

***FUNCTIONING AND REPORT OF ACTIVITIES OF THE
AUDIT AND
CONTROL COMMITTEE OF THE BOARD OF
DIRECTORS OF TELEFÓNICA, S.A.***

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AUDIT AND CONTROL COMMITTEE OF THE BOARD OF DIRECTORS OF TELEFÓNICA, S.A.

I. INTRODUCTION

The purpose of the present document is to describe the functioning of the Audit and Control Committee of Telefónica, S.A. (henceforth, the Company), highlighting, likewise, aspects related to its duties, powers and membership.

The Audit and Control Committee of the Board of Directors was created by resolution adopted by the said Board at its meeting on 29 January 1997, although there has been broad development of its duties, powers and activities subsequently, in accordance with changing legal requirements and recommendations on corporate governance, both national and international (referring especially to the Good Governance Code, published by the Spanish Securities Market Commission in February 2015, the Sarbanes-Oxley Law, and the rules of the New York Stock Exchange -NYSE-),

II. DUTIES AND POWERS OF THE COMMITTEE

The duties and powers of the Audit and Control Committee are laid out in article 39 of the Company Bylaws, and in greater detail in article 22 of the Regulations of the Board of Directors. Specifically, the primary function of the Audit and Control Committee is to aid the Board of Directors in its duties of supervision, and it shall enjoy at least the following competences:

- 1) To report to the shareholders at the General Shareholders' Meeting on matters raised at the Committee and within the purview thereof, and particularly regarding the results of the audit, explaining how it has contributed to the integrity of the financial information and the function performed by the Committee in such process.
- 2) To submit to the Board of Directors proposals for the selection, appointment, re-election or replacement of the external auditor, taking responsibility for the selection process in accordance with the provisions of law, as well as the terms for the hiring thereof, and regularly obtain information from the auditor regarding the audit plan and the implementation thereof, in addition to preserving the independence thereof in the performance of its duties.
- 3) To supervise internal audit and, in particular:
 - a) To ensure the independence and efficiency of the internal audit function;
 - b) To propose the selection, appointment and removal of the person responsible for internal audit;
 - c) To propose the budget for such service;
 - d) To review the internal audit annual work plan and its annual activities report;
 - e) To receive periodic information on its activities; and

- f) To verify that the senior executive officers take into account the conclusions and recommendations of its reports.
- 4) To supervise the process of preparing and submitting mandatory financial information and submit recommendations or proposals to the board of directors intended to safeguard the integrity thereof. With respect thereto, it shall be responsible for supervising the process of preparation and the integrity of the financial information relating to the Company and the Group, reviewing compliance with regulatory requirements, the proper determination of the scope of consolidation, and the correct application of accounting standards, informing the Board of Directors thereof.
- 5) To supervise the effectiveness of the Company's internal control system, internal audit, and systems for the management of risk, including tax risks, and to discuss with the Auditor significant weaknesses in the internal control system detected during the audit, all without infringing the independence thereof. In such cases, and if applicable, it may submit recommendations or proposals to the Board of Directors and the corresponding period for follow-up thereon. With respect thereto, it shall be responsible for proposing to the Board of Directors a risk control and management policy, which shall identify at least the following:
- a) the types of risk (operational, technological, financial, legal and reputational) facing the company;
 - b) the setting of the risk level that the Company deems acceptable; the measures to mitigate the impact of the identified risks, should they materialize; and
 - c) the control and information systems to be used to control and manage the above-mentioned risks.
- 6) To establish and supervise a mechanism to allow employees to confidentially and anonymously report potentially significant irregularities, particularly any financial or accounting irregularities detected within the Company.
- 7) To establish and maintain appropriate relations with the Auditor in order to receive, for review by the Committee, information on all matters that could entail a threat to the independence thereof, as well as any other matters relating to the audit procedure, and when applicable, authorization of services other than those that are prohibited, upon the terms contemplated by applicable law, and such other communications as may be provided for in auditing legislation and auditing rules. In any event, the Audit and Control Committee must receive, on an annual basis, a declaration from the Auditor of its independence vis-à-vis the entity or entities directly or indirectly related thereto, as well as detailed and itemized information regarding additional services of any kind provided and the corresponding fees received by such entities from the Auditor or by the persons or entities related thereto pursuant to the provisions of applicable law.
- 8) To issue on an annual basis, prior to the issuance of the audit report, a report stating an opinion on whether the independence of the Auditor has been compromised. This report must in all cases include a reasoned assessment of the provisions of each and every one of the additional services referred to in point 7) above, both individually and as a whole, other than the legal audit and regarding the rules on independence or regulations on the activity of auditing.
- 9) To analyze and report on the financial terms, accounting impact and, if applicable, the exchange ratio proposed for structural modifications and corporate

transactions that the Company expects to carry out, prior to submission to the Board of Directors.

10) To report in advance to the Board of Directors on all matters provided by law and the By-Laws, and particularly regarding:

1. Financial information that the Company must periodically make public;
2. The creation or acquisition of interests in special-purpose entities or entities domiciled in countries or territories considered to be tax havens; and
3. Related-party transactions.

11) As regards those companies of the Group that are deemed to be Public-Interest Entities (*Entidades de Interés Público*) (as defined by applicable law), to perform all those duties of the Audit Committee at any time contemplated by applicable law, such that they are so approved by the Board of Directors, provided that they are directly or indirectly wholly-owned by the Company pursuant to the provisions of applicable law and that the administration thereof is not vested in a Board of Directors.

The provisions of sections 2, 7 and 8 of this article are deemed to be without prejudice to the regulations governing auditing.

III. COMPOSITION OF THE COMMITTEE

With respect to its composition, and in accordance with article 39 of the Company Bylaws and article 22 of the Regulations of the Board of Directors, the Audit and Control Committee must be made up of a minimum of three Directors, designated by the Board of Directors. All members thereof must be external or non-executive Directors, and at least a majority of them must be independent Directors. In appointing its members, and particularly its Chairman, the Board of Directors shall take into account their knowledge and experience in matters of accounting, auditing or both, as well as in risk management. As a group, the members of the Committee shall have relevant technical knowledge relating to the industry to which the Company belongs.

The Chairman of the Audit and Control Committee, who shall in all events be an independent Director, shall be appointed from among its members, and shall be replaced every four years; he may be re-elected after the passage of one year from the date when he ceased to hold office.

All members of the said Committee must be external or non-executive Directors. The Chairman of the Committee must always be independent, may serve no more than four years continuously, and may be reelected one year after the end of their chairmanship. The Board of Directors shall take into account the knowledge and experience of accounting, auditing and risk management possessed by those designated as members of the Committee.

On 31st of December 2015, the composition of the Audit and Control Committee was as follows:

- Mr. Carlos Colomer Casellas (Chairman)
- Mr. Gonzalo Hinojosa Fernández de Angulo
- Mr. Alfonso Ferrari Herrero
- Mr. Antonio Massanell Lavilla
- Mr. Ignacio Moreno Martínez

The professional profiles of the members of the Audit and Control Committee are publicly available at the Corporate website of Telefónica, S.A.

http://www.telefonica.com/es/shareholders-investors/html/corporate_governance/compconsejo.shtml

Similarly, and pursuant to Rule 10A 3, and in Section 303 of the Securities Exchange Commission (SEC) and the New York Stock Exchange (NYSE), respectively, in 2015 the composition of the Audit and Control Committee was notified to the NYSE, together with information about its members (with express indication of their knowledge and experience in matters of accounting and audit), it being concluded that all its members fulfill the requirements for independence set out in the cited Rule 10A 3

The Secretary to this Committee is the General and Board Secretary of Telefónica, S.A., Mr. Ramiro Sánchez de Lerín García-Ovies, supported by the Vice General Counsel and Chief Legal Officer of the Group, Ms. María Luz Medrano Aranguren, and the Corporate Governance and Securities Market Director, Ms. Consuelo Barbé Capdevila. Therefore, the General and Board Secretary advises on all juridical aspects relating to this Committee.

IV. FUNCTIONING OF THE COMMITTEE

With regard to its operation, the Audit and Control Committee has an Annual Activity Plan and a Session Calendar, which details all the activities that the Committee should undertake throughout the financial year, in terms of the four axes about which its activity turns: i) External Auditor; ii) Internal Audit and Internal Control Systems; iii) Financial Information; and iv) The obligations for information and communication by the Committee to the Board of Directors, and to the relevant supervisory and official bodies.

The existence of the Annual Activity Plan and a Session Calendar allow the Audit and Control Committee to schedule its work for the whole financial year. Thus, it generally meets once per month, according to the Calendar, before the meeting of the Board of Directors of the Company and the presentation of the half-yearly and quarterly results, and as often as may be deemed necessary, when called by the Chairman.

During 2015, the Audit and Control Committee has held 13 meetings.

These meetings have lasted around two hours on average, dedicating its members an appropriate numbers of hours to the study and analysis of the issues to be discussed.

Regarding the attendance, each member of the Committee is subject to attendance control, a record being taken at the start of each session, and recorded in the corresponding Minutes. In 2015, all the members of the Committee have attended, present or represented, to all the meetings.

With regard to preparing the Agenda for the sessions, it should be said that, under the coordination of the General Secretary and Secretary to the Board of Directors, a preparatory meeting is held among all the areas of the Company whose duties relate to the remit of the Committee, so as to propose and analyze the questions and issues which should be addressed at each session, taking the Annual Activity Plan and the Schedule of Sessions as a guide. Subsequently, and after examination by the Chairman of the Committee, the session is called with the predetermined Agenda, together with attached documentation.

All meetings of the Audit and Control Committee discuss the different issues submitted for deliberation, or for decision where appropriate, in the due depth. The members intervene actively in the different debates and discussions, giving their opinion whenever they should see fit.

The deliberations of the Committee and the agreements and decisions adopted are documented in the corresponding Minutes for each session, written by the Secretary of the Committee at the end of the session and later distributed to all members for their assent and observations. Finally, the Minutes are submitted for approval as the first point on the Agenda for the following meeting of the Committee, and they are then signed by the Secretary and with the approval of the Chairman.

Moreover, regarding the rules governing the composition and adoption of resolutions by the Audit and Control Committee, the meetings are quorate when at least half of the members are present, directly or by proxy; and resolutions are adopted by simple majority of those present. In the event of a tie, the Chairman holds a casting vote.

Similarly, it should be said that, through the internal audit portal e-Audit (available on the Telefónica intranet), Directors belonging to the Committee can access all the documentation discussed at each of the sessions from the Internal Audit Service, which lets them track the information appropriately.

Finally, and as has been stated, the relations between the Audit and Control Committee and the Board of Directors of the Company are based on a principle of full transparency. On this point, the Committee informs the Board of Directors, at each of its monthly meetings, about the main matters discussed and the activities and work carried out by the Committee, and where the case requires it, proposes the adoption of the relevant resolutions by the Board of Directors.

V. ATTENDANCE AT MEETINGS

Apart from the members of the Audit and Control Committee, the sessions are generally attended by different members of the management team of Telefónica Group, engaged in duties of support and assistance to Committee members in the matters to be analyzed at the meeting. Specifically, Committee sessions are attended by representatives of the General and Board Secretary, Strategy and Finance, Internal Audit, Intervention & Inspection, Planning and Control, and Global Resources.

In addition to those just mentioned, and as required by the Committee itself, other managers of the Company and its Affiliates may participate, in order to discuss specific matters which affect their respective businesses or duties.

It is also usual for Committee meetings to be participated in by the representing partners of the External Auditor of the Company, Ernst & Young, S.L. The latter intervene to explain the work carried out, as well as to clarify, as required by the Committee, any questions which may arise during the sessions relating to the functions assigned to that firm.

VI. MATTERS DISCUSSED BY THE AUDIT AND CONTROL COMMITTEE IN 2015.

Among the matters which the Audit and Control Committee analyzes in its sessions, some correspond to legal requirements and others prompt the interest of the Committee because of their relation to its remit.

The principal questions analyzed by the Committee in 2015 were as follows:

On Financial Information.

1. Review of the Annual Accounts and Periodic Financial Information of the Company.

In general, the Committee, in accordance with the duties attributed to it, examined and analysed the process of preparing the Company's financial information.

Thus, in terms of the Individual Annual Accounts, Consolidated Financial Statements (Consolidated Annual Accounts) and Management Reports for Telefónica, S.A. and its Consolidated Group for the 2014 financial year, at its meeting held on the 23rd of February 2015, the Committee studied and debated the most pertinent aspects of the close of the financial year. It was also informed of the process to draw up said information and the accounting principles used (International Financial Reporting Standards – IFRS – and the General Accounting Plan in force in Spain).

Regarding the Quarterly and Half-Yearly Regular Financial Information, the Committee debated the most salient issues from the first quarter of the 2015 financial year at its meeting held on the 13th of May 2015; issues from the first semester of 2015 were debated by the Committee at its meeting on the 27th of July

2015; and matters relating to the third quarter of the 2015 financial year were debated at its meeting on the 5th of November 2015.

2. Company Prospectus.

The Committee was also informed, over the course of its various meeting, of the following Filings made by the Company before various Supervisory Bodies:

- At its meeting on the 23rd of February 2015, the Committee was informed of the content and most salient aspects highlighted in the Telefónica, S.A. 20-F Annual Report for the corporate year ending on the 31st of December 2014.
- Likewise, in the month of March 2015, the Committee issued a favourable opinion of the documents drawn up by the Company (i.a. the Note on the Shares in Spain and the Prospectus Supplement in the US) regarding the capital increase with preferential subscription rights, worth a cash amount of 3,048,250,914.56 euros, made by Telefónica, S.A.
- At its meeting on the 13th of May 2015, the Committee was informed of the renewal of the Shelf Programme for Telefónica, S.A. and Telefónica Emisiones, S.A.U. to issue Debt Instruments in the United States, as Guarantor and Issuer, respectively.
- Likewise, the Committee was informed, at its meeting on the 26th of May 2015, of the filing of the new Base Prospectus regarding the Medium Term Notes Programme, "MTN Programme" before the Financial Conduct Authority (FCA) in the United Kingdom.
- The Committee, at its meeting on the 22nd of June 2015, was informed of the filing, before the Tokyo Exchange Commission, of the "Annual Securities Report" (ASR) for the 2014 financial year. The Company delisted from the Tokyo stock exchange on the 25th of December 2011. However, in accordance with Japanese legislation, the Company is still required to file this report. Likewise, the Committee was informed, at its meeting on the 29th of September 2015, of the filing, before the same body, of the "Semi-Annual Securities Report" (SRS) for the first half of the 2015 financial year.
- For its part, at the meeting on the 5th of November 2015, the Committee was informed of the filing, before Spain's CNMV, of the Shares Register Document (Documento de Registro de Acciones) prepared in accordance with Annex 1 of Regulation (EC) No. 809/2004 of the Commission, of the 29th of April 2004.

On the External Auditor.

As regards the External Auditor, at the meeting held on the 27th of January 2015, the Committee unanimously decided to propose to the Telefónica, S.A. Board of Administration the appointment of Ernst & Young, S.L. as the Auditor of Accounts for the Individual Accounts, the Consolidated Financial Statements, and the quarterly and half-yearly information for the 2015 financial year, and to verify all of the information contained in the Corporate Social Responsibility Report.

At the meeting held on the 22nd of June 2015, Ernst & Young, S.L. presented its Work Plan for 2015, reporting on: i) the auditing activities being carried out (both in relation to the annual and quarterly Financial Statements and Internal Control) and other occasional reviews (such as "Comfort and Consent Letters" for specific financing operations); as well as ii) the reports, documents and communications that the External Auditor must issue to the Audit and Control Committee with regard to the work carried out, and required by both Spanish company law and the SEC or the "Public Company Accounting Oversight Board" (PCAOB), covering the most salient areas and those receiving greatest emphasis in their auditing work.

Thus, over the course of the various meetings of the Audit and Control Committee, the work conducted by said External Auditor was presented:

A. Regarding the Financial Statements.

At the meeting of the Audit and Control Committee held on the 23rd of February 2015, the representatives of Ernst & Young, S.L. set out the main conclusions of the audit work conducted on the Individual Annual Accounts and the Company's Consolidated Financial Statements for the 2014 financial year.

Likewise, the Committee was informed of the limited revisions made by the External Auditor to the Company's Quarterly and Half-Yearly Financial Statements.

B. On the internal control systems and information systems (Section 404 of the Sarbanes-Oxley Act).

Equally, at the Committee's meetings held on the 23rd of February and the 5th of November 2015, the representatives of the External Auditor reported on the work conducted to evaluate the internal audit system (as provided for in Section 404 of the Sarbanes-Oxley Act).

C. External Auditor's fees.

Moreover, the Committee received a presentation on the estimated proposal of the fees payable to Ernst & Young, S.L. for the 2015 financial year for the accounts and related auditing work. Likewise, proposed fees for other firms of auditors who carry out work for Telefónica Group were presented.

D. External Auditor Assignments.

Equally, over the course of the 2015 financial year, the Audit and Control Committee approved various auditing assignments for different Telefónica Group companies, to be conducted by companies in the E&Y Group, all of which are duly justified and motivated by the internal standards defined for this purpose.

Furthermore, it should be noted that, at its meeting of the 5th of November 2015, the Committee agreed to begin the work to hold the selection process for a new Auditor. And at its meeting on the 25th of November 2015, it agreed to start the selection process for a new Auditor of Accounts for Telefónica, S.A. and its consolidated Group for the 2017-2019 period, defining the main milestones in that selection process, the work and activities to be carried out in this regard, and detailing the

expected time frame which will end with the appointment, by the Ordinary General Meeting of Shareholders to be held in 2016, of the new Auditor of Accounts of Telefónica, S.A. and its consolidated Group for the 2017-2019 period.

E. Committee Report on the independence of the External Auditor

At the meeting held on the 23rd of February 2015, the Audit and Control Committee approved a report on the independence of the External Auditor, which indicates, amongst others, the services rendered, directly and indirectly, by Ernst & Young, S.L. and its related parties to Telefónica, S.A. and its related parties, additional to the audit services, from 1st of January 2014 to the date of the issuance of the audit report of the Individual Annual Accounts and the Company's Consolidated Financial Statements for fiscal year 2014, as well as the appropriate fees.

This report concluded that the External Auditor is independent from Telefónica, S.A. and its related parties, in terms of the applicable law.

On Internal Control.

Over the course of its meetings, the Audit and Control Committee was informed in detail of the activities conducted by the Internal Audit, Intervention and Inspection area of the Group on the Company's Internal Control Systems.

Also, at the meeting held on the 23rd of February 2015, the Committee received a presentation on the internal assessment of the financial report on Telefónica, S.A., for fiscal year 2014, required by Section 404 of the Sarbanes-Oxley Act and whose main goal is to issue a certificate using Document 20-F 2014 (which was filed before the SEC in February 2015) on the Group's Internal Control f, along with the corresponding "attestation" from the External Auditor.

Similarly, the Committee analysed:

- The 2015 Internal Audit, Intervention and Inspection Plan, as well as the proposal of the budget of this area and the breakdown of its working plan.
- The Internal Audit reports on review of transversal processes.
- Risk Management Systems.
- The inspection, investigative and anti-fraud work carried out on possible non-compliances with regulations, including anti-corruption rules. Likewise, the claims received through Whistleblower Channel.

Other matters of interest analysed by the Audit and Control Commission.

Additionally, the Audit and Control Committee studied and took note of the changes to accounting standards and other accounting aspects related to the Telefónica's Group financial statements.

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