

*AUDIT AND CONTROL COMMITTEE OF THE BOARD OF
DIRECTORS OF TELEFÓNICA, S.A.: OPERATION AND
ACTIVITIES REPORT 2016*



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

I. INTRODUCTION

This document aims to make known the operation of the Audit and Control Committee of the Board of Directors of Telefónica, S.A. (hereinafter the Company) and highlighting certain aspects regarding its roles, competences, and composition.

The Audit and Control Committee was created by a resolution adopted by the Board of Directors of the Company at its meeting held on 29 January 1997, with an extensive development of its roles, competences and activities having subsequently been produced, according to the legal requirements and the recommendations of both national and international corporate governance (with particular reference to the legal reforms introduced in the Capital Companies Law by Law 31/2014 of 3 December, which amended the Capital Companies Law to improve corporate governance, the Code of Good Governance published by the CNMV (*Comisión Nacional de Mercados de Valores*) in February 2015, the Sarbanes-Oxley Law, and the regulations of the New York Stock Exchange -NYSE-).

II. FUNCTIONS AND COMPETENCES OF THE COMMITTEE

The functions and competences of Audit and Control Committee are set out in Article 39 of the Company's Articles of Association, and broken down in greater detail in Article 22 of its Regulations of the Board of Directors. In this sense, the primary duty of the Audit and Control Committee shall be to support the Board of Directors in its supervisory duties. Specifically, it shall have at least the following powers and duties:

- 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 regard to its composition, and in accordance with the provisions of Article 39 of the Company ByLaws and of Article 22 of the Regulations of the Board of Directors, the Audit and Control Committee must be made up by a minimum of three Directors, appointed by the Board of Directors. All its members must be external or non-executive Directors, and most of them, at least, independent Directors.

In the appointment of its members and, especially, its Chairman, the Board of Directors will take into account their knowledge and experience in accounting, auditing or both, as well as in risk management. Taken together, the members of the Committee shall have relevant expertise regarding the sector of activity to which the Company belongs.

The Chairman of the Audit and Control Committee, a post that shall always be taken by an independent Director, shall be appointed from among its members and must be replaced every four years and may be reappointed once within one year after his departure.

On 31st of December 2016, the composition of the Audit and Control Committee was as follows:

- Mr. José Javier Echenique Landiribar (*) (Chairman)
- Mr. Gonzalo Hinojosa Fernández de Angulo
- Mr. Francisco Javier de Paz Mancho (**)
- Mr. Antonio Massanell Lavilla
- Mr. Ignacio Moreno Martínez

(*) Mr. José Javier Echenique Landiribar was appointed Member and Chairman of the Audit and Control Committee on 8 April 2016, replacing Mr. Carlos Colomer Casellas.

(**) Mr. Francisco Javier de Paz Mancho was appointed Member of the Audit and Control Committee on 27 April 2016, replacing Mr. Alfonso Ferrari Herrero.

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

https://www.telefonica.com/en/web/shareholders-investors/corporate_governance/compconsejo



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 2016 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 fulfil the requirements for independence set out in the cited Rule 10A 3.

On the other hand, 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. OPERATION OF THE COMMITTEE

As regards to its operation, the Audit and Control Committee has an annual Action Plan and a Meetings Schedule, in which all actions that the aforementioned Committee must carry out during the year are listed, with regards to the four axes on which its activity rotates: i) External Auditor; ii) Internal Audit and Internal Control Systems; iii) Financial Information; and iv) Reporting and communication obligations of the Committee to the Board of Directors and relevant supervisory bodies and authorities.

The existence of the Annual Action Plan and Meetings Schedule enables the Audit and Control Committee to schedule its work for the whole year. Thus, it generally meets every month, according to the Schedule established, prior to the meeting of the Company's Board of Directors, when presenting its semiannual and quarterly results, and how many times as necessary, when convened by the Chairman.

During 2016, the Audit and Control Committee held 13 meetings.

These meetings lasted for about two hours each on average, with its members having devoted an adequate number of hours to the study and analysis of the matters dealt with.

With regard to the attendance, there is an individual attendance control for each of the members of the Committee, which takes place at the beginning of each meeting, and is entered in the corresponding Minutes. During 2016, all members of the Committee have attended or were represented at all of its sessions.

As regards to the preparation of the Agenda of the meetings, it should also be pointed out that a preparatory meeting takes place under the coordination of the General Secretary and of the Board between all areas of the Company, which are related with the Committee due to their roles, to propose and discuss matters and issues to be addressed in each meeting, following the aforementioned Annual Action Plan and Meetings



Schedule as a guide. After that, and after consideration of the Chairman of the Committee, the meeting is convened with the present agenda, together with the relevant attached documents.

The various matters submitted for deliberation and where appropriate, decision, are treated with proper depth at all meetings of the Committee. Its members are actively involved in different debates and discussions, stating their opinion for this when they deem it appropriate.

The deliberations of the Committee and the resolutions and decisions adopted by it, are documented in the corresponding Minutes of each meeting, which are drafted by the Secretary of said Committee after it has ended, and distributed subsequently to its members for approval and comments. Finally, these are submitted as the first item on the Agenda of the next meeting of the Committee, to be signed by the Secretary 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.

Furthermore it should also be pointed out that, through the e-Audit internal Audit Portal (available on Telefónica's Intranet), the Directors sitting on the Committee can access all documents dealt with at each of the meetings using the Internal audit Area, which enables them to adequately monitor the information.

Finally, and as already stated, relations between the Audit and Control Committee and the Board of Directors of the Company are based on the principle of full transparency. In this regard, the Committee informs the Board of Directors, at each of its monthly meetings, on the main issues discussed and the activities and work done by the Committee and proposes to the Board of Directors of the Company, in cases that this may be required, the adoption of the relevant agreements.

V. ATTENDANCE TO THE MEETINGS

The meetings of the Audit and Control Committee are usually attended by other members of the management team of the Telefónica Group as well as its own members, acting as roles of support and assistance to members of the Committee in matters which are the subject of analysis at each of its meetings. Specifically, the Committee meetings have been attended by representatives of General Secretary and of the Board, Strategy and Finance, Internal Audit, Intervention and Inspection, and Global Resources.

In addition to those stated above, and at the request of the Committee itself, other Executives of the Company and its subsidiaries have participated to explain specific matters that affect their respective businesses or the roles assigned to them.



Partners representing the External Auditor of the Company, Ernst & Young, S.L. have also participated regularly in the Committee meetings 2016. Specifically, these have intervened to explain the work carried out, and to clarify, at the request of the Committee, any issues that may have arise during the course of the meetings related to the roles assigned to that audit firm.

VI. ISSUES DISCUSSED BY THE AUDIT AND CONTROL COMMITTEE DURING 2016

Of the issues that the Audit and Control Committee examines at its meetings, some correspond to legal requirements and others respond to the interest generated in accordance with the competences that the Committee has assigned.

The principal questions analysed by the Committee in 2016 were as follows:

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.

Specifically, the Committee examined and discussed the most important aspects regarding:

- The Individual Annual Accounts, Consolidated Financial Statements (Consolidated Annual Accounts) and Management Reports corresponding to the Financial Year 2015 of Telefónica, S.A. and its Consolidated Group, having knowledge, similarly, of the process for preparing such information and accounting principles used (International Financial Reporting Standards - IFRS - and General accounting Plan in force in Spain).
- Quarterly and Semiannual Periodic Financial Information in 2016.

2. Company Filings.

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

- Annual 20-F Report of Telefónica, S.A. corresponding to the Financial Year 2015, registered before the Stock Exchange Commission (SEC).



- Annual Securities Report (ASR) corresponding to the Financial Year 2015, and Semi-Annual Securities Report (SRS) corresponding to the First Semester of the Financial year 2016, both registered before the Tokyo Exchange Commission.
- Share Registration Document of Telefónica, S.A., prepared in accordance with Annex I to Regulation (EC) No. 809/2004 of the Commission of 29 April 2004, registered with the National Securities Market Commission (CNMV).
- Base Prospectus on the Issuance Programme for Fixed Income Securities (European Medium Term Notes Programme), EMTN Programme before the Financial Conduct Authority (FCA) in the UK.

External Auditor.

Regarding to the External Auditor, the Committee unanimously agreed to propose to the Board of Directors of Telefónica, SA the reappointment of Ernst & Young, S.L. as auditor for the financial year 2016.

Thus, the Ordinary General Shareholders' Meeting of the Company held on 12 May 2016, at the proposal of the Board of Directors, agreed to the aforementioned appointment of Ernst & Young, S.L.

Ernst & Young, S.L. presented the Committee with its Work Plan for 2016, reporting on key services to be provided as external auditor of the Group, and highlighted the matters to review.

Thus, over the course of the various meetings of the Audit and Control Committee, the different works conducted by said External Auditor were presented:

A. Regarding the Financial Statements.

The representatives of Ernst & Young, S.L. presented the main findings of the audit work performed in relation to the Individual Annual Accounts and the Consolidated Annual Accounts of the Company for the Financial Year 2015.

In addition, the Committee has been informed of the limited reviews carried out by said External Auditor on the Periodic Quarterly and Semiannual Financial Information of Telefónica, S.A. for the financial year 2016.

B. Regarding the Internal Control Systems and Information Systems.

Likewise, the representatives of the External Auditor, S.L. reported on the works carried out on the Internal Control Systems and Information Systems, required by the applicable regulations, including the Sarbanes-Oxley Law.

C. Emoluments of the External Auditor.



On the other hand, the Committee has revised the proposed fees estimate for the auditing firm Ernst & Young, S.L., for Financial Year 2016, for works performed on auditing and related services. Similarly, the proposed emoluments for other firms of auditors who carry out work for Telefónica Group were presented.

D. External Auditor Assignments.

Equally, over the course of the 2016 financial year, the Audit and Control Committee approved various auditing assignments for different Telefónica Group companies, to be conducted by companies in the Ernst & Young Group, all of which are duly justified and motivated by the internal standards defined for this purpose.

E. Committee Report on the independence of the External Auditor.

At the meeting held on the 23rd of February 2016, 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, during the Annual Accounts for the year ended 31 December 2015, 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.

F. Selection Process for a New Accounts Auditor.

In addition, during the financial year 2016, the Committee carried out a process for selecting a new auditor of Telefónica, S.A. for the financial years 2017, 2018 and 2019, the final result ended with the appointment, proposed by the Board of Directors of the Company, of the auditing firm PricewaterhouseCoopers (PwC), by the Ordinary General Meeting of Telefónica, S.A., held on 12 May 2016.

The Committee has also examined and reported on the selection process of a new Auditor for Public Interest Entities of the Telefónica Group for the financial years 2017, 2018 and 2019, in respect of which it has assumed the functions of its respective Audit Committees.

Internal Audit and Internal Control.

In the meetings held during the financial year 2016, the Audit and Control Committee has been informed of the actions taken by the Internal Audit, Intervention and Inspection Management of Telefónica, S.A. in relation to the internal control systems of the Company, required both by Spanish and international Law (amongst which is included, among others, the Sarbanes-Oxley Law).

Moreover, throughout the financial year 2016, the Committee discussed, among other matters, the following:



- The 2016 Internal Audit, Intervention and Inspection Plan as well as the budget proposal for this area and the details of its work plans.
- The Internal Audit reports on review of transversal processes.
- Updating the Risk Management Policy, the Risk Management System and the Risk Map.
- Compliance function: Structure, Legal Statute and Regulation.
- Update on the Criminal Prevention Policy.

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

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.
