statement of changes in financial position as self-financing, in accordance with the following breakdown:

Debenture interest .....	632
Promissory Note interest .....	3,447
<b>TOTAL .....</b>	<b>4,079</b>





## **Audited financial statements**



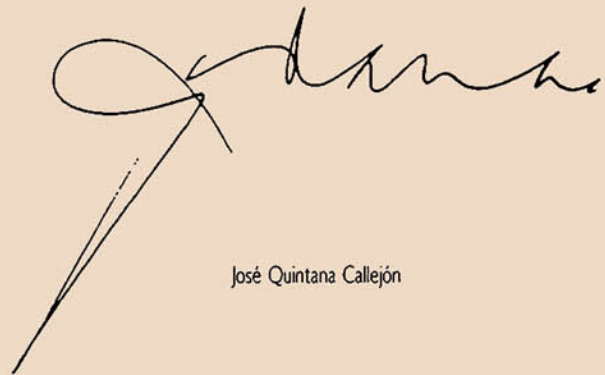
# Auditing Shareholders' Report

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.

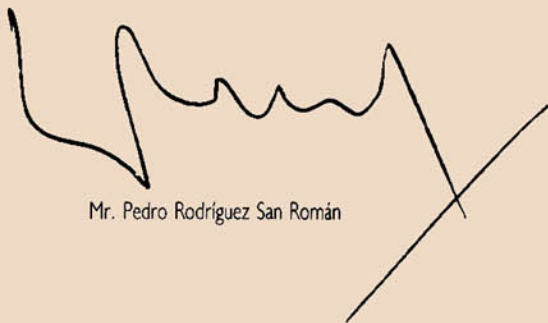
3.2. Costs and expenses.

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>	<b>2,146,682</b>	<b>1,948,793</b>
<b>MEMORANDUM ACCOUNTS (Note 18)</b>		
Unused credit facilities	92,789	97,965
Others	26,051	26,994
	<b>118,840</b>	<b>124,959</b>

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

#### 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 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.

#### 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 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.

#### I.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
Total subsidiaries .....			11,028
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
Total associates .....			9,330
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
Total others .....			3,261
Total group .....			23,619

(\*) 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.
<u>12,037</u>		
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.
<u>10,972</u>		
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	—	
<u>3,377</u>		
<u><u>26,386</u></u>		

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 .....	37,770	36,543

## 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 .....	25,080	24,432

## 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 .....	36,448	39,136

## 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

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### 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**

## SHAREHOLDER INFORMATION

	1987	1986	1985	1984	1983
Share Capital (Millions of Ptas.)	415,367.90	411,793.00	360,468.00	320,414.60	288,374.00
Earnings per share (Ptas.)	64.16	55.76	55.71	55.69	55.85
Price/earnings ratio	12.47	15.69	11.44	8.35	6.27
Dividend payout (%)	85.72	98.64	98.72	98.76	98.40
Capitalisation/Cash-flow	2.47	3.30	2.59	1.99	1.67

### Share Capital

The share capital of **Telefónica** at April, 30 1988 was 430,939,585,000 pesetas, represented by 861,879,170 bearer shares of 500 Ptas. nominal value, fully paid in.

Capital increases since 1983 are as follows:

Year	Ratio	Issue Price (Ptas.)	Paid by the Shareholders (Ptas.)	Nominal Amount Millions of Ptas.
1983	1 x 5	100%	350.00	48,062.3
1984	1 x 9	100%	350.00	32,041.6
1985	1 x 8	100%	400.00	40,051.9
1986	1 x 9	100%	450.00	40,051.9
1986 Conv.	—	128.375 %	641.875	69.1
1986 Conv.	—	168.975 %	844.875	11,204.2
1987 Conv.	—	154.993 %	774.965	181.2
1987 Conv.	—	148.115 %	740.575	2,791.8
1987 Conv.	—	165.225 %	826.125	602.2
1988 Conv.	—	129.600 %	648.00	15,257.5
1988 Conv.	—	144.925 %	724.625	314.3

NOTE: At April 30, 1988 **Telefónica** had in circulation 11,163,07 million pesetas in Convertible Bonds.

### Share Listings

**Telefónica** shares are listed on all the Spanish Stock Exchanges- Madrid, Barcelona, Bilbao and Valencia- and on five foreign Stock Exchanges- London, Paris, Frankfurt, Tokyo and New York\*.

Admission to the New York Stock Exchange was granted on June 11, 1987.

**Telefónica** is listed under the symbol "TEF".

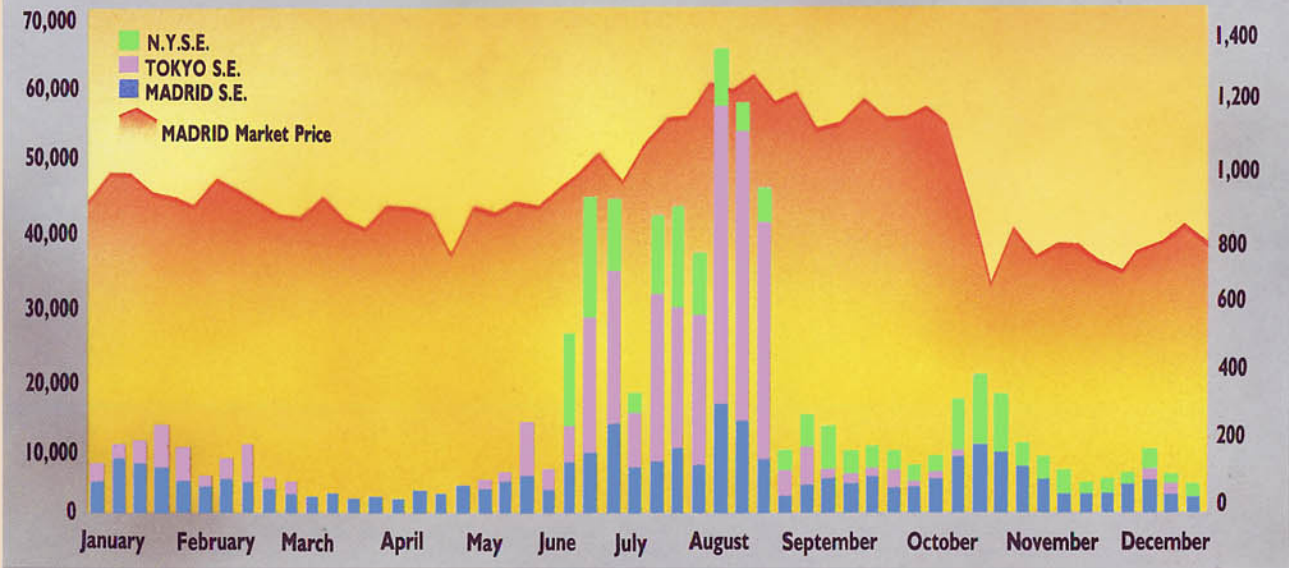
Since April 5, 1988, **Telefónica** is present on the London Stock Exchange SEAQ INTERNATIONAL\* system.

\* It is listed on American Depository Receipts (ADR). 1 ADR = 3 shares.

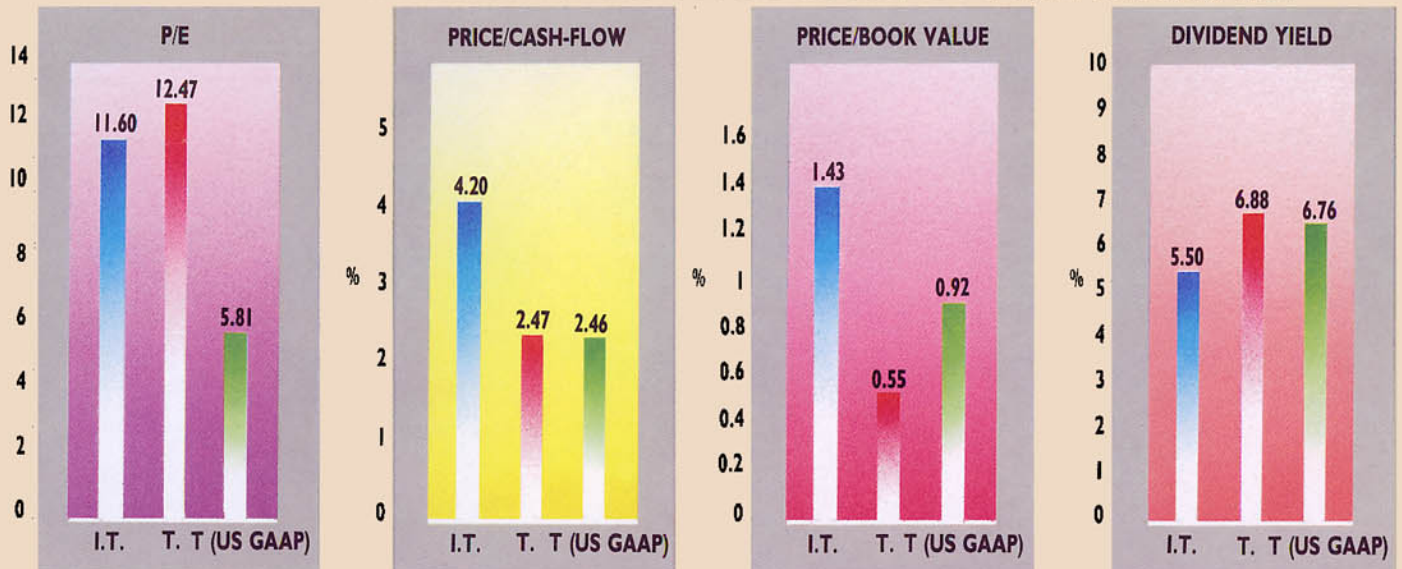


Weekly share turnover (thousands of shares)

Market Price (ptas.)



### TELEFONICA: INTERNATIONAL COMPARISONS AT DECEMBER 31, 1987



IT — INTERNATIONAL TELECOMMUNICATIONS INDEX (source: "Capital International Perspective").  
 T — TELEFONICA. — Data according to spanish accounting principles.  
 T (US. GAAP) - TELEFONICA. — Data according to US accounting principles.

### Market prices

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

Year	High	Low	Year-end close
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
1987 1 <sup>st</sup> quarter	977.50	810.00	810.00
1987 2 <sup>nd</sup> quarter	1,026.25	732.50	975.60
1987 3 <sup>rd</sup> quarter	1,265.00	925.00	1,102.50
1987 4 <sup>th</sup> quarter	1,145.00	645.00	800.00

## Stock Market Capitalisation

	1987	1986	1985	1984	1983	Average growth % 87/83
<b>Telefónica</b>	664.6	701.0	459.6	298.0	201.9	34.70
Total Madrid Stock Exchange	7,748.8	6,477.3	3,007.3	2,294.5	1,711.0	45.88
<b>Telefónica</b> Weighting on the M.S.E. index	10.89	15.20	11.90	10.71	11.20	—

(figures in thousands of millions of pesetas).

## 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:

	1987	% of par val.	1986	% of par val.
Interim	25 Ptas.	5	25 Ptas.	5
Final	30 Ptas.*	6	30 Ptas.	6*
Total	55 Ptas.	11	55 Ptas.	11

\* Pending approval by the General Meeting of Shareholders, in accordance with the proposal for net income distribution (page 56).

## Principal shareholders of Telefónica

Since **Telefónica** shares are bearer shares, no official register of shareholders exists. Nevertheless, on paying the interim dividend for 1987 on January 8, 1988, it was verified that the main shareholders are:

	Interest as % of Share Capital
Spanish State	29.28
Bank of Spain	1.41
Caja Postal (Post Office Savings Bank)	2.14

The Company is not aware of any other shareholder owning more than 5 % of the shares issued. According to the General Register of Foreign Investments at the Directorate General of Foreign Transactions of the Ministry of Finance, foreign shareholdings in the Company amounted to 92,266,710,000 ptas.

### **Notice of the General Meeting of Shareholders**

Date: May 27, 1988. (at the second notice).

Time: 12.00 h.

Place: Paseo de la Castellana, n.º 259. Madrid.

### **Shareholder information**

Copies of this Annual Report may be obtained free of charge at the Company's offices or by writing to:

#### **Telefónica de España, S.A.**

Financial Department  
General Perón, 28 - planta 15  
Edificio Master's II  
28020 MADRID

In compliance with the stipulations of the Ministry Orders of November 17, 1981 and February 26, 1982,

a bi-yearly information brochure is available to shareholders.

Published by **Telefónica.**

Gran Vía, 28. 28013 Madrid.

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**Charts:** Chema Alonso.

**Layout and Printing:** Gaez.

**Legal Deposit:** M-15,887-1988.



**Telefónica de España, S.A.**