

**Telefónica  
de España**

1988 Annual Report

Head Office:  
TELEFONICA DE ESPAÑA  
Gran Vía, 28 - 28013 MADRID

## **1988 ANNUAL REPORT\***

Established in 1924, with 66,000 employees, over 2.3 trillion pesetas of total assets and over 766 billion pesetas of market capitalisation at the end of 1988, today Telefónica is one of Spain's leading corporations in terms of size and strategic importance.

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 over 10.97 million local lines in service and almost 69,000 Ibercom integrated business communication lines. Iberpac—our public packet switching data network—is one of the most advanced in the world with over 45,000 connections. In addition, we are also involved, through the Telefónica Group companies, in designing, manufacturing and marketing a wide array of Information Age services and products.

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

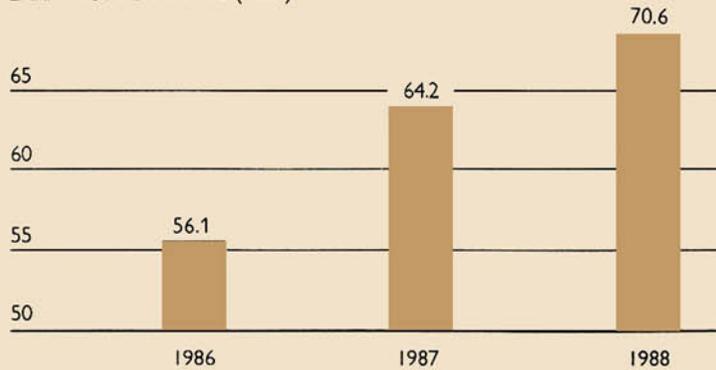
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## HIGHLIGHTS

	1986	1987	1988
Lines in service (thousands)	9,785.3	10,236.4	10,971.6
Lines per 100 inhabitants (thousands)	25.3	26.1	28.1
% Average growth in line usage	5.0	8.2	8.6
Demand for new lines	963,037	1,135,406	1,356,364
Operating revenue (Ptas. millions)	468,011	540,727	612,536
Debt ratio (%)	44.1	43.1	43.6
Capital expenditure in fixed assets (Ptas. millions)	211,514	260,183	357,815
Employees	63,021	63,311	66,062
Lines in service per employee	155.2	161.7	166.1
Gross cash-flow (Ptas. millions)	218,416	268,684	304,537
Net income (Ptas. millions)	45,252	53,247	62,845

### EARNINGS PER SHARE (Ptas.)

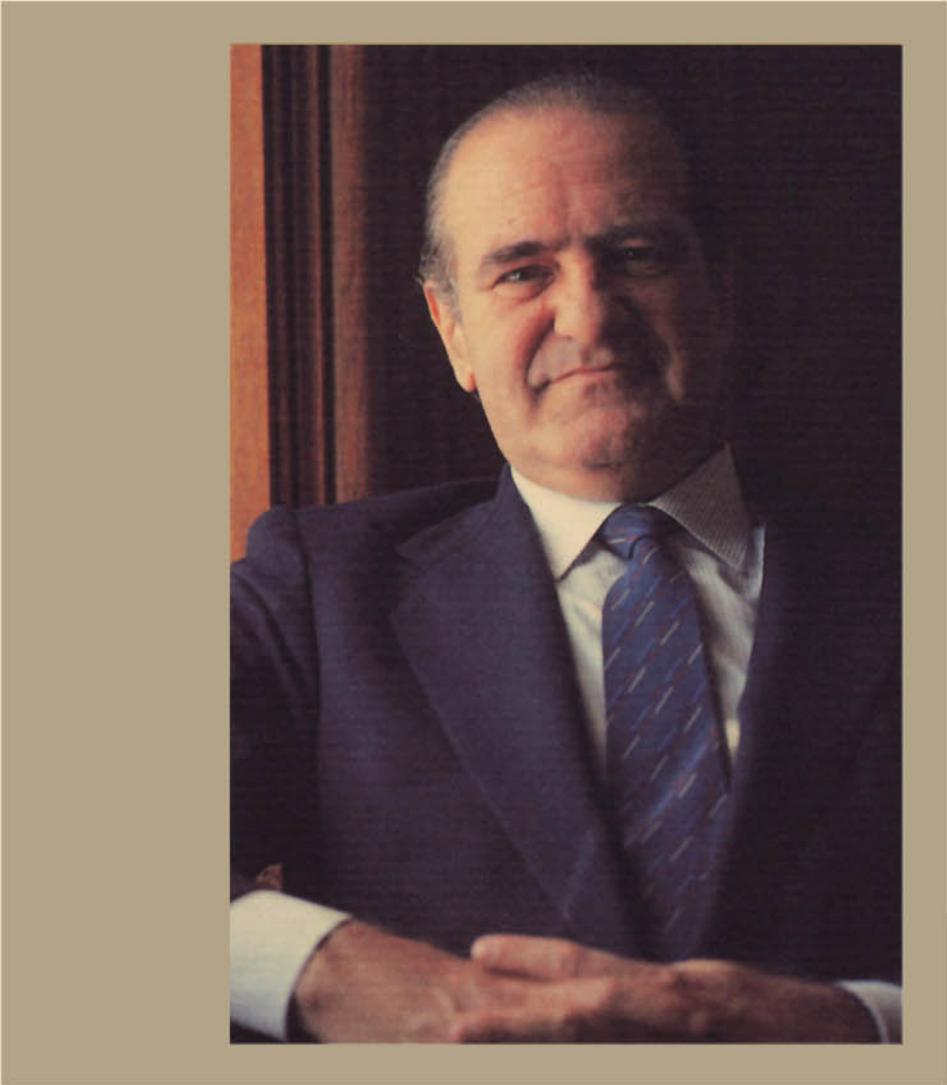


Dear Shareholder,

I would like to take this opportunity to greet you for the first time and share with you some brief thoughts concerning our company.

I am not exaggerating when I say that Telefónica is today facing a historic challenge. At the same time as performing our essential public service role, we must consolidate our reputation as a profitable and fast-evolving enterprise. Along with constantly striving to meet our clients' demands, who wait with understandable impatience, even greater efforts are called for to keep up with and at the forefront of the technological revolution which is leading us by leaps and bounds towards a new kind of society. Our presence in the domestic market is now expanding towards global horizons where, in a keenly competitive arena, we must capitalize on the wealth of opportunities presented by the promising world of new value added services. A new environment, which both sets the way and urges on those who have taken on the responsibility of carrying on the task already initiated by my predecessor, Luis Solana.

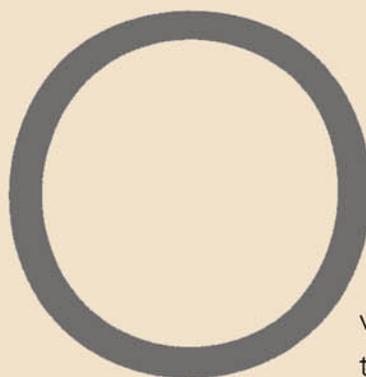
To imagine our road over the next few years will be free of obstacles would be to deceive ourselves. We trust that the whole legal and institutional framework of the telecommunications sector will soon be clarified and Telefónica's role in particular clearly defined. Within this new framework, we are set to accomplish our mission, which is undoubtably an essential ingredient of Spain's economic development over the next decade. I sincerely believe that Telefónica has sound financial foundations and an exceptional human resource base. It is our task to ensure that the best possible use is made of these assets in order to further expand and strengthen our Company. My purpose in drawing your attention to these brief lines is to share with you my hope and trust in the future of Telefónica.



A handwritten signature in black ink, reading "Cándido Velázquez-Gaztelu Ruiz". The signature is fluid and cursive, with a long horizontal line extending from the end of the name.

Cándido Velázquez-Gaztelu Ruiz  
**Chairman of the Board of Telefónica de España**

## 1988: a year of inflexion



Overall, in harmony with the positive trends in

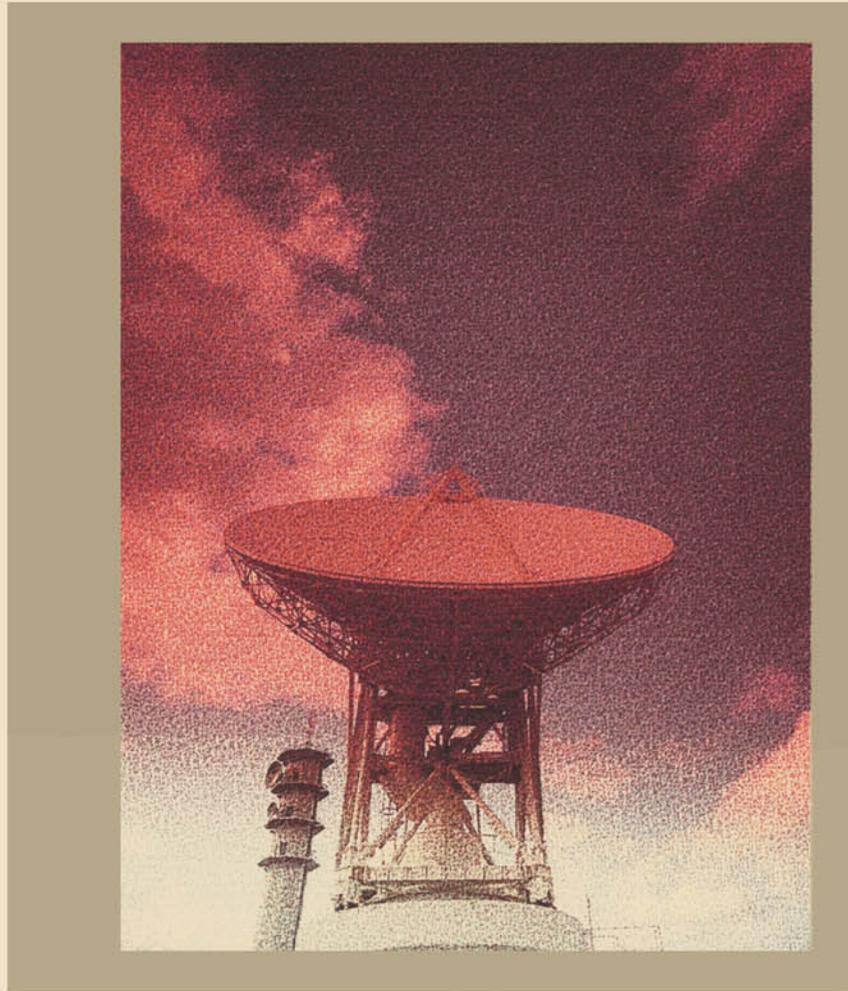
the Spanish economy, 1988 was a year in which Telefónica stepped up its efforts to deal promptly with the domestic demands for telecommunications services. This was reflected in the substantial growth in capital expenditure (both in service expansion and up-dating and in technological enhancements), as well as in the widespread diversification of services supply, the increase in the size and professional expertise of the workforce and in the intense application of the company's resources. As regards provision of services, 1988 witnessed a continuing surge in demand for both conventional and advanced services. Also, from a financial point of view, in a year when service tariffs remained stable, the profits obtained confirm the steady consolidation of Telefónica's sound financial position.

The trends in demand for telecommunications services, especially in the business sector, combined with the healthy prospects for market growth, in a country whose economy is expanding at a faster rate than that of its neighbours, made 1988 the start of a new era for the Company, in response to the current situation within the sector. In this respect, 1988 was a year of inflexion, paving the way towards a new period of capital expenditure, more efficient provision of services, network modernization and deeper penetration of telecommunications throughout Spain. As such, the past year can be considered the start of a new phase during which we aim to narrow the gap separating Spain from other countries in the telecommunications field.

Within this context, it is possible to assess the past financial year. Two of the most notable features were the 19.5% annual rise in demand for lines and the 8.6% increase in average usage per line. In comparative terms, these figures represent exceptionally high levels. In 1988 there were 1,356,364 line applications, that is over 220,000 more than in 1987, when there was also a very high growth in demand of 18%.

Similarly, the 8.6% increase in traffic per line exceeded the figure of 8.2% recorded in 1987.

If we look at the trends over a longer period, we can clearly appreciate the energetic



growth in demand for services during 1988. There were over 582,000 more applications for lines in 1988 than the average for the 1982-1986 period. At the same time, growth in usage per line exceeded by 5.7 points the average 2.9 point increase for 1982-1986.

To deal with this exceptional boost in demand, Telefónica speeded up the pace of line installations, at the same time as taking steps to modernize the network and extend the range of services. Capital expenditure in fixed assets rose by 37.5% over the previous year to reach the figure of 357,815 million pesetas. This enabled us to install 969,998 lines, which represented an increase of 61.4% over 1987. 68.5% of these new lines used digital technology, which will go towards enhancing network capacity to carry advanced telecommunications services.

At the end of the year, the telephone network had 10,971,600 local lines in service, that is 7.2% more than in 1987. 1988 represented the high point in Telefónica automation of the domestic telephone service, with the replacement of the 16,000 manually operated local lines still in service at the start of the year.

On the financial front, 1988 witnessed a continuation of the upward trends set in previous years. Profit before tax was over 84,000 million pesetas and net income rose by 18% over 1987 to 62,845 million pesetas.

Funds generated from operations grew by 13.3% to 304,537 million pesetas. Earnings per share rose by 10% during 1988 to 70.62 pesetas, while gross cash flow per share stood at 342.2 pesetas, showing an increase of 5.7% over 1987.

Finally, the trends in the balance sheet ratios reflected the continuing rationalisation process undertaken by Telefónica during the last few years. Consequently, the 1988 financial profits enable us to confidently embark upon the scheduled capital expenditure programmes in order to meet the growing demand for services and obtain a satisfactory return on the funds invested.

## Basic telephone service: a priority



uring 1988, Telefónica responded to the major surge

in demand and to the decline in service quality by devoting particular attention to the basic telephone service.

At year-end, telephone density throughout Spain stood at 28.1 lines per 100 inhabitants, as opposed to 26.1 the previous year. At the same time, telephone penetration into Spanish households improved by 3.5% over 1987 to 71.2 lines per 100 households.

Telefónica's service targets foresee for 1992 an estimated 38 lines per 100 inhabitants and 83 lines per 100 households, which will bring the level of Spain's telephone service penetration into line with her EEC partners.

At the same time, the Company aims to steadily reduce the imbalance in demand and the average waiting period for service installation.

An additional feature of basic telephony up-grading during 1988 was the public telephony development programme. This included a substantial increase in the number of seasonal telephone booths designed to meet the needs of the floating population in tourist areas. Another significant step was the progress made in up-dating public telephony by introducing new methods of payment, such as multi-coin telephones and the preparations for the introduction of electronic card phones.

**SERVICE QUALITY.** In answer to the decline in service quality, resulting from the surge in demand, in 1988 Telefónica drew up a plan of action and a series of indicators aimed at ensuring a reasonable and consistent level of service quality by directly intervening in the network. Plans include the remodelling of routes and trunk transmission paths to achieve high standards of reliability and efficiency. Network quality targets aim to substantially raise call efficiency levels in the national network from 88% in 1988 to over 95% during the next few years, while maintaining high levels in the number of repairs carried out in less than 24 hours.

During the past year, preliminary works were almost completed for the creation of a National Network Management Centre in 1989. This Centre will supervise and control

the digital telephone network, contributing to enhanced network efficiency and service quality upgrading.

**SERVICE EXPANSION IN THE RURAL COMMUNITY.** The extension of the service throughout the rural community is another basic feature of Telefónica's response to demand for telephone services. This is particularly important in a country such as Spain, with 63,000 population centres, 66% of which have under 500 inhabitants. The development of rural networks is based on a Four Year Plan, approved in January 1988 by the Cabinet, and on the cooperation agreements signed with local and regional bodies, under the Royal Decree 2248/84. The Company plans to install 5,700 Public Service Telephones in villages of over 50 inhabitants and 2,025 Public Telephones in villages of under 50 inhabitants, creating 2,000 new local zones and meeting the demands of 134,000 subscribers outside local zones. During 1988 we created 429 new local zones in rural areas to the benefit of 18,039 subscribers. In addition, we installed Public Telephones in 910 villages, which until then had been without a telephone service. Telefónica's collaboration with local and regional bodies led to the signing of 25 contracts and 510 cooperation agreements aimed at promoting the extension of the telephone service throughout the rural community.

## Serving the business community

The Iberpac packet switching network continued to make new inroads during the year, with applications for connection 70% up on 1987 at around 15,000. At year-end, there were over 56,800 direct access terminals to the Iberpac network, representing a rise of 30% over 1987 when network connections totalled 45,626 (34% more than the year before). At the same time, we extended international access from the Iberpac network to 47 public packet switching data networks. Iberpac also carries a variety of new services, such as Ibertex, which reached a network capacity of 29,300 terminals, and the X-28 service, which had a network capacity of 8,780 terminals by the end of the year.

**ELECTRONIC FUNDS TRANSFER.** During 1988, the Dataphone Electronic Transfer of Funds service witnessed an outstanding boost in sales exceeding all expectations. By the end of 1988 there were over 60,000 terminals connected to the Dataphone service, facilitating the nationwide use of credit cards.

**IBERCOM SERVICE.** 1988 was also a year of spectacular growth for our Ibercom service, with 68,993 lines installed by the end of the year, that is 200% more than the previous year. The warm welcome enjoyed by Ibercom and the future growth potential of the service are reflected in the kind of user and the nature of the service. In 1988 Ibercom had 115 clients, including the major corporations in Spain from all sectors of business and finance. The Ibercom service has been especially well-received by central, regional and local Administration Authorities.

In return for our clients' trust in Ibercom, Telefónica is striving to enhance its infrastructure to guarantee sufficient service capacity. Hence, in 1988, there was a 600% increase in the number of Ibercom front-end centres compared to 1987 and by the end of 1988, 21 provinces had this type of centre installed.

**IBERMIC, HIGH-SPEED RENTED CIRCUITS.** During 1988, the first Ibermic network centres were installed in the main metropolitan areas, coinciding with a especially high rise in demand for high-speed circuits, particularly those of 64 Kbit/s circuits and other higher speeds.

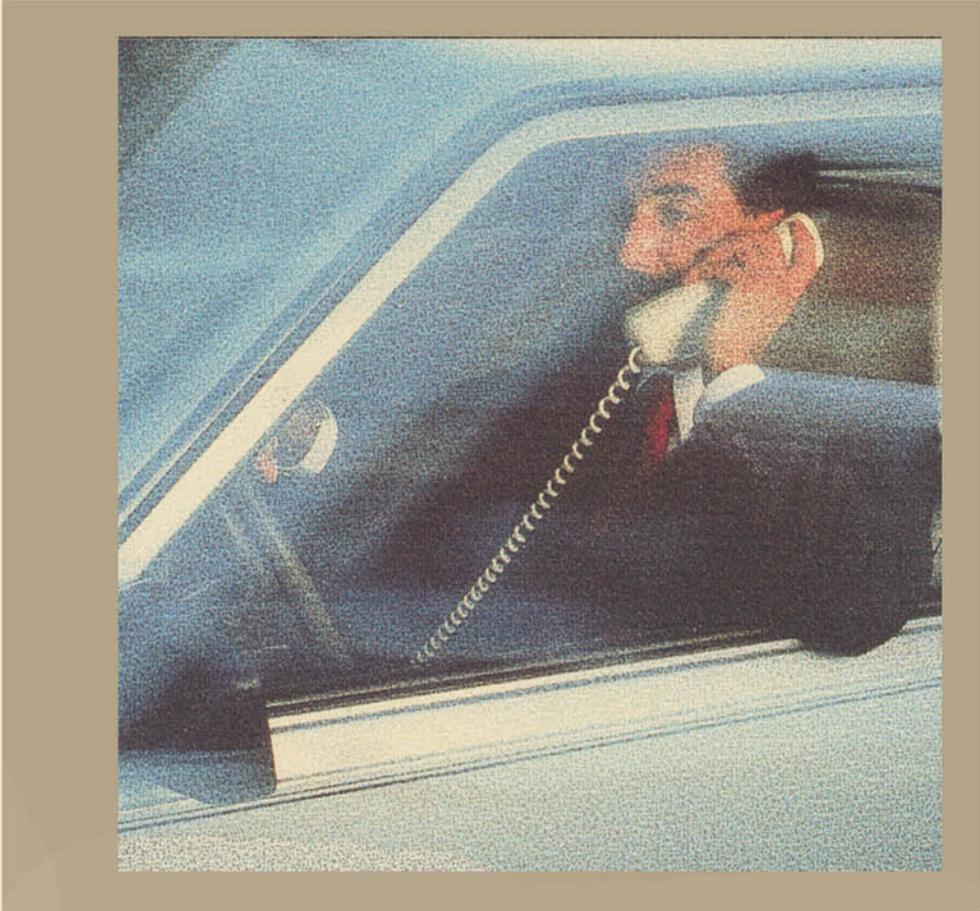
In the next few years, rapid development is planned of Ibermic high-speed data transmission facilities. Optical fibre access loops and metropolitan radioelectric access centres will be created, which will be complemented by the commissioning of the Alcobendas (Madrid), Castellbisbal (Barcelona) and Pineda (Seville) Teleports.

**NEW SATELLITE COMMUNICATIONS.** Along with the formation of a Teleport network designed to meet the demand for domestic and international business services, in 1988 we also increased the number of Satellite Communications Centres (SCC), and completed the definition of two new SCC in La Granada (Barcelona) and El Toril (Seville).

Of particular significance during the year, was the transmission of radio signals on behalf of radio broadcasting stations —via the SMS EUTELSAT service —from the Satellite Communications Centre earth station at Armuña de Tajuña and the broadcasting of television programmes to Europe, via EUTELSAT, and to Latin America, via INTELSAT.

**MOBILE TELEPHONY: A COMMERCIAL SUCCESS.** Our Automatic Mobile Telephony service (TMA) enjoyed a 170% growth in demand over the previous year. The service was extended to 38 provinces with a network capacity of 32,000 users on 450 MHz. During the year a new analog mobile system was designed under the name of TMA-900-A, to be installed during 1989 in order to complement the existing TMA 450 product and offer users a wider range of mobile options. At the start of the next decade, a new cellular mobile system covering the whole European continent will be introduced, also on the 900 MHz waveband. This will enable a vehicle to keep in touch via the telephone while travelling throughout the continent.

There were continuing developments during 1988 in Telefónica's Radiomessage and



Maritime Satellite Services and we expect to see further progress in this area over the coming years. Scheduled for 1989 is the launching of the Radiopaging Service, in its various wavelengths, throughout a total of 33 provinces.

**INTEGRATED SERVICES.** In 1988 Telefónica began preparations for the piloting of the new Integrated Services Digital Network (ISDN), with the first experimental lines to go into operation in Madrid during 1989. There are plans to extend the ISDN lines to the Barcelona-Madrid-Seville axis and the launching of these services on to the market is scheduled for 1991.

**OPTICAL COMMUNICATIONS.** In 1988 the TAT-8 transatlantic, underwater, optical cable linking North America to Europe was commissioned, with a 2 x 280 Mbit/s capacity. Telefónica is a co-owner of this project which represents the first underwater digital line between the two continents. Also of interest in this field was the strengthening of the communications infrastructure between the Spanish Peninsula and the Ba-

learic and Canary Islands, with the installation of underwater cables to guarantee the enhanced connection of both archipelagos with the Spanish mainland.

1988 also signified the start of an expansion phase in the optical fibre land network. This advanced communications medium is to be extended throughout the national, provincial and metropolitan networks.

**INTELLIGENT NETWORK SERVICES.** Last financial year we began marketing the Automatic Reverse Charge 900 service. This has received a warm welcome from our business and large corporation clients with users totalling 439 by the end of the year.

In view of the healthy prospects in the 900 service demand, in 1988 we took steps to strengthen the network infrastructure by incorporating a new Automatic Reverse Charge Centre in Barcelona to complement the existing service in Madrid.



Over the next few years the steady digitization of the network, which will convert the telephone exchanges into genuine communications computers, will enable us to offer clients new Intelligent Network Services. The most notable of these will be multiaddress credit calling, personal telephony and advanced automatic reverse charge calling.

**TELEFAX.** There was an unprecedented rise in the demand for Telefax service, with users totalling 53,574 by December 1988, that is 200% more than at the same time the previous year. We expect these growth trends to continue, as they are doing in the majority of neighbouring countries.

**SUPPLEMENTARY TELEPHONE SERVICES (STS).** Along with basic telephone services, Telefónica now offers a whole range of supplementary facilities from its digital switching exchanges. At 1988 year-end the following Supplementary Telephone Services were on offer:

Call waiting \* Conference calls \* Pre-programmed dialling \* Call rerouting \* Abbreviated dialling \* Detailed information services.

**NEW TERMINALS.** Throughout the past year, Telefónica developed a package of supplementary and complementary telephone equipment which was available for purchase as from January. The new commercial environment has led to an expansion in the range of both models and services. In 1988 16 new products were marketed, among them the display phones, automatic dialling equipment and automatic answering machines. We plan to simplify the supply of main telephones in 1989 and establish just one model of TEIDE telephone apparatus, whose features will enhance the basic service.

**THE OLYMPIC GAMES AND EXPO '92.** The vital significance to the telecommunications sector of the 1992 events, encouraged Telefónica to collaborate closely during 1988 with the Barcelona Olympic Games Organising Committee and the Seville World Expo State Company. Telefónica was appointed Official Telecommunications

Supplier and Collaborating Partner to the Barcelona '92 Olympic Games and Official Telecommunications Supplier and Technological Partner to EXPO '92.

Both events demand the careful planning of telecommunications requirements and Telefónica has designed specific programmes to guarantee adequate network infrastructures in Barcelona and Seville. During 1988 works commenced on La Cartuja site in Seville and on the Montjuic Olympic site in Barcelona.

## Network digitization and extension



during 1988, 969,998 new subscriber lines were in-

stalled, with 68.5% digitization. This figure represents an increase of 61.4% over 1987, which is firm evidence of the huge efforts made in this area.

The technological advances in the telecommunications field and the accomplishment of our goals as far as service provision are not possible without a major enhancement of Telefónica's network infrastructure. Between 1989 and 1992 we plan to triple the number of lines installed in the last four years by installing a further 7 million local lines. 97% of these new lines will be digital which means that by the end of 1992 network digitization of subscriber lines will stand at over 46%. At the same time, to safeguard network and services quality, in the next four years we aim to install 2 million trunk lines in transit exchanges and thereby raise the proportion of long distance lines to local lines by 25%. By the end of this period, network digitization of trunk lines should be approximately 73%. Likewise, digitization of the international network, which commenced in 1988, will also continue, with the commissioning of the international digital exchange in Madrid-Alcobendas. In order to achieve the digitization of the transmission systems, Telefónica aims to install before 1992, over 28,000 kms of land and underwater optical fibre cable. Our plans foresee substantially strengthening the transmission capacity of the national network and creating optical fibre loops to allow the digital connection of the major metropolitan areas.

**INVESTMENT DRIVE.** 1988 represented a real leap forward in Telefónica's capital expenditure programme, which reached the figure of 357,815 million pesetas, with a 37.5% growth over 1987.

The 1989-1992 investment plan amounts to around two and a half trillion pesetas and during 1988 the main priority of the expenditure programme was to enhance network infrastructure. In general, the aim of Telefónica's programme is to meet the service quality demands and requirements, together with putting major efforts into automating and optimizing plant operations, all geared towards both boosting productivity and

guaranteeing top quality services provision to our users. We aim to have efficient network management systems which optimize network utilization in the various sections, as well as cutting operating and maintenance costs.

The increase in digital network capacity will also enable us to meet the Narrow Band Integrated Services Digital Network targets set by the European Community Council for 1993. In Spain these will be in operation by 1992 in preparation for the international events in Barcelona and Seville.

The above targets are subject to the legislation laid down in the Telecommunications Act, including the formalization of the new contract between Telefónica and the State and the finalizing of the Telecommunications National Plan. At the same time, Telefónica's plans are designed within the framework of Spain's full EEC membership and the creation of the Single European Market in 1992.

## Human resources development

The integration and expertise of our human resources team are of vital importance to the company's competitive performance in the marketplace. For this reason, Telefónica's staffing policy is a combination of training in the latest technologies together with incentive and promotion schemes, which are essential in order to equip the Company with a dynamic human resources base.

By 1988 year-end Telefónica had 66,062 employees, which was 4.3% more than the previous year.

This increase in the workforce during 1988 consisted of 895 permanent staff and 1,856 temporary staff (1.4% and 2.9% increases respectively), which makes Telefónica one of the country's major job creating firms.

Significant progress was made in the Company's policy of attracting highly-qualified staff. 714 graduates were employed and 1,697 other technical posts were filled. 6,124 employees took part in initial training and promotion courses and 39,253 in refresher courses. In all, Telefónica's training programmes accounted for 1.7% of total personnel costs. 1988 also saw the continuation of positive trends in productivity ratios, which helped to enhance profit levels. There was a notable rise in productivity per employee (8.6% up on 1987), an increase in the ratio of lines in service per employee and a 0.8% fall in the ratio of personnel costs to revenue from services.



## The Telefónica Group



uring the past financial year  
the Telefónica Group com-

panies firmly established their market positions in the various fields of activity. Sales grew by 44.6% and the major improvements in management efficiency helped raise profit margins and increase the return on shareholders' equity to an average of 27.3%. To safeguard Telefónica's competitive edge in the face of recent moves towards the globalization of telecommunications services and networks, in 1988 we decided to form a new subsidiary company called TS-1 Telefónica de Servicios, S.A., responsible for the promotion and provision of Value Added Services. Telefónica's strategy is to complement its core network business by maintaining a presence in high growth, strategic areas of the market. To further this objective, during 1988 Telefónica invested in a number of ventures, among them:

\*INFONET. A company set up to create and operate a worldwide network designed to provide international value added and data transmission services.

\*The new panEuropean company LOCSTAR and the North American company GEOSTAR. These enterprises have been set up to develop and exploit radio location and radiopaging services via satellite, covering the continents of Europe and America respectively.

## International agreements

To meet the ever more competitive environment and guarantee the company sufficient market outlets, Telefónica took steps in 1988 to procure cooperation agreements with other public network operators in Europe and America. Agreements were signed with France Telecom, British Telecom, the Italian company STET and the Portuguese operator CTT-TLP and negotiations are well underway for further agreements with Germany's Deutsche Bundespost and the Swedish operator TELEVERKET. There were also agreements with the North American operators NYNEX, Bell Atlantic, Ameritech and Southwestern Bell.

## Research and development



At the end of 1988 our subsidiary company Telefónica Investigación y Desarrollo, S.A. (Telefónica I + D) had over 400 employees, 72% of which were degree holders. Telefónica has a 100% holding in Telefónica I+D, whose function is to carry out research activities. In 1988 the company dedicated special efforts towards developing computer programmes for telecommunications network planning and establishing efficient software engineering for its projects. Among these programmes is the Operations and Maintenance Structure (EOC), which is now at the technical rating phase and is especially significant because of its direct application to network management and maintenance.

Throughout the year, Telefónica I + D also carried on the development of existing projects, such as the Tesys-B packet switching system, whose specific application integrated circuits and operating system have now been tested. Equally significant were the results of the recently completed MIAC (ESPRIT) project, which successfully proved its possible application for the provision of multiconferencing services with audiovisual back-up, using the Ibercom and Ibermic facilities.

Lastly, during 1988 Telefónica I+D was involved in several European programmes, among them four ESPRIT and eight RACE projects, three CTS special projects and two European Space Agency (ESA) projects.

# TELEFONICA 1984-88: SELECTED OPERATING DATA

## TELEPHONE SERVICE

Service parameters	31-12-84	31-12-85	31-12-86	31-12-87	31-12-88
Local lines in service (thousands)	8,881.7	9,340.5	9,785.3	10,236.4	10,971.6
Degree of automation (%)	99.2	99.5	99.7	99.9	100.0
Ibercom lines in service (thousands)	—	—	—	21.6	68.9
Automatic trunk circuits (thousands)	217.1	228.8	244.3	257.0	311.8
International circuits (thousands)	9.2	9.6	9.9	10.8	11.7
European service automation (%)	98.9	99.0	99.3	99.5	99.6
International service automation (%)	80.0	84.0	86.0	88.5	91.8
<b>Plant</b>					
Local lines installed (thousands)	9,990	10,313	10,645	11,085	11,981
Digital	127	184	345	635	1,297
(% of total automatic)	1.3	1.8	3.3	5.7	10.8
Conventional and semi-electronic	9,785	10,079	10,271	10,434	10,684
(% of total automatic)	98.7	98.2	96.7	94.3	89.2
Trunk lines (thousands)	888	935	969	1,066	1,356
Analog	848	871	866	869	904
(% total)	95.5	93.2	89.4	81.5	66.7
Digital	40	64	103	197	452
(% total)	4.5	6.8	10.6	18.5	33.3

## BASIC INFRASTRUCTURE

	31-12-84	31-12-85	31-12-86	31-12-87	31-12-88
Coaxial cable (km)	9,933	10,112	10,379	10,454	10,454
Fibre-optics cable (km)	—	93	227	1,159	3,664
Trunk pair cable (km)	44,086	44,979	46,095	49,040	53,140
Subscriber networks (pair km, thousands)	32,067	33,626	35,465	38,295	41,833

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

	31-12-84	31-12-85	31-12-86	31-12-87	31-12-88
Average growth in usage per line	1.8	3.4	5.0	8.2	8.6
Demand for new lines (Telephone + Ibercom)	773,812	756,164	963,037	1,135,406	1,356,364
(% annual growth rate)	(1.3)	(2.3)	27.4	17.9	19.5
Demand for Ibercom lines	—	—	9,085	42,243	67,305

## TRENDS IN DATA TRANSMISSION SERVICES

	31-12-84	31-12-85	31-12-86	31-12-87	31-12-88
Data transmission (D/T) circuits	26,651	28,950	31,152	32,715	34,632
Year-on-year growth (%)	11.0	8.6	7.6	5.0	5.8
Telephone network connections for D/T	24,792	45,080	58,175	77,090	123,831
Year-on-year growth (%)	27.4	81.8	29.0	32.5	60.6
Iberpac network connections	20,056	23,810	27,632	34,059	45,626
Year-on-year growth (%)	40.2	18.7	16.0	23.3	34.0

## INTERNATIONAL BROADCASTING

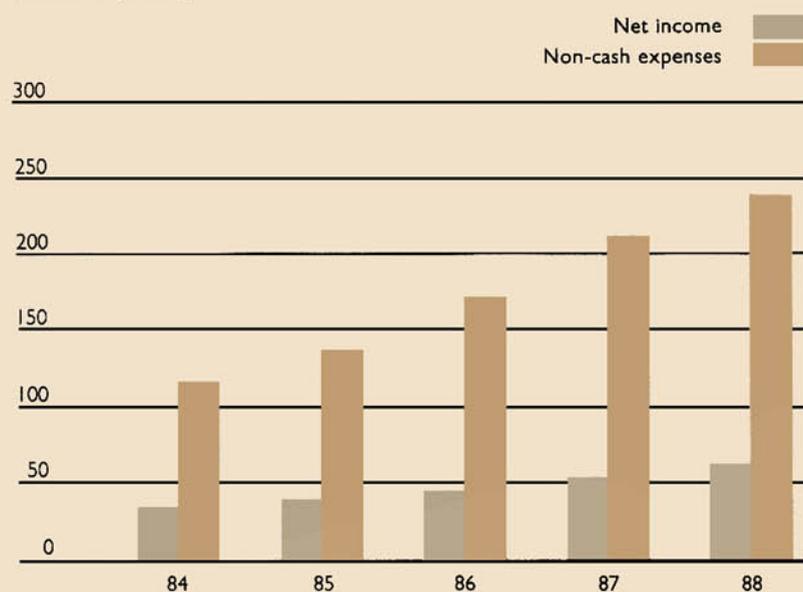
	31-12-84	31-12-85	31-12-86	31-12-87	31-12-88
Radio (thousands of minutes)	N.A.	295	407	347	387
TV (thousands of minutes)	N.A.	44	54	44	73

# Financial Review

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FUNDS GENERATED FROM OPERATIONS  
(Billions of pesetas)



## SELECTED FINANCIAL DATA

(In millions of Ptas., unless otherwise stated)

	1984	1985	1986	1987	1988	1988 \$ (in millions)
Operating revenue	363,937	409,415	468,011	540,727	612,536	5,399.2
Operating expenses	180,777	200,464	216,349	240,151	275,468	2,428.1
Financial expenses	75,817	77,209	77,781	84,094	84,866	748.0
Depreciation and amortization	97,866	116,964	138,204	164,442	203,851	1,796.8
Net income	32,620	39,149	45,252	53,247	62,845	553.9
Gross cash flow	149,518	177,580	218,416	268,684	304,537	2,684.3
Share capital	320,416	360,468	411,793	415,368	460,620	4,060.1
Shareholders' equity	832,543	947,804	1,090,016	1,220,727	1,317,696	11,614.8
Medium and long term debt	636,528	659,545	632,056	683,186	746,812	6,582.7
Capital expenditure *	173,642	188,681	211,514	260,183	357,815	3,153.9

Exchange rate (31-12-88): 1\$ = 113.45 ptas.

(\*) Including Advances to suppliers.

## Telefónica and the Spanish economy

1988 was another year of rapid expansion for Spain's economy, with performance notably exceeding that of other EEC countries and the USA.

G.N.P rose by 5% and especially outstanding was the continuing high level of investment and the rapid growth in consumption. In 1988, gross capital formation showed an increase in real terms of 14% and private consumption rose by 4.6%. Overall, there was a 6.9% real increase in domestic demand.

Throughout fiscal 1988, the rising trend in domestic demand led to the emergence of a certain imbalance. This was manifest both in internal prices and in external accounts, given the relative rigidity of the aggregate supply.

As regards prices on the domestic front, at the end of the year inflation stood at 5.8%, that is 1.2 points higher than the rate recorded for 1987. This trend took place within a context of inflation re-ignition throughout the world. However, Spain's inflation differential remained stable, vis à vis our main trading partners, despite the international environment. All this occurred during a year in which the positive trend in the terms of trade was somewhat more modest than in previous years.

On the international front, Spain's economy showed a current account deficit of almost \$3,000 million, which was a turnabout compared to the surplus of the last few years.

However, this deficit was easily financed by long-term capital inflows, generating reserves of around \$10,000 million. In global terms, at the end of 1988, accumulated reserves totalled \$40,000 million, which gives Spain's economic policy some additional leeway in which to finance the steady growth process, despite the existing deficit in the current account.

The continuing boom in Spain's economy, which has taken place within a framework of industrial restructuring and budgetary restraint, backed up by the vigorous capital expenditure programmes, has had a favourable effect on the labour

market and on the gradual modernization and expansion of the country's productive capacity.

Both these phenomena have helped to encourage a greater degree of competitiveness and to steadily narrow the economic gap between Spain and her European partners.

During 1988, Telefónica registered a higher growth in demand than the national economy,

with a 9% real increase in the company's value added.

Telefónica's activity during the year represented 2.64% of gross national savings, while the company's participation in gross capital formation was over 4%. Capital expenditures were also up 37.5% over the previous year.

The company's gross operating profits represented 2.03% of the national total and 1.54% of the G.D.P.

Finally, as regards price trends in the Spanish economy, during the 1988 financial year, the zero rise in Telefónica tariffs and the minor effects of the rate increases of the previous year, made a significant contribution to keeping down inflationary tendencies during the year.

## Telefónica and the Spanish economy

*(as a % of the national total)*

	1984	1985	1986	1987	1988
Gross value added	1.50	1.51	1.50	1.55	<b>1.54</b>
Wages and related benefits	1.22	1.24	1.21	1.18	<b>1.13</b>
Gross operating profit	1.81	1.84	1.90	2.02	<b>2.03</b>
Gross savings	2.20	2.32	2.32	2.59	<b>2.64</b>
Gross capital formation	3.59	3.53	3.38	3.47	<b>4.13</b>
<b>PRICES</b>					
G.D.P. deflator	10.9	8.3	11.2	5.9	<b>5.6</b>
Telefónica (1)	8.1	6.2	6.5	4.6	<b>1.0</b>

(1) Average yearly effect on service prices due to tariffs increases.

## Management's discussion

From a financial point of view, fiscal 1988 witnessed a continuation of the positive trends in the financial ratios. Income before tax was almost on a par with the previous year, reaching 84,088 million pesetas. Under this year's new fiscal regime, the company is subject to a Corporate Tax and after applying provision for its payment, net income rose by 18.0% over 1987 to 62,845 million pesetas.

These successful results enabled us to set aside 47,407 million pesetas for the payment of dividends. This represented a pay-out level of 75.4%, with 15,437 million pesetas also going to the company's retained earnings reserves, that is 103% more than in 1987.

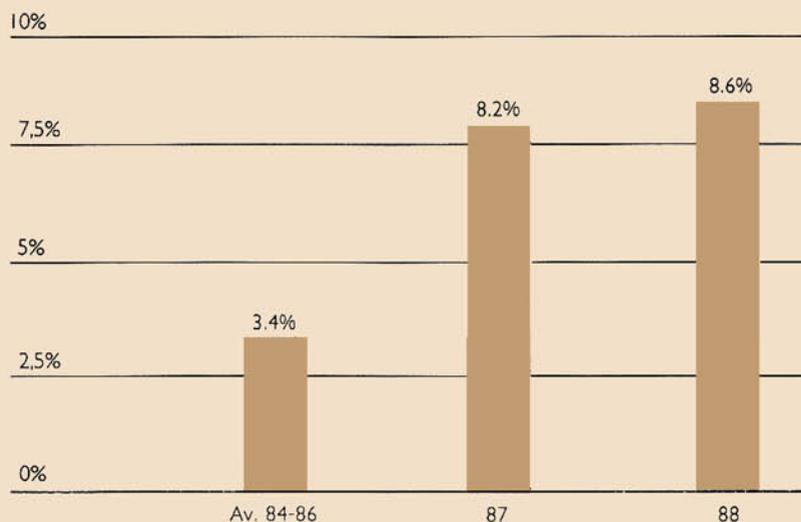
Both these factors clearly indicate that the Com-

pany is keeping to its policy of a stable dividend and the strengthening of internally generated funds, which is essential if we are to meet the demands of the extensive capital expenditure program currently underway.

These results were reflected in the 10% rise in earnings per share to 70.62 pesetas. The extent of this growth was somewhat affected by the increase in shares outstanding (7.2% on average), arising from the conversions of bonds and equity notes throughout the year. These conversions have strengthened the company's equity base.

### TELEPHONE USAGE

(% Increase in average usage per line)



## TAXES

Under the new fiscal regulations (Ley de Tributación) of July 30, 1987, which abolished the special tax regime in force since 1945, Telefónica is now subject to the general Spanish taxation law.

Furthermore, since 1988 the Company is also subject to certain local property taxes (Contribución Rústica y Urbana), substituting all other local taxes by a yearly cash compensation, equivalent to 2% of gross operating revenue, representing 12,210 million pesetas in the year.

In addition, under the new fiscal regime, the provision for corporate tax in 1988 was 21,243 mi-

llion pesetas. In comparative terms therefore, the changes in the tax regime have had a neutral effect, since the sum of both items represents a figure similar to that of the old tax system.

During fiscal 1988, the upward trend in operating revenue continued, reaching the figure of 612,536 million pesetas, with a 13.3% increase over 1987.

This healthy growth rate was despite the fact that no increase in services charges took place during the year. However, since the 1987 price rise occurred in April, the effect on the year's income is 0.99%. If we take both these factors into account, the 1988 income figures compare favourably to the 15.5% growth achieved in 1987. Looking at the different income components, the fastest growing items were revenue from data and image transmission and international service, which rose by 21.7% and 19.9% respec-

## OPERATING REVENUE

### Operating revenue

(In millions of Ptas., unless otherwise stated)

Description	1984	1985	1986	1987	1988 \$		% Increase	
					1988 (in millions)	over 87	84-88(*)	
Subscriber service charges	111,086	126,834	141,894	157,073	166,726	1,469.6	6.1	10.7
Data and image transmission	24,568	32,252	35,859	43,052	52,393	461.8	21.7	20.8
Domestic automatic service	149,646	163,063	196,526	236,491	271,770	2,395.5	14.9	16.1
Trunk calls through operator	2,217	2,186	1,882	1,597	1,249	11.0	(21.8)	(13.4)
International service	51,149	57,505	61,787	72,948	87,497	771.2	19.9	14.4
Mobile land and maritime services	1,437	1,595	1,634	1,646	2,417	21.3	46.8	13.9
Directories and yearbooks	9,123	10,071	10,216	7,598	6,164	54.4	(18.9)	(9.3)
REVENUE FROM SERVICES	349,226	393,506	449,798	520,405	588,216	5,184.8	13.0	13.9
Connection fees and other items	14,711	15,909	18,213	20,322	24,320	214.4	19.7	13.4
OPERATING REVENUE	363,937	409,415	468,011	540,727	612,536	5,399.2	13.3	13.9

Exchange rate (31-12-88): 1\$ = 113.45 ptas. // (\*)84-88 compound rate.

tively, clearly indicating the growth potential of these areas. Domestic automatic service accounted for 44.4% of total operating revenue (43.7% in 1987), rising by 14.9% in 1988 to reach the figure of 271,770 million pesetas.

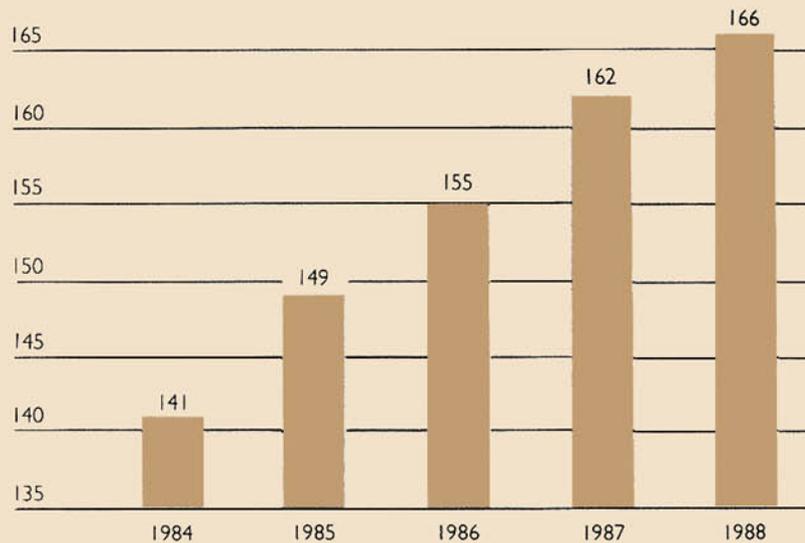
Revenue from subscriber service charges grew by 6.1% to 166,726 million pesetas, representing 27.2% of operating revenue.

Finally, of particular significance, was the sharp rise in mobile service revenue which increased by 46.8% during the year, compared to 0.7% in 1987.

On the domestic telecommunications front, applications for new lines and telephone usage continued to follow the upward trends set in previous years.

In quantitative terms, the demand for new lines rose by 19.5% in 1988 to stand at over 1,356,000. This was a substantial increase over the requests for lines recorded in 1987 (1,135,406). In addition, average usage per line grew by 8.6% (8.2% in 1987) with international traffic showing a particularly significant rise of 10.5% (11.2% in 1987).

#### LINES IN SERVICE PER EMPLOYEE



The constant rise in network demand and usage, which is expected to continue over the coming years, led to a substantial expansion in Telefónica's capital expenditure. In 1988 capital expenditure rose by 37.5% over the previous year to over 357,000 million pesetas.

## OPERATING EXPENSES

The extensive capital expenditure program, together with the increase in personnel expenses and the effect of local taxation, are all reflected in the significant rise in operating expenses.

These grew by 19.8% in 1988, although this increase drops to 14.7% if we exclude the effect of local taxes.

The explanation for the rise in personnel expenses (12.3%) lies in the fact that salary increases for the year were more than initially budgeted because the rate of inflation exceeded the official target. Another cause was the fact that the workforce was increased by 895 permanent staff

and 1,856 temporary workers, representing 4.3% of total workforce numbers at the end of 1987.

Local taxes reached 12,210 million pesetas, representing 2% of operating income. Worthy of mention is the fact that internal expenditure capitalized in fixed assets fell by 2.1% compared to 1987. This was because staff efforts were increasingly dedicated to network conservation and maintenance tasks.

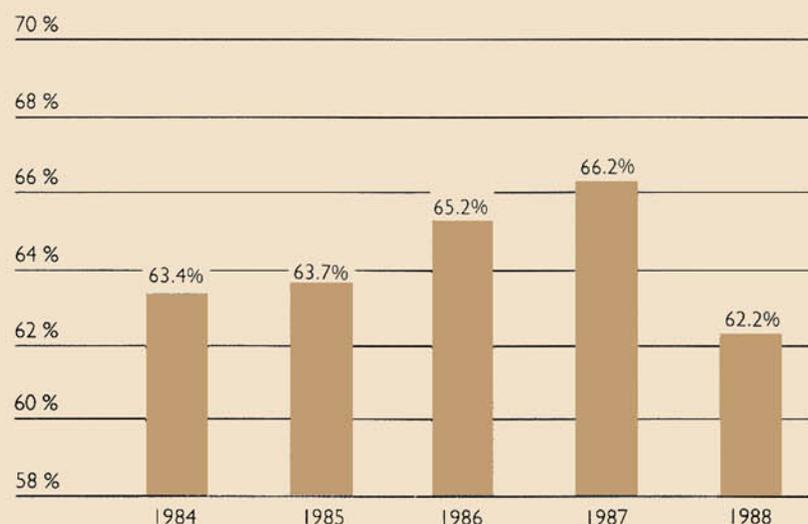
As a result of the above trends, the operating margin grew by 6.4%. An influencing factor was the change in Telefónica's tax regime, which, although the global effect was neutral, led to a re-

arrangement of the various company margins. If local taxes are not taken into account, the rise in the operating margin is 9.8%.

## OPERATING MARGIN

OPERACIONES CREC

### OPERATING MARGIN/OPERATING REVENUE (%)



## Results – profit margins 1984/1988

(In millions of Ptas.)

Description	1984		1985		1986		1987	
	Amount	% Struct.						
+ Revenue from operations	363,937	100.0	409,415	100.0	468,011	100.0	540,727	100.0
– Operating expenses	180,777	(49.6)	200,464	(49.0)	216,349	(46.2)	240,151	(44.4)
– Local taxes	–	–	–	–	–	–	–	–
+ Internal expenditure capitalized in fixed assets	47,634	13.0	51,863	12.7	53,512	11.4	57,571	10.6
= Operating margin	230,794	63.4	260,814	63.7	305,174	65.2	358,147	66.2
+ Interest during construction	6,329	1.7	6,452	1.6	6,580	1.4	8,373	1.5
+ Financial revenue	5,888	1.6	7,283	1.8	5,228	1.1	7,598	1.4
– Financial expenses	75,817	(20.8)	77,209	(18.9)	77,781	(16.6)	84,094	(15.5)
– Exchange losses	14,230	(3.9)	9,277	(2.3)	11,050	(2.4)	10,294	(1.9)
– Depreciation and amortization	97,866	(26.8)	116,964	(28.6)	138,204	(29.5)	164,442	(30.4)
= Gross operating income	55,098	15.2	71,099	17.4	89,947	19.2	115,288	21.3
– Provision for investments depreciation	–	–	–	–	–	–	–	–
– Other provisions and charges	4,802	(1.3)	12,190	(3.0)	23,910	(5.1)	40,701	(7.5)
+ Net extraordinary items	3,170	0.8	3,675	0.9	6,071	1.3	9,735	1.8
= Income before tax	53,466	14.7	62,584	15.3	72,108	15.4	84,322	15.6
– Provision for corporate tax (state levy 1984 to 1987)	20,846	(5.7)	23,435	(5.7)	26,856	(5.7)	31,075	(5.7)
= Net income	32,620	9.0	39,149	9.6	45,252	9.7	53,247	9.9
+ Net income	32,620	9.0	39,149	9.6	45,252	9.7	53,247	9.9
+ Depreciation and amortization	97,866	26.8	116,964	28.6	138,204	29.5	164,442	30.4
+ Provisions and charges	19,032	5.2	21,467	5.2	34,960	7.5	50,995	9.4
+ Non-depreciated dismantled plant	–	–	–	–	–	–	–	–
= Gross cash flow (funds generated from operations)	149,518	41.0	177,580	43.4	218,416	46.7	268,684	49.7

Exchange rate (31-12-88): 1\$ = 113.45 ptas.

(\*) 84-88 compound rate

During 1988, financial expenses remained practically on a par with the previous year, due to the increase in gross cash flow (13.3%) and the strengthening of the Company's shareholders' equity by means of equity-linked instruments (a 10.9% growth in share capital and a 179.9% increase in share premium reserves). A further contributing factor was the fact that fixed assets investment mainly took place during the second half of the year and the effect on financial expenses was therefore very slight. On a final note, the lower nominal interest rates of foreign financing operations undertaken during the year, also helped to keep down financial expenses, with a 62.4% increase in foreign currency debt. Telefónica's prudent financial strategy, which has been rigorously applied over recent years, is clearly reflected in the provision for exchange losses, which rose by 17% during the year. In this respect, particularly significant is the low level of

deferred exchange losses (14,298 million pesetas at the end of 1988), following the major preamortization of foreign debt carried out in previous years and assisted by the relative strength of the peseta.

To keep up with the extensive technological advances which are a constant feature of the telecommunications sector, depreciation charges rose by 24% during 1988, with a notable increase in average plant depreciation rate to 7%. This indicates the prompt equipment renewal rate, with the consequent reduction in average plant service life, in line with international trends.

The efforts of the last few years, which are clearly reflected in the average cumulative growth rate in other provision charges (103.9% annually from 1984-1987), have led to an upgrading in the quality of our assets and enabled us to substantially reduce the ratio of provisions to operating revenue.

## OTHER EXPENSES

1988			Increases (%)	
Amount	% Struct	1988 \$ (in millions)	Over 87	84-88 (*)
612,536	100.0	5,399.2	13.3	13.9
275,468	(45.0)	2,428.1	14.7	11.1
12,210	(2.0)	107.6	—	—
56,336	9.2	496.5	(2.1)	4.3
381,194	62.2	3,360.0	6.4	13.4
—	—	—	—	—
8,880	1.5	78.3	16.9	10.8
84,866	(13.9)	748.0	0.9	2.9
12,046	(2.0)	106.2	17.0	(4.1)
203,851	(33.2)	1,796.9	24.0	20.1
89,311	14.6	787.2	(22.5)	12.8
254	(0.1)	2.2	—	—
16,145	(2.6)	142.3	(60.3)	35.4
11,176	1.8	98.5	14.8	37.0
84,088	13.7	741.2	(0.3)	12.0
21,243	(3.5)	187.3	N/S	N/S
62,845	10.2	553.9	18.0	17.8
62,845	10.2	553.9	18.0	17.8
203,851	33.3	1,796.9	24.0	20.1
28,445	4.6	250.7	(44.2)	10.6
9,396	1.5	82.8	—	—
304,537	49.6	2,684.3	13.3	19.5

## FINANCIAL REVENUE AND EXTRAORDINARY ITEMS

As regards financial revenue, a major factor was the elimination of interest during construction, as a result of the new tax regulations coming into force. The rest of the financial income amounted to 8,880 million pesetas, representing an increase of 16.9%.

Net extraordinary items rose by 14.8%, that is 1.8% of operating revenue. This development was mainly due to the inclusion of the salvage value of dismantled plant, which had previously, under the old tax regime, been credited to the technological development reserve. Another contributing factor was the marketing of custo-

mer premises equipment, under the new Telecommunications Act (LOT), which opened up the liberalisation of the terminals market in Spain. Finally, worthy of mention under extraordinary expenses is dismantled plant pending depreciation (9,396 million pesetas). Since it is an accelerated depreciation item by its very nature, it can be added to the depreciation of fixed assets, raising the depreciation charges growth rate to 29.7%.

As a result of this whole process, funds generated from operations amounted to 304,537 million pesetas, which is 13.3% more than the previous year. In relative terms, gross cash flow per

share was over 342.2 pesetas, 5.7% up on 1987. It is worth highlighting the change that took place in the generated funds breakdown. Provisions and charges fell by around 45% compared to 1987 and depreciation and amortization, including dismantled plant pending depreciation, increased to a figure of 213,247 million pesetas.

## FUNDS GENERATED

### Financial ratios

	1986	1987	1988
Operating margin/Operating revenue	65.2	66.2	62.2
Net financial expenses/Operating revenue	14.1	12.6	12.4
Transfer to provisions/Operating revenue	7.5	9.4	4.7
Operating margin/Av. net plant (1)	18.4	19.6	19.0
Fixed assets coverage (2)	59.4	60.4	60.6
Guarantee ratio (3)	63.3	64.1	63.8
Debt ratio (4)	44.1	43.1	43.6
Debt repayment capacity (years) (5)	3.1	2.7	2.6
Gross cash flow/Net financial expenses (times)	3.3	3.9	4.0

(1) Operating margin/Average net fixed assets.

(2) Shareholders' equity/Net fixed assets.

(3) Shareholders' equity/Net capital employed.

(4) Medium and long term debt + current liabilities/Total assets.

(5) Total debt/Gross cash-flow.

Figures in %, unless otherwise indicated.

## CAPITAL EXPENDITURE AND FINANCING

The accelerated capital expenditure programme, which was mainly reflected in the latter half of the year, led to an apparent drop in the return on fixed assets, measured by means of the operating margin. On the other hand, despite the increase in capital expenditure, the debt ratio remained almost stable at 43.6%. This was owing to the conversion of bonds carried out during 1988.

Finally, during 1988 the expansion ratios continued along the favorable paths of previous years. This was mainly due to the positive cash flow trends and the stable nature of financial expenses. At the end of fiscal 1988, it would take 2.6 years to repay the Company's debt with funds generated from operations, with net financial expenses coverage standing at four times.

To sum up, Telefónica's financial ratios are evidence of the Company's solid financial position, which stands it in good stead for meeting the demands of the ambitious capital expenditure programmes planned for the coming years and for adequately covering the requirements of the Spanish telecommunications services market.

TOTAL DEBT (%)



## Balance sheets 1984/1988

*(After profit distribution, in millions of pesetas,  
unless otherwise stated)*

ITEMS	1984	1985	1986	1987	1988	1988 \$ (in millions)
<b>Fixed assets</b>	1,540,156	1,703,265	1,835,197	2,020,623	2,174,398	19,166.1
Property, plant and equipment	2,298,083	2,568,812	2,828,586	3,162,385	3,462,255	30,517.9
Depreciation of fixed assets	(868,250)	(982,606)	(1,097,404)	(1,234,045)	(1,373,388)	(12,105.7)
Property, plant and equipment-net	1,429,833	1,586,206	1,731,182	1,928,340	2,088,867	18,412.2
Net intangible assets	4,803	5,042	3,997	718	6,281	55.4
Investments	33,895	32,987	38,755	51,859	52,684	464.4
Deferred charges	13,461	12,898	12,424	10,722	12,268	108.1
Unrealised exchange losses	58,164	66,132	48,839	28,984	14,298	126.0
<b>Current assets</b>	124,201	103,122	113,596	126,059	162,731	1,434.4
Consumable inventories	2,993	3,699	5,692	4,146	6,512	57.4
Accounts receivable	78,038	86,078	100,010	114,882	148,699	1,310.7
Cash and banks	34,297	7,981	2,332	2,772	2,044	18.0
Other current assets and prepayments	8,873	5,364	5,562	4,259	5,476	48.3
<b>Assets = Liabilities and shareholders' equity</b>	1,664,357	1,806,387	1,948,793	2,146,682	2,337,129	20,600.5
<b>Shareholders' equity (1)</b>	832,543	947,804	1,090,016	1,220,727	1,317,696	11,614.8
Paid-in share capital	320,416	360,468	411,793	415,368	460,620	4,060.1
Reserves and provisions	512,127	587,336	678,223	805,359	857,076	7,554.7
<b>Medium and long term debt (2)</b>	636,528	659,545	632,056	683,186	746,812	6,582.7
Debt in pesetas	400,374	450,717	532,927	603,694	617,730	5,445.0
Debt in foreign currency	236,154	208,828	99,129	79,492	129,082	1,137.7
<b>Net capital employed (1 + 2)</b>	1,469,071	1,607,349	1,722,072	1,903,913	2,064,508	18,197.5
<b>Current liabilities</b>	195,286	199,038	226,721	242,769	272,621	2,403.0
Short term debt	165,381	168,171	187,585	206,321	233,187	2,055.4
Accruals	29,905	30,867	39,136	36,448	39,434	347.6
<b>Unused credit facilities (In memorandum accounts)</b>	88,680	121,300	97,965	92,789	102,090	899.9

Exchange rate 31-12-88: 1 \$ = 113.45 ptas.

## Statement of changes in financial position

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

	1984	1985	1986	1987	1988	1988 \$ (in millions)
Gross cash flow	149,518	177,580	218,416	268,684	304,537	2,684.3
Reserves	4,769	3,369	2,157	4,444	26,117	230.2
Share capital increases	22,387	32,084	36,047	—	45,252	398.9
M & L.T. Debt	151,510	154,267	204,803	177,028	233,579(a)	2,058.9
— Domestic	97,409	139,370	168,827	165,710	155,249(c)	1,368.4
— Foreign	54,101	14,897	35,976	11,318	78,330(b)	690.4
Total sources and applications of funds	328,184	367,300	461,423	450,156	609,485	5,372.3
Capital expenditure and investments	175,549	195,726	218,458	284,773	380,273	3,351.9
— Capital expenditure	173,642	188,681	211,514	260,183	357,815	3,153.9
— Fixed assets	175,417	187,881	205,592	262,582	353,728	3,117.9
— Advances for plant	(1,775)	800	5,922	(2,399)	4,087	36.0
— Intangible assets	1,607	1,778	1,866	4,398	6,234	55.0
— Investments in affiliates	(3,318)	48	5,051	14,808	1,079	9.5
— Stocks for fixed assets	3,618	5,219	27	5,384	15,145	133.5
Deferred charges and exchange losses	(9,511)	(5,882)	(7,307)	(7,959)	(8,099)	(71.4)
Applications of provisions	50,770	55,056	61,774	66,752	62,022	546.7
Repayment and redemption of M. & L.T. debt	78,642	147,587	205,534	110,335	168,470	1,485.0
— Domestic	53,032	86,900	67,014	89,758	141,212	1,244.7
— Foreign	25,610	60,687	138,520	20,577	27,258	240.3
Variation in working capital	32,734	(25,187)	(17,036)	(3,745)	6,819	60.1
Variation in unused capital	22,839	29,271	(16,976)	(5,533)	(1,586)	(14.0)

Exchange rate 31-12-88: 1 \$ = 113.45

### NOTES

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

Total variation in working capital.....	6,819
Increase in 1988 dividends .....	1,764
<b>TOTAL .....</b>	<b>8,583</b>

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

Eurobonds repayment premium .....	415(b)
Debenture interest .....	837(c)
Promissory Note interest .....	3,381(c)
<b>TOTAL .....</b>	<b>4,633</b>



**Audited  
financial  
statements**

# Auditing Shareholders' Report

Fernando Pérez Olivares and Isidoro Jiménez Gómez, appointed auditors of the 1988 accounts by the Annual General Meeting of Shareholders held on May 27, 1988, have examined the independent auditors' report issued by the firms Price Waterhouse and Audiberia, S.A. and the report of the Spanish Auditors, and propose that the Annual General Meeting approve the Annual Report, Balance Sheet, Statement of Income, Statement of Changes in Financial Position of Telefónica de España, S.A.

And in testimony thereof, we sign this Report in Madrid on the eighteenth of May, nineteen eighty-nine.

A handwritten signature in black ink that reads "Pérez Olivares". The signature is written in a cursive style with a prominent initial 'P' and a long horizontal stroke at the end.

Fernando Pérez Olivares

A handwritten signature in black ink that reads "Isidoro Jiménez Gómez". The signature is highly stylized and cursive, with a large initial 'I' and a complex, looping structure.

Isidoro Jiménez Gómez

# Spanish Statutory Auditors' Report

Mr Pedro RODRIGUEZ SAN ROMAN and Mr Enrique FERNANDEZ PEÑA, full members of the Institute of Spanish Auditors, in compliance with the mandate received from the Management Committee of Telefónica de España, S.A., have examined the Balance Sheet of the Company at December 31, 1988 and the Statement of Income for that year and the corresponding notes thereto.

In the said examination and in order to audit the 1988 accounts, we have taken into account the working reports prepared in previous years by the firms Price Waterhouse and Audiberia, S.A., all in accordance with Telefónica.

The said review has given rise to this Report 29/89, which is issued with the remarks and observations listed below.

## 1. General remarks

- 1.1 The figures contained in the enclosed Balance Sheet and Statement of Income, come from the general ledger and auxiliary records of Telefónica, in accordance with the general account groupings shown in detail in the annual financial statements.
- 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.
- 1.4 Under the new Telefónica Tax Law 15/1987 of July 30 and the Royal Decree 1334/1988 of November 4, which develops it in part as from January 1, 1988, Telefónica is subject to a new tax regime and specifically to Corporate Tax. Accounting standards applied in the preparation of the financial statements therefore adhere to the accounting principles contained in the General Accounting Plan.

## 2. Comments on the Balance Sheet

### 2.1 Fixed Assets

This item increased by 372,960 million pesetas in 1988. This figure included charges for work carried out on the Company's own fixed assets (labour, materials and other) amounting to 56,336 million pesetas.

In 1988 the practice was abandoned of including in fixed assets costs the interest accrued from its financing until start-up. If the criteria of past years had been applied, fixed assets and the profits for the period would have risen by 14,969 million pesetas.

In compliance with note number 1 of the financial statements, the elements acquired prior to January 1, 1988 have been valued at the replacement price at December 31, 1987, under article 3 of the Law of December 31, 1945 and approved by the Ministry of Economics and Finance. Additions as from January 1, 1988 are valued at acquisition price plus installation costs, which includes direct labour and materials, as well as an assigned proportion of indirect costs.

### 2.2 Accumulated depreciation and amortization of assets

The relevant credit items charged to the 1988 Profit and Loss Account amount to 200,294 million pesetas. The overall percentage of the average value of depreciable plant was 6.96%.

### 2.3 Net shareholdings in companies

As from 1988, investments in the Telefónica group are valued charging to the Profit and Loss Account the capital loss between the amount recorded in Telefónica and the respective book value of the issuing company. By applying the criteria of past years, the figure for shareholdings and reserves would have risen by 1,466 million pesetas.

Dividends are recorded as income at the moment of payment (258 million in 1988) and profit from securities as income in the year of disposal of the shares.

### 2.4 Deferred exchange losses

From 1988 onwards accumulated exchange losses of foreign currency borrowings will be charged to the Profit and Loss Account at the moment of amortization, preamortization or extinction of the contractual relation. If the criteria of past years had been applied, the "Deferred Exchange Losses" and "Profit and Loss" accounts would have increased by 2,364 million pesetas.

The net balance of 14,298 million pesetas in the "Deferred Exchange Losses" account, corresponding to the advance repayment of loans, will be practically cancelled in the next three years.

### 2.5 Accounts receivable

The caption "Subscribers" includes ex-subscribers where debt collection is doubtful, with a total balance of 4,088 million pesetas, pending revaluation. There are 4,677 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 45,252 million pesetas of nominal value, for the conversion of debentures and bonds.

## 2.7 Statutory reserves

The balance on this account increased by 7,600 million pesetas to 16,005 million pesetas at December 31, 1988, due to the distribution of 1987 profits.

## 2.8 Voluntary reserve and revaluation surplus

The share premium account increased by 20,360 million pesetas, as a result of the capital increases from the conversion of debentures and bonds to shares.

## 2.9 Debentures and bonds

Debentures amounting to 55,635 million pesetas were issued in 1988 and amortization and conversion operations reached the figure of 67,303 million pesetas.

## 2.10 Pensions

Telefónica employees benefit from a social welfare system with pensions which are substitutory for and complementary to those provided by the Spanish Government Social Security system. These pensions are covered by the "Institución Telefónica de Previsión (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 concerning Social Service Mutual Funds.

The circumstances and explanations relating to this matter are described in Note 15 of the financial statements.

The judgements of independent legal counsel confirm Telefónica's compliance with all of its contractual obligations relating to ITP and confirm the nonexistence of any legal responsibility for Telefónica other than that stated in Note 15.

## 3. Comments on the Statement of Income

### 3.1 Income

The estimates of income at the end of the 1987 and 1988 financial periods 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 reports of the firms Price Waterhouse and Audiberia, S.A., we hereby issue the following:

## REPORT

As a result of the examination carried out, it is our professional opinion that the Balance Sheet and the Statement of Income of Telefónica de España, S.A. (Telefónica) and the Notes thereto attached, present fairly the financial position of Telefónica at December 31, 1988 and the results of its operations, during the year, in accordance with accounting principles generally accepted in Spain and with the requirements of the legislation governing the activities of Telefónica, which, apart from the afore-mentioned new legal and tax regulations, are consistent with those of the preceding year.



Pedro RODRIGUEZ SAN ROMAN



Enrique FERNANDEZ PEÑA

Madrid, March 29, 1989

# Independent Auditors' Report

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

1. We have examined the balance sheet of Telefónica de España, S.A. (Telefónica) at December 31, 1988, 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. 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 15 and 16 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 15.
4. As explained in Note 2, the new legal tax situation applicable to Telefónica has involved modifying the basis adopted for accounting for certain operations, which had been recorded by a different method up to 1987. The effect of these changes, with which we concur, is shown, to the extent possible, in the aforementioned Note 2.
5. In our opinion, the financial statements referred to in paragraph 1 present fairly the financial position of Telefónica de España, S.A. at December 31, 1988, 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, except for the change referred to in paragraph 4. Accounting principles which are of significance in the preparation of the financial statements are described in Note 2.
6. 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 29, 1989

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

<b>ASSETS</b>	<b>1988</b>	<b>1987</b>
<b>FIXED ASSETS (Note 3)</b>	<b>2,088,867</b>	<b>1,928,340</b>
Land	38,640	38,336
Buildings and power equipment	249,043	235,477
Telephone installations	2,790,858	2,653,012
Other fixed assets	37,209	24,039
	<u>3,115,750</u>	<u>2,950,864</u>
Accumulated depreciation	(1,373,388)	(1,234,045)
	<u>1,742,362</u>	<u>1,716,819</u>
Fixed assets under construction:		
Construction in progress	274,840	159,088
Advances to suppliers	21,166	17,079
Stocks for fixed assets	<u>50,499</u>	<u>35,354</u>
<b>INTANGIBLE ASSETS</b>	<b>6,281</b>	<b>718</b>
Research and development and others	20,405	14,760
Accumulated amortization	<u>(14,124)</u>	<u>(14,042)</u>
<b>INVESTMENTS</b>	<b>52,684</b>	<b>51,859</b>
Net shareholdings in companies (Note 4)	32,775	27,000
Loans to Group companies	16,131	20,997
Loans to employees	2,963	3,087
Guarantees and deposits	<u>815</u>	<u>775</u>
<b>DEFERRED CHARGES</b>	<b>12,268</b>	<b>10,722</b>
<b>DEFERRED EXCHANGE LOSSES (Note 5)</b>	<b>14,298</b>	<b>28,984</b>
<b>INVENTORIES</b>	<b>6,512</b>	<b>4,146</b>
<b>ACCOUNTS RECEIVABLE</b>	<b>148,699</b>	<b>114,882</b>
Subscribers (Note 6)	126,645	99,308
Provision for bad debts (Note 6)	(4,677)	(6,258)
Miscellaneous receivables	28,586	23,873
Provision for bad debts	<u>(1,855)</u>	<u>(2,041)</u>
<b>CASH AND BANKS</b>	<b>2,044</b>	<b>2,772</b>
Cash and banks	407	550
Funds in transit and others	<u>1,637</u>	<u>2,222</u>
<b>OTHER CURRENT ASSETS AND PREPAYMENTS</b>	<b>5,476</b>	<b>4,259</b>
Prepayments	<u>5,476</u>	<u>4,259</u>
<b>Total</b>	<b><u>2,337,129</u></b>	<b><u>2,146,682</u></b>
<b>MEMORANDUM ACCOUNTS (Note 17)</b>		
Unused credit facilities	102,090	92,789
Others	<u>59,466</u>	<u>26,051</u>
	<u>161,556</u>	<u>118,840</u>

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

# TELEFONICA DE ESPAÑA, S.A.

<b>LIABILITIES</b>	<b>1988</b>	<b>1987</b>
<b>SHAREHOLDERS' EQUITY</b>	1,203,774	1,130,558
Share capital (Note 7)	460,620	415,368
Reserves: (Note 8)		
Statutory reserve	16,005	8,405
Revaluation surplus and other voluntary reserves	727,057	706,697
Unappropriated profit:	92	88
	<u>743,154</u>	<u>715,190</u>
<b>DEFERRED INCOME</b>	4,682	2,339
Capital Grant	2,348	—
Non-reimbursable contributions for rights of use and others	<u>2,334</u>	<u>2,339</u>
<b>PROVISIONS (Note 9)</b>	93,802	80,226
Risk and exchange loss self-insurance	60,158	61,397
Others provisions	<u>33,644</u>	<u>18,829</u>
<b>LONG TERM DEBT</b>	746,812	683,186
Debentures and bonds (Note 10)	319,055	331,651
Loans and credit facilities (Note 11)	337,908	272,399
Loans from the Institución Telefónica de Previsión (ITP)	57,297	50,744
Notes payable to suppliers	2,832	4,304
Collective insurance for employees (Note 16)	<u>29,720</u>	<u>24,088</u>
<b>SHORT TERM DEBT</b>	185,780	160,678
Loans and credit facilities (Note 11)	39,797	41,543
Suppliers	67,408	43,025
Notes payable to suppliers	2,959	1,966
Taxes payable (Note 12)	6,287	37,770
Company income tax provision (Note 1.3)	21,243	—
Social Security payable	5,887	5,168
Other creditors (Note 13)	36,071	25,080
Dividend payable	<u>6,128</u>	<u>6,126</u>
<b>ACCRUALS (Note 14)</b>	39,434	36,448
Accrued expenses and deferred income	<u>39,434</u>	<u>36,448</u>
<b>NET INCOME</b>	62,845	53,247
Net income for the year after Company income tax (State levy in 1987)	<u>62,845</u>	<u>53,247</u>
<b>Total</b>	<u>2,337,129</u>	<u>2,146,682</u>
<b>MEMORANDUM ACCOUNTS (Note 17)</b>		
Unused credit facilities	102,090	92,789
Other	59,466	26,051
	<u>161,556</u>	<u>118,840</u>

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

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

	1988	1987
<b>INCOME</b>	612,536	540,727
Revenue from services	588,216	520,405
Connection fees and other	24,320	20,322
<b>COSTS AND EXPENSES</b>	553,372	476,175
Salaries and related costs	216,481	192,687
Subcontractors, supplies and services	58,627	47,082
Taxes (Note 1.3)	12,570	382
Provision for contingencies	—	26,702
Provision for pension funds	14,815	—
Other charges	1,330	13,999
Exchange losses (Note 5)	12,046	10,294
Financial expenses	84,866	84,094
Sundry expenses	5,122	2,437
Depreciation of fixed assets	200,294	161,178
Amortization of deferred charges	3,557	3,264
Internal expenditure capitalized in fixed assets:		
Labour, materials and overhead	(56,336)	(57,571)
Notional interest allocated to construction in progress (Note 2.2.b)	—	(8,373)
<b>PROFIT BEFORE OTHER INCOME</b>	59,164	64,552
<b>OTHER INCOME</b>	24,924	19,770
Financial	8,880	7,598
Other	16,044	12,172
<b>INCOME BEFORE COMPANY INCOME TAX (State Levy in 1987)</b>	84,088	84,322
<b>PROVISION FOR COMPANY INCOME TAX (State Levy in 1987) (Note 1.3)</b>	(21,243)	(31,075)
<b>NET INCOME AFTER COMPANY INCOME TAX (State Levy in 1987)</b>	62,845	53,247

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

**STATEMENT OF CHANGES IN FINANCIAL POSITION FOR THE YEARS  
ENDED DECEMBER 31  
(Before distribution of profits) (\*)  
(In millions of pesetas)**

	<u>1988</u>	<u>1987</u>
<b>SOURCES:</b>		
Net income for the year after the Company		
Income Tax (State levy in 1987)	62,845	53,247
Depreciation and amortization	200,294	161,178
Amortization of deferred charges	3,557	3,264
Non amortized dismantled plant	9,396	—
Marketing of installed terminals not amortized	3,414	—
Self-insurance exchange differences and other	31,665	43,404
	<hr/>	<hr/>
Funds provided by operations	311,171	261,093
Shareholder's contribution:	65,612	—
Issuance of share capital	45,252	—
Share premium	20,360	—
	<hr/>	<hr/>
Deferred income	2,343	4,444
Investments in affiliates	10,040	5,168
Debentures and bonds issued	55,635	63,394
Foreign currency loans	53,479	10,795
Other loans, credit facilities and notes payable	119,832	98,760
	<hr/>	<hr/>
<b>TOTAL SOURCES</b>	<b>618,112</b>	<b>443,654</b>
<b>APPLICATIONS</b>		
Dividends	45,643	44,638
Additions to fixed assets	353,728	262,582
Other additions:	41,688	28,839
Advances to suppliers of fixed assets	4,087	(2,399)
Intangible assets	6,234	4,398
Investments in affiliates	11,119	19,976
Stocks for fixed assets	15,145	5,384
Deferred charges	5,103	1,480
	<hr/>	<hr/>
Debentures and bonds redeemed	67,303	43,988
Repayment of foreign currency loans	19,695	13,377
Repayment of other loans, credit facilities and notes payable	81,472	52,970
	<hr/>	<hr/>
<b>TOTAL APPLICATIONS</b>	<b>609,529</b>	<b>446,394</b>
<b>NET VARIATION</b>	<b>8,583</b>	<b>(2,740)</b>
<b>COMPRISING:</b>		
Inventories	2,366	(1,546)
Accounts receivable	33,817	14,872
Cash and banks	(728)	440
Prepayments	1,217	(1,424)
Short term liabilities	(25,101)	(11,684)
Accruals	(2,986)	2,688
Dividend accounts	(2)	(6,086)
	<hr/>	<hr/>
<b>TOTAL</b>	<b>8,583</b>	<b>(2,740)</b>

(\*) These statements have been prepared in accordance with the classification of short and long term debts as described in Note 2.2 j. Notes 1 to 19 form an integral part of these statements.

## PROPOSAL FOR DISTRIBUTION OF NET INCOME FOR THE YEAR 1988

	Millions of pesetas
Unappropriated profit brought forward from previous year .....	92
Net income for the year before Company Income Tax .....	84,088
Provision for Company Income Tax .....	(21,243)
Total available for distribution after Company Income Tax .....	<u>62,937</u>

### PROPOSED DISTRIBUTION

5% Interim dividend on shares No 1 to 861,250,627 payable as from January 31, 1989 .....	21,531
5% Interim dividend on shares No 861,250,628 to 861,879,170, dividend rights as from January 10, 1988, payable as from January 31, 1989 .....	15
5% Interim dividend on shares No 861,879,171 to 862,045,388, dividend rights as from July 15, 1988, payable as from January 31, 1989 .....	2
6% Final dividend on shares No 1 to 861,250,627 pending approval .....	25,838
6% Final dividend on shares No 861,250,628 to 861,879,170, dividend rights as from January 10, 1988, pending approval .....	19
6% Final dividend on shares No 861,879,171 to 862,045,388, dividend rights as from July 15, 1988, pending approval .....	<u>2</u>
To dividends .....	47,407
To statutory reserve .....	8,409
To voluntary reserve .....	7,028
Unappropriated profit carried forward .....	93
Total proposed distribution .....	<u>62,937</u>

## NOTES TO THE FINANCIAL STATEMENTS AT DECEMBER 31, 1988 AND 1987

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

#### 1.1 Conditions of the State Contract

The Telecommunications Law, dated December 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 obliging the Government to formalise a new contract with Telefónica.

On December 31, 1988, the new contract is in a stage of formalization, continuing in force the conditions of the previous state contract, defined by the Law of December 31, 1945 and the Decree of October 31, 1946 where the contract regulating the conditions of the concession was approved. For this reason, Telefónica is a limited company regulated by the specific rules of this contract.

#### 1.2 Regulation of tariffs

According to the State Contract, tariffs will be reviewed at Telefónica's request when, for two consecutive years, they do not give a sufficiently high yield to cover all operating expenses including depreciation of Company installations and properties, to accumulate and maintain the statutory reserve referred to in Condition 7 of the State Contract or any other required by law and obtain an amount of net income in each fiscal year of not less than 5% of the paid-in share capital plus reserves as defined in the State Contract.

#### 1.3 Fiscal status

On July 30, 1987 the Telefónica Taxation Law was enacted, abolishing the state levy established under the terms of Condition 7 and the general tax exemption applied to the Company.

According to the mentioned Law and Royal Decree 1334/1988 of November 4, which develops it, as from January 1, 1988, Telefónica is subject to the general taxation laws and regulations. The Law also provides that Telefónica will be subject to certain specific local property taxes («Contribución Territorial Rústica Urbana») substituting all other local and regional taxes with 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, including as short term debt the income tax provision. The distribution of 1988 profits is therefore subject to by the Shareholders' approval at the Annual General Meeting.

b) 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 applied in Spain. The new legal and fiscal situation has resulted in applying some different accounting rules in accordance with the General Accounting Plan, to certain operations which were previously applied in a specific way until 1987.

### b) Fixed assets and method of depreciation

Fixed assets acquired before December 31, 1987 had been valued at replacement cost as at that date, including voluntary revaluations carried out in accordance with Article 3 of the Law of December 31, 1945 and with the approval of the Finance Ministry.

From January 1, 1988, property additions are valued at cost including installation cost, direct labour and materials used, together with an allocable share of overheads.

In former years, interest up to the time the assets were placed in service was capitalized. From January 1, 1988 interest is no longer capitalized. Had the previous years criteria been continued fixed assets and net income for the year would have been increased by 14,969 millions of pesetas.

When equipment is retired from service the gross book value and amount of accumulated depreciation are removed from plant and equipment and depreciation reserves, considering as loss the difference between the net-book value of the dismantled plant and its recovery value.

Until December 31, 1987, equipment retired from service was considered as the oldest and fully depreciated. The net recovered value was credited to the technological development reserve. This change of criteria has resulted in a charge of 486 millions of pesetas in 1988 statements of income.

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

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

### c) Intangible assets and amortization

Intangible assets include cost incurred in developing new product lines capable of being marketed or utilized in the telephone network. Finished projects with possibility of commercial or industrial use are depreciated in five years and rejected projects are written off immediately.

The acquired rights to use of equipment and plant owned by others are also included under this heading as well as the cost of licences for the indefinite use of software. These assets are amortized on a straight-line basis over 25 and 3 years respectively.

### d) Investments - net shareholdings in companies

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

Until 1987, the carrying values of shareholdings in subsidiary and associated companies were adjusted against the related revaluation reserve, on the basis of the proportional equity value of these companies, using the balance sheets as at December 31 of the previous fiscal year, as approved by the Shareholders at their Annual General Meeting. As from 1988, only reductions in the proportional equity value are recognised, such losses being charged against income. The effect of this change in criteria results in a lower valuation of the investments amounting to 1,466 millions of pesetas.

Dividends are recorded as revenue when received, as are capital gains obtained from sales of investments.

### 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.

Given the nature and characteristics of Telefónica as a regulated price and services company and the tariff review mechanisms, the unrealized exchange losses due to repaid debts from 1985 to 1987 will materialize in accordance with the initial maturity schedule. The fixing of tariffs each year takes into consideration the recovery of these deferred expenses. As from 1988, accumulated exchange gains or losses from foreign currency are materialized when payments are made or the contractual obligations are terminated. If previous years criteria had been kept on, deferred exchange gains or losses and the year's income would have increased by 2,364 millions of pesetas.

### g) Inventories and stocks for fixed assets

Inventories and stocks are generally valued at their weighted average cost. Stocks for fixed assets include subscribers sets which, in accordance with the Ministry Order dated December 2, 1987, are liberalized and available for sale. (See Note 3.3)

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 bi-monthly 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 15.

Endowment insurance is accrued against income by applying the actuarially calculated coefficients to the base-salaries paid; these coefficients include current and past service costs (Note 16).

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

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

k) Corporate income tax

According to general practice in Spain, the income tax provision is an estimate of the amount to be paid without considering deferred or advanced taxes as a consequence of timing differences between book profits and taxable income.

### NOTE 3 - FIXED ASSETS

3.1. The composition by type of fixed asset and accumulated depreciation, is as follows:

	1988	1987	Years of useful life
Land	38,640	38,336	
Buildings	187,430	176,406	40
Accumulated depreciation	(57,299)	(52,678)	
Power equipment	61,613	59,071	18-19
Accumulated depreciation	(33,099)	(31,388)	
Exchange equipment	964,891	930,481	18-23
Accumulated depreciation	(430,376)	(387,925)	
Transmission equipment	326,460	301,922	13-16
Accumulated depreciation	(187,012)	(167,495)	
Local and trunk networks	1,324,934	1,275,208	18-22
Accumulated depreciation	(569,263)	(521,915)	
Subscriber sets and other related installations	174,573	145,401	4-8
Accumulated depreciation	(81,012)	(61,996)	
Furniture, office and other equipment	37,209	24,039	5-10
Accumulated depreciation	(15,327)	(10,648)	
Fixed assets in service	3,115,750	2,950,864	
Accumulated depreciation	(1,373,388)	(1,234,045)	
Net book amount	1,742,362	1,716,819	
Construction in progress	274,840	159,088	
Advances to suppliers of fixed assets	21,166	17,079	
Stocks for fixed assets	50,499	35,354	
Total net book amount	2,088,867	1,928,340	

3.2 Annual variations were as follows:

	1988	1987
Revaluations for the year:		
- Gross book value	-	133,135
- Accumulated depreciation	-	47,804
Additions for the year	372,960	265,567
Dismantled plant (note 2.2 b)	68,445	64,663
Unamortized dismantled plant	9,396	-
Depreciation charge for the year	200,212	153,501
Average rate of depreciation applied	6.96%	5.8%
Stocks for fixed assets:		
Reserve for obsolescence	7,302	9,295
Provision for obsolescence	-	6,920

- 3.3 As at December 31, 1988, of the total balance of «Subscriber sets and other related installations», sets amounting to Ptas. 12,426 million (in 1987, 19,836 millions ptas.), 7,828 millions net of accumulated depreciation (in 1987, 12,496 millions) are subject to sale in accordance with the Ministry Order dated December 2, 1987. During the year equipment was sold for a gross amount of 5,233 millions of pesetas (Ptas. 3,414 millions net of accumulated depreciation).
- 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 1989 amounts to Ptas. 590,000 millions, of which Ptas 572,000 millions 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, 1988, assets amounting to Ptas. 290,017 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 10 and 11.
- 3.7 Insurance policies contracted by Telefónica cover all assets owned by the Company with the exception of the franchise in policies for 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	1,455,318	710,115	745,203

- 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 renewal program. These useful lives are as described in 3.1 above.

#### NOTE 4 - INVESTMENTS

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

	1988	1987
Group companies .....	28,476	23,623
Other investments .....	4,299	3,377
Total .....	32,775	27,000

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

4.2 The information presented in the following table under the titles «Share Capital, reserves and allocated income» and «Income before tax» have been prepared on the basis of Group Companies financial statements at December 31, 1988. The accounting principles are described in Note 2.2 d).

Company name	Share capital	Telefónica holding%	Telefónica book value
Sistemas e Instalaciones de Telecomunicación S.A. (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
Compañía Española de Telecomunicaciones S.A. (ENTEL) .....	650	100	1,179
Compañía Española de Tecnología S.A. (COMET) .....	1,100	100	1,082
Compañía Publicitaria de Exclusivas Telefónicas S.A. (CETESA) .....	434	97.33	696
Hispano Radio Marítima S.A. ....	500	100	692
Telecomunicaciones Marinas S.A. (TEMASA) .....	600	100	520
Telefónica Internacional de España S.A. ....	200	100	204
Cabinas Telefónicas (CABITEL), S.A. ....	200	100	200
Seguros de Vida y Pensiones (ANTARES), S.A. ....	320	100	316
Control Electrónico Integrado .....	320	80.25	148
Telefónica Investigación y Desarrollo (Telefónica I + D) .....	1,000	100	988
Teleinformática y Comunicaciones (TÉLYCO) .....	50	100	50
Urbana Ibérica S.A. ....	330	100	—
Telefónica North America Inc. ....	1	100	1
Casiopea Reaseguradora S.A. ....	498	100	498
Servicios de Teledistribución S.A. ....	10	100	10
TS-1 Telefónica de Servicios S.A. ....	1,000	100	268
Total subsidiaries .....			13,132
Alcatel Standard Eléctrica S.A. ....	25,975	21.14	3,229
Fujitsu España S.A. ....	8,000	40	3,100
Industria Electrónica de Comunicaciones S.A. (INDELEC) .....	600	30	150
Torre de Collserola S.A. ....	500	35	175
Sistemas Técnicos de Loterías del Estado S.A. ....	1,300	49	635
Total associates .....			7,289
ATT Microelectrónica S.A. ....	8,481	20	1,696
Amper S.A. ....	4,110	8.09	1,104
European Silicon Structures .....	7,968	3.429	458
Telettra S.p.A. ....	5,137	10	3,990
Telettra Española S.A. ....	2,800	10	400
Other investments .....			407
Total others .....			8,055
Total Group .....			28,476

(\*) 1987 information.

Share Capital, reserves and allocated income at December 31, 1988	1988 income before tax profit (loss)	Activity
4,056	915	Telecommunication cable and line laying and equipment installation.
2,326	163	Investment management.
806	(48)	Marketing of electronic equipment and services for telecommunications.
1,831	422	Development and implementation of projects in data processing.
1,083	1	Promotion and investment in new companies.
770	74	Promotion of advertising services for directories, telephone booths and others.
663	(55)	Marketing and maintenance of electronic marine communication equipment and navigation aids.
645	87	Surveying, laying and repairing submarine cables.
225	4	Export of telecommunication equipment and resources.
609	302	Collection, cleaning and maintenance of public telephones.
325	5	Life insurance and pension funds.
89	(90)	Security systems engineering.
1,087	87	Research and development.
562	532	Promotion and marketing of telephone and telematic equipment.
—	(46)	Real estate activities.
1	—	Financial mediation.
498	—	Reinsurance.
10	—	Marketing of teledistribution equipment (music, voice, image, data, etc.)
171	(98)	Marketing of value added services.
<u>15,757</u>		
4,302	1,175	Manufacture of telephone and telegraph transmission and exchange systems.
3,741	124	Data transmission and data processing equipment.
395	607	Manufacture of portable and mobile communication equipment.
175	—	Communications Tower.
634	(3)	Installation, maintenance and exploitation of Lottery systems through terminal games.
<u>9,247</u>		
1,696	—	Design, manufacture, assembling and marketing of high technology integrated circuits.
1,629	2,516	Development, manufacture and repair of telephone and telematic terminals. Manufacture of componets (hybrid and flexible circuits).
458	—	(*) Manufacture and marketing of integrated circuits.
2,083	2,928	(*) Manufacturing, assembling and installation of telecommunication equipment.
644	1,713	Development, manufacture and installation of electronic telecommunication equipment.
407		
<u>6,917</u>		
<u>31,921</u>		

- 4.3 In 1988 Telefónica sold its interest in Cables de Comunicaciones and exchanged the 41% interest in Telettra España for the 10% in Telettra, S.p.A., resulting in a profit of 2,903 millions of pesetas.
- 4.4 A provision of 254 millions of pesetas was made for the reduction in the value of the investment portfolio as indicated in Note 2.2.d).
- 4.5 The most relevant operations recorded during the year between Telefónica and Group Companies were as follows:

	Dividends received		Purchase of goods and services by Telefónica	
	1988	1987	1988	1987
Subsidiaries .....	197	91	39,773	28,992
Associates .....	61	302	124,319	90,489
Total .....	258	393	164,092	119,481

Balances of suppliers and notes payable to suppliers include Ptas 21,716 million corresponding to intercompany transactions (1987, Ptas 15,533 million).

## NOTE 5 - DEFERRED EXCHANGE LOSSES

The accounting principles applicable are described in Note 2.2 f).  
The components of the balance and amortization schedule are as follows:

	Maturities				Balance 31-12-88	Balance 31-12-87
	1989	1990	1991	Subsequent		
Unrealised exchange losses (subject to exchange rate fluctuation)						
—deferred unrealized losses .....	1,098	207	—	3,994	5,299	10,721
—deferred unrealized gains .....	(18)	(52)	(11)	(9,886)	(9,967)	(8,974)
Total .....	1,080	155	(11)	(5,892)	(4,668)	1,747
Deferred realized exchange losses (corresponding to early repayment of loans) .....	6,282	5,358	5,244	2,082	18,966	27,237
Total .....	7,362	5,513	5,233	(3,810)	14,298	28,984
					1988	1987
Detail of the charge to expenses for the year are as follows:						
Repayment of loans and other debts .....					11,931	9,404
Services charges in foreign currency and other .....					115	890
Total .....					12,046	10,294

The charge to 1988 income includes the net effect of the charge amounting to 2,364 millions of pesetas corresponding to repaid foreign currency loans, whose contractual repayment was scheduled for March, 1992 and the credit amounting to 1,230 millions of pesetas, representing the cancellation of the provision for exchange losses.

## NOTE 6 - SUBSCRIBERS

The balances at December 31, comprise the following:

	1988	1987
Subscribers services billed:		
Private subscribers .....	12,524	5,106
Public entity subscribers .....	26,969	22,033
Ex-subscribers .....	4,088	4,222
Uncollectible and pending classification .....	291	504
	43,872	31,865
Unbilled services .....	82,773	67,443
	126,645	99,308
Provision for bad debts .....	(4,677)	(6,258)
Total .....	121,968	93,050

During 1988, cancellation of bad debts amounted to Ptas 2,911 million (1987, 2,488 million).

## NOTE 7 - 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, Tokyo and New York.

At December 31, 1988, the State has an approximate 32.5% (30.4% in 1987) direct shareholding, together with a further interest estimated at 3.2% (2.4% in 1987) through official institutions. Under Spanish legislation, total foreign shareholdings cannot exceed 25% of the share capital.

The table below reflects the movements of share capital:

	Number of shares	Par value	Price as a percentage	
			of par value	Paid-in
Balance December 31, 1987	830,735,713	415,368		
Issue of January, 1988	30,514,914	15,258	129.6666%	19,784
Issue of January, 1988	628,543	314	144.921%	455
Issue of July, 1988	166,218	84	180.730%	151
Issue of July, 1988	56,790,495	28,395	152.642%	43,343
Issue of August, 1988	416,841	208	160.341%	334
Issue of September, 1988	22,797	11	166.656%	18
Issue of October, 1988	15,757	8	163.418%	13
Issue of November, 1988	18,808	9	159.809%	15
Issue of December 1988	1,930,607	965	155.268%	1,499
Balance December 31, 1988	921,240,693	460,620		
Issue of January, 1989	3,571,252	1,786	156.477%	2,794

Share capital was issued in connection with the conversion of convertible bonds and debentures of which 45,000 millions pesetas corresponded to a short term issues.

## NOTE 8 - RESERVES

Reserves are as follows:

	1987	Distribution of profits 1987	Issued of share capital 1988	1988
Revaluation reserve	653,780	—	—	653,780
Share premium	11,317	—	20,360	31,677
Statutory reserve	8,405	7,600	—	16,005
Voluntary reserve	41,600	—	—	41,600
Unappropriated profit	88	4	—	92
Total	715,190	7,604	20,360	743,154

The statutory reserve is regulated by the State Contract (Condition 7 and 24). The Telefónica Taxation Law 15/1987 of July 30 partially cancelled the mentioned conditions. Therefore the statutory reserve can be considered as a voluntary reserve.

The revaluation reserve which has been established in accordance with the policy as indicated in Note 2.2.b, can be used to compensate future losses or to issue additional share capital once checked and approved. Within 5 years from the date of the last revalued balance sheet, the balance of the revaluation reserve can be transferred to freely distributable reserves.

The company may make free use of the remainder reserves whenever operating or financial requirements make this necessary.

## NOTE 9 - PROVISIONS

The composition of the provisions is as follows:

	1988	1987
Exchange losses	—	1,230
Self-insurance	4,491	4,500
Contingencies	55,667	55,667
	60,158	61,397
Possible contributions to the employee benefit systems (Note 15.2)	18,829	18,829
Provision for pension funds constituted (see Note 15)	14,815	—
	33,644	18,829
Total	93,802	80,226

## NOTE 10 - DEBENTURES AND BONDS

### 10.1 Composition and movements:

	Balance 31.12.87	New issues	Repayments	Revaluations and other movements	Balance 31.12.88
Debentures and bonds:					
Non-convertible .....	266,491	30,000	(36,767)	726	260,450
Convertible and/or exchangeable .....	51,497	1,200	(23,735)	111	29,073
Debentures and bonds in foreign currency .....	13,663	24,435	(6,801)	(1,765)	29,532
	<u>331,651</u>	<u>55,635</u>	<u>(67,303)</u>	<u>(928)</u>	<u>319,055</u>

### 10.2 Redemption:

	Maturities				Total 31.12.88
	1989	1990	1991	Subsequent	
Amount .....	<u>72,005</u>	<u>74,000</u>	<u>36,501</u>	<u>136,549</u>	<u>319,055</u>

### 10.3 Additional information:

	1988	1987
Interest expense .....	39,096	39,496
Accrued interest at December 31 .....	13,930	13,347
Issues subject to fiscal benefits:		
Debentures .....	73,328	103,970
Debentures in foreign currency .....	29,117	12,979

10.4 Foreign currency debentures amount to Deutsche Marks 100 million and to US dollars 200 million. In 1988 a Deutsche Mark issue, which had its contractual maturity date on March 1992, was preamortized.

In July 1988, debentures convertible into shares, amounting to US dollars 200 million, were issued.

Outstanding debentures are valued at the official closing exchange rate of each currency at year end. The exchange differences credited in 1988 to the unrealised exchange losses account amounted to Ptas 2,179 million. (In 1987 there was a charge of Ptas 286 millions).

10.5 Conversion options of convertible bonds were exercised in January, 1989 in the amount of Ptas 2,794 millions, corresponding to the December 1986 issue.

## NOTE 11 - LOANS AND CREDIT FACILITIES

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

	1988			1987		
	Long term	Short term	Total	Long term	Short term	Total
Commercial paper (face value) .....	23,243	37,974	61,217	23,325	28,972	52,297
Less:						
Deferred interest on commercial paper .....	(1,770)	(1,010)	(2,780)	(5,151)	(846)	(5,997)
	<u>21,473</u>	<u>36,964</u>	<u>58,437</u>	<u>18,174</u>	<u>28,126</u>	<u>46,300</u>
Loans in foreign currencies .....	96,869	-	96,869	62,226	-	62,226
Loans and credit facilities .....	212,862	2,833	215,695	186,415	13,417	199,832
Other loans .....	6,704	-	6,704	5,584	-	5,584
Total .....	<u>337,908</u>	<u>39,797</u>	<u>377,705</u>	<u>272,399</u>	<u>41,543</u>	<u>313,942</u>

### 11.2 The maturities are as follows:

	Maturities				Balances 31.12.88
	1989	1990	1991	Subsequent	
Loans in foreign currencies .....	6,222	567	-	90,080	96,869
Loans and credit facilities .....	23,073	22,722	55,903	113,997	215,695
Other loans .....	-	-	-	6,704	6,704
Commercial paper .....	61,217	-	-	-	61,217
Total .....	<u>90,512</u>	<u>23,289</u>	<u>55,903</u>	<u>210,781</u>	<u>380,485</u>

11.3 Additional information:

	Financial charges		Interest accrual (Deferral)		Interest rates	
	1988	1987	1988	1987	1988	1987
Loans in foreign currency .....	4,760	5,064	746	1,187	1.0625-12.5%	5.50-12.50%
Loans and credit facilities .....	20,515	20,609	2,866	2,838	10.5625-17%	11.125-17%
Commercial paper .....	6,761	6,898	—	—	10.19-17%	10.50-17%
Long term .....			(1,770)	(5,151)		
Short term .....			(1,010)	(846)		

11.4 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 17).

11.5 At December 31, 1988, of the total foreign currency loans, Ptas 47,272 million are covered by the fiscal benefits of Decree Law 19/1961 and Law 61/1978.

11.6 In accordance with the accounting criteria mentioned in Note 2.2 f), the amount of exchange differences arising from these loans in 1988 resulted in a charge to the account of unrealized exchange losses of Ptas 868 million (in 1987 there was a credit of Ptas 6,216 million).

11.7 The composition of foreign currency debt is shown below:

	Millions	
	1988	1987
US Dollars (US\$) .....	231.0	325.0
Deutsche Marks (DM) .....	50.0	50.0
Swiss Francs (SF) .....	261.0	150.0
Swedish Crowns (SKR) .....	-	1.7
Dutch Florins (DFL) .....	20.0	30.0
Yens .....	10,000.0	10,000.0
French Francs (FF) .....	650.0	-
ECU'S .....	190.0	-

11.8 Loans denominated in foreign currencies include:

— A multiple financing operation amounting to US dollars 250 million represented as at December 31, 1988 by euro commercial paper amounting to US dollars 156 million and ECU's 38 million with maturities of less than six months. 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, 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.

A loan granted by the European Investment Bank made through the Official Credit Institute (I.C.O.) amounting to ECU's 400 million, repayable in 15 years, with a grace period in the first 5 years. Repayment being in 20 half-yearly installments. Interest is fixed during the first 5 years and revisable at the end of the 5th and 10th years. The loan also has multicurrency option.

As at December 31, 1988, the first tranche, amounting to the equivalent ECU's 300 million (ECU's 152 million, FF 650 million and FS 107 million) has been drawn down.

11.9 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:

	1989	Subsequent	Total
Interest on commercial paper - long term .....	1,770	—	1,770
Interest on commercial paper - short term .....	1,010	—	1,010

NOTE 12 - TAXES PAYABLE

The balances at December, 31 comprise the following:

	1988	1987
State levy .....	—	31,075
Payroll withholding tax .....	3,756	3,327
Tax withholdings on dividends and interest and other .....	2,531	3,368
Total .....	6,287	37,770

## NOTE 13 - OTHER CREDITORS

These comprise the following groups of accounts:

	1988	1987
Staff bonus provision .....	10,991	9,998
Telephone service interchange .....	7,252	5,084
Guarantees and deposits .....	3,135	2,733
Accrued charges .....	10,238	3,806
Local taxes .....	1,129	-
Other creditors .....	3,326	3,459
Total .....	36,071	25,080

## NOTE 14 - ACCRUED EXPENSES AND DEFERRED INCOME

These are disclosed as follows:

	1988	1987
Accrued interest .....	17,541	17,377
Services billed in advance .....	12,850	11,425
Deferred income - Value Added Tax (transitory rules) .....	1,926	3,852
Other .....	7,117	3,794
Total .....	39,434	36,448

## NOTE 15 - PENSIONS

15.1 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 16).

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 members covered by this plan comprise approximately 10,985 retired persons (pensioners) and 64,100 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 1988 the contributions of Telefónica amounted to Ptas 13,019 million and those of its employees Ptas 6,220 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.

15.2 Telefónica has a provision of 18,829 million pesetas charged in 1982 against the revaluation surplus and which, as indicated in Note 9, 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 met by ITP.

15.3 Telefónica has shown its willingness to collaborate in the configuration of a future scheme that would make its workers' social service system viable. Consequently, negotiations have been held since 1985 without a final agreement being reached. The contribution offered by Telefónica during this negotiation process have been properly accrued at December 31, 1988 and 1987.

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, 1988 nor a significant impact on its prospective future profitability.

15.4 In 1988, and in accordance with the Law 39/1988 of December 29, Telefónica assigned a provision to constitute a pension fund which if it is definitively formalized, shall be created under the new pension funds regulations.

## NOTE 16 - ENDOWMENT INSURANCE

Telefónica's employees have the right on reaching 65 years of age, whether still at work or retired, to receive a single payment for endowment insurance, 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, 1988, amounted to Ptas 2,834 million and Ptas 29,720 million, respectively. In 1988 the Company has provided these funds, with a total of Ptas 8,480 million charged against income (1987, Ptas 7,797 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:

- The annual charge for the year 1988, approximately 4.9% of the overall payroll cost, is sufficient to cover this objective.
- At December 31, 1988, the present value of the future commitments, calculated at an interest rate of 8% applied on current salaries, amounts to approximately Ptas 89,000 million (81,000 million in 1987).

In order to obtain the tax deductibility of the expense in this fiscal year, the provision in 1988 of 8,480 millions of pesetas is considered provisionally to be included within the alternatives permitted in supplement 19 of Law 39/1988. In the event that this provision, for whatever reason, is not finally incorporated into a system of Pension Funds in accordance with the Law, Company income tax payable would be increased at such time, by the corresponding amount.

## NOTE 17 - MEMORANDUM ACCOUNTS

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

	1988	1987
Unused credit facilities: (Note 11.4)		
Available credit - Long-term .....	72,090	46,626
Floating rate credit facilities .....	30,000	32,000
Available credit - short-term .....	—	14,163
	<hr/> 102,090	<hr/> 92,789
Guarantees of financial operations .....	2,917	2,951
Guarantees granted to employees .....	4,080	4,429
Pending tax benefits .....	31,712	—
Others .....	20,757	18,671
	<hr/> 59,466	<hr/> 26,051
Total .....	<hr/> 161,556	<hr/> 118,840

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

## NOTE 18 - FISCAL SITUATION

Years opened to tax inspection are as follows:

- Corporate income tax: 1988.
- Local taxes: 1988.
- Value added tax (IVA): from 1986 to 1988.
- Capital transfer tax: 1988.
- Interest withholding tax: from 1983 to 1988.
- Withholding on account personal income tax: from 1983 to 1988.

In 1988 the provision for Corporate Income Tax amounts to Ptas 21,243 million. This amount is obtained after deducting 8,482 millions pesetas for deductions and allowances, of which 6,270 millions pesetas relates to allowances for fixed asset acquisitions.

The fixed assets acquisitions in 1988 subject to fiscal deductions amount to 349,439 millions of pesetas.

## NOTE 19 - SUBSEQUENT EVENTS

An agreement exists regarding the sale to Amper, S.A. of Telefónica's participation in Cosesa, covering the latter's commercial activities, its remaining activity of piped music being incorporated into Servicios de Teledistribución, S.A.

On March 10, 1989 the Board of Ministers approved the new tariffs applicable from March 12, 1989, the average increase being 3.38%.

## **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 2.2a)\*, 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 i)\*
4. Foreign currency accounts (See Notes 2.2 f and 5)\*
5. Income Tax (See Note 1.3)
6. Property, plant and equipment (See Notes 2.2b) and 3)\*
7. Investments (See Notes 2.2.d) and 4)\*
8. Costs of new equity capital (See Note 2.2 e)\*
9. Income per share is not required to be in the financial statements nor in any other obligatory financial information.
10. Endowment insurance (See Note 2.2 i)\*
11. Allowance for funds during construction (See Note 2.2.b)\*

### **Treatment for IAS purposes**

- Research and development costs 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 11 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.
- Deferred taxes arising from timing differences between income and taxable income must be accounted for.

### **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 value 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.
- Interest accrued up to the time when the assets are placed in service are accounted for.

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	1988
Net income for the year as reported in the Spanish statutory accounts at December 31	53,247	62,845
Adjustments for IAS purposes:		
Research and development expenses – Net effect between prior write-offs and current amortization	3,254	(5,479)
Release of technological development reserve	4,518	–
Self-insurance and other	2,497	1,979
Deferred taxes due to adjustments	–	2,024
Approximate net income for the year in accordance with IAS	63,516	61,369
Adjustments for US GAAP purposes:		
Reversal of depreciation of revalued portion of fixed assets	65,750	61,432
Reversal of amortization of costs of new equity capital	472	950
Adjustment of investments to net equity value	(879)	329
Adjustment of endowment insurance cost	1,401	(1,476)
Allowance for funds during construction	–	14,969
Less amount due to effect of the fixed assets revaluations, of the retired plant not depreciated	–	3,574
Deferred taxes due to adjustments	–	(4,792)
Write down of customer premises equipment at market prices	(16,510)	–
Approximate net income for the year in accordance with US GAAP	113,750	136,355
Approximate net income per share in accordance with US GAAP	140.14	155.86
Shareholders' equity as reported in the Spanish statutory accounts at December 31.	1,130,558	1,203,774
Net income for the year	53,247	62,845
	1,183,805	1,266,619
Adjustments for IAS purposes:		
Investments	(3,073)	(1,085)
Research and development written-off	(4)	(5,483)
Release of provisions	30,754	30,745
Deferred taxes due to adjustment	–	2,024
Approximate shareholders' equity in accordance with IAS	1,211,482	1,292,820
Adjustment for US GAAP purposes:		
Reversal of net effect of revaluation of fixed assets related accumulated depreciation	(478,020)	(416,588)
Costs of new equity capital	(1,200)	(4,352)
Adjustment of investments to equity value	(18,847)	(11,103)
Accrual of past service costs of endowment insurance	200	(1,276)
Allowance for funds during construction	–	14,969
Less amount due to effect of the fixed assets revaluations, of the retired plant not depreciated	–	3,574
Deferred taxes due to adjustments	–	(4,792)
Approximate shareholders' equity in accordance with US GAAP	713,615	873,252

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 46 to 57 of this Annual Report.

## Board of Directors

As it stood on May 31, 1989

### CHAIRMAN

Cándido Velázquez-Gaztelu Ruiz

### VICE-CHAIRMAN

José María Concejo Alvarez

Pablo Garnica y Mansi

José María Amusátegui de la Cierva

### MANAGING DIRECTOR

Germán Ancochea Soto

### DIRECTORS (Representing shareholders)

Baltasar Aymerich Corominas

Juan Antonio Blanco Magadán Amutio

José Luis Bozal González

José María Carballo Cotanda

Miguel Cruz Amorós

Alvaro Espina Montero

Antonio Flos Bassols

José Luis Martín Palacín

José Montes Fernández

Juan Manuel Rebollo Castrillo

Epifanio Ridruejo Brieua

José Teófilo Serrano Beltrán

### DIRECTORS (Representing the Government)

Enrique Martínez Robles

Francisco Zambrana Chico

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 31, 1989

### CHAIRMAN

Cándido Velázquez-Gaztelu Ruiz

### VICE-CHAIRMAN

José María Concejo Alvarez

Pablo Garnica y Mansi

José María Amusátegui de la Cierva

### MANAGING DIRECTOR

Germán Ancochea Soto

### DIRECTORS

José Luis Bozal González

José Luis Martín Palacín

Enrique Martínez Robles

Epifanio Ridruejo Brieua

Francisco Zambrana Chico

### SECRETARY

Heliodoro Alcaraz y García de la Barrera

### VICE-SECRETARY

Mariano Aldama Magnet

### GOVERNMENT DELEGATE

Javier Nadal Ariño

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### Changes recorded in the Board of Directors after the end of the 1988 financial year.

LUIS SOLANA MADARIAGA retired as Chairman of the Board of Directors on January 20, 1989. Appointed in his place was CANDIDO VELAZQUEZ-GAZTELU RUIZ.

CARLOS VIADA FERNANDEZ-VELILLA retired as Managing Director on February 8, 1989. Appointed in his place was GERMAN ANCOCHEA SOTO.

EMILIO BOTIN SANZ DE SAUTUOLA Y GARCIA DE LOS RIOS retired as Director representing shareholders on April 26, 1989. Appointed in his place was JOSE MARIA CARBALLO COTANDA.

On ending their term of office, the Directors JUAN ANTONIO BLANCO MAGADAN AMUTIO and JUAN MANUEL REBOLLO CASTRILLO also retired from the Board, without losing their right to possible re-election by the General Meeting.

# Management Committee

As it stood on May 31, 1989

## CHAIRMAN

Cándido Velázquez-Gaztelu Ruiz.—**Chairman of the Board of Directors.**

## MEMBERS

Germán Ancochea Soto.—**Director/General Manager of Administration and Finance.**

Germán Ramajo Romero.—**General Manager of Operations.**

Enrique Used Aznar.—**General Manager of Sales, Services and Network.**

Francisco Javier Monzón de Cáceres.—**General Manager of Corporate Development.**

Heliodoro Alcaraz y García de la Barrera.—**General Secretary and Secretary of the Board of Directors.**

Antonio López-Barajas y García -Valdecasas.—**Assistant Director to the Chairman.**

# Deputy General Managers

As it stood on May 31, 1989

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 Communications**

## SHAREHOLDER INFORMATION

	1984	1985	1986	1987	1988
Share Capital (Millions of ptas.)	320,415.60	360,467.55	411,792.74	415,367.86	460,620.35
Earnings per share (ptas.)	55.69	55.71	56.13	64.15	70.62
Price/earnings ratio	8.35	11.44	15.59	12.47	12.58
Dividend payout (%)	98.76	98.72	98.66	85.72	75.43
Capitalisation/Cash-flow	1.79	2.57	3.21	2.47	2.52

### Share Capital

The share capital of Telefónica at April 30, 1989 was 462,405,972,500 ptas., represented by 924,811,945 bearer shares of 500 Ptas. nominal value, fully paid in.

Capital increases since 1984 are as follows:

Year	Ratio	Issue price (ptas.)	Paid by the Shareholders (ptas.)	Nominal Amount Millions of Ptas.
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	—	129.666%	648.330	15,257.5
1988 Conv	—	144.921%	724.605	314.3
1988 Conv	—	180.730%	903.650	83.1
1988 Conv	—	152.642%	763.210	28,395.2
1988 Conv	—	160.341%	801.705	208.4
1988 Conv	—	166.656%	833.280	11.4
1988 Conv	—	163.418%	817.090	7.9
1988 Conv	—	159.809%	799.045	9.4
1988 Conv	—	155.268%	776.340	965.3
1989 Conv	—	156.477%	782.385	1,785.6

Note: At April 30, 1989 Telefónica had outstanding 8,220.5 million pesetas and 200 millions dollars 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.\*

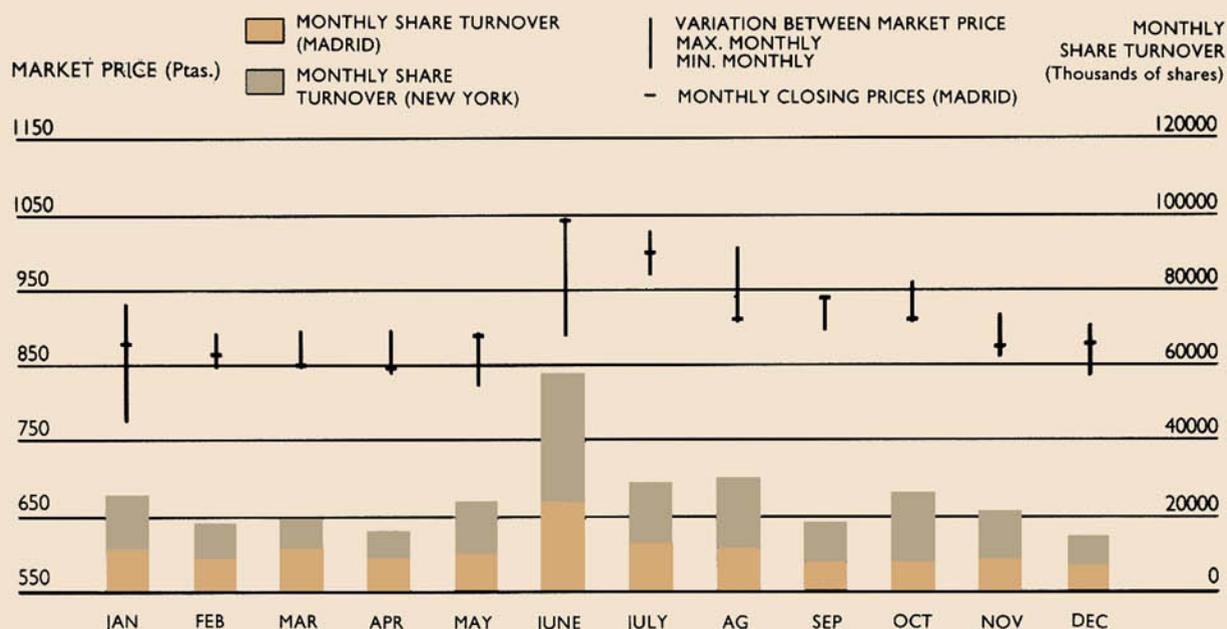
Admission to the New York Stock Exchange was granted on June 11, 1987.

Telefónica is listed under the symbol "TEF".

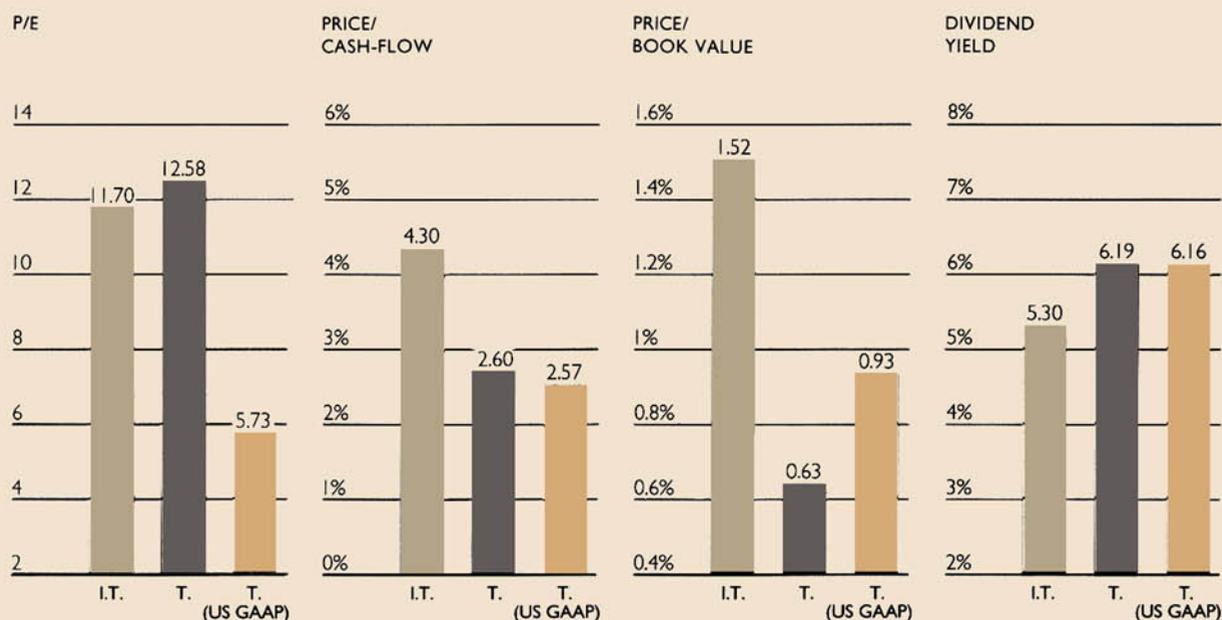
Since April 5, 1988, Telefónica is present on the London Stock Exchange SEAQ INTERNATIONAL\* system.

\*It is listed on American Depositary Receipts. 1 ADR = 3 shares.

## TRENDS IN TELEFONICA SHARES DURING 1988



## TELEFONICA: INTERNATIONAL COMPARISONS AT DECEMBER 31, 1988



I.T. - 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 Ptas.

Year	High	Low	Year-end close
1984	523.75	330.00	465.00
1985	720.00	472.50	637.50
1986	1,142.50	632.50	875.00
1987	1,265.00	645.00	800.00
1988 1st quarter	930.00	800.00	850.00
1988 2nd quarter	1,047.50	831.25	1,047.50
1988 3rd quarter	1,028.12	893.12	938.75
1988 4th quarter	959.38	840.00	888.75

## Stock Market Capitalisation

	1984	1985	1986	1987	1988	Average Growth % 88/84
Telefónica	268.2	456.2	700.9	663.7	766.1	30.00
Total Madrid Stock Exchange	2,294.5	3,007.3	6,477.3	7,748.8	10,313.1	45.60
Telefónica Weighting on the M.S.E. index (%)	10.71	11.90	15.20	10.89	9.07	—

(figures in thousands of millions 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, following the proposal of the Board of Directors.

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

Recent dividends were:

	1987	% of par value	1988	% of par value
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 46).

## Principal shareholders of Telefónica

Since Telefónica shares are bearer shares, no official register of shareholders exists. Nevertheless, in paying the interim dividend for 1988 on January 31, 1989, it was verified that the main shareholders are as follows:

	Interest as % of Share Capital
Spanish State	32.36
Bank of Spain	1.31
Caja Postal (Post Office Savings Bank)	1.85

**Notice of the General Meeting of Shareholders**

Date: June 30, 1989 (at the second notice)

Time: 12 h.

Place: Paseo de la Castellana, 259. Madrid.

Pabellón de Deportes de la Ciudad Deportiva del Real Madrid.

**Shareholder information**

Copies of this Annual Report may be obtained free of charge from the Company offices or by request in writing to:

**Telefónica de España, S.A.**

Financial Department

General Perón, 38-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 biannual information brochure is available to shareholders.

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**Charts:** Chema Alonso

**Layout and Printing:**

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Artegraf

Legal Deposit: M-22591-1989



**Telefónica de España, S.A.**