

*Telefónica*

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AUDIT REPORT, ANNUAL FINANCIAL STATEMENTS, AND  
MANAGEMENT REPORT OF TELEFÓNICA, S.A., ALL FOR THE  
YEAR ENDED DECEMBER 31, 2016

Independent Audit Report

TELEFÓNICA, S.A.  
Financial Statements and Management Report  
for the year ended  
December 31, 2016

*Translation of a report and financial statements originally issued in Spanish. In the event of discrepancy, the Spanish-language version prevails (See Note 24)*

## INDEPENDENT AUDIT REPORT ON THE FINANCIAL STATEMENTS

To the Shareholders of  
Telefónica, S.A.

### Report on the financial statements

We have audited the accompanying financial statements of Telefónica, S.A., which comprise the balance sheet at December 31, 2016, and the income statement, the statement of changes in equity, the cash flow statement, and the notes thereto for the year then ended.

#### *Directors' responsibility for the financial statements*

The Directors are responsible for the preparation of the accompanying financial statements so that they give a true and fair view of the equity and financial position and the results of Telefónica, S.A., in accordance with the regulatory framework for financial information applicable to the Entity in Spain, identified in Note 2.a to the accompanying financial statements, and for such internal control as they determine is necessary to enable the preparation of financial statements that are free from material misstatement, whether due to fraud or error.

#### *Auditor's responsibility*

Our responsibility is to express an opinion on the accompanying financial statements based on our audit. We conducted our audit in accordance with prevailing audit regulations in Spain. Those standards require that we comply with ethical requirements and plan and perform the audit to obtain reasonable assurance about whether the financial statements are free from material misstatement.

An audit involves performing procedures to obtain audit evidence about the amounts and disclosures in the financial statements. The procedures selected depend on the auditor's judgment, including the assessment of the risks of material misstatement of the financial statements, whether due to fraud or error. In making those risk assessments, the auditor considers internal control relevant to the preparation of financial statements by the Directors of the Company in order to design audit procedures that are appropriate in the circumstances, but not for the purpose of expressing an opinion on the effectiveness of the entity's internal control. An audit also includes evaluating the appropriateness of accounting policies used and the reasonableness of accounting estimates made by management, as well as evaluating the overall presentation of the financial statements.

We believe that the audit evidence we have obtained is sufficient and appropriate to provide a basis for our audit opinion.

### *Opinion*

In our opinion, the accompanying financial statements give a true and fair view, in all material respects, of the equity and financial position of Telefónica, S.A. at December 31, 2016, and its results and cash flow for the year then ended, in accordance with the applicable regulatory framework for financial information in Spain, and specifically the accounting principles and criteria contained therein.

### **Report on other legal and regulatory requirements**

The accompanying 2016 management report contains such explanations as the Directors consider appropriate concerning the situation of the Company, the evolution of its business and other matters; however, it is not an integral part of the financial statements. We have checked that the accounting information included in the aforementioned management report agrees with the 2016 financial statements. Our work as auditors is limited to verifying the management report in accordance with the scope mentioned in this paragraph, and does not include the review of information other than that obtained from the Company's accounting records.

ERNST & YOUNG, S.L.



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Alicia Martínez Durán

February 23, 2017

2016

TELEFÓNICA, S.A.

*Annual financial statements and management report for the year ended December 31,  
2016*

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## Telefónica, S.A.

## Balance sheet at December 31

Millions of euros			
ASSETS	Notes	2016	2015 (*)
<b>NON-CURRENT ASSETS</b>		<b>76,817</b>	<b>62,177</b>
<b>Intangible assets</b>	5	<b>23</b>	<b>28</b>
Software		9	8
Other intangible assets		14	20
<b>Property, plant and equipment</b>	6	<b>205</b>	<b>222</b>
Land and buildings		131	143
Plant and other PP&E items		53	62
Property, plant and equipment under construction and prepayments		21	17
<b>Investment property</b>	7	<b>399</b>	<b>401</b>
Land		94	94
Buildings		305	307
<b>Non-current investments in Group companies and associates</b>	8	<b>68,211</b>	<b>50,300</b>
Equity instruments		65,249	47,971
Loans to Group companies and associates		2,950	2,313
Other financial assets		12	16
<b>Financial investments</b>	9	<b>5,016</b>	<b>5,073</b>
Equity instruments		339	384
Loans to third parties		-	41
Derivatives	16	4,667	4,638
Other financial assets	9	10	10
<b>Deferred tax assets</b>	17	<b>2,963</b>	<b>6,153</b>
<b>CURRENT ASSETS</b>		<b>6,443</b>	<b>22,809</b>
<b>Net assets held for sale</b>	8	<b>-</b>	<b>12,508</b>
<b>Trade and other receivables</b>	10	<b>447</b>	<b>594</b>
<b>Current investments in Group companies and associates</b>	8	<b>3,227</b>	<b>7,504</b>
Loans to Group companies and associates		3,167	7,426
Derivatives	16	30	40
Other financial assets		30	38
<b>Investments</b>	9	<b>1,942</b>	<b>2,060</b>
Loans to companies		42	60
Derivatives	16	1,652	1,996
Other financial assets		248	4
<b>Accruals</b>		<b>16</b>	<b>33</b>
<b>Cash and cash equivalents</b>		<b>811</b>	<b>110</b>
<b>TOTAL ASSETS</b>		<b>83,260</b>	<b>84,986</b>

The accompanying Notes 1 to 24 and Appendix I and II are an integral part of these balance sheets

(\*) Revised data, see Note 2



Millions of euros			
Equity and liabilities	Notes	2016	2015 (*)
<b>EQUITY</b>		<b>20,277</b>	<b>23,136</b>
CAPITAL AND RESERVES		20,943	23,926
<b>Share capital</b>	11	<b>5,038</b>	<b>4,975</b>
<b>Share premium</b>	11	<b>3,227</b>	<b>3,227</b>
<b>Reserves</b>	11	<b>12,928</b>	<b>18,081</b>
Legal		985	984
Other reserves		11,943	17,097
<b>Treasury shares and own equity instruments</b>	11	<b>(1,480)</b>	<b>(1,656)</b>
<b>Profit for the year</b>	3	<b>24</b>	<b>5</b>
<b>Interim dividend</b>	3	<b>-</b>	<b>(1,912)</b>
<b>Other equity instruments</b>	11	<b>1,206</b>	<b>1,206</b>
UNREALIZED GAINS (LOSSES) RESERVE	11	(666)	(790)
<b>Available-for-sale financial assets</b>		<b>8</b>	<b>11</b>
<b>Hedging instruments</b>		<b>(674)</b>	<b>(801)</b>
<b>NON-CURRENT LIABILITIES</b>		<b>45,471</b>	<b>46,255</b>
<b>Non-current provisions</b>	18	<b>367</b>	<b>835</b>
<b>Non-current borrowings</b>	12	<b>7,249</b>	<b>8,610</b>
Bonds and other marketable debt securities	13	-	800
Bank borrowings	14	4,427	4,825
Derivatives	16	2,684	2,847
Other debts		138	138
<b>Non-current borrowings from Group companies and associates</b>	15	<b>37,274</b>	<b>36,683</b>
<b>Deferred tax liabilities</b>	17	<b>571</b>	<b>88</b>
<b>Long term deferred revenues</b>		<b>10</b>	<b>39</b>
<b>CURRENT LIABILITIES</b>		<b>17,512</b>	<b>15,595</b>
<b>Current provisions</b>	18	<b>121</b>	<b>43</b>
<b>Current borrowings</b>	12	<b>3,712</b>	<b>1,628</b>
Bonds and other marketable debt securities	13	1,158	85
Bank borrowings	14	1,635	1,269
Derivatives	16	679	274
Other financial liabilities	14	240	-
<b>Current borrowings from Group companies and associates</b>	15	<b>13,146</b>	<b>13,217</b>
<b>Trade and other payables</b>	18	<b>486</b>	<b>619</b>
<b>Accruals</b>		<b>47</b>	<b>88</b>
<b>TOTAL EQUITY AND LIABILITIES</b>		<b>83,260</b>	<b>84,986</b>

The accompanying Notes 1 to 24 and Appendices I and II are an integral part of these balance sheets

(\*) Revised data, see Note 2

## Telefónica, S.A.

## Income statements for the years ended December 31

Millions of euros	Notes	2016	2015 (*)
<b>Revenue</b>	19	<b>2,710</b>	<b>5,936</b>
Rendering of services to Group companies and associates		548	599
Rendering of services to non-group companies		59	4
Dividends from Group companies and associates		1,928	5,171
Interest income on loans to Group companies and associates		175	162
<b>Impairment and gains (losses) on disposal of financial instruments</b>		<b>3,045</b>	<b>(5,309)</b>
Impairment losses and other losses	8	2,049	(5,309)
Gains (losses) on disposal and other gains and losses	8	996	-
<b>Other operating income</b>	19	<b>46</b>	<b>91</b>
Non-core and other current operating revenue - Group companies and associates		30	22
Non-core and other current operating revenue - non-group companies		16	69
<b>Employees benefits expense</b>	19	<b>(310)</b>	<b>(315)</b>
Wages, salaries and others		(281)	(284)
Social security costs		(29)	(31)
<b>Other operational expense</b>		<b>(356)</b>	<b>(786)</b>
External services - Group companies and associates	19	(109)	(135)
External services - non-group companies	19	(252)	(624)
Taxes other than income tax		5	(27)
<b>Depreciation and amortization</b>	5, 6 and 7	<b>(38)</b>	<b>(46)</b>
<b>Gains (losses) on disposal of fixed assets</b>		<b>(4)</b>	<b>17</b>
<b>OPERATING PROFIT</b>		<b>5,093</b>	<b>(412)</b>
<b>Finance revenue</b>	19	<b>922</b>	<b>593</b>
<b>Finance costs</b>	19	<b>(2,996)</b>	<b>(2,804)</b>
<b>Change in fair value of financial instruments</b>		<b>-</b>	<b>(19)</b>
Gain (loss) on available-for-sale financial assets recognized in the period	9 and 11	-	(19)
<b>Exchange rate gains (losses)</b>	19	<b>(170)</b>	<b>(98)</b>
<b>Impairment and gains (losses) on disposal of financial instruments with third-parties</b>	9.3 and 19.9	<b>17</b>	<b>426</b>
<b>NET FINANCIAL EXPENSE</b>		<b>(2,227)</b>	<b>(1,902)</b>
<b>PROFIT BEFORE TAX</b>	21	<b>2,866</b>	<b>(2,314)</b>
<b>Income tax</b>	17	<b>(2,842)</b>	<b>2,319</b>
<b>PROFIT FOR THE YEAR CONTINUED OPERATIONS</b>		<b>24</b>	<b>5</b>
<b>Discontinued operations net of taxes</b>	2 and 22	<b>-</b>	<b>-</b>
<b>PROFIT FOR THE YEAR</b>		<b>24</b>	<b>5</b>

The accompanying Notes 1 to 24 and Appendices I and II are an integral part of these income statements

(\*) Revised data, see Note 2

## Telefónica, S.A.

## Statements of changes in equity for the years ended December 31

## A) Statement of recognized income and expense

Millions of euros	Notes	2016	2015 (*)
<b>Profit of the period</b>		<b>24</b>	<b>5</b>
<b>Total income and expense recognized directly in equity</b>	11	<b>368</b>	<b>580</b>
From measurement of available-for-sale financial assets		13	467
From cash flow hedges		477	380
Income tax impact		(122)	(267)
<b>Total amounts transferred to income statement</b>	11	<b>(244)</b>	<b>(306)</b>
From measurement of available-for-sale financial assets		(17)	(481)
From cash flow hedges		(308)	56
Income tax impact		81	119
<b>TOTAL RECOGNIZED INCOME AND EXPENSE</b>		<b>148</b>	<b>279</b>

The accompanying Notes 1 to 24 and Appendices I and II are an integral part of these statements of changes in equity.

(\*) Revised data, see Note 2

## B) Statements of total changes in equity for the years ended December 31

Millions of euros	Share capital	Share premium and Reserves	Treasury shares	Profit for the year	Interim dividend	Other net equity instruments	Net unrealized gains (losses) reserve	Total
<b>Balance at December 31, (*)</b>	<b>4,657</b>	<b>19,118</b>	<b>(1,587)</b>	<b>2,604</b>	<b>(1,790)</b>	<b>1,206</b>	<b>(1,064)</b>	<b>23,144</b>
Total recognized income and expense	-	-	-	5	-	-	274	279
Transactions with shareholders and owners	318	1,374	(69)	-	(1,912)	-	-	(289)
Dividends paid (Note 11)	111	(448)	-	-	(1,912)	-	-	(2,249)
Transactions with treasury shares or own equity instruments (net)	-	(75)	(1,510)	-	-	-	-	(1,585)
Other transactions with shareholders and owners	-	(17)	555	-	-	-	-	538
Other movements	-	2	-	-	-	-	-	2
Appropriation of prior year profit (loss)	-	814	-	(2,604)	1,790	-	-	-
<b>Balance at December 31, (*)</b>	<b>4,975</b>	<b>21,308</b>	<b>(1,656)</b>	<b>5</b>	<b>(1,912)</b>	<b>1,206</b>	<b>(790)</b>	<b>23,136</b>
Total recognized income and expense	-	-	-	24	-	-	124	148
Transactions with shareholders and owners	63	(3,247)	176	-	-	-	-	(3,008)
Capital decreases (Note 11)	(74)	(739)	813	-	-	-	-	-
Dividends paid (Note 11)	137	(2,543)	-	-	-	-	-	(2,406)
Other transactions with shareholders and owners	-	35	(637)	-	-	-	-	(602)
Other movements	-	1	-	-	-	-	-	1
Appropriation of prior year profit (loss)	-	(1,907)	-	(5)	1,912	-	-	-
<b>Balance at December 31, 2016</b>	<b>5,038</b>	<b>16,155</b>	<b>(1,480)</b>	<b>24</b>	<b>-</b>	<b>1,206</b>	<b>(666)</b>	<b>20,277</b>

The accompanying Notes 1 to 24 and Appendices I and II are an integral part of these statements of changes in equity.

(\*) Revised data, see Note 2

## Telefónica, S.A.

## Cash flow statements for the years ended December 31

Millions of euros	Notes	2016	2015 (*)
<b>A) CASH FLOWS FROM OPERATING ACTIVITIES</b>		<b>3,193</b>	<b>2,451</b>
Profit before tax		<b>2,866</b>	<b>(2,314)</b>
<b>Adjustments to profit:</b>		<b>(2,855)</b>	<b>1,988</b>
Depreciation and amortization	5,6 and 7	38	46
Impairment of investments in Group companies and associates	8	(2,049)	5,309
Change in long term provisions		24	81
Gains on the sale of financial assets		(992)	5
Losses on disposal of property, plant and equipment		-	(22)
Dividends from Group companies and associates	19	(1,928)	(5,171)
Interest income on loans to Group companies and associates	19	(175)	(162)
Net financial expense		2,227	1,902
<b>Change in working capital</b>		<b>(132)</b>	<b>337</b>
Trade and other receivables		43	165
Other current assets		39	(26)
Trade and other payables		(156)	222
Other current liabilities		(58)	(24)
<b>Other cash flows from operating activities</b>	21	<b>3,314</b>	<b>2,440</b>
Net interest paid		(1,868)	(1,801)
Dividends received		4,212	3,091
Income tax receipts		970	1,150
Other payments/proceeds from operating activities		-	-
<b>B) CASH FLOWS (USED IN)/FROM INVESTING ACTIVITIES</b>		<b>(1,563)</b>	<b>(2,867)</b>
Payments on investments	21	(5,002)	(4,915)
Proceeds from disposals	21	3,439	2,048
<b>C) CASH FLOWS USED IN FINANCING ACTIVITIES</b>		<b>(924)</b>	<b>(4,042)</b>
Payments on equity instruments		(624)	(1,626)
Proceeds from financial liabilities	21	2,095	(3,227)
Debt issues		15,884	8,465
Repayment and redemption of debt		(13,789)	(11,692)
Capital increase			3,048
Dividends paid	21	(2,395)	(2,237)
<b>D) NET FOREIGN EXCHANGE DIFFERENCE</b>		<b>(5)</b>	<b>(16)</b>
<b>E) NET INCREASE/(DECREASE) IN CASH AND CASH EQUIVALENTS</b>		<b>701</b>	<b>(4,474)</b>
Cash and cash equivalents at January 1		110	4,584
Cash and cash equivalents at December 31		811	110

Notes 1 to 24 and Appendices I and II are an integral part of these cash flow statements.

(\*) Revised data see Note 2

# TELEFÓNICA, S.A.

*Annual financial statements for the ended December 31, 2016*

## Note 1. Introduction and general information

Telefónica, S.A. (“Telefónica” or “the Company”) is a public limited company incorporated for an indefinite period on April 19, 1924, under the corporate name of Compañía Telefónica Nacional de España, S.A. It adopted its present name in April 1998.

The Company's registered office is at Gran Vía 28, Madrid (Spain), and its Employer Identification Number (CIF) is A-28/015865.

Telefónica's basic corporate purpose, pursuant to Article 4 of its Bylaws, is the provision of all manner of public or private telecommunications services, including ancillary or complementary telecommunications services or related services. All the business activities that constitute this stated corporate purpose may be performed either in Spain or abroad and wholly or partially by the Company, either through shareholdings or equity interests in other companies or legal entities with an identical or a similar corporate purpose.

In keeping with the above, Telefónica is currently the parent company of a group that offers both fix and mobile telecommunications with the aim to turn the challenges of the new digital business into reality and being one of the most important players. The objective of the Telefónica Group is positioning as a Company with an active role in the digital business taking advantage of the opportunities of its size and industrial and strategic alliances.

The Company is taxed under the general tax regime established by the Spanish State, the Spanish Autonomous Communities and local governments, and files consolidated tax returns with most of the Spanish subsidiaries of its Group under the consolidated tax regime applicable to corporate groups.

## Note 2. Basis of presentation

### a) True and fair view

These financial statements have been prepared from Telefónica, S.A.'s accounting records by the Company's Directors in accordance with the accounting principles and standards contained in the Spanish GAAP in force approved by Royal Decree 1514/2007, on November 16 (PGC 2007), modified by Royal Decree 602/2016, dated December 2, 2016 and other prevailing legislation at the date of these financial statements, to give a true and fair view of the Company's equity, financial position, results of operations and of the cash flows obtained and applied in 2016.

The accompanying financial statements for the year ended December 31, 2016 were prepared by the Company's Board of Directors at its meeting on February 22, 2017 for submission for approval at the General Shareholders' Meeting, which is expected to occur without modification.

The figures in these financial statements are expressed in millions of euros, unless indicated otherwise, and therefore may be rounded. The euro is the Company's functional currency.

### b) Comparison of information

In 2015 and 2016 there have not been significant transactions that should be taken into account in order to ensure the comparison of information included in the Annual Financial Statements of both years.

As a consequence of the sale agreement signed on March, 24, 2015 between Telefónica, S.A. and Hutchison 3G UK Investment Limited and Hutchison 3G UK Holdings (CI) Limited (together, "Hutchison") and according to PGC 2007 Valuation Rule N° 7, 11 caption, the figures related to the investment in Telefónica Europe, plc and the transactions with this company were classified as held for sale assets and discontinued operations, respectively, in 2015 Annual Financial Statements.

On May 11, 2016 the European Commission made public its decision to prohibit the transaction. Following this decision, the Board of Directors of Telefónica at its meeting on June 29, 2016 agreed that Telefónica will continue to explore different strategic alternatives for O2 UK, to be implemented when market conditions are deemed appropriate. Given that the execution of a sale transaction is less certain, following the submission of the financial information of the second quarter of 2016 Telefónica's operations in UK were no longer presented as discontinued operations and data related to the investment in Telefónica Europe, plc ceased to be classified as held for sale. Thus, items are presented line by line according to their nature in financial statements. Comparative financial statements have been amended accordingly with respect to those published in the financial statements for the year 2015. The impacts of this classification change are described in Note 22.

In accordance with PGC 2007 approved by Royal Decree 1514/2007, goodwill and intangible assets with indefinite useful life were not amortized. However, following the provisions of Royal Decree 602/2016, dated December 2, 2016, that modify PGC 2007, starting January 1, 2016 the Company amortizes goodwill and intangibles with indefinite useful lives on a systematic basis.

Pursuant to the sole transitory provision of the mentioned Royal Decree 602/2016, in 2016 the Company elected to retrospectively amortize the carrying amount of goodwill and intangible assets with indefinite useful lives (see Note 5). Thus, amortization charges for all periods prior to 2015 have been recognized in reserves, on a straight-line basis and over a ten-year useful life starting January 1, 2008, which is the initial date of the period in which the currently in force PGC 2007 was first applied.

Therefore, comparative information for earlier periods presented has been adjusted for application of these new requirements, as follows:

- An increase in the intangible asset amortization with a charge to,
- Initial balance of reserves as of December 31, 2015 amounting to 24 million euros, including a balance of 10 million euros related to the non-distributable reserve for goodwill amortization (see Note 11.c).

- Amortization charge amounting to 3 million euros in the profit and loss account for the year ended December 31, 2015.

### c) Materiality

These financial statements do not include any information or disclosures that, not requiring presentation due to their qualitative significance, have been determined as immaterial or of no relevance pursuant to the concepts of *materiality* or *relevance* defined in the PGC 2007 conceptual framework.

### d) Use of estimates

The financial statements have been prepared using estimates based on historical experience and other factors considered reasonable under the circumstances. The carrying value of assets and liabilities, which is not readily apparent from other sources, was established on the basis of these estimates. The Company periodically reviews these estimates.

A significant change in the facts and circumstances on which these estimates are based could have an impact on the Company's results and financial position.

The key assumptions concerning the future and other key sources of estimation uncertainty at the reporting date that have a significant risk of causing a material adjustment to the financial statements of the following year are discussed below.

### Provisions for impairment of investments in Group companies and associates

Investments in group companies, joint ventures and associates are tested for impairment at each year end to determine whether an impairment loss must be recognized in the income statement or a previously recognized impairment loss be reversed. The decision to recognize an impairment loss (or a reversal) involves estimates of the reasons for the potential impairment (or recovery), as well as the timing and amount. In note 8.2 it is assessed the impairment of these investments.

There is a significant element of judgment involved in the estimates required to determine recoverable amount and the assumptions regarding the performance of these investments, since the timing and scope of future changes in the business are difficult to predict.

### Deferred taxes

The Company assesses the recoverability of deferred tax assets based on estimates of future earnings, and of all the options available to achieve an outcome, it considers the most efficient one in terms of tax within the legal framework the Company is subject to. The ability to recover these taxes depends ultimately on the Company's ability to generate taxable earnings over the period for which the deferred tax assets remain deductible. This analysis is based on the estimated schedule for reversing deferred tax liabilities, as well as estimates of taxable earnings, which are sourced from internal projections and are continuously updated to reflect the latest trends.

The appropriate valuation of tax assets and liabilities depends on a series of factors, including estimates as to the timing and realization of deferred tax assets and the projected tax payment schedule. Actual income tax receipts and payments could differ from the estimates made by the Company as a result of changes in tax legislation or unforeseen transactions that could affect tax balances. The information about deferred tax assets and unused tax credits for loss carryforwards, whose effect has been registered when necessary in balance, is included in Note 17.

### Note 3. Proposed appropriation of profit

Telefónica, S.A. obtained 24 million euros of profit in 2016. Accordingly, the Company's Board of Directors will submit the following proposed appropriation of 2016 profit for approval at the Shareholders' Meeting:

**Millions of euros**

<b>Proposed appropriation:</b>	
Profit for the year	24
<b>Distribution to:</b>	
Legal reserve	2
Interim Dividend	22



## Note 4. Recognition and measurement accounting policies

As stated in Note 2, the Company's financial statements have been prepared in accordance with the accounting principles and standards contained in the Código de Comercio, which are further developed in the Plan General de Contabilidad currently in force (PGC 2007), as well as any commercial regulation in force at the reporting date.

Accordingly, only the most significant accounting policies used in preparing the accompanying financial statements are set out below, in light of the nature of the Company's activities as a holding.

### a) Intangible assets

Intangible assets are stated at acquisition or production cost, less any accumulated amortization or any accumulated impairment losses.

Intangible assets are amortized on a straight-line basis over their useful lives. The most significant items included in this caption are computer software licenses, which are generally amortized on a straight-line basis over three years.

### b) Property, plant and equipment and investment property

Property, plant and equipment is stated at cost, net of accumulated depreciation and any accumulated impairment in value.

The Company depreciates its property, plant and equipment once the assets are in full working conditions using the straight-line method based on the assets' estimated useful lives, calculated in accordance with technical studies which are revised periodically based on technological advances and the rate of dismantling, as follows:

Estimated useful life	Years
Buildings	40
Plant and machinery	3 - 25
Other plant or equipment, furniture and fixtures	10
Other items of property, plant and equipment	4 - 10

Investment property is measured and depreciated using the same criteria described for land and buildings for own use.

### c) Impairment of non-current assets

Non-current assets are assessed at each reporting date for indicators of impairment. Where such indicators exist, or in the case of assets which are subject to an annual impairment test, the Company estimates the asset's recoverable amount as the higher of its fair value less costs to sell and its value in use. In assessing value in use, the estimated future post-tax cash flows deriving from the use of the asset or its cash generating unit, as applicable, are discounted to their present value, using a post-tax discount rate reflecting current market assessments of the time value of money and the risks specific to the asset, whenever the result obtained is the same that would be obtained by discounting pre-tax cash flows at a pre-tax discount rate.

Telefónica bases the calculation of impairment on the business plans of the various companies approved by the Board of Directors' of Telefónica, S.A. to which the assets are allocated. The projected cash flows, based on strategic business plans, cover a period of five years not including the present year when the analysis is calculated. Starting with the sixth year, an expected constant growth rate is applied.

### d) Financial assets and liabilities

Financial investments

All regular way purchases and sales of financial assets are recognized on the trade date, i.e. the date that the Company commits to purchase or sell the asset.

"Investments in group companies, joint ventures and associates" are classified into a category of the same name and are shown at cost less any impairment loss (see Note 4.c). Group companies are those over which the Company exercises

control, either by exercising effective control or by virtue of agreements with the other shareholders. Joint ventures are companies which are jointly controlled with third parties. Associates are companies in which there is significant influence, but not control or joint control with third parties. Telefónica assesses the existence of significant influence not only in terms of percentage ownership but also in qualitative terms such as presence on the board of directors, involvement in decision-making, the exchange of management personnel, and access to technical information.

Financial investments which the Company intends to hold for an unspecified period of time and could be sold at any time to meet specific liquidity requirements or in response to interest rate movements and which have not been included in the other categories of financial assets defined in the PGC 2007 are classified as available-for-sale. These investments are recorded under "Non-current assets," unless it is probable and feasible that they will be sold within 12 months.

#### Derivative financial instruments and hedge accounting

When Telefónica chooses not to apply hedge accounting criteria but economic hedging, gains or losses resulting from changes in the fair value of derivatives are taken directly to the income statement.

#### e) Revenue and expenses

Revenue and expenses are recognized on the income statement based on an accruals basis; i.e. when the goods or services represented by them take place, regardless of when actual payment or collection occurs.

The income obtained by the Company in dividends received from Group companies and associates, and from the interest accrued on loans and credits given to them, are included in revenue in compliance with the provisions of consultation No. 2 of BOICAC 79, published on September 30, 2009.

#### f) Related party transactions

In mergers and spin-offs of businesses involving the parent company and its direct or indirect subsidiary, in cases of non-monetary contributions of businesses between Group companies, and in cases of dividends, the contributed assets are valued, in general, at their pre-transaction carrying amount in the individual financial statements, given that the Telefónica Group does not prepare its consolidated financial statements in accordance with the Standards on Preparing Consolidated Financial Statements (Spanish "NOFCAC").

In these same operations, companies may also opt to use the consolidated values under International Financial Reporting Standards (IFRS) as adopted by the European Union, providing that the consolidated figures do not differ from those obtained under the NOFCAC. Lastly, the Company may also opt to use the values resulting from a reconciliation to the NOFCAC. Any accounting difference is recognized in reserves.

#### g) Financial guarantees

The Company has provided guarantees to a number of subsidiaries to secure their transactions with third parties (see Note 20.a). Where financial guarantees provided have a counterguarantee on the Company's balance sheet, the value of the counterguarantee is estimated to be equal to the guarantee given, with no additional liability recognized as a result.

Guarantees provided for which there is no item on the Company's balance sheet acting as a counterguarantee are initially measured at fair value which, unless there is evidence to the contrary, is the same as the premium received plus the present value of any premiums receivable. After initial recognition, these are subsequently measured at the higher of:

- i) The amount resulting from the application of the rules for measuring provisions and contingencies.
- ii) The amount initially recognized less, when applicable, any amounts taken to the income statement corresponding to accrued income.

#### h) Consolidated data

As required under prevailing legislation, the Company has prepared separate consolidated annual financial statements, drawn up in accordance with International Financial Reporting Standards (IFRS) as adopted by the European Union. The balances of the main headings of the Telefónica Group's consolidated financial statements for 2016 and 2015 are as follows:

## Millions of euros

Item	2016	2015 (*)
Total assets	123,641	120,329
Equity:		
Attributable to equity holders of the parent	18,157	15,771
Attributable to minority interests	10,228	9,665
Revenue from operations	52,036	54,916
Profit for the year:		
Attributable to equity holders of the parent	2,369	616
Attributable to minority interests	30	135

(\*) Amended data

## Note 5. Intangible assets

The movements in the items composing intangible assets and the related accumulated amortization in 2016 and 2015 are as follows:

### 2016

Millions of euros	Opening balance	Additions and allowances	Disposals	Transfers	Closing balance
<b>INTANGIBLE ASSETS, GROSS</b>	<b>254</b>	<b>8</b>	<b>(33)</b>	<b>1</b>	<b>230</b>
Software	132	3	-	5	140
Other intangible assets	122	5	(33)	(4)	90
<b>ACCUMULATED AMORTIZATION</b>	<b>(226)</b>	<b>(13)</b>	<b>33</b>	<b>(1)</b>	<b>(207)</b>
Software	(124)	(7)	-	-	(131)
Other intangible assets	(102)	(6)	33	(1)	(76)
<b>Net carrying amount</b>	<b>28</b>	<b>(5)</b>	<b>-</b>	<b>-</b>	<b>23</b>

### 2015

Millions of euros	Opening balance	Additions and allowances	Disposals	Transfers	Closing balance
<b>INTANGIBLE ASSETS, GROSS</b>	<b>274</b>	<b>8</b>	<b>(30)</b>	<b>2</b>	<b>254</b>
Software	129	2	-	1	132
Other intangible assets	145	6	(30)	1	122
<b>ACCUMULATED AMORTIZATION</b>	<b>(240)</b>	<b>(16)</b>	<b>30</b>	<b>-</b>	<b>(226)</b>
Software	(116)	(8)	-	-	(124)
Other intangible assets (*)	(124)	(8)	30	-	(102)
<b>Net carrying amount</b>	<b>34</b>	<b>(8)</b>	<b>-</b>	<b>2</b>	<b>28</b>

(\*) Revised data, see Note 2

At December 31, 2016 and 2015 commitments exist to acquire intangible assets amounting to 1.4 and 0.2 million euros, respectively.

At December 31, 2016 and 2015, the Company had 140 million euros and 164 million euros, respectively, of fully amortized intangible assets.

After the merger of Terra Networks, S.A. with Telefónica, S.A., in 2006 the Company registered a goodwill, which was amortized on an annual basis until the entry into force of PGC 2007. As of December 31, 2007 that asset had a net carrying amount of 33.9 million euros. Subsequently, Telefónica, S.A. tested for impairment that asset every year, which did not disclose any need to recognise a write-down. The Company has set aside 1.6 million euros annually (5% of the net carrying amount of the asset) of its profit to a non-distributable reserve for goodwill amortization. The balance of this reserve at December 31, 2015 was 12 million euros.

After the publication of Royal Decree 602/2016, on December, 2, 2016, modifying PGC 2007, the Company has amortized all its intangible assets with infinite useful life in a retrospective way since they had not been amortized when PGC 2007 entered into force. Retrospective amortization was obliged to revise 2015 figures of other intangible asset amortization, in the amounts detailed in Note 2.

## Note 6. Property, plant and equipment

The movements in the items composing property, plant and equipment and the related accumulated depreciation in 2016 and 2015 are as follows:

### 2016

Millions of euros	Opening balance	Additions and allowances	Disposals	Transfers	Closing balance
<b>PROPERTY, PLANT AND EQUIPMENT, GROSS</b>	<b>572</b>	<b>8</b>	-	<b>(11)</b>	<b>569</b>
Land and buildings	232	-	-	(9)	223
Plant and other PP&E items	323	1	-	1	325
Property, plant and equipment under construction and prepayments	17	7	-	(3)	21
<b>ACCUMULATED DEPRECIATION</b>	<b>(350)</b>	<b>(14)</b>	-	-	<b>(364)</b>
Buildings	(89)	(3)	-	-	(92)
Plant and other PP&E items	(261)	(11)	-	-	(272)
<b>Net carrying amount</b>	<b>222</b>	<b>(6)</b>	-	<b>(11)</b>	<b>205</b>

### 2015

Millions of euros	Opening balance	Additions and allowances	Disposals	Transfers	Closing balance
<b>PROPERTY, PLANT AND EQUIPMENT, GROSS</b>	<b>557</b>	<b>24</b>	<b>(7)</b>	<b>(2)</b>	<b>572</b>
Land and buildings	228	8	(4)	-	232
Plant and other PP&E items	322	3	(2)	-	323
Property, plant and equipment under construction and prepayments	7	13	(1)	(2)	17
<b>ACCUMULATED DEPRECIATION</b>	<b>(332)</b>	<b>(20)</b>	<b>2</b>	-	<b>(350)</b>
Buildings	(86)	(3)	-	-	(89)
Plant and other PP&E items	(246)	(17)	2	-	(261)
<b>Net carrying amount</b>	<b>225</b>	<b>4</b>	<b>(5)</b>	<b>(2)</b>	<b>222</b>

Firm commitments to acquire property, plant and equipment at December 31, 2016 and 2015 amounted to 3 million euros and 1 million euros, respectively. At December 31, 2016 and 2015, the Company had 205 million euros and 178 million euros, respectively, of fully depreciated items of property, plant and equipment.

Telefónica, S.A. has taken out insurance policies with appropriate limits to cover the potential risks which could affect its property, plant and equipment.

"Property, plant and equipment" includes the net carrying amount of the land and buildings occupied by Telefónica, S.A. at its Distrito Telefónica headquarters, amounting to 70 million euros and 68 million euros at the 2016 and 2015 year-ends, respectively. Also included is the net carrying amount of the remaining assets (mainly plant and property) of 30 and 37 million euros at December 31, 2016 and 2015, respectively. The land and buildings rented to other Group Companies have been included as "Investment properties" in Note 7.

## Note 7. Investment properties

The movements in the items composing investment properties in 2016 and 2015 and the related accumulated depreciation are as follows:

### 2016

Millions of euros	Opening balance	Additions and allowances	Disposals	Transfers	Closing balance
<b>INVESTMENT PROPERTIES, GROSS</b>	<b>486</b>	<b>-</b>	<b>-</b>	<b>9</b>	<b>495</b>
Land	94	-	-	-	94
Buildings	392	-	-	9	401
<b>ACCUMULATED DEPRECIATION</b>	<b>(85)</b>	<b>(11)</b>	<b>-</b>	<b>-</b>	<b>(96)</b>
Buildings	(85)	(11)	-	-	(96)
<b>Net carrying amount</b>	<b>401</b>	<b>(11)</b>	<b>-</b>	<b>9</b>	<b>399</b>

### 2015

Millions of euros	Opening balance	Additions and allowances	Disposals	Transfers	Closing balance
<b>INVESTMENT PROPERTIES, GROSS</b>	<b>499</b>	<b>-</b>	<b>(13)</b>	<b>-</b>	<b>486</b>
Land	94	-	-	-	94
Buildings	405	-	(13)	-	392
<b>ACCUMULATED DEPRECIATION</b>	<b>(82)</b>	<b>(10)</b>	<b>7</b>	<b>-</b>	<b>(85)</b>
Buildings	(82)	(10)	7	-	(85)
<b>Net carrying amount</b>	<b>417</b>	<b>(10)</b>	<b>(6)</b>	<b>-</b>	<b>401</b>

“Investment properties” mainly includes the value of land and buildings leased by Telefónica, S.A. to other Group companies at the Distrito Telefónica head offices in Madrid and the building of its headquarters in Barcelona, known as “Diagonal 00”.

In October 2015 the sale of the building addressed in Don Ramón de la Cruz street (Madrid) was completed. This building had been rented as a whole to other Group companies. The profit from the sale of the asset amounting to 22 million euros was booked as “Profit from the sale of fixed assets” in the income statement.

In 2016, the Company has buildings with a total area of 311,128 square meters leased to several Telefónica Group and other companies, equivalent to an occupancy rate of 95.35% of the buildings it has earmarked for lease. In 2015, it had a total of 328,314 square meters leased, equivalent to an occupancy rate of 93.27% of the buildings earmarked for lease.

Total income from leased buildings in 2016 (see Note 19.1) amounted to 44 million euros (48 million euros in 2015). Future minimum rentals receivable under non-cancellable leases are as follows:

Millions of euros	2016	2015
	Future minimum recoveries	Future minimum recoveries
Up to one year	40	44
Between two and five years	5	9
Over 5 years	1	1
<b>Total</b>	<b>46</b>	<b>54</b>

The most significant lease contracts held with subsidiaries occupying Distrito Telefónica have been renewed in 2016 for a non-cancellable period of 12 months. The figures also include non-cancellable lease revenue from Diagonal 00, the contracts for which expire in July 2017.

The main contracts of operating leases in which Telefónica, S.A. acts as lessee and there is no sub-lease are described in Note 19.5.

## Note 8. Investments in group companies and associates

8.1. The movements in the items composing investments in Group companies, joint ventures and associates in 2016 and 2015 are as follows:

### 2016

Millions of euros	Opening balance	Additions	Disposals	Transfers	Exchange losses	Dividends	Hedges of a net investment	Closing balance	Fair value
Equity instruments (Net) (1)	47,971	6,446	(236)	12,338	-	(619)	(651)	65,249	127,748
Equity instruments (Cost)	62,182	4,397	(285)	26,154	-	(619)	(651)	91,178	
Impairment losses	(14,211)	2,049	49	(13,816)	-	-	-	(25,929)	
Loans to Group companies and associates	2,313	1,853	(1,315)	191	(92)	-	-	2,950	2,985
Other financial assets	16	11	-	(15)	-	-	-	12	12
<b>Total non-current investment in Group companies and associates</b>	<b>50,300</b>	<b>8,310</b>	<b>(1,551)</b>	<b>12,514</b>	<b>(92)</b>	<b>(619)</b>	<b>(651)</b>	<b>68,211</b>	<b>130,745</b>
Loans to Group companies and associates	7,426	1,293	(5,400)	(181)	29	-	-	3,167	3,171
Derivatives	40	30	(40)	-	-	-	-	30	30
Other financial assets	38	6	(29)	15	-	-	-	30	30
<b>Total current investments in Group companies and associates</b>	<b>7,504</b>	<b>1,329</b>	<b>(5,469)</b>	<b>(166)</b>	<b>29</b>	<b>-</b>	<b>-</b>	<b>3,227</b>	<b>3,231</b>

(1) Fair value at December 31, 2016 of Group companies and associates quoted in an active market (Telefónica Brasil, S.A.) was calculated taking the listing of the investments on the last day of the year; the rest of the shareholdings are stated at the value of discounted cash flows based on those entities' business plans.

### 2015

Millions of euros	Opening balance	Additions	Disposals	Transfers	Exchange losses	Dividends	Hedges of a net investment	Closing balance	Fair value
Equity instruments (Net) (1)	59,123	2,354	(340)	(13,166)	-	-	-	47,971	110,470
Equity instruments (Cost)	82,005	6,811	(340)	(26,294)	-	-	-	62,182	
Impairment losses	(22,882)	(4,457)	-	13,128	-	-	-	(14,211)	
Loans to Group companies and associates	3,227	124	(202)	(795)	(41)	-	-	2,313	2,337
Other financial assets	17	18	-	(19)	-	-	-	16	16
<b>Total non-current investment in Group companies and associates</b>	<b>62,367</b>	<b>2,496</b>	<b>(542)</b>	<b>(13,980)</b>	<b>(41)</b>	<b>-</b>	<b>-</b>	<b>50,300</b>	<b>112,823</b>
Loans to Group companies and associates	5,031	4,779	(3,108)	795	(71)	-	-	7,426	7,438
Derivatives	105	40	(105)	-	-	-	-	40	40
Other financial assets	32	19	(32)	19	-	-	-	38	38
<b>Total current investments in Group companies and associates</b>	<b>5,168</b>	<b>4,838</b>	<b>(3,245)</b>	<b>814</b>	<b>(71)</b>	<b>-</b>	<b>-</b>	<b>7,504</b>	<b>7,516</b>

(1) Fair value at December 31, 2015 of Group companies and associates quoted in an active market (Telefónica Brasil, S.A.) was calculated taking the listing of the investments on the last day of the year; the rest of the shareholdings are stated at the value of discounted cash flows based on those entities' business plans.

The most significant transactions occurred in 2016 and 2015 as well as their accounting impacts are described below:



2016

As detailed in Note 2, following the decision of the European Commission to prohibit the sale of Telefónica Europe, plc to the Hutchison Whampoa group, and as a consequence of the strategy approved by the Board of Directors of Telefónica at its meeting on June 29, 2016, the investment in the company which was previously considered as a "Held for sale asset" has been reclassified to the "Long Term investment in Group companies and associates" caption amounting to 12,501 million euros. The reclassification is shown in 2015 and 2016 charts of movements under the "Transfers" column.

During the first semester of 2016, Telefónica has decided to rearrange the assets related to infrastructures of the Group, including the telecommunication towers as well as the network of underwater and terrestrial optic fiber unifying the concept within the same holding company (Telxius Telecom, S.A.U.). In the framework of this reorganization the following investing transactions have been made by Telefónica, S.A.:

- On January 29, 2016, Telefónica Internacional, S.A.U. sold at its net book value the 50% of its stake in Telefónica América, S.A. to Telefónica, S.A. After this transaction Telefónica, S.A. became the sole stakeholder of Telefónica América, S.A.U. On March 7<sup>th</sup>, 2016, the company's denomination was changed to Telxius Telecom, S.A.U. Telxius Telecom, S.A.U. was thus designated to be the parent company of the rearranged group of the above mentioned infrastructure entities.
- On February 16, 2016 Telefónica Móviles España, S.A.U. carried out a partial split-off of Wireless Towers, S.L.U. (a newly-incorporated company renamed after as Telxius Torres España, S.L.U.) with the aim of placing in this new company the business line of ownership and exploitation of mobile phone towers. Telefónica, S.A. has recorded the split-off transaction at book value of the assets (214 million euros), and therefore it is not reflected in the chart of movements above.
- On March 28, 2016 Telefónica Internacional Wholesale Services América, S.A. executed a capital increase of 187 million dollars fully subscribed and paid pro-rata by the shareholders. The transaction implied a disbursement of 122 million euros for Telefónica, S.A., included as "Additions" in the 2016 chart of movements. The funds were used to compensate prior years' negative reserves before the nonmonetary contribution of the company to Telxius Telecom, S.A.U. The contribution was completed on March 31 at its book value (448 million euros), and therefore it is not reflected in the chart of movements above.
- On March 30, 2016 Telxius Telecom, S.A.U. made a capital increase of 1,450 million euros fully subscribed and paid by the Company. On May 27, 2016 an additional capital increase was carried forward amounting to 502 million euros, also fully subscribed and paid by Telefónica, S.A. The total amount of these transactions is shown as Additions in 2016 chart.
- On March 31, 2016, Telxius entered into a purchase agreement to acquire all the shares of Telxius Torres España, S.L.U. from Telefónica, S.A. at fair value (1,210 million euros). The profit of the transaction amounts to 996 million euros in the income statement of Telefónica, S.A.

On the other hand, with respect to the investment of Telefónica, S.A. in Colombia Telecomunicaciones, S.A., this company and its shareholders are analyzing the most appropriate steps to strengthen their equity position.

2015

Once the pertinent regulatory authorizations were obtained on April 27, 2015, and with the aim of raising the funds needed to complete the acquisition of Global Village Telecom, S.A. and its parent company GVT Participações, S.A. the General Shareholders' Meeting of Telefónica Brasil, S.A. launched a capital increase of 15,812 million reales. Telefónica, S.A. subscribed 3,995 million reales (equivalent to 1,262 million euros). On the same date, and with the object of subscribing the above mentioned capital increase, SP Telecomunicações Participações, Ltda approved a capital increase of 3,223 million reales. Telefónica, S.A. paid 1,270 million reales (equivalent to 401 million euros).

On June 24, 2015 and in compliance with the undertakings assumed in the agreement entered into for the acquisition of Global Village Telecom, S.A. (GVT), it has, through its 100% subsidiary Telco TE S.p.A., delivered 1,110 million ordinary shares of Telecom Italia S.p.A. (representing 8.2% of its ordinary shares) to Vivendi, S.A. and has received from Vivendi, S.A. all the ordinary shares and part of the preferred shares of Telefónica Brasil S.A. that Vivendi S.A. received as consideration for the sale of GVT, which together represent 4.5% of the total share capital of Telefónica Brasil S.A. The fair value of Telecom Italia shares contributed to Vivendi has been calculated using the quoted price at the approval date

amounting to 1,264 million euros. This same amount has been used to value the 4.5% additional investment in Telefónica Brasil, S.A.

On July 29, 2015, Telefónica, S.A. entered into an agreement with Vivendi, S.A. through which Telefónica has committed to deliver 46 million of its treasury shares in exchange for 58.4 million of Telefónica Brasil, S.A. shares, representing approximately 3.5% of the share capital of Telefónica Brasil, S.A. The execution of the agreement was performed on September 16, 2015 and valued at the quoted price of Telefónica's shares at that date, 538 million euros.

As a consequence of the aforementioned transactions, the direct stake of Telefónica, S.A. in Telefónica Brasil, S.A. was increased to 29.77% and the stake at SP Telecomunicações Participações, Ltda is 39.4% of its capital.

On June 18, 2015 the public deed of Telco, S.p.A.'s spin off transaction was filed to the Companies Register. As a result of the process, Telecom Italia, S.p.A. ordinary shares owned by Telco, S.p.A. (equivalent to a 22.3% of the company's share capital) were transferred to its stakeholders. Therefore, Telefónica, S.A. through a 100% owned newly incorporated subsidiary, Telco TE, S.p.A. received ordinary shares representing 14.72% of Telecom Italia's share capital. In this same spin off process, Telco TE, S.p.A. registered the part of the liability that Telco, S.p.A. owed its stakeholders, pro-rata their percentage of ownership. The net book value of assets and liabilities registered was 603 million euros and it is included as "additions" in the table of movements above (Note 9.3.).

On the other hand, Telco TE S.p.A. entered into a purchase agreement with a financing institution for the sale of 872 million ordinary shares of Telecom Italia S.p.A., representing 6.5% of the ordinary shares of this company, for an amount of 1,025 million euros.

Likewise, Telefónica has arranged several hedging instruments which will allow Telefónica to repurchase the shares of Telecom Italia S.p.A. that are necessary to meet its exchange obligations under the mandatory exchangeable bonds for shares of Telecom Italia S.p.A., issued by Telefónica, S.A. in July 2014.

Telefónica, S.A. has therefore ended the divesting process of its indirect stake at Telecom Italia, S.p.A., in accordance with the regulatory and competence requirements.

#### Other movements

The column "Dividends" contains mainly a distribution of reserves made by Telco TE, S.p.A. amounting to 603 million euros. These reserves were originated prior to the investment in the company.

Movement in "Transfers" in "Loans to Group Companies and Associates" both 2016 and 2015 mainly includes the reclassification between long-term and current loans in accordance with the loan maturity schedule.

In addition to the aforementioned reclassification of the investment in Telefónica Europe, plc, in 2015 "Transfers" figure under the caption of "Equity Instruments" the reclassification to "Held for sale assets" of the net carrying amount of the investment in Telefónica Gestión de Servicios Compartidos España, S.A.U. amounting to 8 million euros.

"Impairment losses" Transfers in both 2016 and 2015 corresponds to the reclassification of the negative carrying amount of certain investments amounting to -163 and 31 million euros, respectively.

In 2016 and 2015, Telefónica, S.A. bought and sold the following shareholdings:

**a) Acquisitions of investments and capital increases (Additions):**

Millions of euros		
Companies	2016	2015
Telefónica Brasil, S.A.	-	3,064
Sao Paulo Telecomunicações, Ltda	-	401
Telefónica Internacional, S.A.U.	-	2,157
Telxius Telecom, S.A.U.	1,952	-
Telefónica de Contenidos, S.A.U.	733	-
Telefónica Digital Holding, S.L.U.	301	399
Telefónica Móviles Argentina Group	327	-
Telco TE, S.p.A.	-	603
Telefónica Móviles México, S.A. de C.V.	548	110
Telefónica Global Technology, S.A.U.	202	-
Other companies	334	77
<b>Total Group companies and associates</b>	<b>4,397</b>	<b>6,811</b>

**2016**

Additions related to Telxius Telecom, S.A.U. have been fully described at the beginning of this Note. "Other companies" includes the amount of the capital increase carried out by Telefónica International Wholesale Services América, S.A. amounting to 122 million euros also detailed at the beginning of this Note.

On January 27, 2016 Telefónica de Contenidos, S.A.U. made a capital increase amounting to 733 million euros totally subscribed and paid by the Telefónica, S.A.

On April 5, 2016 and with the aim of financing its subsidiary Telefónica Digital UK, Telefónica Digital Holding, S.L.U. executed a capital increase of 301 million euros fully subscribed and paid by its shareholder Telefónica, S.A.

On May 1, 2016 Telefónica, S.A. has granted Telefónica Móviles Argentina Holdings, S.A. with credits over Telefónica Móviles Argentina, S.A. amounting to a total of 1,110 million Argentinian pesos, including nocional and accrued interests. On May 5, 2016 the Company has subscribed a capital increase launched by Telefónica Móviles Argentina, S.A., pro-rata its stake, with a disbursement of 174 million Argentinian pesos, equivalent to 11 million euros. In addition, on June 16, 2016, Telefónica, S.A. has made an irrevocable capital contribution of 280 million dollars (248 million euros) in Telefónica Móviles Argentina, S.A. After this contribution the Company has increased its stake from 15.4% to 21.1%.

In order to provide Telefónica México, S.A. de C.V. with the funds needed to cancel credit lines, in December 2016 the subsidiary has made a capital increase amounting to 548 million euros fully subscribed and paid by its sole stakeholder, Telefónica, S.A.

As of June 22, Telefónica, S.A. has capitalized all the equity loans given to its subsidiary Telefónica Global Technology, S.A.U. amounting to 202 million euros.

**2015**

Transactions referring the investment increase in Telefónica Brasil, S.A. and Sao Paulo Telecomunicações, Ltda have been detailed at the beginning of this Note.

On June 25, 2015 Telefónica Internacional, S.A.U. made a capital increase with share premium reserve amounting to 2,157 million euros totally subscribed and paid by the Company.

With the object of regaining equity balance, on February 26, 2015 Telefónica Digital Holding, S.L.U. increased its share capital subscribed in full with a loan capitalization of 156 million euros and proceeds in cash amounting to 175 million euros. Moreover, on November 18, 2015 and with the aim of enabling the fulfillment of its financing needs, the company has executed a capital increase of 68 million euros subscribed and paid in full by Telefónica, S.A.

The amount in the above chart regarding Telco TE, S.p.A. has been explained at the beginning of the Note.

In order to provide Telefónica México, S.A. de C.V. with the funds needed to cancel short term payments, in November and December the subsidiary has made several capital increases amounting to 2,000 million Mexican pesos (110 million euros) fully subscribed and paid by its sole stakeholder, Telefónica, S.A.

#### b) Disposals of investments and capital decreases:

Millions of euros		
Companies	2016	2015
Phenix Investments, S.A.	-	340
Telxius Torres España, S.L.U.	214	-
Others	71	-
<b>Total Group companies and associates</b>	<b>285</b>	<b>340</b>

#### 2016

Disposal of Telxius Torres España, S.L.U. refers to the sale at fair value amount of this subsidiary to Telxius Telecom, S.A.U. as detailed at the beginning of the Note.

#### 2015

The disposal in 2015 refers to the decrease and pay back of the share premium reserve of Phenix Investments, S.A.

### 8.2. Assessment of impairment of investments in group companies, joint ventures and associates

At each year end, the Company re-estimates the future cash flows derived from its investments in Group companies and associates. The estimate is made based on the discounted cash flows to be received from each subsidiary in its functional currency, net of the liabilities associated with each investment (mainly net borrowings and provisions), considering the percentage of ownership in each subsidiary and translated to euros at the official closing rate of each currency at December 31.

As a result of these estimations and the effect of the net investment hedge in 2016, a reversal of the impairment provision of 2,049 million euros was recognized (5,309 million euros of impairment in 2015, including the write down regarding Telefónica Europe, plc, which was previously recognized under the caption "net assets held for sale"). This amount derives mainly from the following companies:

(a) reverse of the write down by 2,491 million euros for Telefónica Brasil, S.A. (1,872 million euros in 2015) and reverse of 705 million euros for Sao Paulo Telecomunicações, Ltda (753 million euros in 2015).

(b) write down, net of hedges, of 582 million euros for Telefónica Europe, plc (852 million euros, net of hedges, in 2015).

(c) write down of 1,264 million euros for Telefónica México, S.A. de C.V. (233 million euros in 2015).

(d) the total reversal of the write down of 1,133 million euros booked in 2015 for Telefónica Internacional, S.A.U. (this company was merged with Telefónica Latinoamérica Holding, S.L.), mainly due to the revaluation of the Brazilian Real which has a positive impact in the investments of 36,01% stake in Telefónica Brasil, S.A.

(e) write down of 232 million euros for Telefónica Digital Holding, S.L.U. (267 million euros in 2015).

#### Main hypothesis used for the calculation of the discounted cash flows of investments

In the case of Brazil, revenues reflect the strength of Telefónica's leadership driven by its leadership and quality and capturing integration synergies; and in the United Kingdom, the drive of mobile data.

In addition, in Brazil favorable effects in the macro-finance scenario have been produced. Firstly, and most remarkable, the appreciation of the exchange rate has resolved into an increase in the value of the assets nominated in Brazilian

reales by 18%. Secondly, the improvement in the macroeconomic environment of the country during the second semester of 2016, as well as the more stable political situation as a consequence of the government compromise to implement structural changes in the country, has significantly reduced the uncertainties about the economic sustainability in the middle and long term. The operating income before depreciation and amortization (OIBDA) margin for Brazil is in line with the average of analysts' three year forecasts for peers in emerging markets, at approximately 36%, and also considers analysts' long-term opinions about Brazil. Over the term of the strategic plan, the operator will invest a percentage at the lower end of the range for its peers. However, this is also in line with the investment needs identified by analysts (17%). Discount rate of 11.3% is slightly lower than the rate used in 2015 (11.9%), in line with the expectations of the analysts' consensus. The perpetuity growth rate is in line with the Brazilian Central Bank's medium-term inflation target (4.5%, within a range of  $\pm 1.5$  p.p.) and is aligned with the analyst consensus for the Strategic Plan horizon (around 5%) and below the forecast nominal GDP growth rate (which oscillates around 7%). A conservative outlook has been maintained, in line with analysts' expectations.

Regarding the investment in México, the economic uncertainty and resultant financial volatility associated with the change of president in the United States of America (which have been concluded in a 16% exchange rate depreciation of the Mexican Peso against euro in 2016 with a subsequent negative effect on revenues) and the changing competitive environment in the Mexican telecommunications market, have led to a slowdown in the growth forecast in the business plan of the operator and a set of efficiency ratios that have improved more slowly than in previous years. This new economic scenario requires a more conservative medium-term outlook to be taken in the valuation parameters. The after-tax discount rates increased from 9.05% in 2015 to 9.86% in 2016 as a result of the financial volatility mentioned earlier.

With regard to United Kingdom, the long-term OIBDA margin for operations (26%) is somewhat lower than the average for European peers over a three year period in 34%. With respect to the ratio of CapEx over revenues, over the term of the strategic plan, in United Kingdom the ratio of invest at a percentage of revenue is aligned with the range for peers in the region (around 13%) and it is in line with analysts' estimations. The discount rate (7.1%) is considered to have greater market risk, due to the increase in uncertainty of British equity securities as a result of *Brexit*, however, this risk is in line with the estimates given by analysts. Accordingly, the currency which is the main variable used for external adjustments because of the great commercial dependence on Europe, has suffered a 16% depreciation against euro in 2016, and therefore a negative impact in the British net assets and cash flows nominated in euros. In the United Kingdom the perpetuity growth rate is a 0.8% in line with the analysts' consensus.

### 8.3. The detail of subsidiaries and associates is shown in Appendix I.

### 8.4. Transactions protected for tax purposes

Transactions carried out in 2016 that qualify for special tax treatment, as defined in Articles 76 and 87, as applicable, of Chapter VII of Title VII of Legislative Royal Decree 27/2014 of November 27 approving the Spanish Corporate Income Tax Law, are detailed in the following paragraph. Transactions qualified for special tax treatment carried out in prior years are disclosed in the financial statements for those years.

On February 18, 2016 Telefónica Móviles España, S.A.U. spins off neutrally the activity branch of the towers in Spain, in favour of the company Wireless Towers España, S.L.U. In accordance with the accounting valuation principles, the asset subject to the spun-off is recognized at its net carrying amount, 214 million euros. The market value of the spun-off asset is 1,210 million euros.

On March 30, 2016, Telefónica, S.A., as stakeholder of Telefónica International Wholesale Services America, S.A., made a non-monetary contribution of the 73.14% of the shares of this company to the reserves of Telxius Telecom, S.A.U., which the Company also owned. The contribution transaction is governed by the tax neutral regime. In accordance with the accounting valuation principle the contribution is recognized at its net carrying amount (447 million euros). The market value of the contributed asset was 1,233 million euros.

On May 5, 2016, Telefónica Digital España, S.L., as sole stakeholder of Telefónica Digital Identity & Privacy S.L., approved the merger by absorption of this latter by the first, with the subsequent dissolution without liquidation of the absorbed company and the transfer en bloc of its assets and liabilities to Telefónica Digital España, S.L., which also acquires all its rights and obligations by universal succession. The deed of the merger was filed in the Madrid Companies Register on June 17, 2016.

On July 1, 2016, Telefónica, S.A. as stakeholder of Telefónica Global Technology, S.A., adopted the agreements to partially spin off this company in favour of Telefónica de España, S.A.U., which is also wholly-owned by the Company. Through the spin-off it is transferred en bloc the independent unit of production, consisting of the maintenance and operation of the Data Center in Alcalá de Henares, as well as its infrastructure, just as the one located in the Data Center in Julián Camarillo street, and the services delivery. Telefónica, S.A as sole stakeholder of both companies, recognizes a net carrying amount of 152 million euros, the partial spin-off transaction of the cost in TGT and the capital increase in Telefónica de España, S.A.U. The spin-off was notarized on September 1, 2016.

On September 26, 2016, filed in the Madrid Companies Register on October 7, 2016, Telefónica Internacional, S.A.U. (absorbed) merged with Telefónica Latinoamérica Holding, S.L. (absorbing). In accordance with the accounting principles the merged asset is recognized at its net carrying amount (9,722 million euros) in Telefónica, S.A. There is no appreciation. The transaction was governed by the Special Regime.

8.5. The breakdown and maturity of loans to Group companies and associates in 2016 and 2015 are follows:

## 2016

Millions of euros

Company	2017	2018	2019	2020	2021	2022 and subsequent years	Final balance, current and non-current
Telefónica Móviles España, S.A.U.	88	400	-	-	-	-	488
Telefónica Móviles México, S.A. de C.V.	-	796	-	-	-	-	796
Telefónica de Contenidos, S.A.U.	386	-	-	-	-	-	386
Telefónica de España, S.A.U.	259	-	550	-	-	-	809
Telxius Telecom, S.A.U.	8	-	-	-	140	560	708
Telefónica Latinoamérica Holding, S.L.	2,099	-	-	-	-	-	2,099
Other companies	327	139	59	176	17	113	831
<b>Total</b>	<b>3,167</b>	<b>1,335</b>	<b>609</b>	<b>176</b>	<b>157</b>	<b>673</b>	<b>6,117</b>

## 2015

Millions of euros

Company	2016	2017	2018	2019	2020	2021 and subsequent years	Final balance, current and non-current
Telefónica Móviles España, S.A.U.	710	-	400	-	-	-	1,110
Telefónica Móviles México, S.A. de C.V.	255	623	-	-	-	-	878
Telefónica de Contenidos, S.A.U.	419	-	-	-	-	-	419
Telefónica de España, S.A.U.	371	165	-	550	-	-	1,086
Telefónica Global Technology, S.A.U.	18	-	-	17	68	97	200
Telfin Ireland, Ltd.	455	-	-	-	-	-	455
Telefónica Internacional, S.A.U.	3,632	-	-	-	-	-	3,632
Telefónica Latinoamérica Holding, S.L.	1,039	-	-	-	-	-	1,039
Other companies	416	69	178	29	55	62	809
<b>Total</b>	<b>7,426</b>	<b>857</b>	<b>578</b>	<b>596</b>	<b>123</b>	<b>159</b>	<b>9,739</b>

The main loans granted to Group and associated companies are described below:

- The financing extended to Telefónica Móviles España, S.A.U. in 2016 consists of a loan for 400 million euros, with maturity date in 2018, and formalised in 2013 to enable this company to meet its payment obligations. These credits have 1 million euros of accrued interest receivable.

Moreover, 87 million euros of taxes are receivable from this subsidiary for its tax expense declared in the consolidated tax return (68 million euros in 2015).

- At December 31, 2016 and 2015, the account receivable with Telefónica Móviles México, S.A. de C.V. amounts to 11,697 million Mexican pesos, equivalent to 538 and 623 million euros, respectively. This consideration is recognised as non-current pursuant to the expected collection date at the reporting date. At December 31, 2016, accrued interest receivable totals 258 million euros (255 million euros in 2015), which forms part of the non-current balance receivable.
- At December 31, 2016, the account receivable with Telefónica de Contenidos, S.A.U. consist of a 340 million-euro participating loan awarded in 2013 and maturity date in May 2016 that has been extended until May 2017 with the same principal amount and conditions, all of which has been drawn down. Interest on this loan is calculated according to the performance of Telefónica de Contenidos, S.A.U. At December 31, 2016 and 2015, no accrued interest is outstanding.

In addition, 46 million euros of taxes are receivable from this subsidiary for its tax expense declared in the consolidated tax return (no amounts were outstanding for this concept in 2015).

- The 2016 balance for Telefónica de España, S.A.U. consists of a 550 million euros credit facility granted and drawn down in full in November 2014 and maturing in 2019, and a credit facility of 165 million euros maturing in 2017. Additionally, there is also a balance of 93 million euros comprising tax receivables from the subsidiary for its tax expense declared in the consolidated tax return (370 million euros in 2015) and accrued interest of 1 million euros.

On May 27, 2016, with the aim of enabling the necessary funds for restructuring the infrastructure business line of the Group as described above, the Company has granted its subsidiary Telxius Telecom, S.A.U. with a credit of 560 million euros at a fix interest rate and maturity in 2026 and a credit of 140 million euros and an interest rate referred to euribor maturing 2021. In addition, 8 million euros of taxes are receivable from this subsidiary for its tax expense declared in the consolidated tax return.

- In 2015 the outstanding balance of Telefónica Internacional, S.A.U. included dividends distributed and not paid by 3,529 million euros. In July and November 2016 parcial payments have been received of 328 and 1,500 million euros, respectively. On January 1, 2016 the company has merged with Telefónica Latinoamérica Holding, S.L., and this last one being the merged company. As of December 31, 2016 there are unpaid dividends from both companies amounting to 2,041 million euros.

Moreover, 58 million euros of taxes are receivable from this subsidiary for its tax expense declared in the consolidated tax return (103 million euros in 2015).

- On December, 30, 2015, General Shareholders' Meeting of Telfin Ireland, Ltd. approved a dividend distribution totaling 455 million euros. This amount has been received in 2016.
- In 2016, under "Other companies" it is included a long term tax receivable with Telefónica Emisiones, S.A.U. amounting to 96 million euros due to the limitation of the deductibles financial expenses (calculated in the tax group).

The Company has also extended 446 million euros (597 million euros in 2015) of loans in connection with the taxation of Telefónica, S.A. as the head of the tax group pursuant to the consolidated tax regime applicable to corporate groups (see Note 17). The most significant amounts have already been disclosed through this Note. All these amounts fall due in the short term.



Disposals of current loans to group companies and associates includes the cancellation of balances receivable from subsidiaries on account of their membership of Telefónica, S.A.'s tax group totaling 597 million euros (825 million euros in 2015).

Total accrued interest receivable at December 31, 2016 included under "Current loans to group companies and associates" amounted to 2 million euros (271 million euros in 2015).

#### **8.6. Other financial assets with Group companies and associates**

This includes rights to collect amounts from other Group companies related to share-based payment plans involving Telefónica, S.A. shares offered by subsidiaries to their employees maturing in 2017 and 2018 (see Note 19.3).

## Note 9. Financial investments

9.1. The breakdown of "Financial investments" at December 31, 2016 and 2015 is as follows:

2016

	Assets at fair value					Assets at amortized cost							Total carrying amount	Total fair value
	Available-for-sale financial assets	Financial assets held for trading	Hedges	Subtotal assets at fair value	Level 1: quoted prices	Level 2: Estimates based on other directly observable market inputs	Level 3: Estimates not based on observable market data	Loans and receivables	Other financial assets	Subtotal assets at amortized cost	Subtotal liabilities at fair value			
<i>Millions of euros</i>														
<b>Non-current financial investments</b>	<b>339</b>	<b>1,757</b>	<b>2,910</b>	<b>5,006</b>	<b>339</b>	<b>4,667</b>	<b>-</b>	<b>-</b>	<b>10</b>	<b>10</b>	<b>10</b>	<b>5,016</b>	<b>5,016</b>	
Equity instruments	339	-	-	339	339	-	-	-	-	-	-	339	339	
Derivatives (Note 16)	-	1,757	2,910	4,667	-	4,667	-	-	-	-	-	4,667	4,667	
Loans to third parties and other financial assets	-	-	-	-	-	-	-	-	10	10	10	10	10	
<b>Current financial investments</b>	<b>-</b>	<b>716</b>	<b>936</b>	<b>1,652</b>	<b>-</b>	<b>1,652</b>	<b>-</b>	<b>42</b>	<b>248</b>	<b>290</b>	<b>290</b>	<b>1,942</b>	<b>1,716</b>	
Loans to third parties	-	-	-	-	-	-	-	42	248	290	290	290	64	
Derivatives (Note 16)	-	716	936	1,652	-	1,652	-	-	-	-	-	1,652	1,652	
<b>Total financial investments</b>	<b>339</b>	<b>2,473</b>	<b>3,846</b>	<b>6,658</b>	<b>339</b>	<b>6,319</b>	<b>-</b>	<b>42</b>	<b>258</b>	<b>300</b>	<b>300</b>	<b>6,958</b>	<b>6,732</b>	

2015

	Assets at fair value					Assets at amortized cost							
	Measurement hierarchy					Loans and receivables	Other financial assets	Subtotal assets at amortized cost	Subtotal liabilities at fair value	Total carrying amount	Total fair value		
	Available-for-sale financial assets	Financial assets held for trading	Hedges	Subtotal assets at fair value	Level 1: quoted prices							Level 2: Estimates based on other directly observable market inputs	Level 3: Estimates not based on observable market data
<i>Millions of euros</i>													
<b>Non-current financial investments</b>	<b>384</b>	<b>2,339</b>	<b>2,299</b>	<b>5,022</b>	<b>384</b>	<b>4,638</b>	<b>-</b>	<b>41</b>	<b>10</b>	<b>51</b>	<b>51</b>	<b>5,073</b>	<b>5,073</b>
Equity instruments	384	-	-	384	384	-	-	-	-	-	-	384	384
Derivatives (Note 16)	-	2,339	2,299	4,638	-	4,638	-	-	-	-	-	4,638	4,638
Loans to third parties and other financial assets	-	-	-	-	-	-	-	41	10	51	51	51	51
<b>Current financial investments</b>	<b>-</b>	<b>590</b>	<b>1,406</b>	<b>1,996</b>	<b>-</b>	<b>1,996</b>	<b>-</b>	<b>60</b>	<b>4</b>	<b>64</b>	<b>64</b>	<b>2,060</b>	<b>2,060</b>
Loans to third parties	-	-	-	-	-	-	-	60	4	64	64	64	64
Derivatives (Note 16)	-	590	1,406	1,996	-	1,996	-	-	-	-	-	1,996	1,996
<b>Total financial investments</b>	<b>384</b>	<b>2,929</b>	<b>3,705</b>	<b>7,018</b>	<b>384</b>	<b>6,634</b>	<b>-</b>	<b>101</b>	<b>14</b>	<b>115</b>	<b>115</b>	<b>7,133</b>	<b>7,133</b>

Derivatives are measured using the valuation techniques and models normally used in the market, based on money-market curves and volatility prices available in the market.

The calculation of the fair values of the Company's financial debt instruments required an estimate for each currency of a credit spread curve using the prices of the Company's bonds and credit derivatives.

## 9.2 Held-for-trading financial assets and hedges

These two categories include the fair value of outstanding derivative financial instruments at December 31, 2016 and 2015 (see Note 16).

## 9.3 Available-for-sale financial assets.

This category mainly includes the fair value of investments in listed companies (equity instruments) over which the Company does not have significant control or influence. The movement of items composing this category at December 31, 2016 and 2015 are as follows:

### December 31, 2016

Millions of euros	Opening balance	Additions	Disposals	Other movements	Fair value adjustments	Closing balance
Banco Bilbao Vizcaya Argentaria, S.A.	298	-	-	(9)	(6)	283
Other companies	86	35	(68)	-	3	56
<b>Total</b>	<b>384</b>	<b>35</b>	<b>(68)</b>	<b>(9)</b>	<b>(3)</b>	<b>339</b>

### December 31, 2015

Millions of euros	Opening balance	Additions	Disposals	Other movements	Fair value adjustments	Closing balance
Banco Bilbao Vizcaya Argentaria, S.A.	347	-	-	(10)	(39)	298
Telco, S.p.A.	73	-	(603)	15	515	-
Other companies	63	32	-	-	(9)	86
<b>Total</b>	<b>483</b>	<b>32</b>	<b>(603)</b>	<b>5</b>	<b>467</b>	<b>384</b>

#### Banco Bilbao Vizcaya Argentaria, S.A.

The impacts shown in the column "Fair value adjustments" on both years include the fair value adjustment, net of tax effect of Banco Bilbao Vizcaya Argentaria, S.A. (BBVA). These impacts are registered in the Equity of the Company (Note 11.2.). The effect, recorded both in 2016 and 2015 under "other movements", relates to the sale of rights to scrip dividends that the bank distributed in both years.

At December 31, 2016 Telefónica, S.A.'s investment in BBVA represents 0.67% of that company's share capital.

#### Telco, S.p.A.

The revaluation in the quotation of Telecom Italia, S.p.A.'s shares since January 2015 until the spin off date is shown under "Fair value adjustments" column of the charts above. In June 2015, the spin off deed of Telco, S.p.A. was filed to the Companies Register. After this spin off, the net book value of the assets and liabilities of the company that according to the percentage of ownership corresponded pro-rata to Telefónica, S.A., were transferred to a newly incorporated subsidiary, Telco TE, S.p.A. as indicated in Note 8. This transaction is registered as "Disposal" in 2015 chart of movements and has originated a financial revenue of 500 million euros.

#### 9.4 Other financial assets and loans to third parties

The breakdown of investments included in this category at December 31, 2016 and 2015 is as follows:

Millions of euros	2016	2015
<b>Other non-current financial assets:</b>		
Loans to third parties	-	41
Guarantees given	10	10
Other non-current financial assets	-	-
<b>Other current financial assets:</b>		
Loans to third parties	42	60
Other current financial assets	248	4
<b>Total</b>	<b>300</b>	<b>115</b>

“Other current financial assets” includes 240 million euros of the collateral funds reinvested in BBVA (see Notes 12 and 20).

##### 9.4.1 Loans to third parties

In June 2015, when the sale of the shares of Telecom Italia, S.p.A. was completed (see Note 8), Telefónica arranged several hedging instruments which will allow Telefónica to repurchase the shares of Telecom Italia, S.p.A. that are necessary to meet its exchange obligations under the mandatory exchangeable bonds for shares of Telecom Italia S.p.A. (see Note 13). This “Equity Swap” contract envisages a premium for Telefónica, S.A. that it is being quarterly cashed until the contract vesting in 2017. The pending amounts are registered in the balance sheet according to its maturity schedule and amounting to 41 million euros as short term at December 31, 2016. As of December 31, 2015 there were 41 million euros as long term loans to third parties and 55 million euros as short term loans to third parties.

## Note 10. Trade and other receivables

The breakdown of “Trade and other receivables” at December 31, 2016 and 2015 is as follows:

Millions of euros	2016	2015
Trade receivables	3	10
Trade receivables from Group companies and associates	247	295
Other receivables	16	1
Employee benefits receivable	-	2
Tax receivables (Note 17)	181	286
<b>Total</b>	<b>447</b>	<b>594</b>

“Trade receivables from Group companies and associates” mainly includes amounts receivable from subsidiaries for the impact of the rights to use the Telefónica brand and the monthly office rental fees (see Note 7).

“Trade receivables” and “Trade receivables from Group companies and associates” in 2016 and 2015 include balances in foreign currency equivalent to 117 million and 150 million euros, respectively. In both years these amounts relate entirely to receivables in US dollars.

These balances gave rise to exchange losses in the income statement of approximately 3 million euros in 2016 (22 million euros of exchange gains in 2015).

## Note 11. Equity

### 11.1 Capital and reserves

#### a) Share capital

##### 2016

On October 11, 2016, the deed of a share capital decrease was registered, cancelling 74,627,988 of own shares, reducing the company's share capital by 74,627,988 euros.

On December 7, 2016, the deed of a share capital increase of 137,233,781 euros ordinary shares with a par value of 1 euro each were issued, with a charge to reserves; as part of the scrip dividend shareholder remuneration deal. Share capital amounts to 5,037,804,990 euros subsequent to this increase.

At December 31, 2016, Telefónica, S.A.'s share capital amounted to 5,037,804,990 euros and consisted of 5,037,804,990 fully paid ordinary shares of a single series, par value of 1 euro, all recorded by the book-entry system and traded on the Spanish electronic trading system ("Continuous Market"), where they form part of the "Ibex 35" Index, on the four Spanish Stock Exchanges (Madrid, Barcelona, Valencia and Bilbao) and listed on the London and Buenos Aires Stock Exchanges, and on the New York and Lima Stock Exchanges, through American Depositary Shares ('ADSs').

##### 2015

On April 20, 2015, the public deed evidencing the share capital increase granted by Telefónica, S.A. was registered with the Commercial Registry of Madrid for a nominal value of 281,213,184 euros recorded as "share capital". The difference with the effective amount issued, amounting 3,048,350,914.56 euros was recorded as Share premium.

On July 24, 2015, the public deed of the share capital reduction was registered, cancelling 74,076,263 of the own shares, reducing the company's share capital by 74,076,263 euros.

On December 10, 2015, the public deed of a share capital increase of 110,857,946 euros was executed, during which 110,857,946 ordinary share with a par value of 1 euro each were issued, with a charge to reserves, as part of the scrip dividend shareholder remuneration deal. Share capital amounts to 4,975,199,197 euros subsequent to this increase.

#### Authorizations by Shareholders' Meeting

With respect to authorizations given regarding share capital, on June 12, 2015, authorization was given at the Annual Shareholders' Meeting of Telefónica, S.A. for the Board of Directors, at its discretion and in accordance with the Company's needs, to increase the Company's capital, once or several times, within a maximum period of five years from that date, up to a maximum nominal increase of 2,469,208,757 euros, equivalent to half of Telefónica, S.A.'s share capital at that date, by issuing and placing new shares (with or without a share premium) and, in all cases, in exchange for cash, expressly considering the possibility that the new shares may not be fully subscribed. The Board of Directors was also empowered to exclude, partially or fully, pre-emptive subscription rights under the terms of Section 506 of the Spanish Enterprises Act. However, the power to exclude preemptive rights is limited to 20% of the Company's share capital on the date of adoption of this resolution.

Furthermore, on May 30, 2014, shareholders voted to authorize the acquisition by the Board of Directors of Telefónica, S.A. treasury shares, up to the limits and pursuant to the terms and conditions established at the Shareholders' Meeting, within a maximum period of five years from that date. However, it specified that in no circumstances could the par value of the shares acquired, added to that of the treasury shares already held by Telefónica, S.A. and by any of its controlled subsidiaries, exceed the maximum legal percentage at any time (currently 10% of Telefónica, S.A.'s share capital).

In addition, at the May 30, 2014 Shareholders' Meeting of Telefónica, S.A., authorization was given for the Board of Directors to issue debentures, bonds, notes and other fixed-income securities and hybrid instruments, including preferred shares at one or several times within a maximum period of five years from that date. These securities may be in the form of debentures, bonds, promissory notes or any other kind of fixed-income security, or debt instruments of similar category or hybrid instruments whatever may be the forms admitted in law, plain or, in the case of debentures, bonds and hybrid instruments convertible into shares of the Company and/or exchangeable for shares of any of the Group companies, or

any other company. This delegation also includes warrants or other similar securities that might give the right to directly or indirectly subscribe or acquire shares of the Company, whether newly issued or outstanding, and which may be paid for by physical delivery or by offset. The aggregated amount of the issuance(s) of securities approved under this delegation of powers may not exceed, at any given time, the sum of 25,000 million euros or the equivalent in another currency. For promissory notes, the outstanding balance of promissory notes issued under this authorization will be calculated for purposes of the aforementioned limit. Also for purposes of the foregoing limit, in the case of warrants, the sum of the premiums and exercise prices of the warrants for each issuance that is approved under this delegation shall be taken into account.

At December 31, 2016 and 2015, Telefónica, S.A. held the following treasury shares:

	Euros per share				
	Number of shares	Acquisition price	Trading price	Market value (1)	%
Treasury shares at 12/31/16	141,229,134	10.48	8.82	1,246	2.80339%
Treasury shares at 12/31/15	141,639,159	11.69	10.24	1,450	2.84690%

(1) Millions of euros

The movement in treasury shares of Telefónica, S.A. in 2016 and 2015 is as follows:

	Number of shares
<b>Treasury shares at 12/31/14</b>	<b>128,227,971</b>
Acquisitions	138,036,450
Disposals	(47,824,300)
PIP II share plan delivery (see Note 19.3)	(2,724,699)
Share redemption	(74,076,263)
<b>Treasury shares at 12/31/15</b>	<b>141,639,159</b>
Acquisitions	77,087,297
Disposals	(2,869,334)
Share redemption	(74,627,988)
<b>Treasury shares at 12/31/16</b>	<b>141,229,134</b>

#### Acquisitions

The amount of the acquisitions of treasury shares in 2016 and 2015 was 668 million euros and 1,654 million euros, respectively.

#### Share redemption and disposals

On October 13, 2016, pursuant to the resolution of the share capital reduction, by the cancellation of own shares, adopted by the Annual General Shareholders' Meeting of Telefónica held on May 12, 2016, the public deed of this share capital reduction was registered in the Madrid Mercantile Registry (Registro Mercantil). Therefore, 74,627,988 of the own shares of Telefónica, S.A. totalling 813 million euros have been cancelled.

On July 24, 2015, pursuant to the resolution of the share capital reduction, by the cancellation of own shares, adopted by the Annual General Shareholders' Meeting of Telefónica held on June 12, 2015, the public deed of this share capital



reduction was registered in the Madrid Mercantile Registry (Registro Mercantil). Therefore, 74,076,263 of the own shares of Telefónica, S.A. totalling 886 million euros have been cancelled.

Treasury shares sold, including share plans redemptions, in 2016 and 2015 amount to 26 million euros and 593 million euros, respectively.

The main treasury share sale transaction in 2015 was the agreement entered by Telefónica, S.A. with Vivendi, S.A. through which Telefónica has committed to deliver 46.0 million of its treasury shares, in exchange for 58.4 million preferred shares of Telefónica Brasil, S.A. The impact in equity amounted to 555 million euros.

On June 30, 2016 the third phase of the Telefónica, S.A. long-term incentive plan called "Performance and Investment Plan 2013-2016" (PIP 2013-2016) ended. No shares were delivered to Telefónica Group Management (see Note 19.3).

On June 30, 2015, the second phase of the Telefónica, S.A. long-term incentive plan called "Performance and Investment Plan 2012-2015" ("PIP 2012-2015") ended. According to the level of "Total Shareholder Return" (TSR) achieved, 77%, 2,724,699 shares were delivered (see Note 19).

The Company also has a derivative instrument, to be settled by offset, on a nominal value equivalent to 35.2 million of Telefónica shares in 2016 (33.8 million shares in 2015), recognized in both years under "Current interest-bearing debt" in the accompanying balance sheet.

#### **b) Legal reserve**

According to the text of the Corporate Enterprises Act, companies must transfer 10% of profit for the year to a legal reserve until this reserve reaches at least 20% of share capital. The legal reserve can be used to increase capital by the amount exceeding 10% of the increased share capital amount. Except for this purpose, until the legal reserve exceeds the limit of 20% of share capital, it can only be used to offset losses, if there are no other reserves available. At December 31, 2015 the balance of this reserve amounted to 984 million euros. The General Shareholders' Meeting held on May 12, 2016 approved the allocation of 1 million euros in this caption. After the capital increase carried forward in 2016, the Company needs to increase the legal reserve by 23 million euros. The proposed appropriation of profit (see Note 3) includes an allocation of 2 million euros.

#### **c) Other reserves**

"Other reserves" includes:

- The "Revaluation reserve" which arose as a result of the revaluation made pursuant to Royal Decree-Law 7/1996 dated June 7. The revaluation reserve may be used, free of tax, to offset any losses incurred in the future and to increase capital. From January 1, 2007, it may be allocated to unrestricted reserves, provided that the capital gain has been realized. The capital gain will be deemed to have been realized in respect of the portion on which the depreciation has been recorded for accounting purposes or when the revalued assets have been transferred or derecognized. In this respect, at the end of 2016 and 2015, an amount of 8 million euros corresponding to revaluations reserves subsequently considered unrestricted has been reclassified to "Other reserves" in both periods. The balance of this reserve at December 31, 2016 and 2015 was 85 million euros and 93 million euros, respectively.
- Reserve for cancelled share capital: In accordance with Section 335.c) of the Corporate Enterprises Act and to render null and void the right of opposition provided for in Section 334 of the same Act, whenever the Company decreases capital it records a reserve for cancelled share capital for an amount equal to the par value of the cancelled shares, which can only be used if the same requirements as those applicable to the reduction of share capital are met. In 2015 and 2016 new reserves for cancelled capital share amounting to 74 million euros, in both years have been created. The cumulative amount of the reserve for cancelled share capital at December 31, 2016 and 2015 was 731 and 656 million euros, respectively.
- Pursuant to the provisions of Royal Decree 1514/2007, since 2008, after the distribution of profits for each year, the Company set aside a non-distributable reserve of 2 million euros for goodwill amortization. Pursuant to the provisions of Royal Decree 602/2016 of December 2, 2016, the goodwill amortization amounting to 10 million euros has been registered with a counterpart in this reserve (see Note 2).

- In addition to the restricted reserves explained above, "Other reserves" includes unrestricted reserves from gains obtained by the Company in prior years.

#### **d) Dividends**

##### **Dividend distribution in 2016**

Approval was given at the Shareholder's Meeting of Telefónica S.A. of May 12, 2016 to pay a dividend with a charge to unrestricted reserves of a fixed gross 0.40 euros per outstanding share carrying dividend rights. The dividend was paid in full on May 19, 2016, and the total amount paid was 1,906 million euros.

On November 11, 2016 the Executive Commission of Telefónica, S.A.'s Board of Directors approval to pay a scrip dividend amounting to approximately 0.35 per share consisting of the assignment of free allotment rights with an irrevocable purchase commitment by the Company, and a subsequent capital increase with a charge to reserves by such amount as may be determined pursuant to the terms and conditions of the resolution, by means of the issue of new ordinary shares having a par value of one euro, to fulfill said allotments. The payment was paid on December 7, 2016, with an impact in equity amounting to 500 million euros.

The shareholders of 70.01% of the free-of-charge allotment rights were entitled, therefore, to receive new shares of Telefónica, S.A. Thus, the final number of shares issued in the capital increase was 137,233,781 shares with a nominal value of 1 euro each.

##### **Dividend Distribution in 2015**

Approval was given at the Board of Directors' Meeting of April 29, 2015 to pay a gross 0.4 euros dividend per outstanding share against 2015 profit. This dividend was paid on May 12, 2015 and the total gross amount paid was 1,912 million euros.

At its meeting held on November 13, 2015, the Executive Commission of Telefónica, S.A.'s Board of Directors agreed to carry out the execution of the increase in paid-up capital, related to the shareholders compensation by means of a scrip dividend, approved by the Annual General Shareholder's Meeting held on June 12, 2015.

Thus, each shareholder received one free allotment right for each Telefónica share held. Such free allotment rights were traded on the Continuous Market in Spain during a period of fifteen calendar days. Once this trading period ended, the shareholders of 20.01% of the free-of-charge allotment rights accepted the irrevocable purchase commitment assumed by Telefónica, S.A. Cash payment to these shareholders was made on December 7, 2015, representing an impact in equity of 337 million euros.

The shareholders of 79.99% of the free-of-charge allotment rights were entitled, therefore, to receive new shares of Telefónica, S.A. Nevertheless, Telefónica, S.A. has waived the subscription of new shares corresponding to its treasury shares, so the final number of shares issued in the capital increase was 110,857,946 shares with a nominal value of 1 euro each.

#### **e) Other equity instruments**

On September 24, 2014, Telefónica Participaciones, S.A.U., issued 1,500 million euros of bonds necessarily convertible into new and/or existing shares of Telefónica, S.A. at a nominal fixed interest rate of 4.9%, due on September 25, 2017, guaranteed by Telefónica, S.A. The notes could be converted at the option of the noteholders or the issuer at any time from the 41<sup>st</sup> day after the Issue Date up to the 25<sup>th</sup> trading day prior to the Maturity Date. The minimum conversion price of the notes will be equal to 11.9 euros per share and the maximum conversion price will be equal to 14.5775 euros per share, resulting in a premium equal to 22.5% over the minimum conversion price.

On the same date, Telefónica, S.A. issued bonds with the same amount and characteristics of the previously detailed bond and a derivative instrument (warrant) in order to hedge the conversion price of the bonds. These bonds were wholly acquired by Telefónica Participaciones, S.A.U. In the balance sheet of Telefónica, S.A. the present value of the coupons

was recorded as debt (See Note 15), the warrant was accounted as long term liabilities to group companies (see Note 16) and the remaining amount of 1,206 million euros has been recorded as “other net equity instruments”.

## 11.2 Unrealized gains (losses) reserve

The movements in the items composing “Unrealized gains (losses) reserve” in 2016 and 2015 are as follows:

### 2016

Millions of euros	Opening balance	Valuation at market value	Tax effect of additions	Amounts transferred to income statement	Tax effect of transfers	Closing balance
Available-for-sale financial assets (Note 9.3)	11	13	(3)	(17)	4	8
Cash flow hedges (Note 16)	(801)	477	(119)	(308)	77	(674)
<b>Total</b>	<b>(790)</b>	<b>490</b>	<b>(122)</b>	<b>(325)</b>	<b>81</b>	<b>(666)</b>

### 2015

Millions of euros	Opening balance	Valuation at market value	Tax effect of additions	Amounts transferred to income statement	Tax effect of transfers	Closing balance
Available-for-sale financial assets (Note 9.3)	20	467	(130)	(481)	135	11
Cash flow hedges (Note 16)	(1,084)	380	(137)	56	(16)	(801)
<b>Total</b>	<b>(1,064)</b>	<b>847</b>	<b>(267)</b>	<b>(425)</b>	<b>119</b>	<b>(790)</b>

## Note 12. Financial liabilities

The breakdown of "Financial liabilities" at December 31, 2016 and 2015 is as follows:

2016

Millions of euros	LIABILITIES AT FAIR VALUE						LIABILITIES AT AMORTIZED COST		TOTAL CARRYING AMOUNT	TOTAL FAIR VALUE
	Financial liabilities held for trading	Hedges	Subtotal financial liabilities at fair value	MEASUREMENT HIERARCHY			Trade and other payables	Subtotal liabilities at fair value		
				Level 1: quoted prices	Level 2: Estimates based on other directly observable market inputs	Level 3: Estimates not based on other directly observable market data				
<b>Non-current financial liabilities</b>	<b>1,721</b>	<b>963</b>	<b>2,684</b>	-	<b>2,684</b>	-	<b>41,839</b>	<b>45,248</b>	<b>44,523</b>	<b>47,932</b>
Payable to Group companies and associates	-	-	-	-	-	-	37,274	40,680	37,274	40,680
Bank borrowings	-	-	-	-	-	-	4,427	4,430	4,427	4,430
Derivatives (Note 16)	1,721	963	2,684	-	2,684	-	-	-	2,684	2,684
Other financial liabilities	-	-	-	-	-	-	138	138	138	138
<b>Current financial liabilities</b>	<b>628</b>	<b>51</b>	<b>679</b>	-	<b>679</b>	-	<b>16,179</b>	<b>16,274</b>	<b>16,858</b>	<b>16,953</b>
Payable to Group companies and associates	-	-	-	-	-	-	13,146	13,233	13,146	13,233
Bank borrowings	-	-	-	-	-	-	1,635	1,637	1,635	1,637
Bonds and other marketable debt securities	-	-	-	-	-	-	1,158	1,164	1,158	1,164
Derivatives (Note 16)	628	51	679	-	679	-	-	-	679	679
Other financial liabilities	-	-	-	-	-	-	240	240	240	240
<b>Total financial liabilities</b>	<b>2,349</b>	<b>1,014</b>	<b>3,363</b>	-	<b>3,363</b>	-	<b>58,018</b>	<b>61,522</b>	<b>61,381</b>	<b>64,885</b>

2015

Millions of euros	LIABILITIES AT FAIR VALUE						LIABILITIES AT AMORTIZED COST			
	Financial liabilities held for trading	Hedges	Subtotal financial liabilities at fair value	MEASUREMENT HIERARCHY			Trade and other payables	Subtotal liabilities at fair value	TOTAL CARRYING AMOUNT	TOTAL FAIR VALUE
				Level 1: quoted prices	Level 2: Estimates based on other directly observable market inputs	Level 3: Estimates not based on other directly observable market data				
<b>Non-current financial liabilities</b>	<b>2,361</b>	<b>486</b>	<b>2,847</b>	-	<b>2,847</b>	-	<b>42,446</b>	<b>44,868</b>	<b>45,293</b>	<b>47,715</b>
Payable to Group companies and associates	-	-	-	-	-	-	36,683	39,109	36,683	39,109
Bank borrowings	-	-	-	-	-	-	4,825	4,805	4,825	4,805
Bonds and other marketable debt securities	-	-	-	-	-	-	800	816	800	816
Derivatives (Note 16)	2,361	486	2,847	-	2,847	-	-	-	2,847	2,847
Other financial liabilities	-	-	-	-	-	-	138	138	138	138
<b>Current financial liabilities</b>	<b>236</b>	<b>38</b>	<b>274</b>	-	<b>274</b>	-	<b>14,571</b>	<b>13,853</b>	<b>14,845</b>	<b>14,127</b>
Payable to Group companies and associates	-	-	-	-	-	-	13,217	12,502	13,217	12,502
Bank borrowings	-	-	-	-	-	-	1,269	1,265	1,269	1,265
Bonds and other marketable debt securities	-	-	-	-	-	-	85	86	85	86
Derivatives (Note 16)	236	38	274	-	274	-	-	-	274	274
<b>Total financial liabilities</b>	<b>2,597</b>	<b>524</b>	<b>3,121</b>	-	<b>3,121</b>	-	<b>57,017</b>	<b>58,721</b>	<b>60,138</b>	<b>61,842</b>

Derivatives are measured using the valuation techniques and models normally used in the market, based on money-market curves and volatility prices available in the market.

The calculation of the fair values of the Company's financial debt instruments required an estimate for each currency of a credit spread curve using the prices of the Company's bonds and credit derivatives.

The entire amount of "Other financial liabilities" relates to the received deposit of 240 million as collateral guarantees with BBVA (see Note 9 and 20).

## Note 13. Bonds and other marketable debt securities

13.1 The balances and movements in issues of debentures, bonds and commercial paper at December 31, 2016 and 2015 are as follows:

### 2016

Millions of euros	Non-convertible debentures and bonds	Other marketable debt securities	Total
<b>Opening balance</b>	<b>820</b>	<b>65</b>	<b>885</b>
Additions	-	374	374
Disposals	-	(69)	(69)
Revaluation and other movements	(32)	-	(32)
<b>Closing balance</b>	<b>788</b>	<b>370</b>	<b>1,158</b>
Details of maturities:			
Non-current	-	-	-
Current	788	370	1,158

### 2015

Millions of euros	Non-convertible debentures and bonds	Other marketable debt securities	Total
<b>Opening balance</b>	<b>902</b>	<b>6</b>	<b>908</b>
Additions	-	83	83
Disposals	(50)	(24)	(74)
Revaluation and other movements	(32)	-	(32)
<b>Closing balance</b>	<b>820</b>	<b>65</b>	<b>885</b>
Details of maturities:			
Non-current	800	-	800
Current	20	65	85

The balance of "Non-convertible debentures and bonds" in 2016 is referred to Telefónica's bond issuance made on July 24, 2014 amounting to 750 million euros. The bonds were mandatorily exchangeable into ordinary shares of Telecom Italia, S.p.A, maturing on July 24, 2017. The bonds might be exchanged in advance of the transfer of the shares, except under certain circumstances where the company might opt to redeem the bonds in cash. Under "revaluation and other movements" it is included the payment of the coupon for that issuance amounting to 45 million euros in 2016.

In March 2015, in accordance with its maturity schedule, the Company cancelled the bonds issued in 2000. This movement is included as "Disposals" in the column of Non-convertible debentures and bonds of the 2015 chart of movements.

Maturities of the nominal amounts of debenture and bond issues at December 31, 2016 and 2015 are as follows:

**2016**

Millions of euros			Maturity						Subsequent years	TOTAL
Name	Interest rate	% interest rate	2017	2018	2019	2020	2021			
<b>DEBENTURES AND BONDS:</b>										
Bonds ex changeable inb Telecom Italia shares	FIXED	6.00%	750	-	-	-	-	-	750	
<b>Total issues</b>			<b>750</b>	<b>-</b>	<b>-</b>	<b>-</b>	<b>-</b>	<b>-</b>	<b>750</b>	

**2015**

Millions of euros			Maturity					Subsequent years	TOTAL
Name	Interest rate	% interest rate	2016	2017	2018	2019	2020		
<b>DEBENTURES AND BONDS:</b>									
Bonds ex changeable inb Telecom Italia shares	FIXED	6.00%	-	750	-	-	-	-	750
<b>Total issues</b>			<b>-</b>	<b>750</b>	<b>-</b>	<b>-</b>	<b>-</b>	<b>-</b>	<b>750</b>

13.2 At December 31, 2016, Telefónica, S.A. had a corporate promissory note program registered with the CNMV, with the following features:

Millions of euros Amount	Placement system	Nominal amount of the Promissory notes	Terms of the Promissory notes	Placement
500 million; can be increased to 2,000 million	Auctions	100,000 euros	30, 60, 90, 180, 365, 540 and 731 days	Competitive auctions
	Tailored	100,000 euros	Between 3 and 731 days	Specific transactions

At December 31, 2016 the outstanding balance on this promissory note program was 370 million euros (65 million euros in 2015).

13.3 The average interest rate during 2016 on debentures and bonds outstanding during the year was 6.01% (5.96% in 2015) and the average interest rate on corporate promissory notes was 0.045% (0.14% in 2015).

## Note 14. Interest-bearing debt and derivatives

14.1 The balances at December 31, 2016 and 2015 are as follows:

### December 31, 2016

#### Millions of euros

Item	Current	Non-current	Total
Loans with financial entities	1,635	4,427	6,062
Derivative financial liabilities (Note 16)	679	2,684	3,363
<b>Total</b>	<b>2,314</b>	<b>7,111</b>	<b>9,425</b>

### December 31, 2015

#### Millions of euros

Item	Current	Non-current	Total
Loans with financial entities	1,269	4,825	6,094
Derivative financial liabilities (Note 16)	274	2,847	3,121
<b>Total</b>	<b>1,543</b>	<b>7,672</b>	<b>9,215</b>



14.2 The nominal values of the main interest-bearing debts at December 31, 2016 and 2015 are as follows:

Description	Value Date	Maturity Date	Currency	Limit 12/31/16 (millions)	Balance (million of euros)
Structured Financing (*)	05/03/11	07/30/21	USD	200	190
Structured Financing (*)	02/22/13	01/31/23	USD	669	635
Structured Financing (*)	08/01/13	10/31/23	USD	532	505
Syndicated facility (1)	02/18/14	02/18/21	EUR	3,000	-
Bilateral	06/26/14	06/26/18	EUR	1,500	1,500
Syndicated facility (2)	02/19/15	02/19/22	EUR	2,500	550
Bilateral	06/30/15	06/30/20	EUR	200	200
Syndicated facility (3)	11/17/15	02/15/19	EUR	1,500	-
Structured Financing (*)	12/11/15	03/11/26	USD	737	324
Structured Financing (*)	12/11/15	03/11/26	EUR	492	240
Bilateral loan	02/23/16	02/23/19	EUR	100	100
Bilateral loan	02/23/16	02/23/21	EUR	100	100
Loan	03/08/16	03/08/21	EUR	300	300
Bilateral loan	10/24/16	03/19/19	EUR	300	300

(1) Extended for 12 additional months of the syndicated facility signed in February 2014.

(2) Extended for 12 additional months of the syndicated facility signed in February 2015.

(3) On November 15, 2016 an amendment was signed extending the maturity for 12 additional months of the syndicated facility and an early repayment of 1,500 million euros was made.

\* Facilities with amortization schedule.

Description	Value Date	Maturity Date	Currency	Limit 12/31/15 (millions)	Balance (million of euros)
Structured financing*	05/03/11	07/30/21	USD	247	226
Structured financing *	02/22/13	01/31/23	USD	786	722
Structured financing *	08/01/13	10/31/23	USD	618	447
Syndicated facility	02/18/14	02/18/19 <sup>(1)</sup>	EUR	3,000	700
Bilateral *	06/26/14	06/26/18 <sup>(2)</sup>	EUR	1,500	1,500
Syndicated facility	02/19/15	02/19/20 <sup>(3)</sup>	EUR	2,500	500
Bilateral	06/30/15	06/30/20	EUR	200	200
Syndicated facility	11/17/15	02/17/18	EUR	3,000	-
Structured financing *	12/11/15	03/11/26	USD	750	-
Structured financing *	12/11/15	03/11/26	EUR	500	-

\* Facilities with amortization schedule.

(1) The parties could mutually agree to extend the maturity to as late as 2021.

(2) On 06/25/15 an amendment was signed modifying the maturity date and including an amortization schedule. On 07/01/15 an early repayment for 500 million euros was made.

(3) The parties could mutually agree to extend the maturity to as late as 2022.

14.3 Maturities of balances at December 31, 2016 and 2015 are as follows:

#### December 31, 2016

Millions of euros Items	Maturity					Subsequent years	Closing balance
	2016	2017	2018	2019	2020		
Loans with financial entities	1,635	1,159	702	380	965	1,221	6,062
Derivative financial liabilities (Note 16)	679	298	348	1,003	515	519	3,363
<b>Total</b>	<b>2,314</b>	<b>1,457</b>	<b>1,050</b>	<b>1,383</b>	<b>1,480</b>	<b>1,740</b>	<b>9,425</b>

## December 31, 2015

Millions of euros Items	Maturity					Subsequent years	Closing balance
	2016	2016	2017	2018	2019		
Loans w with financial entities	1,269	174	1,596	1,065	872	1,118	6,094
Derivative financial liabilities (Note 16)	274	658	330	256	799	804	3,121
<b>Total</b>	<b>1,543</b>	<b>832</b>	<b>1,926</b>	<b>1,321</b>	<b>1,671</b>	<b>1,922</b>	<b>9,215</b>

14.4 Interest-bearing debt arranged or repaid in 2016 mainly includes the following:

Description	Limit 12/31/2016 (millions)	Currency	Outstanding balance 12/31/2016 (million euros)	Arrangement date	Maturity date	Drawdown 2016 (million euros)	Repayment 2016 (million euros)
<b>Telefónica, S.A.</b>							
Structured financing <sup>(*)</sup>	669	USD	635	02/22/13	01/31/23	-	(111)
Structured financing <sup>(*)</sup>	532	USD	505	08/01/13	10/31/23	124	(82)
Syndicated facility <sup>(1)</sup>	3,000	EUR	-	02/18/14	02/18/21	1,280	(1,980)
Syndicated facility <sup>(2)</sup>	2,500	EUR	550	02/19/15	02/19/22	300	(250)
Syndicated facility <sup>(3)</sup>	1,500	EUR	-	11/17/15	02/15/19	3,070	(3,070)
Structured financing <sup>(*)</sup>	737	USD	324	12/11/15	03/11/26	337	(12)
Structured financing <sup>(*)</sup>	492	EUR	240	12/11/15	03/11/26	248	(8)
Bilateral loan	100	EUR	100	02/23/16	02/23/19	100	-
Bilateral loan	100	EUR	100	02/23/16	02/23/21	100	-
Loan	300	EUR	300	03/08/16	03/08/21	300	-
Bilateral loan	300	EUR	300	10/24/16	03/19/19	300	-

(1) Extended for 12 additional months of the syndicated facility signed in February 2014.

(2) Extended for 12 additional months of the syndicated facility signed in February 2015.

(3) On November 15, 2016 an amendment was signed extending the maturity for 12 additional months of the syndicated facility and an early repayment of 1,500 million euros was made.

(\*) Facility with amortization schedule.

#### 14.5 Average interest on loans and borrowings

The average interest rate in 2016 on loans and borrowings denominated in euros was 0.566% and 2.066% for foreign-currency loans and receivables.

The average interest rate in 2015 on loans and borrowings denominated in euros was 0.557% and 2.099% for foreign-currency loans and receivables.

#### 14.6 Unused credit facilities

The balances of loans and borrowings relate only to amounts drawn down.

At December 31, 2016 and 2015, Telefónica had undrawn credit facilities amounting to 10,302 million euros and 11,705 million euros, respectively.

Financing arranged by Telefónica, S.A. at December 31, 2016 and 2015 is not subject to compliance with financial ratios (covenants).

## Note 15. Payable to group companies and associates

15.1 The breakdown at December 31, 2016 and 2015 is as follows:

### December 31, 2016

Millions of euros	Non-current	Current	Total
Loans	37,218	12,365	49,583
Trade payables to Group companies and associates	6	239	245
Derivatives (Note 16)	18	202	220
Payable to subsidiaries due to taxation on a consolidated basis	32	340	372
<b>Total</b>	<b>37,274</b>	<b>13,146</b>	<b>50,420</b>

### December 31, 2015

Millions of euros	Non-current	Current	Total
Loans	36,517	12,221	48,738
Trade payables to Group companies and associates	7	805	812
Derivatives (Note 16)	131	22	153
Payable to subsidiaries due to taxation on a consolidated basis	28	169	197
<b>Total</b>	<b>36,683</b>	<b>13,217</b>	<b>49,900</b>

The maturity of these loans at the 2016 and 2015 year ends is as follows:

#### December 31, 2016

Company (Millions of euros)	2017	2018	2019	2020	2021	2020 and subsequent years	Final balance, current and non-current
Telefónica Emisiones, S.A.U.	5,901	3,902	3,467	4,853	3,588	13,031	34,742
Telefónica Europe, B.V.	2,814	1,121	848	1,445	621	3,771	10,620
Telfisa Global, B.V.	3,577	-	-	-	-	-	3,577
Telefónica Participaciones, S.A.U.	73	-	-	-	571	-	644
<b>Total</b>	<b>12,365</b>	<b>5,023</b>	<b>4,315</b>	<b>6,298</b>	<b>4,780</b>	<b>16,802</b>	<b>49,583</b>

#### December 31, 2015

Company (Millions of euros)	2016	2017	2018	2019	2020	2019 and subsequent years	Final balance, current and non-current
Telefónica Emisiones, S.A.U.	7,369	5,283	3,998	3,443	3,704	13,140	36,937
Telefónica Europe, B.V.	1,683	-	1,119	850	1,558	3,350	8,560
Telfisa Global, B.V.	2,571	-	-	-	-	-	2,571
Telefónica Finanzas, S.A.U.	500	-	-	-	-	-	500
Telefónica Participaciones, S.A.U.	73	72	-	-	-	-	145
Others	25	-	-	-	-	-	25
<b>Total</b>	<b>12,221</b>	<b>5,355</b>	<b>5,117</b>	<b>4,293</b>	<b>5,262</b>	<b>16,490</b>	<b>48,738</b>

Financing raised by Telefónica, S.A. through its subsidiary Telefónica Europe, B.V. at December 31, 2016 amounting 10,620 million euros (8,560 million euros in 2015). This financing entails a number of loans paying market interest rates calculated on a Euribor plus spread basis, with an average interest rate in 2016 of 4.20% (5.01% in 2015). The main source of this financing was the funds obtained through the issuance of undated deeply subordinated reset rate guaranteed securities amounting 6,052 million euros (5,167 million euros in 2015), bonds and debentures amounting 1,686 million euros (1,648 million euros in 2015) and commercial paper amounting 2,630 million euros (1,431 million euros in 2015).

Financing raised by Telefónica, S.A. through Telefónica Emisiones, S.A.U. at December 31, 2016 was 34,742 million euros (36,937 million euros in 2015). This financing is arranged as loans from these companies on the same terms as those of the issuance programs. The average interest rate in 2016 was 4.26% (4.63% in 2015). The financing arranged includes, as a related cost, the fees or premiums taken to the income statement for the period corresponding to the financing based on the corresponding effective interest rates. Telefónica Emisiones, S.A.U. raised financing in 2016 mainly by tapping the European capital markets, issuing bonds totaling 4,900 million euros (1,467 million euros in 2015).

The characteristics of the main bonds issued during 2016 are the following:

Description	Issue date	Maturity date	Amount in millions (nominal)	Currency of issue	Amount in millions of euros (nominal)	Coupon
<b>Telefónica Emisiones, S.A.U.</b>						
EMTN bonds	04/13/16	04/13/22	1,400	EUR	1,400	0.75%
	04/13/16	04/13/26	1,350	EUR	1,350	1.46%
	10/17/16	10/17/20	1,250	EUR	1,250	0.318%
	10/17/16	10/17/31	750	EUR	750	1.93%
	12/28/16	12/28/51	150	EUR	150	4.00%
<b>Telefónica Participaciones, S.A.U.</b>						
Cash-settled equity -link bonds non-dilutive (*)	03/09/16	03/09/21	600	EUR	600	0%

(\*) Based on the quotation of Telefónica, S.A. shares

Part of the amount owed by Telefónica, S.A. to Telefónica Emisiones, S.A.U. and to Telefónica Europe, B.V. includes restatements to amortized cost at December 31, 2016 and 2015 as a result of fair value interest rate and exchange rate hedges.

Telfisa Global, B.V. centralizes and handles cash management and flows for the Telefónica Group in Latin America, the United States, Europe and Spain since 2016. The balance payable to this subsidiary is formalized through several Deposit Agreements accruing interest at market rates and amounting to 3,577 million euros in 2016 (2,571 million euros in 2015).

Financing raised by Telefónica, S.A. through Telefónica Finanzas, S.A.U. was 500 million euros during 2015. In 2016, it has been transferred to Telfisa Global, B.V. in charge of the integrated cash management of the companies comprising the Telefónica Group.

Financing raised by Telefónica, S.A. through Telefónica Participaciones, S.A.U. at December 31, 2016 totals 644 million euros (145 million euros in 2015). This financing of 2016 corresponds to these two concepts:

- A loan with a principal of 600 million euros at an annual interest rate of 0.25%; which funds are a result of the issuance of non-dilutive convertible bonds carried out by Telefónica Participaciones, S.A.U., guaranteed by Telefónica, S.A. at March 9, 2016. These bonds are benchmarked against the value of Telefónica S.A. shares, with an aggregate nominal amount of 600 million euros, an issue price of 101.25% and 5-year maturity.
- The actual value of the interests from a bond issuance launched on September 24, 2014 by Telefónica, S.A. and fully subscribed by Telefónica Participaciones, S.A.U., 3-year maturity and an annual coupon of 4.90%. The nominal amount of the bonds necessarily convertible into treasury shares, amounting to 1,500 million euros, has been booked as "Other equity instruments".

**15.2** The balance of "Payable to subsidiaries due to taxation on a consolidated basis" was 372 million euros and 197 million euros at December 31, 2016 and 2015, respectively. This basically includes payables to Group companies for their contribution of taxable income (tax losses) to the tax group headed by Telefónica, S.A. (see Note 17). The current- or non-current classification is based on the Company's projection of maturities.

The main amounts here correspond to Telefónica Latinoamérica Holding, S.L. (the acquiring company from the merger with Telefónica Internacional, S.A.U. carried out on the accounting date of January 1, 2016) for 228 million euros (84 million in 2015), Telefónica Digital España, S.A.U. for 26 million euros (38 million in 2015), Latin American Cellular Holdings, S.L. for 49 million euros in 2016 (which had no significant amount relating to it in 2015).

## Note 16. Derivative financial instruments and risk management policies

### a) Derivative financial instruments

During 2016, the Group continued to use derivatives to limit interest and exchange rate risk on otherwise unhedged positions, and to adapt its debt structure to market conditions.

At December 31, 2016, the total outstanding balance of derivatives transactions was 126,938 million euros (144,823 million euros in 2015), of which 105,303 million euros related to interest rate risk and 21,635 million euros to foreign currency risk. In 2015, 112,276 million euros related to interest rate risk and 32,547 million euros to foreign currency risk.

It should be noted that at December 31, 2016, Telefónica, S.A. had transactions with financial institutions to hedge exchange rate risk for other Telefónica Group companies amounting to 1,739 million euros (2,618 million euros in 2015). At year-end 2016 and 2015, the Company had no transactions to hedge interest rate risk for other Group companies. These external trades are matched by intra-group hedges with identical terms and maturities between Telefónica, S.A. and Group companies, and therefore involve no risk for the Company. External derivatives not backed by identical intragroup transactions consist of hedges on net investment and future acquisitions that, by their nature, cannot be transferred to Group companies and/or transactions to hedge financing raised by Telefónica, S.A. as parent company of the Telefónica Group, which are transferred to Group subsidiaries in the form of financing rather than via derivative transactions.

The breakdown of Telefónica, S.A.'s interest rate and exchange rate derivatives at December 31, 2016, their notional amounts at year end and the expected maturity schedule is as follows:

2016

Millions of euros Type of risk	Value in Euros	Telefónica receives		Telefónica pays	
		Carrying	Currency	Carrying	Currency
<b>Euro interest rate swaps</b>	<b>79,252</b>				
Fixed to fixed	265	265	EUR	265	EUR
Fixed to floating	44,866	44,899	EUR	44,866	EUR
Floating to fixed	34,121	34,121	EUR	34,121	EUR
<b>Foreign currency interest rate swaps</b>	<b>23,939</b>				
Fixed to floating					
CHFCHF	582	625	CHF	625	CHF
CZKCZK	194	5,250	CZK	5,250	CZK
GBPGBP	4,203	3,595	GBP	3,595	GBP
JPYJPY	81	10,000	JPY	10,000	JPY
USDUSD	15,469	16,304	USD	16,304	USD
Floating to fixed					
CZKCZK	46	1,250	CZK	1,250	CZK
GBPGBP	1,391	1,190	GBP	1,190	GBP
USDUSD	1,973	2,079	USD	2,079	USD
<b>Exchange rate swaps</b>	<b>11,836</b>				
Fixed to fixed					
EURBRL	159	163	EUR	546	BRL
Fixed to floating					
JPYEUR	95	15,000	JPY	95	EUR
Floating to floating					
CHFEUR	515	625	CHF	515	EUR
GBPEUR	2,048	1,600	GBP	2,048	EUR
JPYEUR	101	10,000	JPY	101	EUR
USDEUR	8,918	11,417	USD	8,918	EUR
<b>Forwards</b>	<b>7,526</b>				
BRLEUR	56	203	BRL	(56)	EUR
CLPEUR	1	840	CLP	(1)	EUR
CZKEUR	47	1,250	CZK	(46)	EUR
EURBRL	573	573	EUR	(1,969)	BRL
EURCLP	208	208	EUR	(146,800)	CLP
EURGBP	2,614	2,614	EUR	(2,236)	GBP
EURMXN	1	1	EUR	(21)	MXN
EURUSD	1,849	1,849	EUR	(1,949)	USD
GBPEUR	1,011	860	GBP	(1,011)	EUR
GBPUSD	3	3	GBP	(3)	USD
USDBRL	22	22	USD	(76)	BRL
USDCLP	4	4	USD	(2,824)	CLP
USDCOP	3	4	USD	(10,691)	COP
USDGBP	19	21	USD	(17)	GBP
USDPEN	2	2	USD	(8)	PEN
<b>Swaption</b>	<b>435</b>				
Fixed to floating					
EUREUR	205	205	EUR	205	EUR

Floating to fixed					
EUREUR	230	230	EUR	230	EUR
<b>Subtotal</b>	<b>122,988</b>				

Millions of euros

Notional amounts of structured products with options

	Value in euros	Notional	Currency
<b>Interest rate options Caps &amp; Floors</b>	<b>1,677</b>		
<b>Caps&amp;Floors</b>	<b>1,677</b>		
GBP	877	750	GBP
EUR	800	800	EUR
<b>Currency options</b>	<b>2,273</b>		
USDEUR	1,558	1,558	EUR
EURUSD	715	715	EUR
<b>Subtotal</b>	<b>3,950</b>		
<b>TOTAL</b>	<b>126,938</b>		

The breakdown by average maturity is as follows:

Millions of euros

Hedged underlying item	Notional	Up to 1 year	From 1 to 3 years	From 3 to 5 years	Over 5 years
<b>With underlying instrument</b>					
<b>Promissory notes</b>	<b>1,460</b>	<b>160</b>	<b>50</b>	<b>1,250</b>	<b>-</b>
<b>Pension Plan</b>	<b>5,160</b>	<b>375</b>	<b>1,155</b>	<b>955</b>	<b>2,675</b>
<b>Loans</b>	<b>30,939</b>	<b>3,024</b>	<b>8,761</b>	<b>7,477</b>	<b>11,677</b>
in national currency	20,310	1,625	5,400	5,360	7,925
in foreign currencies	10,629	1,399	3,361	2,117	3,752
<b>Debentures and bonds MtM</b>	<b>59,074</b>	<b>10,363</b>	<b>14,298</b>	<b>26,531</b>	<b>7,882</b>
in national currency	26,800	8,550	7,750	9,000	1,500
in foreign currencies	32,274	1,813	6,548	17,531	6,382
<b>Other underlying*</b>	<b>30,305</b>	<b>16,255</b>	<b>5,467</b>	<b>3,265</b>	<b>5,318</b>
CCS	1,237	910	77	250	-
Currency options	2,470	2,470	-	-	-
Forward	6,721	6,721	-	-	-
IRS	19,877	6,154	5,390	3,015	5,318
<b>Total</b>	<b>126,938</b>	<b>30,177</b>	<b>29,731</b>	<b>39,478</b>	<b>27,552</b>

(\*) Most of these transactions are related to economic hedges of investments, assets and liabilities of subsidiaries



The breakdown of Telefónica, S.A.'s derivatives in 2015, their notional amounts at year end and the expected maturity schedule is as follows:

## 2015

Millions of euros Type of risk	Value in Euros	Telefónica receives		Telefónica pays	
		Carrying	Currency	Carrying	Currency
<b>Euro interest rate swaps</b>	<b>79,718</b>				
Fixed to fixed	65	65	EUR	65	EUR
Fixed to floating	44,199	44,199	EUR	44,199	EUR
Floating to fixed	35,454	35,454	EUR	35,454	EUR
<b>Foreign currency interest rate swaps</b>	<b>30,273</b>				
Fixed to floating					
CHFCHF	577	625	CHF	625	CHF
CZKCZK	429	11,600	CZK	11,600	CZK
GBPGBP	5,212	3,825	GBP	3,825	GBP
JPYJPY	130	17,000	JPY	17,000	JPY
USDUSD	19,403	21,124	USD	21,124	USD
Floating to fixed					
CZKCZK	46	1,250	CZK	1,250	CZK
GBPGBP	2,510	1,843	GBP	1,843	GBP
USDUSD	1,966	2,141	USD	2,141	USD
<b>Exchange rate swaps</b>	<b>16,303</b>				
Fixed to fixed					
BRLEUR	96	313	BRL	96	EUR
EURBRL	516	516	EUR	2,193	BRL
EURCZK	361	361	EUR	9,759	CZK
Fixed to floating					
JPY/EUR	95	15,000	JPY	95	EUR
Floating to floating					
CHFEUR	515	625	CHF	515	EUR
EURGBP	551	551	EUR	405	CZK
GBPEUR	1,721	1,350	EUR	1,721	GBP
JPYEUR	167	17,000	GBP	167	EUR
USDEUR	12,281	15,858	JPY	12,281	EUR
<b>Forwards</b>	<b>13,428</b>				
BRLEUR	107	412	BRL	107	EUR
CLPEUR	1	990	CLP	1	EUR
EURBRL	230	230	EUR	5	BRL
EURCLP	49	49	EUR	37,800	CLP
EURGBP	5,697	5,697	EUR	4,181	GBP
EURMXN	1	1	EUR	13	MXN
EURUSD	4,129	4,129	EUR	4,495	USD
GBPEUR	1,554	1,140	GBP	1,554	EUR
USDBRL	16	18	USD	70	BRL
USDCLP	4	4	USD	2,757	CLP
USDCOP	1	1	USD	4,402	COP
USDEUR	1,178	1,273	USD	1,178	EUR
USDGBP	51	58	USD	38	GBP
USDPEN	2	2	USD	7	PEN

CZKEUR	408	11,009	CZK	408	EUR
<b>Spot</b>	<b>2</b>				
EURGBP	2	2	EUR	1	GBP
USDGBP	-	1	USD	-	GBP
<b>Subtotal</b>	<b>139,724</b>				

Millions of euros

## Notional amounts of structured products with options

	Value in Euros	Notional	Currency
<b>Interest rate options Caps &amp; Floors</b>	<b>2,285</b>		
<b>Caps&amp;Floors</b>	<b>2,285</b>		
USD	13	14	USD
EUR	1,250	1,250	EUR
GBP	1,022	750	GBP
<b>Currency options</b>	<b>2,814</b>		
GBPEUR	714	714	EUR
EUR	1,558	1,696	USD
USDEUR	542	542	EUR
<b>Subtotal</b>	<b>5,099</b>		
<b>TOTAL</b>	<b>144,823</b>		

The breakdown by average maturity is as follows:

Millions of euros

Hedged underlying item	Notional	Up to 1 year	From 1 to 3 years	From 3 to 5 years	Over 5 years
<b>With underlying instrument</b>					
<b>Promissory notes</b>	<b>261</b>	<b>-</b>	<b>61</b>	<b>200</b>	<b>-</b>
<b>Loans</b>	<b>33,533</b>	<b>3,309</b>	<b>9,297</b>	<b>8,528</b>	<b>12,399</b>
in national currency	22,035	1,775	5,100	6,900	8,260
in foreign currencies	11,498	1,534	4,197	1,628	4,139
<b>Debentures and bonds MtM</b>	<b>76,601</b>	<b>17,275</b>	<b>18,333</b>	<b>20,973</b>	<b>20,020</b>
in national currency	30,445	3,045	12,650	12,050	2,700
in foreign currencies	46,156	14,230	5,683	8,923	17,320
<b>Without underlying*</b>	<b>34,428</b>	<b>15,389</b>	<b>10,401</b>	<b>2,710</b>	<b>5,928</b>
CCS	9,086	9,086	-	-	-
Currency options	2,323	1,853	438	32	-
Forward	2,990	718	2,272	-	-
IRS	20,029	3,732	7,691	2,678	5,928
<b>Total</b>	<b>144,823</b>	<b>35,973</b>	<b>38,092</b>	<b>32,411</b>	<b>38,347</b>

(\*) Most of these transactions are related to economic hedges of investments, assets and liabilities of subsidiaries

The debentures and bonds hedged relate to both those issued by Telefónica, S.A. and intragroup loans on the same terms as the issues of Telefónica Europe, B.V. and Telefónica Emisiones, S.A.U.

The fair value of Telefónica, S.A. derivatives portfolio with external counterparties at December 31, 2016 was equivalent to a net asset of 2,956 million euros (net asset of 3,513 million euros in 2015).

**b) Risk management policy**

Telefónica, S.A. is exposed to various financial market risks as a result of: (i) its ordinary business activity, (ii) debt incurred to finance its business, (iii) its investments in companies, and (iv) other financial instruments related to the above commitments.

The main market risks affecting Telefónica are as follows:

*Exchange rate risk*

Foreign currency risk primarily arises in connection with: (i) Telefónica's international presence, through its investments and businesses in countries that use currencies other than the euro (primarily in Latin America and in the United Kingdom), and (ii) debt denominated in currencies other than that of the country where the business is conducted or the home country of the company incurring such debt.

*Interest rate risk*

Interest rate risk arises primarily in connection with changes in interest rates affecting (i) financial expenses on floating rate debt (or short-term debt likely to be renewed), due to changes in interest rates and (ii) the value of non-current liabilities at fixed interest rates.

*Share price risk*

Share price risk arises primarily from changes in the value of the equity investments (that may be bought, sold or otherwise involved in transactions), from changes in the value of derivatives associated with such investments, from changes in the value of treasury shares and from equity derivatives.

*Other risks*

Telefónica, S.A. is also exposed to liquidity risk if a mismatch arises between its financing needs (operating and financial expense, investment, debt redemptions and dividend commitments) and its sources of finance (revenues, divestments, credit lines from financial institutions and capital market operations). The cost of finance could also be affected by movements in the credit spreads (over benchmark rates) demanded by lenders.

Credit risk appears when a counterpart fails to meet or delays its payment obligations in accordance with the agreed terms, driving an impairment in an asset due to: (i) solvency issues, or (ii) no intention to pay.

Finally, Telefónica is exposed to country risk (which overlaps with market and liquidity risks). This refers to the possible decline in the value of assets, cash flows generated or cash flows returned to the parent company as a result of political, economic or social instability in the countries where Telefónica, S.A. operates, especially in Latin America.

**Risk management**

Telefónica, S.A. actively manages these risks through the use of derivatives (primarily on exchange rates, interest rates and share prices) and by incurring debt in local currencies, where appropriate, with a view to optimize the financial cost and to stabilizing cash flows, the income statement and investments. In this way, Telefónica attempts to protect its solvency, facilitate financial planning and take advantage of investment opportunities.

Telefónica manages its exchange rate risk and interest rate risk in terms of net debt and net financial debt as calculated by them. Telefónica believes that these parameters are more appropriate to understanding its debt position. Net debt and net financial debt take into account the impact of the Group's cash balance and cash equivalents including derivatives positions with a positive value linked to liabilities. Neither net debt nor net financial debt as calculated by Telefónica should be considered an alternative to gross financial debt (the sum of current and non-current interest-bearing debt) as a measure of leverage.

*Exchange rate risk*

The fundamental objective of the exchange rate risk management policy is that, in event of depreciation in foreign currencies relative to the euro, any potential losses in the value of the cash flows generated by the businesses in such currencies, caused by depreciation in exchange rates of a foreign currency relative to the euro, are offset (to some extent) by savings from the reduction in the euro value of debt denominated in such currencies and/or synthetic debt in such

currencies. This objective is also reflected on the decrease of the sensitivity to exchange rate variations of the net debt to operating income before depreciation and amortization (OIBDA) ratio, in order to protect the Group solvency. The degree of exchange rate hedging employed varies depending on the type of investment. For transactions of purchase or sale of business in currencies other than euro, additional hedges can be made on the estimate prices of the transactions or on estimated cash flows and OIBDA.

Telefónica occasionally takes out dollar-denominated debt to hedge the euro-dollar intermediate component in the relation Euro-Latin American currencies, either in Spain (where such debt is associated with an investment as long as it is considered to be an effective hedge) or in the country itself, where the market for local currency financing or hedges may be inadequate or non-existent.

At December 31, 2016, the debt in pounds sterling was approximately 1.85 times the value of the business' OIBDA in 2016 for Group companies in the United Kingdom, which is in line with the target of twice that of previous years. At December 31, 2016, the debt denominated in pounds sterling was equivalent to 3,000 million euros, which is less than the 6,227 million euros at December 31, 2015, as a result of the hedging policy in force at the end of 2015, linked to the sale of the subsidiary O2 in the United Kingdom, which in the end was not approved by the European regulator in 2016.

Telefónica also manages its exchange rate risk, seeking to significantly reduce the negative impact of any currency exposure on the income statement, both from transactions recognized on the balance sheet and those classified as highly probable, regardless of whether or not open positions are held. Such open position exposure can arise for any of three reasons: (i) a thin market for local derivatives or difficulty in obtaining funding in the local currency, making it impossible to arrange a low-cost hedge (as in Argentina and Venezuela); financing through intra-group loans, where the accounting treatment of exchange rate risk is different from that for funding through capital contributions, and (iii) as the result of a deliberate policy decision, to avoid the high cost of hedges that are not warranted by expectations or high depreciation risks.

The main transactions that generate or may generate exchange rate risk (regardless of whether or not they have an impact on the income statement) are, among others, as follows: issues in currencies other than the euro, which is Telefónica S.A.'s functional currency, highly probable transactions in other currencies, future cash inflows in other currencies, investments and divestments, provisions for collections or payments in foreign currency, the actual value of the investments (subsidiaries) in currencies other than the euro.

#### *Interest rate risk*

The Telefónica Group's financial expenses are exposed to changes in interest rates. In 2016, the rates applied to the largest amount of short-term debt were mainly based on the Euribor, the dollar Libor and the pound sterling Libor. Telefónica manages its interest rate risk by entering into derivative financial instruments, primarily swaps and interest rate options.

Telefónica analyzes its exposure to changes in interest rates at the Telefónica Group level. The table illustrates the sensitivity of finance costs and the balance sheet to variability in interest rates at Group and Telefónica, S.A. level.

To calculate the sensitivity of the income statement, a 100 basis point rise in interest rates in all currencies in which there are financial positions at December 31, 2016 has been assumed, as well as a 100 basis point decrease in all currencies (EUR, GBP, USD, etc.) in order to avoid negative rates. The constant position equivalent to that prevailing at the end of the year has also been assumed.

To calculate the sensitivity of equity to variability in interest rates, a 100 basis point increase in interest rates in all currencies and terms in which there are financial positions at December 31, 2016 was assumed, as well as a 100 basis point decrease in all currencies and terms. Cash flow hedge positions were also considered as they are the only positions where changes in market value due to interest-rate fluctuations are recognized in equity.

In both cases, only transactions with external counterparties have been considered.

	Impact on Consolidated net income	Impact on P/L Telefónica, S.A.	Impact on Consolidated Equity	Impact on Telefónica, S.A. Equity
+100bp	(232)	(136)	138	173
-100bp	201	94	(135)	(174)

### Share price risk

The Telefónica Group is exposed to changes in the value of equity investments from changes in the value of derivatives associated with such investments, from convertible or exchangeable instruments issued by Telefónica Group, from Share-based payments plans, from treasury shares and from equity derivatives over treasury shares.

According to the Share-based payments plans (see Note 19) the shares to be delivered to employees under such plan may be either the parent company treasury shares, acquired by them or any of its Group companies; or newly-issued shares. The possibility of delivering shares to beneficiaries of the plan in the future, implies a risk since there could be an obligation to hand over a maximum number of shares at the end of each phase, whose acquisition (in the event of acquisition in the market) in the future could imply a higher cash outflow than required on the start date of each phase if the share price is above the corresponding price on the phase start date. In the event that new shares are issued for delivery to the beneficiaries of the plan, there would be a dilutive effect for ordinary shareholders of Telefónica as a result of the higher number of shares delivered under such plan outstanding.

During 2014 and 2015, they were launched two new cycles of the long-term incentive Plan consisting of the delivery of shares of Telefónica, S.A. aimed at members of the Executives of Telefónica Group denominated Performance Share Plan (PIP). The third and last cycle of this Plan, initially scheduled for 2016, was cancelled (see Note 19).

To reduce the risk associated with variations in share price under these plans, Telefónica could acquire instruments that hedge the risk profile of some of these plans.

In addition, the Group may use part of the treasury shares of Telefónica, S.A. held at December 31, 2016 to cover shares deliverable under the PIP or the Global Employee Share Plan. The net asset value of the treasury shares could increase or decrease depending on variations in Telefónica, S.A.'s share price.

### Liquidity risk

The Telefónica Group seeks to match the schedule for its debt maturity payments to its capacity to generate cash flows to meet these maturities, while allowing for some flexibility. In practice, this has been translated into two key principles:

1. The Telefónica Group's average maturity of net financial debt is intended to stay above 6 years, or be restored above that threshold in a reasonable period of time if it eventually falls below it. This principle is considered as a guideline when managing debt and access to credit markets, but not a rigid requirement. When calculating the average maturity for the net financial debt and part of the undrawn credit lines can be considered as offsetting the shorter debt maturities, and extension options on some financing facilities may be considered as exercised, for calculation purposes.
2. The Telefónica Group must be able to pay all commitments over the next 12 months without accessing new borrowing or tapping the capital markets (drawing upon firm credit lines arranged with banks), assuming budget projections are met.

### Country risk

The Telefónica Group managed or mitigated country risk by pursuing two lines of action (in addition to its normal business practices):

1. Partly matching assets to liabilities (those not guaranteed by the parent company) in the Telefónica Group's Latin American companies such that any potential asset impairment would be accompanied by a reduction in liabilities; and,
2. Repatriating funds generated in Latin America that are not required for the pursuit of new, profitable business development opportunities in the region.

### Credit risk

The Telefónica Group trades in derivatives with creditworthy counterparties. Therefore, Telefónica, S.A. generally trades with credit entities whose "senior debt" ratings are of at least "A-" or in case of Spanish entities in line with the credit rating

of Kingdom of Spain. In Spain, where most of the Group's derivatives portfolio is held, there are netting agreements with financial institutions, with debtor or creditor positions offset in case of bankruptcy, limiting the risk to the net position; however, the entity has decided not to present the netting on its balance sheet. In addition, the CDS (Credit Default Swap) of all the counterparties with which Telefónica, S.A. operates is monitored at all times in order to assess the maximum allowable CDS for operating at any given time. Transactions are generally only carried out with counterparties whose CDS is below the threshold.

CVA or Credit Valuation Adjustment is the method used to measure credit risk for both counterparties and Telefónica in order to determine the fair value of the derivatives portfolio. This adjustment reflects the probability of default or the deterioration of the credit quality of both Telefónica and its counterparties. The simplified formula to calculate CVA is Expected Exposure times Probability of Default times Loss Given Default. In order to calculate these variables standard market practices are used.

When managing credit risk, Telefónica considers the use of CDS, novations, derivatives with Break Clauses and signing CSA's under certain conditions.

For other subsidiaries, particularly those in Latin America, assuming a stable sovereign rating provides a ceiling which is below "A", trades are with local financial entities whose rating by local standards is considered to be of high creditworthiness.

Meanwhile, with credit risk arising from cash and cash equivalents, the Telefónica Group places its cash surpluses in high quality and highly liquid money-market assets. These placements are regulated by a general framework, revised annually. Counterparties are chosen according to criteria of liquidity, solvency and diversification based on the conditions of the market and countries where the Group operates. The general framework sets: the maximum amounts to be invested by counterparty based on its rating (long-term debt rating); and the instruments in which the surpluses may be invested (money-market instruments).

The Telefónica Group considers credit risk management as a key element to achieve its business and customer base growth targets in a manner that is both sustainable and consistent with Telefónica Corporate Risk Management Policy. This management approach relies on the active monitoring of the risk-reward balance within the commercial operations and on the adequate separation between the risk ownership and risk management functions.

Formal delegation of authority procedures and management practices are implemented in all Group companies, taking into account benchmark risk management techniques but adapted to the local characteristics of each market. Debtors that may cause a relevant impact on the Telefónica Group consolidated financial statements and increased risk profile products – due to customer target, term, channels or other commercial characteristics - are subject to specific management practices in order to mitigate the exposure to credit risk.

This commercial credit risk management model is embedded in the day-to-day operational processes, where the credit risk assessment guides both the product and services available for the different customers and the collection strategy.

Telefónica's maximum exposure to credit risk is initially represented by the carrying amounts of the assets (see Notes 8 and 9) and the guarantees given by Telefónica.

#### *Capital management*

Telefónica's corporate finance department takes into consideration several factors for the evaluation of the Telefónica's capital structure, with the aim of maintaining the solvency and creating value to the shareholders.

The corporate finance department estimates the cost of capital on a continuous basis through the monitoring of the financial markets and the application of standard industry approaches for calculating weighted average cost of capital, or WACC, so that it can be applied in the valuation of businesses in course and in the evaluation of investment projects. Telefónica also uses as reference a net financial debt (excluding items of a non-recurring or exceptional nature) that allows for a comfortable investment grade credit rating as assigned by credit rating agencies, aiming at protecting credit solvency and making it compatible with alternative uses of cash flow that could arise at any time.

These general principles are refined by other considerations and the application of specific variables, such as country risk in the broadest sense, or the volatility in cash flow generation that are considered, when evaluating the financial structure of the Telefónica Group and its different areas.

### *Derivatives Policy*

Telefónica's derivatives policy emphasizes the following points:

- Derivatives based on a clearly identified underlying.
- Matching of the underlying to one side of the derivative.
- Matching the company contracting the derivative and the company that owns the underlying.
- Ability to measure the derivative's fair value using the valuation systems available to the Telefónica Group.
- Sale of options only when there is an underlying exposure.

### *Hedge accounting*

Hedges can be of three types:

- Fair value hedges
- Cash flow hedges, which can be set at any value of the risk to be hedged (primarily interest rate and foreign currency) or for a defined range through options.
- Hedges of net investment in a foreign operation.

Hedges can comprise a combination of different derivatives. There is no reason to suppose management of accounting hedges will be static, with an unchanging hedging relationship lasting right through to maturity. Hedging relationships may change to allow appropriate management that serves our stated principles of stabilizing cash flows, stabilizing net financial income/expense and protecting our share capital. The designation of hedges may therefore be cancelled, before maturity, because of a change in the underlying, a change in perceived risk on the underlying or a change in market view. Derivatives included in these hedges may be reassigned to new hedges where they meet the effectiveness test and the new hedge is well documented. To gauge the efficiency of transactions defined as accounting hedges, we analyze the extent to which the changes in the fair value or in the cash flows attributable to the hedged item would offset the changes in fair value or cash flows attributable to the hedged risk using a linear regression model for both forward- and backward-looking analysis.

Risk management guidelines are issued by the Corporate Finance Department. This department may allow exceptions to this policy where these can be justified, normally when the market is too thin for the volume of transactions required or on clearly limited and small risks.

In 2016 the Company recognized a profit of 1.19 million euros for the ineffective part of cash flow hedges (a loss of 63 million euros in 2015).

The fair value of Telefónica, S.A. derivatives with third parties amounted to a positive MTM (accounts receivable) of 2,956 million euros in 2016 (3,513 million euros in 2015).

The fair value of Telefónica, S.A. intragroup derivatives amounted to a negative MTM (accounts payable) of -190 million euros in 2016 (-113 million euros in 2015).

The breakdown of the Company's derivatives with counterparties not belonging to the Telefónica Group at December 31, 2016 and 2015 by type of hedge, their fair value at year end and the expected maturity schedule is as follows:

## 2016

Millions of euros	Fair value (**)	Notional amount maturities (*)				
		2017	2018	2019	Subsequent years	Total
<b>Derivatives</b>						
<b>Interest rate hedges</b>	<b>(229)</b>	<b>(334)</b>	<b>(396)</b>	<b>(667)</b>	<b>383</b>	<b>(1,014)</b>
Cash flow hedges	323	(240)	150	(500)	2,950	2,360
Fair value hedges	(552)	(94)	(546)	(167)	(2,567)	(3,374)
<b>Exchange rate hedges</b>	<b>(1,094)</b>	<b>(955)</b>	<b>1,137</b>	<b>323</b>	<b>2,760</b>	<b>3,265</b>
Cash flow hedges	(1,063)	834	1,170	359	2,760	5,123
Fair value hedges	(31)	(1,789)	(33)	(36)	-	(1,858)
<b>Interest and exchange rate hedges</b>	<b>(1,507)</b>	<b>111</b>	<b>367</b>	<b>1,187</b>	<b>4,527</b>	<b>6,192</b>
Cash flow hedges	(1,507)	111	367	1,187	4,527	6,192
Fair value hedges	-	-	-	-	-	-
<b>Net investment Hedges</b>	<b>-</b>	<b>-</b>	<b>-</b>	<b>-</b>	<b>-</b>	<b>-</b>
<b>Other derivatives</b>	<b>(126)</b>	<b>1,819</b>	<b>(331)</b>	<b>(437)</b>	<b>(3,052)</b>	<b>(2,001)</b>
Interest rate	(5)	1,232	(471)	(456)	(3,168)	(2,863)
Exchange rate	(84)	-	140	19	116	275
Other	(37)	587	-	-	-	587

(\*) For interest rate hedges, the positive amount is in terms of fixed "payment." For foreign currency hedges, a positive amount means payment in functional v.s. foreign currency.

(\*\*) Positive amounts indicate payables.

## 2015

Millions of euros	Fair value (**)	Notional amount maturities (*)				
		2016	2017	2018	Subsequent years	Total
<b>Derivatives</b>						
<b>Interest rate hedges</b>	<b>(650)</b>	<b>1,360</b>	<b>210</b>	<b>(363)</b>	<b>(2,521)</b>	<b>(1,314)</b>
Cash flow hedges	427	(75)	460	250	2,100	2,735
Fair value hedges	(1,077)	1,435	(250)	(613)	(4,621)	(4,049)
<b>Exchange rate hedges</b>	<b>(1,429)</b>	<b>(3,948)</b>	<b>891</b>	<b>1,170</b>	<b>2,936</b>	<b>1,049</b>
Cash flow hedges	(1,429)	(3,948)	891	1,170	2,936	1,049
Fair value hedges	-	-	-	-	-	-
<b>Interest and exchange rate hedges</b>	<b>(1,100)</b>	<b>355</b>	<b>111</b>	<b>367</b>	<b>5,387</b>	<b>6,220</b>
Cash flow hedges	(1,100)	355	111	367	5,387	6,220
<b>Net investment Hedges</b>	<b>-</b>	<b>-</b>	<b>-</b>	<b>-</b>	<b>-</b>	<b>-</b>
<b>Other derivatives</b>	<b>(334)</b>	<b>(2,738)</b>	<b>(187)</b>	<b>(312)</b>	<b>(1,562)</b>	<b>(4,799)</b>
Interest rate	(85)	(1,882)	(289)	(399)	(1,526)	(4,096)
Exchange rate	(527)	(1,264)	(201)	87	(36)	(1,414)
Other	278	408	303	-	-	711

(\*) For interest rate hedges, the positive amount is in terms of fixed "payment." For foreign currency hedges, a positive amount means payment in functional v.s. foreign currency.

(\*\*) Positive amounts indicate payables.



## Note 17. Income tax

Pursuant to a Ministerial Order dated December 27, 1989, since 1990 Telefónica, S.A. has filed consolidated tax returns with certain Group companies. The consolidated tax group in 2016 and 2015 comprised 58 and 52 companies, respectively.

Consolidated tax group is valid during an indefinite period as long as the law requirements are fulfilled, or the Company decides to expressly resign to it.

Tax balances as of December 31, 2016 and 2015 are as follows:

Millions of euros	2016	2015
<b>Tax receivables:</b>	<b>3,144</b>	<b>6,439</b>
<b>Deferred tax assets:</b>	<b>2,963</b>	<b>6,153</b>
Deferred income tax (income)	479	3,444
Long-term tax credits for loss carryforwards	1,174	2,077
Unused tax deductions	1,310	632
<b>Current tax receivables (Note 10):</b>	<b>181</b>	<b>286</b>
Withholdings	14	36
Corporate income tax payable	152	229
VAT and Canary Islands general indirect tax refundable	15	21
<b>Tax payable:</b>	<b>645</b>	<b>172</b>
<b>Deferred tax liabilities:</b>	<b>571</b>	<b>88</b>
<b>Current payables to public administrations (Note 18):</b>	<b>74</b>	<b>84</b>
Personnel income tax withholdings	6	4
Corporate income tax payable	-	12
Withholding on investment income, VAT and other	66	67
Social security	2	1

Telefónica, S.A. has tax credits for loss carryforwards, unused by Tax Group in Spain at December 31, 2016 amounting to 8,391 million euros (gross):

2016/12/31	Total carryforwards	Less than 1 year	More than 1 year	Total recognized
Tax Group tax credits for loss carryforwards	<b>8,140</b>	403	7,737	<b>4,696</b>
Prior to Tax Group loss carryforwards (*)	<b>251</b>	-	251	-

(\*) Unused tax credits for loss carryforwards

Total tax credits based on the taxable income recognized in the balance sheet at December 31, 2016 therefore amount to 1,174 million euros (2,077 million euros in 2015).

During 2016, Telefónica, S.A., as head of the Telefónica tax group, made payments on account of income tax amounting to 150 million euros (47 million euros in 2015).

### 17.1 Movement in deferred tax assets and liabilities

The balances and movements in "Deferred tax assets" and "Deferred tax liabilities" for Telefónica, S.A. at December 31, 2016 and 2015 are as follows:

## 2016

Millions of euros	Tax credits	Temporary differences, assets	Deductions	Total deferred tax assets	Deferred tax liabilities
<b>Opening balance</b>	<b>2,077</b>	<b>3,444</b>	<b>632</b>	<b>6,153</b>	<b>88</b>
Arising in the year	-	95	639	734	-
Reversal	(866)	(3,705)	-	(4,571)	(25)
Transfers to the tax group's net position	(37)	645	39	647	508
<b>Closing balance</b>	<b>1,174</b>	<b>479</b>	<b>1,310</b>	<b>2,963</b>	<b>571</b>

## 2015

Millions of euros	Tax credits	Temporary differences, assets	Deductions	Total deferred tax assets	Deferred tax liabilities
<b>Opening balance</b>	<b>1,167</b>	<b>3,096</b>	<b>26</b>	<b>4,289</b>	<b>179</b>
Arising in the year	1,801	1,330	-	3,131	10
Reversal	-	(994)	(526)	(1,520)	(71)
Transfers to the tax group's net position	(891)	12	1,132	253	(30)
Other movements	-	-	-	-	-
<b>Closing balance</b>	<b>2,077</b>	<b>3,444</b>	<b>632</b>	<b>6,153</b>	<b>88</b>

There have been reversals of active temporary differences due to the value adjustments of its investments in shares for 1,541 million euros. In the case the amendment of the Corporate Tax Law by Royal Legislative Decree (RLD) 3/2016, of December 2 had not been released, the deferred tax assets derived from the value adjustments of investments in shares would have totalled 2,085 million euros as of December 31, 2016.

Furthermore, and due to the aforementioned legislative change that also limits the offsetting of negative tax bases 25%, as a result of the impairment testing on the recoverability of deferred tax assets carried out by the Group, it has been derecognized tax loss carryforwards amounting to 866 millions of euros.

Transfers between temporary differences, assets and deferred tax liabilities in Telefónica, S.A. are related mainly to the accounting of the gross amount of deferred taxes in connection with the impairment losses of investments of 675 million euros.

After the completion of a recoverability analysis, tax deductions of 639 million euros, unrecognized at December 31, 2015 have been capitalized. The total amount of deductions generated as of December 31, 2016 by Telefónica, S.A. amount to 1,310 million euros.

The effect of deferred taxes in equity in 2016 is a net disposal of 42 million euros.

In addition, and in compliance with the sixteenth transitional provision of this RLD 3/2016, which requires the inclusion of one-fifth of the investment portfolio impairment losses which had been deductible in the tax base before 1 January 2013, 166 million euros of recorded deferred tax liabilities have been reverted, recorded in full in these annual accounts.

## 17.2 Reconciliation of accounting profit to taxable income and income tax expense to income tax payable.

The calculation of the income tax expense and income tax payable for 2016 and 2015 is as follows.

Millions of euros	2016	2015 (*)
<b>Accounting profit before tax</b>		
<b>from continued operations</b>	<b>2,866</b>	<b>(2,314)</b>
<b>from discontinued operations</b>	<b>-</b>	<b>-</b>
Permanent differences	8,855	(2,815)
Temporary differences:	(13,781)	374
Arising in the year	206	3,541
Arising in prior years	(13,987)	(3,167)
<b>Tax result</b>	<b>(2,060)</b>	<b>(4,755)</b>
Gross tax payable	(515)	(1,331)
<b>Corporate income tax refundable</b>	<b>(515)</b>	<b>(1,331)</b>
Capitalization losses carry forward/write down deductions	227	(631)
Temporary differences for tax valuation	3,445	(322)
Temporary differences derived from the consolidation process	-	-
Other effects	(336)	(52)
Corporate income tax accrued in Spain	2,822	(2,336)
Foreign taxes	20	17
<b>Income tax</b>		
<b>continued operations</b>	<b>2,842</b>	<b>(2,319)</b>
Current income tax	(553)	(618)
Deferred income tax	3,395	(1,701)
<b>discontinued operations</b>	<b>-</b>	<b>-</b>

(\*) Revised data see Note 2

The permanent differences mainly correspond to the change in the provision of the securities portfolio of the Telefónica Group companies, to the dividends and capital gains exempted during the year, and to the financial goodwill.

The heading "Activation/reversion: negative tax bases and / or deductions" includes the effect of the activation of tax credits by deductions amounting to 639 million euros and the reversal of tax credits by negative tax bases of 866 million euros as a result of the analysis of recoverability indicated above.

The caption "Other effects" includes the impact arising from the provision made in relation to the tax deductibility of the financial goodwill taken in the year (see section 17.3), the effect of the decrease in the temporary differences of assets related to the corrections of investments in shares for the non-deductibility of negative income derived from the transfer of participations established by RLD 3/2016 mentioned above. In addition, as explained in Note 22 to Telefónica, S.A.'s 2015 annual accounts, the Telefónica Group had decided to make provision for the amount corresponding to the goodwill amortized on a tax basis for the purchase of the O2 Group companies subject to the sale agreement. Since the likelihood of execution of a sale transaction in similar terms is more uncertain, the aforementioned provision has been reversed.

## 17.3 Tax inspections and tax-related lawsuits

With regard to the tax inspection for the years 2001 to 2004, the Supreme Court issued a ruling in 2015, accepting the tax losses incurred by the Group in relation to the transfer of certain interests in TeleSudeste, Telefónica Móviles México and Lycos as tax deductible, rejecting the other contentions, and therefore the contingencies related to this process disappeared. This resulted in recognition of a tax expense of 49 million euros in the 2015 financial statements (1 million euros in Telefónica, S.A.'s standalone annual accounts). However, this did not require payment of any tax because the Company applied unused tax credits for loss carryforwards to offset the effect of these adjustments, at the corresponding tax rate for each period.

In 2012, tax inspections for all taxes for the years 2005 to 2007 were completed, with the Company signing off a corporate income tax assessment of 135 million euros, which was paid in 2012, whilst disputing other adjustments with which it disagreed. Although the settlement agreement for the disputed tax assessment did not give rise to any tax payment, since the adjustments proposed were offset by unused tax credits for loss carryforwards, the Company filed an appeal with the Central Economic-Administrative Court against these adjustments in May 2015, regarding the tax treatment of the “juros sobre el capital propio” (interest on own capital) as dividends.

On the other hand, in July 2015, tax inspections for all taxes for the years 2008 to 2011 were completed, with the Company signing off certain corporate income tax assessments and disputing others. This resulted in an expense amounting to 206 million euros in 2015 (80 million euros in Telefónica, S.A.’s annual accounts). However, this did not require any tax payment, as the adjustments arising from the inspection were offset by unused tax credits for loss carryforwards, at the corresponding tax rate for each period.

Although the settlement agreement for the disputed tax assessment did not give rise to any tax payment, in July 2015 the Company filed an appeal with the Central Economic-Administrative Court against the adjustments it disputes, regarding the tax treatment of the “juros sobre el capital propio” (interest on own capital) as dividends, and the criteria to use tax credits for loss carryforwards in the years subject to settlement.

At 2016 year end, it is not expected that there is any need to recognize additional liabilities for the outcome of these litigations.

#### Tax deductibility of financial goodwill (Article 12.5)

Spain added a new Article 12.5 to its Corporate Income Tax Law, which came into force on January 1, 2002. The article regulated the deductibility of tax amortization of financial goodwill arising from the acquisition of non-Spanish companies, which could be amortized over 20 years at 5% per annum. Following the entry into force of the Laws 9/2011 of August 19, 2011 and 16/2013 of October 29, 2013, the amount of goodwill amortization deductible for tax purposes under article 12.5 for the years 2011 to 2015 was reduced from 5% to 1%. The effect is temporary because the 4% not amortized during 5 years (20% in total) will be recovered extending the deduction period from the initial 20 years to 25 years.

The Company, under this standard, has been amortizing for tax purposes the financial goodwill from its investments, both direct and indirect, in O2, BellSouth and Colt (prior to December 21, 2007) and Vivo (acquired in 2010). The positive accumulated tax effect in the corresponding settlements of Corporate Income Tax from 2004 to the closing of December 31, 2016, was 1,063 million euros.

Worthy of note is the fact that in relation to this tax incentive, the European Commission has in recent years commenced three proceedings against the Spanish State as it deems that this tax benefit could constitute State Aid. Although the Commission itself acknowledged the validity of its first two decisions for those investors that invested in European companies (for operations carried out before December 21, 2007 in the first decision, and before May 21, 2011 for investments in other countries in the second decision) in the third case (concluded October 15, 2014), it calls into question the applicability of the principle of legitimate expectations in the application of the incentive for indirect acquisitions, whatever the date of acquisition may have been.

However, at the issuance date of these annual accounts the three decisions are pending of final ruling: the first two have been annulled by two Judgments of the General Court of the European Union and they have been appealed by the Commission in the Court of Justice of the European Union and sent again to the General Court in a sentence ruled on December 21, 2016 so that the court reviews again the nature of this tax deduction, and the third is still pending a judgment at first instance. Furthermore, there are doubts in the Spanish courts regarding the classification of the incentive as a deduction and its maintenance in the case of subsequent transmission.

The Company has decided to carry on setting up a provision of the amount relating to the goodwill amortized for tax purposes corresponding to the purchase of Vivo, for a total of 147 million euros as of December 31, 2016 (79 million euros as of December 31, 2015). The amount relating to the companies of the O2 Group was reversed after the European Commission made public its decision to prohibit the sale transaction of Telefónica UK (see Note 22).

## Note 18. Trade, other payables and provisions

### A) Trade and other payables

The breakdown of "Trade and other payables" is as follows:

Millions of euros	2016	2015
Suppliers	110	134
Accounts payable to personnel	42	48
Other payables	260	353
Current income tax liabilities (Note 17)	-	12
Other payables to public administrations (Note 17)	74	72
<b>Total</b>	<b>486</b>	<b>619</b>

#### Other payables

In accordance with Telefónica's irrevocable commitment, undertaken in 2015, to pay a 325 million euros donation to Fundación Telefónica, in 2016 cash payments have been made in an amount of 53 million euros.

#### Information on deferred payments to third parties. (Third additional provision, "Information requirement" of Law 15/2010 of 5 July).

In accordance with the aforementioned Law, the following information corresponding to the Company is disclosed:

	2016	2015
	Number of days	Number of days
<b>Weighted average maturity period</b>	<b>27</b>	<b>24</b>
Ratio of payments	27	26
Ratio of outstanding invoices	25	11

	Million of euros	Million of euros
Total Payments	313	345
Outstanding invoices	38	36

Telefónica, S.A. has adapted its internal processes and payment schedules to the provisions of Law 15/2010 (amended by Law 31/2014) and Royal Decree 4/2013, amending Law 3/2004, establishing measures against late payment in commercial transactions. Engagement conditions with commercial suppliers, as contractually agreed with them, in 2016 included payment periods of up to 60 days.

For reasons of efficiency and in line with general practice in the business, the Company has set payment schedules, whereby payments are made on set days. Invoices falling due between two payment days are settled on the following payment date in the schedule.

Payments to Spanish suppliers in 2016 surpassing the legal limit were due to circumstances or incidents beyond the payment policies, mainly the delay in the billing process (a legal obligation for the supplier), the closing of agreements with suppliers over the delivery of goods or the rendering of services, or occasional processing issues.

### B) Provisions

In 2016 and 2015 the concepts and amounts under the provision captions are the following:

## 2016

Millions of euros	Non-current	Current	Total
Tax Provisions	162	-	162
Negative net book value of investments (Note 8)	22	-	22
Termination plans (Note 19)	140	44	184
Other provisions	43	77	120
<b>Total</b>	<b>367</b>	<b>121</b>	<b>488</b>

## 2015

Millions of euros	Non-current	Current	Total
Tax Provisions	455	-	455
Negative net book value of investments (Note 8)	186	-	186
Personnel expenses related provisions	81	39	120
Other provisions	113	4	117
<b>Total</b>	<b>835</b>	<b>43</b>	<b>878</b>

Movements in the provisions during 2016 and 2015 are disclosed below:

Millions of euros	2016	2015
<b>Opening balance:</b>	<b>878</b>	<b>313</b>
Additions	278	501
Amortization and reversals	(520)	(45)
Transfers	(163)	106
Fair value adjustments and others	15	3
<b>Closing balance:</b>	<b>488</b>	<b>878</b>
Maturity:		
Non-current	367	835
Current	121	43

The caption "additions" includes in 2016 the 62 million euros of tax provisions for the article 12.5 of the Spanish Corporate Tax Law related to the acquisition of Vivo (see Note 17).

In respect of the sale of Telefónica Europe, plc, in 2015 an accrual of 377 million euros was registered relating to the tax deduction of goodwill amortization of the company. In 2016, after the European Commission decided not to authorise this transaction, that amount has been reversed (see Note 17).

Under "transfers" it is shown the negative book value of certain investments in group companies and associates (see Note 8). During 2016, there has been a partial recovery of the value of the investments and, therefore, this concept totals -163 million euros.

With respect to the simplification and transformation process of the Telefónica Group, Telefónica, S.A. launched in 2015 a voluntary termination plan ending in December 2017 for the employees who met the requirements defined by the Plan regarding age and seniority in the Company, among others. Following this transformation and simplification framework, the Company has, on the one hand, extended the plan termination till 2018 and on the other hand, has set up in December 2016 a new voluntary programme aimed at some employees who met certain requirements related to seniority in the Company. In 2015 the total amount was shown as additions in the table of movements (see Note 19). In 2016 an additional 128 million euros amount has been accrued for this same concept, shown as additions in the 2016 table of movements. During 2016, amortization and reversals regarding this Plan have been booked by 67 million euros. The amount accrued for this concept at December 31, 2016 totals 184 million euros (120 million euros in 2015).

## Note 19. Revenue and expenses

### 19.1 Revenue

#### a) Rendering of services

Telefónica, S.A. has contracts for the right to use the Telefónica brand with Group companies which use the license. The amount each subsidiary must recognize as a cost for use of the license is stipulated in the contract as a percentage of income obtained by the licensor. In 2016 and 2015, "Rendering of services to Group companies and associates" included 460 million euros and 511 million euros, respectively, for this item.

Telefónica, S.A. has signed contracts to provide management support services to Telefónica de España, S.A.U., Telefónica Móviles España, S.A.U., Telefónica O2 Holding, Ltd., Telefónica Latinoamérica Holding, S.L. and, this last year, also to Telxius Telecom, S.A.U. Revenue received for this concept in 2016 and 2015 amounted to 36 million euros and 29 million euros, respectively, recognized under "Rendering of services to Group companies and associates".

It is included under "Revenues" Strategic Partnership agreements with third parties amounted to 55 million euros in 2016.

Revenues also include property rental income amounting to 44 and 48 million euros in 2016 and 2015, respectively, mainly from the lease of office space in Distrito Telefónica to several Telefónica Group companies (see Note 7).

#### b) Dividends from Group companies and associates

The detail of the main amounts recognized in 2016 and 2015 is as follows:

Millions of euros	2016	2015
Telefónica Latinoamérica Holding, S.L. (merged with Telefónica Internacional, S.A.U.)	-	1,341
Telefónica de España, S.A.U.	-	1,601
Telefónica Europe, plc.	623	-
Telefónica Móviles España, S.A.U.	373	718
Telefónica Brasil, S.A.	266	371
Sao Paulo Telecomunicações, Ltda	73	85
Telfin Ireland, Ltd.	-	705
Telefónica Centroamérica Inversiones, S.A.	42	42
Taetel, S.A.U.	-	94
Telefónica y Finanzas, S.A.U.	-	98
Telefónica International Wholesale Services, S.L.	484	19
Other companies	67	97
<b>Total</b>	<b>1,928</b>	<b>5,171</b>

### c) Interest income on loans to Group companies and associates

This heading includes the return obtained on loans made to subsidiaries to carry out their business (see Note 8.5). The breakdown of the main amounts is as follows:

Millions of euros	2016	2015
Telefónica Móviles México, S.A. de C.V.	40	42
Telefónica de España, S.A.U.	9	18
Telefónica Internacional, S.A.U.	29	34
Telefónica Móviles Argentina, S.A.	11	25
Telefónica Participaciones, S.A.U.	24	-
Other companies	62	43
<b>Total</b>	<b>175</b>	<b>162</b>

19.2 “Non-core and other current operating revenues – Group companies” relates to revenues on centralized services that Telefónica, S.A., as head of the Group, provides to its subsidiaries. Telefónica, S.A. bears the full cost of these services and then charges each individual subsidiary for the applicable portion.

### 19.3 Personnel expenses and employee benefits

The breakdown of “Personnel expenses” is as follows:

Millions of euros	2016	2015
Wages, salaries and other personnel expenses	281	284
Pension plans	13	10
Social security costs	16	21
<b>Total</b>	<b>310</b>	<b>315</b>

In 2016, “Wages, salaries and other personnel expenses” includes 115 million euros of compensation payable during the year (126 million euros in 2015). The outstanding figure of this concept at the closing balance has been described in Note 18.

Telefónica has reached an agreement with its staff to provide an Occupational Pension Plan pursuant to Legislative Royal Decree 1/2002, of November 29, approving the revised Pension Plans and Funds Law. The features of this plan are as follows:

- Defined contribution of 4.51% of the participating employees’ base salary. The defined contributions of employees transferred to Telefónica from other Group companies with different defined contributions (e.g. 6.87% in the case of Telefónica de España, S.A.U.) will be maintained.
- Mandatory contribution by participants of a minimum of 2.2% of their base salary.
- Individual and financial capitalization systems.

This fund was outsourced to Telefónica subsidiary, Fonditel Entidad Gestora de Fondos de Pensiones, S.A., which has added the pension fund assets to its Fonditel B fund.

At December 31, 2016, 2,043 employees had signed up for the plan (1,960 employees in 2015). This figure includes both employees contributing and those who have ceased to contribute to the plan, as provided for in Royal Decree 304/2004 approving the regulations for Pension Plans and Funds. The cost for the Company amounted to 5 million euros in 2016 (3 million euros in 2015).

In 2006, a Pension Plan for Senior Executives, wholly funded by the Company, was created and complements the previous plan and involves additional defined contributions at a certain percentage of the executive’s fixed remuneration, based on professional category, plus some extraordinary contributions depending on the circumstances of each executive, payable in accordance with the terms of the plan.



Telefónica, S.A. has recorded costs related to the contributions to this executive plan of 8 million euros and 9 million euros in 2016 and 2015 respectively.

No provision was made for this plan as it has been fully externalized.

The main share-based payment plans in place in the 2015-2016 period are as follows:

**Long-term incentive plan based on Telefónica, S.A. shares: "Performance and Investment Plan 2011-2016"**

At the General Shareholders' Meeting held on May 18, 2011, a long-term share-based incentive plan called "Performance and Investment Plan" was approved for Telefónica Group directors and executive officers.

Under this plan, a certain number of shares of Telefónica, S.A. were delivered to plan participants selected by the Company who decided to participate on compliance with stated requirements and conditions.

The plan lasted five years and was divided into three independent phases.

The second phase expired on June 30, 2015. The maximum number of shares assigned to this phase of the plan was 7,347,282, assigned on July 1, 2012, with a fair value of 5.87 euros per share. At the end date of this phase, it was determined that 77% of "Total Shareholder Return" (TSR) had been achieved, under the terms and conditions of the plan. Therefore, the eligible Telefónica Group executives received a total of 2,724,699 shares (corresponding to a total of 3,691,582 gross shares, of which 966,883 shares were withheld at the option of the employee prior to distribution).

The third and final phase expired on June 30, 2016. The maximum number of shares assigned to this phase of the plan was 7,020,473 shares assigned on July 1, 2013, with a fair value of 6.40 euros per share. Delivery of shares was not required at the end of the phase according to the general conditions of the plan; therefore, managers did not receive any shares.

**Long-term incentive plan based on Telefónica, S.A. shares: "Performance and Investment Plan 2014-2019"**

The Telefónica, S.A. General Shareholders' Meeting on May 30, 2014 approved a new instalment of the long-term share-based incentive "Performance and Investment Plan" for certain senior executives and members of the Group's management team, operational on completion of the first "Performance and Investment Plan".

Like its predecessor, the term of the new plan is a total of five years divided into three phases. The initial and the second share allocations took place on October 1, 2014, and on October 1, 2015, respectively.

With regard to the third phase of this 2016-2019 Plan, the Company's Board of Directors, following a favorable report from the Nomination, Compensation and Corporate Governance Committee, resolved not to execute or implement it, after having decided that it was not sufficiently in line with the Telefónica Group's strategic plan, taking into account the circumstances and macroeconomic environment.

The maximum number of shares allocated under the plan (including the amount of co-investment) and the number of shares outstanding at December 31, 2016 are set out below:

	No. of shares assigned	No. of shares assigned at 12/31/16	Unit fair value	End date
1st phase October 1, 2014	6,927,953	5,658,725	6.82	September 30, 2017
2nd phase October 1, 2015	6,775,445	5,829,806	6.46	September 30, 2018

Out of the total figure of shares assigned at 12/31/2016, 2,269,161 and 2,325,463 shares correspond to employees of Telefónica, S.A. in phases 1 and 2, respectively.

**Long-term incentive plan based on Telefónica, S.A. shares: “Talent for the Future Share Plan” (TFSP)**

At the General Shareholders' Meeting held on May 30, 2014, a long-term share-based incentive plan called “Talent for the Future Share Plan” was approved for certain Telefónica Group employees.

Under this Plan, a certain number of shares of Telefónica, S.A. will be delivered to participants selected by the Company who have opted to take part in the scheme and meet the requirements and conditions stipulated to this end. The plan has been implemented for employees with persistently outstanding performance, high potential and key skills who are expected to take leading roles in the future, by granting a stake in the share capital of the Company.

The term of the plan is five years and it is divided into three phases. The initial and the second share allocations took place on October 1, 2014, and on October 1, 2015, respectively.

With regard to the third phase of this 2016-2019 Plan, the Company's Board of Directors, following a favorable report from the Nomination, Compensation and Corporate Governance Committee, resolved not to execute or implement it, after having decided that it was not sufficiently in line with the Telefónica Group's strategic plan, taking into account the circumstances and macroeconomic environment.

The maximum number of shares assigned and the number of shares outstanding at December 31, 2016 is as follows:

	No. of shares assigned	No. of shares assigned at 12/31/16	Unit fair value	End date
1st phase October 1, 2014	556,795	533,552	6.82	September 30, 2017
2nd phase October 1, 2014	618,000	592,200	6.46	September 30, 2018

Out of the total figure of shares assigned at 12/31/2016, 72,767 and 72,000 shares correspond to employees of Telefónica, S.A. in phases 1 and 2, respectively.

**Telefónica, S.A. global share plan: “Global Employee Share Plan II” (2012-2014) and “Global Employee Share Plan III” (2015-2017)**

Likewise, the Telefónica, S.A. Ordinary General Shareholders' Meeting on May 30, 2014 approved a new voluntary plan for incentivized purchases of shares for the employees of the Group. Under this Plan, employees were offered the option to acquire Telefónica, S.A. shares during a twelve month period (the acquisition period), with the company undertaking to deliver a certain number of free shares to participants, subject to certain requirements. Each employee was limited to buying a maximum of 1,800 euros in Telefónica, S.A. shares, subject to a minimum of 300 euros. If the employee remains part of the Telefónica Group and holds on to the shares for one year following the acquisition period (the shareholding period), they will be entitled to receive one free share for each share they acquire and retain throughout the shareholding period.

The acquisition period commenced in July 2015 and ended in June 2016. As of December 31, 2016, 29,700 employees had registered for the plan. The plan will be settled in 2017 through the delivery of shares to employees.

**19.4 Average number of employees in 2016 and 2015 and number of employees at year-end:**

Professional category	Employees at 12/31/16			Average no. of employees in 2016		
	Females	Males	Total	Females	Males	Total
General managers and chairmen	-	1	1	-	1	1
Directors	65	151	216	62	143	205
Managers	145	156	301	147	162	309
Project Managers	173	116	289	169	117	286
University graduates and experts	134	85	219	123	74	197
Administration, clerks, advisors	106	3	109	116	4	120
<b>Total</b>	<b>623</b>	<b>512</b>	<b>1,135</b>	<b>617</b>	<b>501</b>	<b>1,118</b>

2015

Professional category	Employees at 12/31/15			Average no. of employees in 2015		
	Females	Males	Total	Females	Males	Total
General managers and chairmen	-	1	1	-	1	1
Directors	61	140	201	58	137	195
Managers	150	162	312	145	154	299
Project Managers	169	112	281	168	112	280
University graduates and experts	107	68	175	101	60	161
Administration, clerks, advisors	128	2	130	121	3	124
<b>Total</b>	<b>615</b>	<b>485</b>	<b>1,100</b>	<b>593</b>	<b>467</b>	<b>1,060</b>

According to the new requirement of the Spanish Companies Law established in article 260; the average number of employees in 2016 with disability of 33% or higher, establishing the categories to which they belong; are six in Telefónica, S.A. as detailed below:

Professional category	Number of disabled
Project Managers	2
University graduates and experts	2
Administration, clerks, advisors	2
<b>Total</b>	<b>6</b>

### 19.5 External services.

The items composing "External services" are as follows:

Millions of euros	2016	2015
Rent	11	12
Independent professional services	187	188
Donations (Note 18)	1	369
Marketing and advertising	121	128
Other expenses	41	62
<b>Total</b>	<b>361</b>	<b>759</b>

On December 19, 2007, Telefónica, S.A. signed a rental contract with a view to establishing the headquarters of the "Telefónica Corporate University". The contract included construction and refurbishment of certain facilities by the lessor. On October 31, 2008, some of the facilities were partially accepted and thus the lease period commenced. The lease period is for 15 years (until 2023), renewable for another five.

Future minimum rentals payable under non-cancellable operating leases without penalization at December 31, 2016 and 2015 are as follows:

Millions of euros	Total	Up to 1 year	From 1 to 3 years	From 3 to 5 years	Over 5 years
<b>Future minimum rentals 2016</b>	<b>35</b>	1	10	10	14
<b>Future minimum rentals 2015</b>	<b>39</b>	5	10	10	14

### 19.6 Finance revenue

The items composing "Finance revenue" are as follows:

Millions of euros	2016	2015
Dividends from other companies	4	7
Other third parties financial revenues and gains on derivative instruments	918	586
<b>Total</b>	<b>922</b>	<b>593</b>

It is included under "other finance revenue" the impacts on the result of the financial hedges arranged to unwind positions for 2016 and 2015, which have the same amount under " *Finance costs payable to third parties by financial hedges* " and they don't have a real effect in the profit and loss account.

It was included under "other finance revenue" the impacts of the hedges arranged to meet the commitments of the bonds mandatory exchangeable into ordinary shares of Telecom Italia see Note 9), as well as the valuation of the Equity Swap for Treasury shares described in Note 11.

### 19.7 Finance costs

The breakdown of "Finance costs" is as follows:

Millions of euros	2016	2015
Interest on borrowings from Group companies and associates	1,862	2,094
Finance costs payable to third parties and losses on interest rates of financial hedges	1,134	710
<b>Total</b>	<b>2,996</b>	<b>2,804</b>

The breakdown by Group Company of debt interest expenses is as follows:

Millions of euros	2016	2015
Telefónica Europe, B.V.	452	471
Telefónica Emisiones, S.A.U.	1,337	1,589
Other companies	73	34
<b>Total</b>	<b>1,862</b>	<b>2,094</b>

Other companies includes financial costs with Telefónica Finanzas, S.A.U. and Telfisa Global, B.V. related to current payables for specific cash needs.

The amount included as "Finance costs payable to third parties and gain (losses) on interest rate of financial hedges" refers to fair value effects in the valuation of derivative instruments described in Note 16. As has been explained in the Note 19.6; some of these derivative instruments don't have a real impact in the profit and loss account, because they are part of the hedges to unwind positions; so they have a similar impact under "other financial revenues".

### 19.8 Exchange differences:

The breakdown of exchange losses recognized in the income statement is as follows:

Millions of euros	2016	2015
On current operations	40	49
On loans and borrowings	472	62
On derivatives	1,070	1,959
On other items	81	62
<b>Total</b>	<b>1,663</b>	<b>2,132</b>

The breakdown of exchange gains recognized in the income statement is as follows:

Millions of euros	2016	2015
On current operations	53	53
On loans and borrowings	106	511
On derivatives	1,640	1,549
On other items	33	117
<b>Total</b>	<b>1,832</b>	<b>2,230</b>

The change in exchange gains and losses is basically due to the fluctuations in the main currencies the Company works with. In 2016 US dollar has been strengthened by 3.2% against euro (12% against euro in 2015) not like the pound sterling has been strongly weakened by 14% (in 2015 strengthened by 6% against euro). Brazilian real, by contrast, has been significantly strengthened by 24% against euro, reversing 2015 trend (weakened by 34% against euro). These impacts are offset by the hedges contracted to mitigate exchange rate fluctuations.

### 19.9 Impairment losses on disposal of financial instruments with third parties

In 2016, it is included under "Other Companies" gains of 17 million euros due to the sale of the financial assets (Note 9).

The amount included under this caption in 2015 corresponds to the change in valuation of Telco, S.p.A. investments. The net amount was a financial revenue of 411 million euros.

## Note 20. Other information

### a) Financial guarantees

At December 31, 2016, Telefónica, S.A. had provided financial guarantees for its subsidiaries and investees to secure their transactions with third parties amounting to 45,448 million euros (44,868 million euros at December 31, 2015). These guarantees are measured as indicated in Note 4.g).

Millions of euros

Nominal Amount	2016	2015
Debentures and bonds and equity instruments	40,596	41,685
Loans and other payables	2,222	1,752
Other marketable debt securities	2,630	1,431
<b>Total</b>	<b>45,448</b>	<b>44,868</b>

The debentures, bonds and equity instruments in circulation at December 31, 2016 issued by Telefónica Emisiones, S.A.U., Telefónica Europe, B.V., Telefónica Finanzas México, S.A. de C.V. and Telefónica Participaciones, S.A.U., were guaranteed by Telefónica, S.A. The nominal amount guaranteed was equivalent to 40,596 million euros at December 31, 2016 (41,685 million euros at December 31, 2015). During 2016, Telefónica Emisiones, S.A.U. issued debt instruments on capital markets for an equivalent of 4,900 million euros (1,467 million euros in 2015) and 6,540 million euros matured during 2016 (3,292 million euros during 2015).

The main loans and other debts guaranteed by Telefónica, S.A. at December 31, 2016 are: the cash-settled equity link bonds non-dilutive issued by Telefónica Participaciones, S.A.U., whose outstanding amount at December 31, 2016 was 2,100 million euros (1,500 million euros at December 31, 2015). During 2016 it was paid by Telefónica Finanzas, S.A.U. to the European Investment Bank, according to installments and the repayment schedule of the financings reducing its guaranteed balance in approximately 136 million euros.

“Other marketable debt securities” includes the guarantee of Telefónica, S.A. relating to the commercial paper issue program of Telefónica Europe, B.V. The outstanding balance of commercial paper in circulation issued through this program at December 31, 2016 was 2,630 million euros (1,431 million euros at December 31, 2015).

Telefónica, S.A. provides operating guarantees granted by external counterparties, which are offered during its normal commercial activity. At December 31, 2016, these guarantees amounted to approximately 39 million euros (107 million euros at December 31, 2015).

### b) Litigation

Telefónica and its group companies are party to several legal proceedings which are currently in progress in the courts of law and the arbitration bodies of the various countries in which we are present.

Based on the advice of our legal counsel it is reasonable to assume that these legal proceedings will not materially affect the financial condition or solvency of the Telefónica Group.

The following unresolved legal proceedings or those underway in 2016 are highlighted (see Note 17 for details of tax-related cases):

#### **Appeal against the Decision of the EC dated January 23, 2013 to sanction Telefónica for the infringement of Article 101 of the Treaty on the functioning of the European Union**

On January 19, 2011, the EC initiated formal proceedings to investigate whether Telefónica, S.A. (Telefónica) and Portugal Telecom SGPS, S.A. (Portugal Telecom) had infringed European Union anti-trust laws with respect to a clause contained in the sale and purchase agreement of Portugal Telecom's ownership interest in Brasilcel, N.V., a joint venture in which both were venturers and which was the owner of the Brazilian company Vivo.

On January 23, 2013, the EC passed a ruling on the formal proceedings. The ruling imposed a fine on Telefónica of 67 million euros, as the EC ruled that Telefónica and Portugal Telecom committed an infraction of Article 101 of the Treaty on the Functioning of the European Union for having entered into the agreement set forth in Clause Nine of the sale and purchase agreement of Portugal Telecom's ownership interest of Brasilcel, N.V.

On April 9, 2013, Telefónica filed an appeal for annulment of this ruling with the European Union General Court. On August 6, 2013, the European Union General Court notified Telefónica of the response issued by the EC, in which the EC reaffirmed the main arguments of its ruling and, specially, that Clause Nine includes a competition restriction. On September 30, 2013, Telefónica filed its reply. On December 18, 2013, the EC filed its appeal.

A hearing was held on May 19, 2015, at the European Union General Court.

On June 28, 2016, the European Union General Court ruled. Although it declares the existence of an infringement of competition law, it annuls Article 2 of the contested Decision and requires the EC to reassess the amount of the fine imposed. The General Court considers that the EC has not neutralized the allegations and evidences provided by Telefónica on services in which there was not potential competition or were outside the scope of Clause Nine.

Telefónica understands that there are grounds for believing that the ruling does not suit at law; consequently, it filed an appeal to the Court of Justice of the European Union, on September 11, 2016.

On November 23, 2016, the EC filed its response against the Telefónica's appeal. On January 30, 2017, Telefónica filed its reply.

#### **Decision by the High Court regarding the acquisition by Telefónica of shares in Český Telecom by way of tender offer**

Venten Management Limited ("Venten") and Lexburg Enterprises Limited ("Lexburg"), were minority shareholders of CESKY TELECOM. In September 2005 both companies sold their shares to Telefónica in a mandatory tender offer. Subsequently Venten and Lexburg, in 2006 and 2009, respectively, filed actions against Telefónica claiming a higher price than the price for which they sold their shares in the mandatory tender offer.

On August 5, 2016, the hearing before the High Court in Prague took place in order to decide the appeal against the second decision of the Municipal Court, which had been favourable to Telefónica's position (as was also the case with the first decision of the Municipal Court). At the end of the hearing, the High Court announced the Second Appellate Decision by which it reversed the second decision of the Municipal Court and ordered Telefónica to pay 644 million Czech koruna (approximately 23 million euros) to Venten and 227 Czech koruna (approximately 8 million euros) to Lexburg, in each case plus interest.

On December 28, 2016, the decision was delivered to Telefónica. Telefónica has filed an extraordinary appeal, requesting the suspension of the effects of the decision.

#### **Other contingencies**

Telefónica is currently conducting an internal investigation regarding possible violations of applicable anti-corruption laws. Telefónica has been in contact with governmental authorities about this matter and intends to cooperate with those authorities as the investigation continues. It is not possible at this time to predict the scope or duration of this matter or its likely outcome.

#### **c) Commitments**

##### **Agreement related to the Sale of Customer Relationship Management (CRM) Business, Atento**

As a result of the sale agreement of Atento by Telefónica, announced on October 12, 2012, and ratified on December 12, 2012, both companies signed a Master Service Agreement which regulates Atento's relationship with the Telefónica Group as a service provider for a period of nine years and which was amended on May 16, 2014, and on November 8, 2016. This period was extended only for Spain and Brazil in November 2016, for two additional years until 2023.

By virtue of this Agreement, Atento became Telefónica's preferred Contact Center and Customer Relationship Management (CRM) service provider, stipulating annual commitments in terms of turnover which is updated based on inflation and deflation that vary from country to country, pursuant to the volume of services Atento has been providing to

the entire Group. Effective January 1, 2017, the minimum volume commitments that Telefónica must comply with have significantly decreased from Brazil.

Failure to meet the annual turnover commitments generally results in the obligation to the counterparty, to pay additional amounts, which would be calculated based on the difference between the actual amount of turnover and the predetermined commitment, applying a percentage based on the Contact Center's business margin to the final calculation.

The Master Agreement sets forth a reciprocal arrangement, whereby Atento assumes similar commitments to subscribe its telecommunications services to Telefónica.

#### **Agreement for the divestment of Telefónica's operations in the UK (O2 UK)**

On March 24, 2015, Telefónica signed an agreement with Hutchison Whampoa Group for the acquisition by the latter of Telefónica's operations in the UK (O2 UK) for a price (firm value) of 10,250 million pounds sterling in cash (approximately 14,000 million euros at the exchange rate as of the date of the agreement).

On May 11, 2016, the European Commission made public its decision to prohibit the transaction under the European Union merger regulations, the aforementioned agreement between Telefónica and Hutchison Whampoa Group having been terminated.

#### **Agreement for the sale of the shares of Telefónica Gestión de Servicios Compartidos España, S.A.U., Telefónica Gestión de Servicios Compartidos Argentina, S.A. and T-Gestiona Servicios Contables y Capital Humano, S.A.C.**

On March 1, 2016, a share purchase agreement between, on one hand, Telefónica, S.A., Telefónica Servicios Globales, S.L.U. and Telefónica Gestión de Servicios Compartidos Perú, S.A.C. (as sellers), and, on the other hand, IBM Global Services España, S.A., IBM del Perú, S.A.C., IBM Canada Limited and IBM Americas Holding, LLC (as purchasers) for the sale of the companies Telefónica Gestión de Servicios Compartidos España, S.A.U., Telefónica Gestión de Servicios Compartidos Argentina, S.A. and Tgestiona Servicios Contables y Capital Humano, S.A.C., for a total price of approximately 22 million euros, was ratified before Notary Public. This share purchase agreement was subscribed on December 31, 2015.

Following the aforementioned share purchase agreement and in connection with the latter transaction, also, on December 31, 2015, Telefónica subscribed a master services agreement with IBM for the outsourcing of economic-financial and HR activities and functions to be provided to the Telefónica Group during a period of ten years, for a total amount of approximately 450 million euros. Most of the Telefónica Group's subsidiary companies have already adhered to that master services agreement.

#### **d) Directors' and senior executives' compensations and other benefits**

##### **Directors' and Senior Executives' compensation**

The compensation of the members of Telefónica's Board of Directors is governed by article 35 of the Company's By-Laws, which provides that the annual amount of the compensation to be paid thereby to all of the Directors in their capacity as such, i.e., as members of the Board of Directors and for the performance of the duty of supervision and collective decision-making inherent in such body, shall be fixed by the shareholders at the General Shareholders' Meeting. The Board of Directors shall determine the exact amount to be paid within such limit and the distribution thereof among the Directors, taking into account the duties and responsibilities assigned to each Director, their membership on Committees within the Board of Directors and other objective circumstances that it deems relevant. Furthermore, Executive Directors shall receive such compensation as the Board determines for the performance of executive duties delegated or entrusted to them by the Board of Directors. Such compensation shall conform to the Director compensation policy approved by the shareholders at the General Shareholders' Meeting.

In accordance with the foregoing, the shareholders acting at the Ordinary General Shareholders' Meeting held on April 11, 2003 set at 6 million euros the maximum amount of annual gross compensation to be received by the Board of Directors as a fixed allotment and as attendance fees for attending the meetings of the Advisory or Control Committees of the Board of Directors. Thus, as regards fiscal year 2016, the total amount of compensation received by the Directors of Telefónica, in their capacity as such, was 3,752,754 euros for the fixed allocation and for attendance fees.



The compensation of the Directors of Telefónica in their capacity as members of the Board of Directors, of the Executive Commission and/or of the Advisory or Control Committees consists of a fixed amount payable monthly and of attendance fees for attending the meetings of the Advisory or Control Committees.

Set forth below are the amounts established in fiscal year 2016 as fixed amounts for belonging to the Board of Directors, the Executive Commission and the Advisory or Control Committees of Telefónica and the attendance fees for attending meetings of the Advisory or Control Committees of the Board of Directors.

### Compensation of the Board of Directors and of the Committees thereof

#### Amounts in euros

Position	Board of Directors	Executive Commission	Advisory or Control Committees (*)
Chairman	240,000	80,000	22,400
Vice chairman	200,000	80,000	-
Executive Member	-	-	-
Proprietary Member	120,000	80,000	11,200
Independent Member	120,000	80,000	11,200
Other external	120,000	80,000	11,200

(\*) In addition, the amount of the attendance fee for each of the meetings of the Advisory or Control Committees is 1,000 euros.

Based on Mr. Alier Izuel's special commitment as Director of Telefónica to the development of the Group's institutional relations, Mr. Alier Izuel has a special annual fixed amount (in addition to what he is entitled as a Member of the Board of Directors and as a member of any of its Committees) of 500,000 euros.

In this regard, it is noted that the current Executive Chairman, Mr. José María Álvarez-Pallete López, has waived the receipt of the above amounts (i.e., 240,000 euros as Chairman of the Board of Directors and 80,000 euros as Chairman of the Executive Commission).

Likewise, the fixed remuneration of 1,923,100 euros that the Executive Chairman, Mr. José María Álvarez-Pallete López, has established for the 2017 financial year is equal to the one received in the year 2016, which was set in his capacity as Chief Executive Officer, remaining invariably after his appointment as Chairman. This compensation is a 13.8% lower to the compensation established for the position of Executive Chairman for the 2016 fiscal year.

#### Individualized description

Annex II provides an individual breakdown by item of the compensation and benefits that the members of the Board of Directors and of the Senior Management of the Company have received from Telefónica, S.A. and from other companies of the Telefónica Group during fiscal year 2016.

**e) Related-party transactions***Significant shareholders*

The significant shareholders of the Company are Bilbao Vizcaya Argentaria, S.A. (BBVA), Blackrock, Inc. and Caja de Ahorros y Pensiones de Barcelona ("la Caixa") with stakes in Telefónica, S.A. of 6.33%, 5.22% and 5.15%, respectively.

During 2016 the Group did not carry out any significant transactions with Blackrock, Inc., other than the dividends paid corresponding to its stake.

A summary of significant transactions between Telefónica, S.A. and the companies of BBVA and those of la Caixa, carried out at market prices, is as follows:

Millions of euros		
2016	BBVA	la Caixa
Financial expenses	9	1
Receipt of services	2	2
<b>Total expenses</b>	<b>11</b>	<b>3</b>
Financial revenues	-	-
Dividends received (1)	15	-
<b>Total revenues</b>	<b>15</b>	<b>-</b>
Financing transactions	244	203
Guarantees granted	-	8
Time deposits	350	45
Dividends distributed (2)	243	185

(1) As of December 31, 2016 Telefónica holds 0.67% investment in BBVA (See Note 9.3).

Millions of euros		
2015	BBVA	la Caixa
Financial expenses	7	1
Receipt of services	4	3
<b>Total expenses</b>	<b>11</b>	<b>4</b>
Financial revenues	1	1
Dividends received	16	-
<b>Total revenues</b>	<b>17</b>	<b>1</b>
Financing transactions	54	49
Guarantees granted	68	8
Time deposits	421	412
Dividends distributed	212	113

(1) As of December 31, 2015 Telefónica holds 0.69% investment in BBVA (See Note 9.3).

(2) Additionally to the amount included in this line, it should be considered the shares received by la Caixa, in relation with the scrip dividend paid on December 2015.

In addition, the nominal outstanding value of derivatives held with BBVA and la Caixa in 2016 amounted to 16,680 and 392 million euros, respectively (18,483 million euros held with BBVA and 1,241 million euros held with la Caixa in 2015). The fair value of these same derivatives in the balance sheet is 855 and -35 million euros, respectively, in 2016 (805 and -26 million euros, respectively, in 2015). As explained in Derivatives policy in Note 16, this figure is inflated by the use in some cases of several levels of derivatives applied to the nominal value of a single underlying. Moreover, in 2016 there are collateral guarantees of certain derivatives held with BBVA amounting to 240 million euros.

*Group companies and Associates*

Telefónica, S.A. is a holding company for various investments in companies in Latin, Spain and the rest of Europe which do business in the telecommunications, media and entertainment sectors.

The balances and transactions between the Company and these subsidiaries (Group and Associated Companies) at December 31, 2016 and 2015 are detailed in the notes to these individual financial statements.

*Directors and senior executives*

During the financial year to which these accompanying financial statements refer, the Directors and senior executives did not perform any transactions with Telefónica, S.A. or any Telefónica Group company other than those in the Group's normal trading activity and business.

Compensation and other benefits paid to members of the Board of Directors and senior executives are detailed in Note 20 d) and Appendix II of these financial statements.

Furthermore, certain Telefónica Group subsidiaries have performed transactions with the Inditex Group in 2016, transactions related to the Group's ordinary course of business, concerning telecommunications and related services, amounting to 36 million euros.

In 2015 a member of Telefónica, S.A.'s Board of Directors was also board member of Abertis Infraestructuras, S.A., parent of Abertis. Telefónica signed agreements with Abertis, through its subsidiary On Tower Telecom Infraestructuras S.A. (previously Abertis Tower, S.A.), by virtue of which Telefónica Spain sold mobile phone towers for 44 in 2015, generating a gain of 38 million euros. An agreement was also signed through which On Tower Telecom Infraestructuras, S.A. leased certain space in the aforesaid infrastructures for Telefónica Móviles España, S.A.U. to install its communications equipment. In 2016 the aforementioned companies are not related parties anymore.

Telefónica S.A. contracted a civil liability insurance scheme (D&O) for Directors, managers and staff with similar functions in the Telefónica Group, with standard conditions in these type of insurance and a premium attributable to 2016 of 2,088,500 euros. This scheme provides coverage for Telefónica S.A. and its subsidiaries, in certain cases.

**f) Auditors' fees**

The fees accrued in 2016 and 2015 to the various member firms of the EY international organization (previously Ernst & Young), to which Ernst&Young, S.L. (the auditors of Telefónica, S.A. in 2016 and 2015) belongs, amounted to 4.73 million euros and 3.73 million euros, respectively, broken down as follows.

Millions of euros	2016	2015
Audit services	4.52	3.52
Audit-related services	0.21	0.21
<b>Total</b>	<b>4.73</b>	<b>3.73</b>

EY has not provided the Company with tax advice or other services except as disclosed above.

**g) Environmental matters**

Telefónica has an Environmental Policy which is applicable to all of its companies, which sets out the road map for the company to advance towards a green economy, reducing the environmental impact of its facilities at the same time as developing the potential for digital services to reduce the environmental footprint of other sectors.

Currently over half of the companies in the Group have Environmental Management Systems (EMS) in accordance with Regulation ISO 14001, certified by an external body, which contribute to the proper management of the environmental aspects of the company and to extending a culture of environmental responsibility across the whole supply chain.

Telefónica's environmental risks and climate change are controlled and managed under the company's global risk model. The environmental aspects of the telecommunications operations are mainly focused on the risk of high geographical dispersion and energy consumption, which is controlled by means of environmental management based on uniform processes and a global energy efficiency programme.

Telefónica has a global environmental team made up of experts in environmental management.

**h) Trade and other guarantees**

The Company is required to issue trade guarantees and deposits for concession and spectrum tender bids and in the ordinary course of its business. No significant additional liabilities in the accompanying financial statements are expected to arise from guarantees and deposits issued (see Note 20 a).

## Note 21. Cash flow analysis

### Cash flows from/(used in) operating activities

The net result before tax in 2016 amounted to positive 2,866 million euros (see the income statement), adjusted by items recognized in the income statement that did not require an inflow or outflow of cash in the year.

These adjustments relate mainly to:

- Reversion of impairments of investments in Group companies, associates and other investments of 2,049 million euros (in 2015 there was an impairment of 5,309 million euros).
- The gains on disposal of subsidiaries amounting to 992 million euros (5 million euros loss in 2015).
- Declared dividends as income in 2016 for 1,928 million euros (5,171 million euros in 2015), interest accrued on loans granted to subsidiaries of 175 million euros (162 million euros in 2015) and a net financial expense of 2,226 million euros (1,902 million euros in 2015), adjusted initially to include only movements related to cash inflows or outflows during the year under "Other cash flows from operating activities."

"Other cash flows from operating activities" amounted to 3,314 million euros (2,440 million euros in 2015). The main items included are:

a) Net interest paid:

Payments of net interest and other financial expenses amounted to 1,868 million euros (1,801 million euros in 2015), including:

- Net proceeds from external credit entities, net of hedges, for 84 million euros, (net payments of 11 million euros in 2015 discounted by their hedges), and
- Interest and hedges paid to Group companies of 1,952 million euros (1,812 million euros in 2015).

b) Dividends received:

The main receipts relate to:

Millions of euros	2016	2015
Telefónica de España, S.A.U.	-	1,601
Telefónica Móviles España, S.A.U.	373	718
Telefónica Europe, plc.	616	-
Telfin Ireland, Ltd.	455	250
Telefónica Latinoamérica Holding, S.L.	1,828	-
Telefónica International Wholesale Services, S.L.	500	-
Telefónica Brasil, S.A.	236	252
Sao Paulo Telecomunicações, Ltda	65	83
Other dividend collections	139	187
<b>Total</b>	<b>4,212</b>	<b>3,091</b>

In addition to the dividends recognized as income in 2016 (see Note 19.1) and collected in the same period, this caption also includes dividends from 2015 collected in 2016.

- c) Income tax collected: Telefónica, S.A. is the parent of its consolidated Tax Group (see Note 17) and therefore it is liable for filing income tax with the Spanish Treasury. It subsequently informs companies included in the Tax Group of the amounts payable by them. Payments of totaling 150 million euros were made in 2015 (47 million in 2015), as disclosed in Note 17. In this regard, the main amounts passed on to subsidiaries of the tax group were as follows:

- Telefónica Móviles España, S.A.U.: collection of 165 million euros, corresponding to: 146 million euros for the 2015 income tax settlement, 98 million in payments of account of 2016 income tax and 79 million corresponding to the settlement agreed with the Tax Authorities for 2008-2011 income tax inspection.

In 2015, rebilling amounted to 344 million euros, corresponding mainly to: 288 million euros for the 2014 income tax settlement and 56 million in payments of account of 2015 income tax.

- Telefónica de España, S.A.U.: collection of 640 million euros, corresponding to: 367 million euros for the 2015 income tax settlement, 263 million in payments of account of 2016 income tax and 10 million corresponding to the settlement agreed with the Tax Authorities for 2008-2011 income tax inspection.

In 2015, rebilling amounted to 616 million euros, corresponding to: 506 million euros for the 2014 income tax settlement and 110 million in payments of account of 2015 income tax.

### Cash flows from/(used in) investing activities

"Payments on investments" under "Cash flows from/ (used in) investing activities" included a total payment of 5,002 million euros (4,915 million euros in 2015). The main transactions to which these payments refer are as follows:

- Capital increases: the main disbursements correspond to Telxius Telecom, S.A.U. amounting to 1,951 million euros, Telefónica Móviles México, S.A. de C.V. amounting to 548 million euros and Telefónica Digital Holding, S.L.U. amounting to 301 million euros. These capital increases, as well as other minor disbursements of this same concept are disclosed fully in Note 8.1.a).
- Credits granted to Group and affiliated companies: In 2016 the most significant disbursements related to Telxius Telecom, S.A.U. amounting to 700 million euros and it has been detailed in Note 8.5.

Proceeds from disposals totaling 3,439 million euros in 2016 (2,048 million euros in 2015) includes:

- Proceed from the repayment of the loans granted to Telefónica Móviles España, S.A.U. in accordance with the payment schedule of the loan, totaling 638 million euros.
- The proceeds from the sale, within the framework of the restructuring process of the infrastructure business line, at its fair value of the investment in Telxius Towers España, S.L. to Telxius Telecom, S.A.U. amounting to 1,210 million euros.
- Proceeds from derivatives hedging the transaction of the sale of Telefónica Europe, plc amounting to 399 million euros.
- Repayment of a loan granted to Telefónica Latinamérica Holding, S.L. amounting to 690 million euros.

### Cash flows from/(used in) financing activities

This caption includes the following items:

- i. Net payments for equity instruments of 624 million euros (1,626 million euros in 2015), relating to the net amount of treasury shares acquired in 2016.

## ii. Proceeds from financial liabilities:

## a) Debt issues: The main collections comprising this heading are as follows:

Millions of euros	2016	2015
Telefónica Participaciones (Note 15).	608	-
Syndicated facilities with several entities (Note 14.4)	4,650	3,950
Bilateral loans with several entities (Note 14.4)	265	475
Telefónica Emisiones, S.A.U. (Note 15)	4,900	1,467
Telefónica Europe, B.V. promissory notes (Note 15)	1,200	935
Telfisa Global, B.V. financing (Note 15)	998	-
Structured Financing	699	506
Promissory notes (Note 13)	305	61
Credit lines with several entities	-	826
Bonds issued by Telefónica Europe B.V. (Note 15)	1,000	-
Loan (Note 14)	300	
Other collections	959	245
<b>Total</b>	<b>15,884</b>	<b>8,465</b>

## b) Prepayments and redemption of debt. The main payments comprising this heading are as follows:

Millions of euros	2016	2015
Bond redemption (Note 13)	-	50
Bilateral loans with several entities (Note 14.4)	-	500
Syndicated facilities with several entities (Note 14.4)	5,300	3,778
Telefónica Europe, B.V. (Note 15)	80	1,073
Telfisa Global, B.V.	-	2,048
Telefónica Finanzas, S.A.U.	497	534
Telefónica Emisiones, S.A.U. (Note 15)	6,540	3,292
Structured Financing	327	245
Credit lines with several entities	358	
Other payments	712	172
<b>Total</b>	<b>13,789</b>	<b>11,692</b>

The commercial paper transactions with Telefónica Europe, B.V. are stated at their net balance as recognized for the purposes of the cash flow statement, being high-turnover transactions where the interval between purchase and maturity never exceeds six months.

The financing obtained by the Company from Telefónica Finanzas, S.A.U. and Telfisa Global, B.V. relates to the Group's integrated cash management (see Note 15). These amounts are stated net in the cash flow statement as new issues or redemptions on the basis of whether or not at year-end they represent current investment of surplus cash or financed balances payable.

- iii. Payments of dividends for 2,395 million euros (2,237 million euros in 2015) as described in Note 11.1. d). The difference between the figure of Dividends shown in this Note and in Note 11 is caused by withholding taxes deducted in the payment to certain major shareholders, and despite the reimbursement of the amounts has been requested to Tax Authorities, the cash has not been received until 2016.
- iv. Proceeds on the 2015 share capital increase amounted to 3,048 million euros are described in Note 11, and presented net of all the expenses related to the transaction in the statement of changes in equity.

## Note 22. Discontinued operations

As detailed in Note 2, the 2016 transactions between Telefónica, S.A. and the subsidiaries which included in the agreement to sell the Group's operation in the United Kingdom have been reclassified from "Profit after tax from discontinued operations" to the corresponding lines of expenses or revenues according to their nature. This classification implies the change in 2015 income statement and in the Cash Flow statement.

The figure in 2015 Balance sheet have not been altered, and the investment in Telefónica Europe, plc amounting to 12,501 thousand euros is thus presented under the caption "Held for sale assets" in the accompanying 2015 balance sheet. In 2016, the investment has been classified again as "Long Term investments in Group and Associated companies", and this change is shown as a "Transfer" in 2016 chart of movements (see Note 8).

The disclosure of concepts and amounts reclassified in the 2015 income statement is the following:

<i>(Millions of euros)</i>	<b>2015</b>
Services rendered to Group companies	35
Other operating income Group companies	1
Impairment losses in Group companies and associates	(852)
External services Group companies	(3)
Financial revenue Group companies	1
Exchange rate differences, net	3
Income Tax	217
Discontinued operations, net of tax	(598)

The disclosure of concepts and amounts reclassified in the 2015 cash flow statement is the following:

<i>(Millions of euros)</i>	<b>2015</b>
Profit before tax	(815)
Adjustments to profits - Change in long term provisions	852
Changes in working capital	37
Other cash flows from operating activities - Net interest paid	30
Cash flow used in financing activities	(11)
Cash flow used in investing activities	(19)



## Note 23. Events after the reporting period

The following events regarding the Company took place between the reporting date and the date of preparation of the accompanying financial statements:

### Financing

On January 10, 2017, Telefónica, S.A. redeemed 300 million euros of its 2,500 million euros syndicated credit facility signed on February 19, 2015 and maturing in 2021.

On January 17, 2017, Telefónica Emisiones S.A.U. issued notes under its EMTN Programme filed on September 13, 2016 in an aggregate nominal amount of 1,750 million euros. This issuance was split into two series: one series, amounting to 1,250 million euros, maturing on January 17, 2025 and an annual coupon of 1.53% and the other series, amounting to 500 million euros maturing on October 17, 2028 and with an annual coupon of 2.32%. Both series of notes are guaranteed by Telefónica, S.A.

On January 17, 2017, Telefónica, S.A. amended the bilateral loan, signed originally on June 26, 2014 for an amount of 2,000 million euros and with an outstanding amount of 1,500 million euros, divided in two tranches with a new amortization schedule: tranche A for 500 million euros maturing on June 26, 2017 and tranche B for 1,000 million euros maturing on June 26, 2019. Later, on February 17, 2017, Telefónica, S.A. signed a new amended to its bilateral loan extending the maturity date of the tranche A for 500 million euros until June 26, 2019.

On January 25, 2017, Telefónica Emisiones S.A.U. issued notes under its EMTN Programme filed on September 13, 2016 in an aggregate nominal amount of 150 million euros, maturing on January 25, 2019. The notes are guaranteed by Telefónica, S.A.

On February 7, 2017, Telefónica Emisiones, S.A.U. redeemed 1,200 million euros, 100 million euros and 120 million euros of its notes, issued on February 7, 2011, March 21, 2011, February 7, 2012, respectively. The notes were guaranteed by Telefónica, S.A.

On February 15, 2017, Telefónica Europe, B.V. drew down an aggregate principal amount of 750 million euros of its long term financing of 1,500 million euros signed on November 28, 2016 and maturing in 2024. This financing is guaranteed by Telefónica, S.A.

### Investing in Group and affiliated companies

On January 12, 2017 Telefónica Móviles México, S.A. de C.V. has completed a capital increase of 3,000 million Mexican pesos (equivalent to 129,7 million euros) which has been subscribed and paid in full by Telefónica, S.A. on January 17, 2017.

In order to provide adequate financing funds to Telefónica Digital Holding, S.L.U. to enable the company refinancing its subsidiaries, on January 12, 2017 Telefónica, S.A. completed a capital increase of 301 million euros. This contribution has been paid in full.

On January 26, 2017 Telefónica Latinoamérica Holding, S.L. has executed a capital increase of 747 million euros which has been fully subscribed and paid by the Company.

### Telxius

On February 20, 2017 Telefónica reached an agreement for the sale of up to 40% of the total share capital of Telxius Telecom, S.A.U. to Taurus Bidco S.à.r.l. (hereafter, "KKR", an entity managed by Kohlberg Kravis Roberts & Co. L.P.), for a total amount of 1,275 million euros (12.75 euros per share).

The aforementioned agreement includes a purchase agreement for the sale of 62 million shares (representing 24.8% of the share capital) of Telxius Telecom, S.A.U. for a price of 790.5 million euros, as well as options over 38 million shares (representing 15.2% of the share capital) for a price of at least 484.5 million euros.

These options correspond to a call option exercisable by KKR and to a put option exercisable by Telefónica upon maturity of the call option.

The closing is subject to obtaining the corresponding regulatory approvals. The exercise window of the options would take place during the fourth quarter of 2017, provided that regulatory approvals have been obtained on that date.

After the transaction Telefónica will continue to maintain control over Telxius.

## Note 24. Additional note for English translation

These annual financial statements were originally prepared in Spanish and were authorized for issue by the Company's Directors in the meeting held on February 22, 2017. In the event of a discrepancy, the Spanish-language version prevails.

## Appendix I: Details of subsidiaries and associates at December 31, 2016

MILLIONS OF EUROS NAME AND CORPORATE PURPOSE	%OWNERSHIP					INCOME (LOSS)		
	Direct	Indirect	Capital	Reserves	Dividends	From operations	For the year	Net carrying amount
<b>Telefónica Latinoamérica Holding, S.L. (SPAIN)</b> Holding company Gran Vía, 28 - 28013 Madrid	100.00%	-	198	6,724	-	1,533	1,169	12,051
<b>Telefónica Móviles España, S.A.U. (SPAIN)</b> Wireless communications services provider Distrito Telefónica, Ronda de la Comunicación s/n, Madrid 28050	100.00%	-	209	495	373	672	506	5,561
<b>Telfin Ireland Limited (IRELAND)</b> Intragroup financing 28/29 Sir John Rogerson's Quay, Dublin 2	100.00%	-	-	8,205	-	-	165	8,191
<b>O2 (Europe) Ltd. (UNITED KINGDOM)</b> Holding company Wellington Street, Slough, SL1 1YP	100.00%	-	1,239	4,848	-	-	340	2,764
<b>Telefónica Móviles México, S.A. de C.V. (MEXICO) (1)</b> Holding company Prolongación Paseo de la Reforma 1200 Col. Cruz Manca, México D.F. CP.05349	100.00%	-	4,999	(3,357)	-	(302)	(399)	796
<b>Telefónica de España, S.A.U. (SPAIN)</b> Telecommunications service provider in Spain Gran Vía, 28 - 28013 Madrid	100.00%	-	1,024	1,247	-	1,535	1,089	2,455
<b>Telefónica Datacorp, S.A.U. (SPAIN)</b> Holding company Gran Vía, 28 - 28013 Madrid	100.00%	-	700	64	-	(53)	(72)	692
<b>Telefónica de Contenidos, S.A.U. (SPAIN)</b> Organization and operation of multimedia service- related activities and businesses Distrito Telefónica, Ronda de la Comunicación s/n, Madrid 28050	100.00%	-	226	1,122	-	88	(11)	1,337
<b>Telfisa Global, B.V. (NETHERLANDS)</b> Integrated cash management, consulting and financial support for Group companies Straw inskylaan 1259 ; tower D ; 12th floor 1077 XX - Amsterdam	100.00%	-	-	718	-	(6)	727	712
<b>Ecuador Cellular Holdings, B.V. (NETHERLANDS)</b> Holding company Straw inskylaan 3105, Atium 7th, Amsterdam	100.00%	-	-	537	-	(3)	(3)	581
<b>Telefónica Chile Holdings, S.L (SPAIN)</b> Holding company Distrito Telefónica, Ronda de la Comunicación s/n, Madrid 28050	100.00%	-	-	1,209	-	-	-	473
<b>Telefónica Innovación Alpha, S.L. (SPAIN)</b> Telecommunications activities Distrito Telefónica, Ronda de la Comunicación s/n, Madrid 28050	100.00%	-	-	6	-	(3)	(3)	6
<b>Telco TE, S.p.A. (ITALY)</b> Holding company Via dell'Annunciata n.21 20121 - Milano	100.00%	-	-	-	43	-	-	-
<b>Panamá Celular Holdings, B.V. (NETHERLANDS)</b> Holding company Straw inskylaan 3105, Atium 7th, Amsterdam	100.00%	-	-	1	-	-	-	1

MILLIONS OF EUROS	%OWNERSHIP				INCOME (LOSS)				
	NAME AND CORPORATE PURPOSE	Direct	Indirect	Capital	Reserves	Dividends	From operations	For the year	Net carrying amount
<b>Telefónica de Costa Rica TC, S.A. (COSTA RICA)</b>	100.00%	-	296	(148)	-	-	(1)	296	
Holding company Plaza Roble, Edificio Los Balcones 4to. Piso, San José									
<b>Telefónica Global Technology, S.A. (SPAIN)</b>	100.00%	-	16	178	-	6	(27)	166	
Global management and operation of IT systems Gran Vía, 28 - 28013 Madrid									
<b>Telefónica Capital, S.A. (SPAIN)</b>	100.00%	-	7	144	-	-	7	110	
Finance company Gran Vía, 28 - 28013 Madrid									
<b>Seguros de Vida y Pensiones Antares, S.A. (SPAIN)</b>	100.00%	-	51	28	9	10	39	69	
Life insurance, pensions and health insurance Ronda de la Comunicación, s/n Distrito Telefónica Edificio Oeste 1, planta 9- 28050 Madrid									
<b>Telefónica Digital Holding, S.L.U. (SPAIN)</b>	100.00%	-	13	389	-	(243)	(244)	158	
Holding company Ronda de la Comunicación, s/n Distrito Telefónica Edificio Central - 28050 Madrid									
<b>Taetel, S.L. (SPAIN)</b>	100.00%	-	28	41	-	(2)	(2)	67	
Acquisition, ownership and disposal of shares and stakes in other companies Gran Vía, 28 - 28013 Madrid									
<b>Telefónica Internacional USA Inc. (EE.UU.)</b>	100.00%	-	-	1	-	-	-	-	
Financial Advisory services 1221 Brickell Avenue suite 600 - 33131 Miami - Florida									
<b>Lotca Servicios Integrales, S.L. (SPAIN)</b>	100.00%	-	17	(8)	-	(5)	(5)	4	
Holding and operation of aircraft and aircraft leases Gran Vía, 28 - 28013 Madrid									
<b>Telefónica Ingeniería de Seguridad, S.A. (SPAIN)</b>	100.00%	-	12	(8)	-	(1)	2	8	
Security services and systems Ramón Gómez de la Serna, 109-113 posterior - 28035 Madrid									
<b>Compañía Española de Tecnología, S.A. (SPAIN)</b>	100.00%	-	5	5	-	-	-	9	
Promotion of business initiatives and holding of real estate assets Gran Vía, 28 - 28013 Madrid									
<b>Telefónica Finanzas, S.A.U. (TELFISA) (SPAIN)</b>	100.00%	-	3	8	-	(3)	43	13	
Integrated cash management, consulting and financial support for Group companies Ronda de la Comunicación, s/n - 28050 Madrid									
<b>Centro de Investigación y Experimentación de la Realidad Virtual, S.L. (SPAIN)</b>	100.00%	-	-	-	-	-	-	-	
Design of communications products Vía de Dos Castillas, 33 - Comp. Atica Ed. 1, 1ª Plta. Pozuelo de Alarcón - 28224 Madrid									
<b>Telefónica International Wholesale Services II, S.L. (SPAIN)</b>	100.00%	-	1	24	-	(12)	(19)	5	
Telecommunications service provider and operator Ronda de la Comunicación, s/n - 28050 Madrid									
<b>Telefónica Investigación y Desarrollo, S.A.U. (TIDSA) (SPAIN)</b>	100.00%	-	6	6	-	(48)	(34)	-	
Telecommunications research activities and projects Telecommunications Ronda de la Comunicación, s/n - 28050 Madrid									

MILLIONS OF EUROS	%OWNERSHIP					INCOME (LOSS)			
	NAME AND CORPORATE PURPOSE	Direct	Indirect	Capital	Reserves	Dividends	From operations	For the year	Net carrying amount
<b>Telefónica Luxembourg Holding S.à.r.L. (LUXEMBOURG)</b>	100.00%	-	3	76	-	(1)	11	4	
Holding company 26, rue Louvingny, L-1946- Luxembourg									
<b>Telefónica Servicios Globales, S.L.U. (SPAIN)</b>	100.00%	-	1	11	-	(4)	7	14	
Management and administrative services rendered Ronda de la Comunicación, s/n – 28050 Madrid									
<b>Fisatel Mexico, S.A. de C.V. (MEXICO)</b>	100.00%	-	195	(22)	-	-	9	182	
Integrated cash management, consulting and financial support for Group companies Boulevard Manuel Avila Camacho, 24 - 16ª Plta. - Lomas de Chapultepec - 11000 Mexico D.F.									
<b>Terra Networks Marocs S.A.R.L.</b>	100.00%	-	-	-	-	-	-	-	
Dormant Company 332 Boulevard Brahim Roudani, Casablanca									
<b>Telefónica Participaciones, S.A (SPAIN)</b>	100.00%	-	-	1	-	-	-	-	
Integrated cash management, consulting and financial support for Group Companies Gran Vía, 28 - 28013 Madrid									
<b>Telefónica Emisiones, S.A. (SPAIN)</b>	100.00%	-	-	8	-	(1)	2	-	
Integrated cash management, consulting and financial support for Group Companies Gran Vía, 28 - 28013 Madrid									
<b>Telefónica Europe, B.V. (NETHERLANDS)</b>	100.00%	-	-	5	1	(1)	2	-	
Fund raising in capital markets Strawinskylaan 1259 ; tower D ; 12th floor 1077 XX – Amsterdam									
<b>Telefónica Europe, pl.c (UNITED KINGDOM)</b>	100.00%	-	13	15,157	623	(2)	648	11,268	
Wireless communications Wellington Street, Slough, SL11YP									
<b>Compañía Señales del Norte, S.A. de C.V.</b>	100.00%	-	6	(1)	-	-	-	6	
Other business support services Prolongación Paseo de la Reforma 1200 Col. Cruz Manca, México D.F. CP.05349									
<b>O2 Oak Limited (REINO UNIDO)</b>	100.00%	-	-	-	-	-	-	-	
Private Limited Company Avda. de la Industria, 17 Tres Cantos - 28760 Madrid									
<b>O2 Worldwide Limited (REINO UNIDO)</b>	100.00%	-	-	-	-	-	-	-	
Private Limited Company 20 Air Street, London, England W1B 5AAN									
<b>Telxius Telecom, S.A.U.</b>	100.00%	-	250	2,150	-	(8)	34	2,400	
Investment management and gestion of companies in the telecommunications sector Distrito Telefónica. Avda. Ronda Comunicación, s/n. - 28050 Madrid									
<b>Telefónica International Wholesale Services, S.L. (SPAIN)</b>	100.00%	-	230	(290)	484	325	291	214	
International services provider Ronda de la Comunicación, s/n Distrito Telefónica - 28050 Madrid									
<b>Telefónica Consumer Finance E.F.C., S.A. (SPAIN.)</b>	50.00%	-	5	24	-	12	7	15	
Lending and consumer loans c/Caleruega, 102 -28033 Madrid									

MILLIONS OF EUROS NAME AND CORPORATE PURPOSE	%OWNERSHIP				INCOME (LOSS)			
	Direct	Indirect	Capital	Reserves	Dividends	From operations	For the year	Net carrying amount
<b>Corporation Real Time Team, S.L. (SPAIN)</b> Internet design, advertising and consulting Plaza Canalejas, 3 – 28014 Madrid	87.96%	12.04%	-	-	-	-	-	-
<b>Telefónica Móviles Argentina Holding, S.A. (ARGENTINA) (2)</b> Holding company Ing Enrique Butty 240, piso 20-Capital Federal-Argentina	75.00%	25.00%	306	923	-	346	204	954
<b>Telefónica Centroamérica Inversiones, S.L (SPAIN)</b> Holding company Distrito Telefónica. Avda. Ronda Comunicación, s/n. - 28050 Madrid	60.00%	-	1	878	42	17	53	655
<b>Comtel Comunicaciones Telefónicas, S.A. (VENEZUELA)</b> Holding company Torre Edicampo, Avda. Francisco de Miranda, Caracas 1010	65,14%	34,86%	-	-	-	-	-	-
<b>Aliança Atlântica Holding B.V. (NETHERLANDS)</b> Portfolio company Straw inskylaan 1725 – 1077 XX – Amsterdam	50.00%	50.00%	150	(107)	-	-	-	21
<b>Sao Paulo Telecomunicações Participações, Ltda (BRAZIL)</b> Holding company Rua Martiniano de Carvalho, 851 20º andar, parte, Sao Paulo	39.40%	60.60%	5,346	(379)	73	(1)	234	2,310
<b>Telefónica Brasil, S.A. (BRAZIL) (1)(*)</b> Wireline telephony operator in Sao Paulo Sao Paulo	29.77%	43,76%	23,164	(2,519)	266	1,718	1,122	9,928
<b>Colombia Telecomunicaciones, S.A. ESP (COLOMBIA)</b> Wireless operator Calle 100, N° 7-33, Piso 15, Bogotá, Colombia	18.51%	48.99%	-	(155)	-	154	(101)	227
<b>Telefónica Móviles Argentina, S.A. (SPAIN) (2)</b> Wireless communications and services operator Ing Enrique Butty 240, piso 20-Capital Federal-Argentina	15.40%	84.60%	N/D	N/D	N/D	N/D	N/D	N/D
<b>Pléyade Peninsular, Correduría de Seguros y Reaseguros del grupo Telefónica, S.A. (SPAIN)</b> Distribution, promotion or preparation of insurance contracts, operating as a broker Distrito Telefónica, Avda. Ronda de la Comunicación, s/n Edificio Oeste 1 – 28050 Madrid	16.67%	83.33%	-	(1)	1	3	6	-
<b>Inversiones Telefónica Móviles Holding, Ltd. (CHILE)</b> Holding company Miraflores, 130 - 12º - Santiago de Chile	1.13%	98.87%	1,702	340	-	(2)	180	89
<b>Telefónica de Argentina, S.A. (1) (ARGENTINA)</b> Holding company Ing Enrique Butty 240, piso 20-Capital Federal-Argentina	1.67%	83.32%	229	249	-	111	88	15
<b>Telefónica Venezolana, C.A. (VENEZUELA) (1)</b> Av. Francisco de Miranda, Edif. Parque Cristal, Caracas 1060	0.09%	99.91%	-	-	-	-	-	-

MILLIONS OF EUROS	%OWNERSHIP					INCOME (LOSS)			
	NAME AND CORPORATE PURPOSE	Direct	Indirect	Capital	Reserves	Dividends	From operations	For the year	Net carrying amount
<b>Canal 21 (ESPAÑA)</b>	50.00%	-	14	-	-	(5)	(10)	2	
TV Channel Calle Ronda de la comunicación s/n Edif. Norte 1. Planta 5 28050 Madrid									
<b>Telefónica Factoring España, S.A. (SPAIN)</b>	50.00%	-	5	2	8	7	7	9	
Factoring Zurbano, 76, 8 Plta. - 28010 Madrid									
<b>Telefónica Factoring México, S.A. de C.V. SOFOM ENR (MEXICO)</b>	40.50%	19.00%	2	-	-	(1)	1	1	
Factoring México D.F.									
<b>Telefónica Factoring Perú, S.A.C. (PERÚ)</b>	40.50%	19.50%	1	2	1	-	2	1	
Factoring Ciudad de Lima									
<b>Telefónica Factoring Colombia, S.A. (COLOMBIA)</b>	40.50%	19.00%	1	1	-	2	1	1	
Factoring Bogotá									
<b>Telefónica Factoring Chile, S.A. (CHILE)</b>	40.50%	19.00%	-	-	-	1	-	-	
Factoring Ciudad y Comuna de Santiago.									
<b>Telefónica Factoring Do Brasil, Ltd. (BRASIL)</b>	40.00%	20.00%	1	(2)	3	(1)	11	1	
Factoring Av da. Paulista, 1106 – Sao Paulo									
<b>Jubii Europe N.V. (NETHERLANDS) (*)</b>	32.10%	-	N/D	N/D	-	N/D	N/D	5	
Internet portal - In liquidation Richard Holkade 36, 2033 PZ Haarlem – PAISES BAJOS									
<b>Torre de Colçerola, S.A. (SPAIN)</b>	30.40%	-	6	1	-	-	-	2	
Operation of telecommunications mast and technical assistance and consulting services. Ctra. Vallvidrera-Tibidabo, s/nº - 08017 Barcelona									
<b>Other companies</b>			-	-	1	-	-	-	
<b>Total group companies and associates</b>					<b>1,656</b>			<b>65,249</b>	

(1) Consolidated data.

(2) Data included in Telefónica Móviles Argentina Holding as consolidated figures.

(\*) Companies listed on international stock exchanges at December 31, 2016.



## Appendix II: Board and Senior Management Compensation

## TELEFÓNICA, S.A.

(Amounts in euros)

Directors	Salary <sup>1</sup>	Fixed compensation <sup>2</sup>	Attendance fees <sup>3</sup>	Short-term variable compensation <sup>4</sup>	Compensation for belonging to Committees of the Board <sup>5</sup>	Other items <sup>6</sup>	Total
Mr. José María Álvarez-Pallete López	1,923,100	-	-	3,461,580	-	5,803	5,390,483
Mr. Isidro Fainé Casas	-	200,000	-	-	80,000	6,000	286,000
Mr. José María Abril Pérez	-	200,000	3,000	-	91,200	-	294,200
Mr. Julio Linares López	-	200,000	20,000	-	37,333	-	257,333
Mr. César Alierta Izuel	607,273	538,554	-	4,015,440	20,000	1,338	5,182,605
Ms. Eva Castillo Sanz	-	120,000	20,000	-	33,600	-	173,600
Mr. Juan Ignacio Cirac Sasurain <sup>7</sup>	-	30,000	-	-	-	-	30,000
Mr. José Javier Echenique Landiribar <sup>7</sup>	-	90,000	7,000	-	76,800	-	173,800
Mr. Peter Erskine	-	120,000	24,000	-	117,333	-	261,333
Ms. Sabina Fluxà Thienemann <sup>7</sup>	-	90,000	4,000	-	7,467	-	101,467
Mr. Luiz Fernando Furlán	-	120,000	-	-	-	-	120,000
Mr. Gonzalo Hinojosa Fernández de Angulo	-	120,000	28,000	-	143,467	6,000	297,467
Mr. Pablo Isla Álvarez de Tejera	-	120,000	5,000	-	11,200	-	136,200
Mr. Peter Löscher <sup>7</sup>	-	90,000	6,000	-	7,467	-	103,467
Mr. Antonio Massanell Lavilla	-	120,000	18,000	-	56,000	7,000	201,000
Mr. Ignacio Moreno Martínez	-	120,000	22,000	-	33,600	-	175,600
Mr. Francisco Javier de Paz Mancho	-	120,000	25,000	-	122,933	6,000	273,933
Mr. Wang Xiaochu	-	120,000	-	-	-	-	120,000

1 Salary: The amount for Mr. José María Álvarez-Pallete López includes compensation amounts that are not variable in nature and that the Director received for his executive work. Mr. César Alierta Izuel held the position of Executive Chairman of the Company through April 8, 2016, including through such date the amount of compensation that is not variable in nature and that the Director received for his executive work.

2 Fixed compensation: Amount of compensation in cash, with a pre-established payment frequency, whether or not vesting over time, and received by the Director for belonging to the Board, regardless of the actual attendance by the Director at meetings of the Board.

3 Attendance fees: Total amount of attendance fees for attending the meetings of the Advisory or Control Committees.

4 Short-term variable compensation (bonus): Variable amount linked to the performance or achievement of a number of individual or group goals (quantitative or qualitative) over a period equal to or less than one year, for fiscal year 2015 and paid in fiscal year 2016. As regards the bonus for 2016 and which will be paid in 2017, the Executive Director Mr. José María Álvarez-Pallete López will receive 3,430,430 euros.

5 Compensation for belonging to Committees of the Board: Amount of compensation in cash, with a pre-established payment frequency, whether or not vesting over time, and received by the Director for belonging to the Executive Commission and the Advisory or Control Committees, regardless of the actual attendance by the Director at meetings of the Advisory or Control Committees.

6 Other items: Includes, among other things, the amounts received for belonging to the Territorial Advisory Boards in Spain (Valencia, Andalusia and Catalonia) and other in-kind compensation (general medical insurance and dental coverage) paid by Telefónica, S.A. It is noted that, from January 2017, and in order to reach the highest level of efficiency possible and to optimize the management of Telefónica, S.A., the aforementioned Territorial Advisory Boards in Spain were eliminated.

7 Mr. Juan Ignacio Cirac Sasurain, Mr. José Javier Echenique Landiribar, Ms. Sabina Fluxà Thienemann, and Mr. Peter Löscher were appointed as Directors of the Company on April 8, 2016, thus reflecting the compensation received as from such date.

Furthermore, Mr. José Fernando de Almansa Moreno-Barreda, Mr. Carlos Colomer Casellas, Mr. Alfonso Ferrari Herero and Mr. Santiago Fernández Valbuena ceased to hold office as Directors on April 8, 2016, with the compensation received by them through such date being reflected below.

Directors	Salary <sup>1</sup>	Fixed compensation <sup>2</sup>	Attendance fees <sup>3</sup>	Short-term variable compensation <sup>4</sup>	Compensation for belonging to Committees of the Board <sup>5</sup>	Other items <sup>6</sup>	Total
Mr. José Fernando de Almansa Moreno-Barreda	-	30,000	8,000	-	8,400	3,333	49,733
Mr. Calos Colomer Casellas	-	30,000	14,000	-	36,800	4,333	85,133
Mr. Alfonso Ferrari Herrero	-	30,000	17,000	-	39,600	3,333	89,933
Mr. Santiago Fernández Valbuena	-	-	-	-	-	-	-

1 Salary: Includes compensation amounts that are not variable in nature and that the Director received for his executive work.

2 Fixed compensation: Amount of compensation in cash, with a pre-established payment frequency, whether or not vesting over time, and received by the Director for belonging to the Board, regardless of the actual attendance by the Director at meetings of the Board.

3 Attendance fees: Total amount of attendance fees for attending the meetings of the Advisory or Control Committees.

4 Short-term variable compensation (bonus): Variable amount linked to the performance or achievement of a number of individual or group goals (quantitative or qualitative) over a period equal to or less than one year, for fiscal year 2015 and paid in fiscal year 2016.

5 Compensation for belonging to Committees of the Board: Amount of compensation in cash, with a pre-established payment frequency, whether or not vesting over time, and received by the Director for belonging to the Executive Commission and the Advisory or Control Committees, regardless of the actual attendance by the Director at meetings of the Advisory or Control Committees.

6 Other items: Includes, among other things, the amounts received for belonging to the Territorial Advisory Boards in Spain (Valencia, Andalusia and Catalonia) and other in-kind compensation (general medical insurance and dental coverage) paid by Telefónica, S.A. It is noted that, from January 2017, and in order to reach the highest level of efficiency possible and to optimize the management of Telefónica, S.A., the aforementioned Territorial Advisory Boards in Spain were eliminated.

To break down the amounts included in the table above, set forth below is the specific compensation received by Telefónica's Directors for belonging to the various Advisory or Control Committees during fiscal year 2016, including both the fixed amount and the attendance fees.

In this regard, it is noted that the Board of Directors, at its meeting held on April 27, 2016, after a favorable report from the Nominating, Compensation and Corporate Governance Committee, approved a new configuration for the organization, structure and composition of the Advisory and Control Committees of the Company in order to reach the highest level of efficiency possible and to optimize the management of Telefónica, S.A.'s corporate governance structure.

Within this context, the Board of Directors unanimously adopted the following resolutions: i) To reorganize the then-existing Regulation and Institutional Affairs Committees, which became a single Committee called the Regulation and Institutional Affairs Committee, the powers, duties and responsibilities of which are those that until such time corresponded to each of such Committees; and ii) To reorganize the then-existing Strategy and Innovation Committees, which became a single Committee called the Strategy and Innovation Committee, the powers, duties and responsibilities of which are those that until such time corresponded to each of such Committees.

## ADVISORY OR CONTROL COMMITTEES OF TELEFÓNICA, S.A.

(Amounts in euros)

Directors	Audit and Control	Nominating, Compensation and Corporate Governance	Service Quality and Customer Service	Strategy and Innovation	Regulation and Institutional Affairs	TOTAL 2016
Mr. José María Álvarez-Pallete López	-	-	-	-	-	-
Mr. Isidro Fainé Casas	-	-	-	-	-	-
Mr. José María Abril Pérez	-	-	-	14,200	-	14,200
Mr. Julio Linares López <sup>1</sup>	-	-	9,467	15,466	32,400	57,333
Mr. César Alierta Izuel	-	-	-	-	-	-
Ms. Eva Castillo Sanz	-	-	15,200	21,200	17,200	53,600
Mr. Juan Ignacio Cirac Sasurain	-	-	-	-	-	-
Mr. José Javier Echenique Landiribar	23,800	-	-	-	-	23,800
Mr. Peter Erskine	-	21,200	-	40,133	-	61,333
Ms. Sabina Fluxà Thienemann	-	11,467	-	-	-	11,467
Mr. Luiz Fernando Furlán	-	-	-	-	-	-
Mr. Gonzalo Hinojosa Fernández de Angulo	18,200	19,200	13,200	16,200	24,667	91,467
Mr. Pablo Isla Álvarez de Tejera	-	16,200	-	-	-	16,200
Mr. Peter Löscher	-	-	-	13,467	-	13,467
Mr. Antonio Massanell Lavilla	22,200	-	26,400	11,200	14,200	74,000
Mr. Ignacio Moreno Martínez	23,200	-	15,200	-	17,200	55,600
Mr. Francisco Javier de Paz Mancho <sup>1</sup>	13,467	23,800	5,733	-	24,933	67,933
Mr. Wang Xiaochu	-	-	-	-	-	-

<sup>1</sup> In the case of Mr. Linares, includes the amount received for belonging to the former Strategy Committee until April 27, 2016, and in the case of Mr. de Paz includes the amount received for belonging to the Service Quality and Customer Service Committee until April 27, 2016.

Mr. José Fernando de Almansa Moreno-Barreda, Mr. Carlos Colomer Casellas and Mr. Alfonso Ferrari Herrero ceased to hold office as Directors on April 8, 2016, with the compensation received by them through such date being reflected below.

Directors	Audit and Control	Nominating, Compensation and Corporate Governance	Regulation	Service Quality and Customer Service	Innovation	Strategy	Institutional Affairs	TOTAL 2016
Mr. José Fernando de Almansa Moreno-Barreda	-	-	3,800	-	-	6,800	5,800	16,400
Mr. Carlos Colomer Casellas	11,600	5,800	-	4,800	8,600	-	-	30,800
Mr. Alfonso Ferrari Herrero	7,800	8,600	3,800	3,800	-	6,800	5,800	36,600

The following table also breaks down on an individualized basis the amounts received by the Company's Directors from companies of the Telefónica Group other than Telefónica, S.A. for the performance of executive duties or for belonging to the Boards of Directors and/or Advisory Committees of such companies:

## OTHER COMPANIES OF THE TELEFÓNICA GROUP

(Amounts in euros)

Directors	Salary <sup>1</sup>	Fixed compensation <sup>2</sup>	Attendance fees <sup>3</sup>	Short-term variable compensation <sup>4</sup>	Compensation for belonging to Committees of the Board <sup>5</sup>	Other items <sup>6</sup>	Total
Mr. José María Álvarez-Pallete López	-	-	-	-	-	-	-
Mr. Isidro Fainé Casas	-	-	-	-	-	-	-
Mr. José María Abril Pérez	-	-	-	-	-	-	-
Mr. Julio Linares López	-	-	-	-	-	30,000	30,000
Mr. César Aliería Izuel	-	-	-	-	-	-	-
Ms. Eva Castillo Sanz	-	60,000	-	-	-	-	60,000
Mr. Juan Ignacio Cirac Sasurain	-	-	-	-	-	-	-
Mr. José Javier Echenique Landiribar	-	-	-	-	-	-	-
Mr. Peter Erskine	-	-	-	-	-	53,066	53,066
Ms. Sabina Fluxà Thienemann	-	-	-	-	-	-	-
Mr. Luiz Fernando Furlán	-	86,656	-	-	-	30,000	116,656
Mr. Gonzalo Hinojosa Fernández de Angulo	-	19,254	-	-	-	30,000	49,254
Mr. Pablo Isla Álvarez de Tejera	-	-	-	-	-	-	-
Mr. Peter Löscher	-	-	-	-	-	-	-
Mr. Antonio Massanell Lavilla	-	-	-	-	-	-	-
Mr. Ignacio Moreno Martínez	-	-	-	-	-	-	-
Mr. Francisco Javier de Paz Mancho	-	181,394	-	-	-	30,000	211,394
Mr. Wang Xiaochu	-	-	-	-	-	-	-

1 Salary: Compensation amounts that are not variable in nature and that the Director received from other companies of the Telefónica Group for his/her executive work.

2 Fixed compensation: Amount of compensation in cash, with a pre-established payment frequency, whether or not vesting over time, and received by the Director for belonging to the boards of directors of other Companies of the Telefónica Group.

It is noted that Ms. Eva Castillo accrued an amount of 60,000 euros during fiscal year 2016 for belonging to the Supervisory Board of Telefónica Deutschland Holding, A.G. Such amount had not been paid as of the date of preparation of this document. Mr. Peter Erskine also accrued an amount of 12,403 euros during fiscal year 2016 for belonging to the Supervisory Board of Telefónica Deutschland Holding, A.G. Such amount had not been paid as of the date of preparation of this document.

3 Attendance fees: Total amount of attendance fees for attending the meetings of the boards of directors of other Companies of the Telefónica Group.

4 Short-term variable compensation (bonus): Variable amount linked to the performance or achievement of a number of individual or group goals (quantitative or qualitative) over a period equal to or less than one year, for fiscal year 2015 and paid in fiscal year 2016, by other companies of the Telefónica Group.

5 Compensation for belonging to Committees of the Board of other companies of the Telefónica Group: Amount of compensation in cash, with a pre-established payment frequency, whether or not vesting over time and accrued by the Director for belonging to the Committees of boards of directors of other Companies of the Telefónica Group.

6 Other items: Includes, among other things, the amounts received for belonging to other Regional and Business Advisory Boards (Spain, UK and Latam) and other in-kind compensation (general medical insurance and dental coverage) paid by other companies of the Telefónica Group. It is noted that, from January 2017, and in order to reach the highest level of efficiency possible and to optimize the management of Telefónica, S.A., the aforementioned Regional and Business Boards were eliminated.

Furthermore, Mr. José Fernando de Almansa Moreno-Bareda, Mr. Carlos Colomer Casellas, Mr. Alfonso Ferrari Herero and Mr. Santiago Fernández Valbuena ceased to hold office as Directors on April 8, 2016, with the compensation received by them through such date being reflected below.

Directors	Salary <sup>1</sup>	Fixed compensation <sup>2</sup>	Attendance fees <sup>3</sup>	Short-term variable compensation <sup>4</sup>	Compensation for belonging to Committees of the Board <sup>5</sup>	Other items <sup>6</sup>	Total
Mr. José Fernando de Almansa Moreno-Barreda	-	95,944	-	-	-	30,000	125,944
Mr. Calos Colomer Casellas	-	-	-	-	-	-	-
Mr. Alfonso Ferrari Herrero	-	84,865	-	-	-	30,000	114,865
Mr. Santiago Fernández Valbuena <sup>7</sup>	319,223	-	-	1,149,205	-	9,218	1,477,646

1 Salary: Compensation amounts that are not variable in nature and that the Director received from other companies of the Telefónica Group for his/her executive work.

2 Fixed compensation: Amount of compensation in cash, with a pre-established payment frequency, whether or not vesting over time, and received by the Director for belonging to the boards of directors of other Companies of the Telefónica Group.

3 Attendance fees: Total amount of attendance fees for attending the meetings of the boards of directors of other Companies of the Telefónica Group.

4 Short-term variable compensation (bonus): Variable amount linked to the performance or achievement of a number of individual or group goals (quantitative or qualitative) over a period equal to or less than one year, for fiscal year 2015 and paid in fiscal year 2016, by other companies of the Telefónica Group.

5 Compensation for belonging to Committees of the Board of other companies of the Telefónica Group: Amount of compensation in cash, with a pre-established payment frequency, whether or not vesting over time and accrued by the Director for belonging to the Committees of boards of directors of other Companies of the Telefónica Group.

6 Other items: Includes, among other things, the amounts received for belonging to other Regional and Business Advisory Boards (Spain, UK and Latam) and other in-kind compensation (general medical insurance and dental coverage) paid by other companies of the Telefónica Group. It is noted that, from January 2017, and in order to reach the highest level of efficiency possible and to optimize the management of Telefónica, S.A., the aforementioned Regional and Business Boards were eliminated.

7 It is noted that Executive Director Mr. Santiago Fernández Valbuena collected his remuneration in Brazilian reais and, accordingly, the stated amounts of his compensation in euros may vary depending on the exchange rate applicable at any particular time.

Also as stated in the section on Compensation Policy, the Executive Directors have a number of Benefits. Set forth below is a breakdown of the contributions made by the Company to the long-term savings plans (Pension Plans and Benefits Plan) during fiscal year 2016:

#### LONG-TERM SAVINGS SYSTEMS

(Amounts in euros)

Directors	Contributions for fiscal year 2016
Mr. José María Álvarez-Pallete López	673,085
Mr. César Alierta Izuel	44,912

The breakdown of the long-term saving systems includes contributions to Pension Plans, to the Benefit Plan and to the Unit link-type Insurance, as set out below:

(Amounts in euros)

Directors	Contributions to Pension Plans	Contributions to Benefits Plan <sup>1</sup>	Contributions to Unit link-type Insurance/Pension Plan Surplus
Mr. José María Álvarez-Pallete López	6,060	540,968	126,057
Mr. César Alierta Izuel	5,377	-	39,535

<sup>1</sup> Contributions to the Executive Benefits Plan in 2006, funded solely by the Company, to supplement the Pension Plan in effect, which entails defined contributions equal to a particular percentage of the Officer's fixed compensation based on professional levels within the Telefónica Group's organization.

It is noted that in 2015 applicable law reduced the financial and tax limits of the contributions to Pension Plans; for this reason, in order to compensate for the difference in favor of the Beneficiaries, a Unit-link type group insurance policy was arranged to channel such differences that occur during each fiscal year.

This Unit-link type insurance is arranged with the entity Seguros de Vida y Pensiones Antares, S.A., and covers the same contingencies as those of the "Pension Plan" and the same exceptional liquidity events in case of serious illness or long-term unemployment.

The 2016 amounts for life insurance premiums were as follows:

### LIFE INSURANCE PREMIUMS

(Amounts in euros)

Directors	Life insurance premiums
Mr. José María Álvarez-Pallete López	17,111
Mr. César Alierta Izuel	62,959

As regards share-based compensation plans (in which only the Executive Directors participate), there were three long-term variable compensation plans in effect during fiscal year 2016:

1.- The first "Performance & Investment Plan" ("PIP") made up of three cycles (2011-2014; 2012-2015; 2013-2016), was approved at the Ordinary General Shareholders' Meeting held on May 18, 2011. Pursuant to the general terms and conditions thereof, there was no delivery of shares from the third cycle of the Plan (2013-2016), for which reason no shares were delivered to the Executive Directors who participated in this cycle.

2.- The second Plan, also called "Performance & Investment Plan" ("PIP"), was approved at the Ordinary General Shareholders' Meeting held on May 30, 2014. The first cycle of this Plan began in 2014 and will end in October 2017. The second cycle of this Plan began in 2015 and will end in October 2018. As regards the third cycle of this Plan (2016-2019), the Board of Directors of the Company, after a favorable report from the Nominating, Compensation and Corporate Governance Committee, resolved not to execute or implement this cycle after finding that it was not sufficiently aligned with the strategic planning of the Telefónica Group, taking into account the circumstances and the macroeconomic environment.

Set out below is the maximum number of theoretical shares allocated (without co-investment), as well as the maximum number of theoretical shares allocated upon compliance with the "co-investment" requirement established in such second Plan and maximum completion of the TSR target set for the first and second cycle of the Plan.

#### SECOND PIP - First Cycle / 2014-2017

Directors	Theoretical shares allocated (without co-investment)	Maximum number of shares (*)
Mr. José María Álvarez-Pallete López	192,000	300,000
Mr. César Alierta Izuel	324,000	506,250

(\*) Maximum possible number of shares to be received in case of meeting the co-investment requirement and maximum completion of TSR target.

#### SECOND PIP - Second Cycle / 2015-2018

Directors	Theoretical shares allocated (without co-investment)	Maximum number of shares (*)
Mr. José María Álvarez-Pallete López	192,000	300,000
Mr. César Alierta Izuel	324,000	506,250

(\*) Maximum possible number of shares to be received in case of meeting the co-investment requirement and maximum completion of TSR target.

In any event, it is noted that no shares have been delivered to the Executive Directors under either the first or the second cycle of the second PIP and that the table above only reflects the number of shares potentially deliverable under various scenarios, without in any way meaning that all or part thereof will actually be delivered.

In fact, the number of shares of Telefónica, S.A. that always, within the maximum limit and that could be delivered, where appropriate, to the Participants is subject to and determined by the Total Shareholder Return ("TSR") of the Telefónica, S.A. shares during the cycle (3 years), as compared to TSRs experienced by certain companies within the telecommunications sector, weighted according to their relevance to Telefónica, S.A. which shall constitute the

comparison group (hereinafter, the “Comparison Group”) for purposes of the Plan. The companies included in the Comparison Group are the following: America Movil, BT Group, Deutsche Telekom, Orange, Telecom Italia, Vodafone Group, Proximus, Royal KPN, Millicom, Oi, Swisscom, Telenor, TeliaSonera, and Tim Participações.

The achievement scale approved by the Board is the following: if the TSR performance of Telefónica, S.A. shares is within at least the median of the Comparison Group, the number of shares to be delivered will be 30% of the maximum. If performance falls in the third quartile of the Comparison Group, the number of shares to be delivered shall be 100% of the maximum. Those cases falling between the median and the third quartile shall be calculated by linear interpolation. If the TSR of Telefónica, S.A. falls within the ninth decile or higher, the delivery rate will be higher than 100%, up to a maximum of 125%, calculated by linear interpolation between said third quartile and the ninth decile.

3.- The Telefónica, S.A. Incentive Share Purchase Plan (2015-2017) directed towards all employees of the Group at the international level (including executive personnel as well as the Executive Chairmen), called the “Global Employee Incentive Share Purchase Plan” (“GESP”), the third edition of which was approved by the shareholders at the Ordinary General Shareholders’ Meeting of the Company held on May 30, 2014.

This Plan is intended to strengthen Telefónica’s nature as a global employer, creating a common remuneration culture throughout the Company, incentivize participation in capital by all employees of the Group, and encourage their motivation and loyalty.

Through this Plan, employees are offered the possibility of acquiring shares of Telefónica, S.A. for a maximum period of twelve months (purchase period), with the Company’s commitment to deliver to the participants therein a certain number of shares free of charge, provided that certain requirements are met. Each employee can allocate a maximum amount of 1,800 euros, and a minimum amount of 300 euros. If the employee remains with the Telefónica Group and maintains the shares for an additional year after the purchase period (vesting period), they will have the right to receive one free share for each share that they have acquired and maintained through the end of the vesting period.

Mr. Álvarez-Pallete and Mr. Alierta Izuel participated in this Plan with the maximum contribution, i.e., 150 euros monthly, for twelve months. At December 31, 2016, they had acquired a total of 178 shares under this Plan, having the right to receive an equivalent number of shares free of charge, provided that the shares acquired have been kept for the vesting period (twelve months from the end of the purchase period), among other conditions.

It should also be noted that the external Directors of the Company have not received and will not receive during 2016 any compensation as pensions or life insurance, and will also not participate in compensation plans linked to the listing price of the shares (except as described for Mr. Alierta and Mr. Linares in the tables above).

The Company does not grant, and has not granted during 2016, any advance, loan or credit to any of the Directors or to its Senior Management, in compliance with the requirements of the Sarbanes-Oxly Act in the United States, which applies to Telefónica as a company listed on such market.

### **Compensation of the Senior Management of the Company.**

For their part, the Officers who in 2016 were members of the Company’s Senior Management,<sup>1</sup> excluding those forming part of the Board of Directors, received the total amount of 9,838,615 euros during fiscal year 2016.

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<sup>1</sup> With Senior Management being understood for these purposes as those persons who, *de facto* or *de jure*, perform senior management duties while reporting to the Board of Directors or the Executive Commissions or Chief Operating Officers of the Company, including in all cases the head of Internal Audit.

<sup>2</sup> Maximum possible number of shares to be received in case of meeting the co-investment requirement and maximum completion of TSR target. In any event, it is noted that no shares have been delivered to the Executive Directors under either the first or the second cycle of the second PIP and that the table above only reflects the number of shares potentially deliverable under various scenarios, without in any way meaning that all or part thereof will actually be delivered.

It is noted that Mr. Santiago Fernández Valbuena received an amount of 10,560,000 euros in compensation as a result of his cessation as an Officer of Telefónica, S.A. in May 2016.

In addition, as to the long-term savings plans, the contributions made by the Telefónica Group during 2016 to the Benefits Plan described in the note on "Income and expenses" as regards these Officers was 1,414,777 euros; the contributions for the Pension Plan was 137,650 euros; and the contributions to the Unit-Link Insurance-Pension Plan Surplus were 133,351 euros.

Furthermore, amounts relating to in-kind compensation (including life insurance and other insurance premiums as well as general medical insurance, dental coverage, and vehicle) were 131,665 euros.

And as regards share-based compensation plans, there were three long-term variable compensation plans in effect during fiscal year 2016:

1.- First "Performance & Investment Plan" ("PIP") made up of three cycles (2011-2014; 2012-2015; 2013-2016), approved at the Ordinary General Shareholders' Meeting held on May 18, 2011. Pursuant to the general terms and conditions thereof, there was no delivery of shares from the third cycle of the Plan (2013-2016), for which reason no shares were delivered to the Officers.

2.- Second "Performance & Investment Plan" ("PIP") made up of three cycles (2014-2017; 2015-2018; 2016-2019), approved at the Ordinary General Shareholders' Meeting held on May 30, 2014. The number of theoretical shares assigned (without co-investment) to the beginning of the cycle to all Officers within the company's Senior Management and the maximum number of shares assigned<sup>2</sup> is 453,580 and 706,975, respectively, in the first cycle (2014-2017), and 349,650 and 544,563, respectively, in the second cycle (2015-2018).

As regards the third cycle of this Plan (2016-2019), the Board of Directors of the Company, after a favorable report from the Nominating, Compensation and Corporate Governance Committee, resolved not to execute or implement this cycle after finding that it was not sufficiently aligned with the strategic planning of the Telefónica Group, taking into account the circumstances and the macroeconomic environment.

3.- "Global Employee Incentive Share Purchase Plan" ("GESP") (2015-2017), the third edition of which was approved by the shareholders at the Ordinary General Shareholders' Meeting of the Company held on May 30, 2014. All Officers within the Company's Senior Management have decided to participate therein with the maximum contribution (i.e., 150 euros monthly, for twelve months). At December 31, 2016, the Officers within the Senior Management had acquired a total of 1,033 shares under this Plan, having the right to receive an equivalent number of shares free of charge, provided that the shares acquired are kept for the vesting period (twelve months from the end of the purchase period), among other conditions.



## Management report 2016

This Management Report has been prepared taking into consideration the 'Guidelines on the preparation of annual corporate governance reports for listed companies', published by CMNV in July 2013.

### Business Model

Telefónica is one of the world's leading communications services providers. Our objective is to create, protect and promote fixed and mobile connections for our customers helping them to take control of their digital lifestyle. Therefore, we offer our customers connectivity, simple products and services and also the security that we protect their data, managing it in a responsible way.

In order to develop its business model, Telefónica has an organizational structure completely focused on customers and incorporates the digital offering as the main focus for commercial policies. The structure gives greater visibility to local operations, bringing them closer to the corporate decision-making center, simplifying the global structure and strengthening the transverse areas to improve flexibility and agility in decision making.

. On top of the transverse areas, which are led by the Chief Commercial Digital Officer, who is responsible for fostering revenue growth, and the Chief Global Resources Officer who is in charge of the efficiency of the cost side, the organizational structure is composed of the following segments: Telefónica Spain, Telefónica United Kingdom, Telefónica Germany, Telefónica Brazil and Telefónica Hispanoamérica (comprised of our consolidated subsidiaries in Argentina, Chile, Peru, Colombia, Mexico, Venezuela, Central America, Ecuador and Uruguay). These segments include the information related to wireline, wireless, DSL, TV, and other digital services provided in each country or countries.

The Telefónica Group's strategy aims to:

- Enhance value through:
  - Offering excellent connectivity, for which, our infrastructure management and our continuous investment in network are key. We aim to return the control over the data to our customers.
  - Providing a bundled offer with video and digital services. We offer our customers additional data in order to amplify their services, such as video or digital services, through unique, simple and clear offers.
  - Providing increased customer value and customer experience with digital access, aiming to offer the best products, solutions and contents.
- With the following enablers:
  - End-to-end Digitalization. We reduce our legacy investments to improve virtualization, reduce physical servers, data centers and applications, digitalization of IT systems and processes, digitalization of front- and back office, offering a true digital experience to our customers.
  - Big Data and Innovation to add value to our customers and return the control over data to our customers.
  - Continued focus on capital allocation in our legacy investments and simplification processes in order to continue investing.

Moreover, Telefónica has increased its presence in key markets. In 2014 Telefónica acquired E-Plus through Telefónica Germany and in 2015 Telefónica acquired DTS through Telefónica Spain and GVT through Telefónica Brazil.

On February 10, 2016, Telefónica announced the creation of “Telxius” a company which brings together certain infrastructure assets of the Group in several countries, which will enable the management of the Telefónica Group’s infrastructure on a global scale with a more specialized and focused approach, with the aim of increasing the services provided to other operators, improving the return on capital invested and allowing Telefónica to participate more actively in the growth opportunities that exist in the industry, including the possibility of incorporating third party assets.

#### Other information

Non-controlling interests can be divided into two groups. Firstly, subsidiaries listed in a regulated market, such as Telefónica Brasil or Telefónica Deutschland, where minority shareholdings are widely dispersed and in respect of which Telefónica protects minority interests by complying with the regulations of the related market. Secondly, subsidiaries with a main minority shareholder, with whom agreements are entered into in order to guarantee the protection of such shareholder’s rights and, in certain cases (such as Colombia Telecomunicaciones) where there are also specific commitments resulting from corporate transactions.

The Telefónica Group’s Spanish companies have adapted their internal processes and payment schedules to the provisions of Law 15/2010 (amended by Law 31/2014) and Royal Decree-Law 4/2013, amending Law 3/2004, which establishes measures against late payment in commercial transactions. Engagement conditions with commercial suppliers in 2016 included payment periods of up to 60 days, according to the terms agreed between the parties. For efficiency purposes, the Telefónica Group’s companies in Spain have agreed payment schedules with suppliers, whereby payments are made on set days of each month. Payments to Spanish suppliers in 2016 surpassing the established legal limit were the result of circumstances or incidents beyond the payment policies, mainly the delay in issuing invoices (legal obligation of the supplier), the closing of agreements with suppliers over the delivery of goods or the rendering of services, or occasional processing issues. The average payment period to suppliers of Telefónica, S.A. in Spain in 2016, according to the Spanish Law, amounted to 27 days (24 days in 2015).

The Company has a governance system, which applies to Telefónica’s entire structure. Pursuant to the Company’s commitment to its shareholders, the Board of Directors, supported by its Committees, manages the Company’s business in accordance with the corporate governance rules laid down primarily in the Corporate By-laws, in the Regulation of the General Shareholders’ Meeting, and in the Regulation of the Board of Directors.

Telefónica’s Board of Directors consists of 18 directors and is responsible for overseeing and controlling the Company’s activity. It has sole powers regarding general strategy and policies on corporate governance, corporate social responsibility, remuneration of the Board and senior management, shareholder remuneration, and strategic investments.

In order to strengthen the corporate governance of the Company, the Board of Directors of Telefónica, S.A. has eight committees (including the Executive Commission) which are charged with examining and overseeing areas of particular relevance. Pursuant to its regulation, the Board also confers responsibility for day-to-day management of the businesses to Telefónica’s executive bodies (primarily through the Executive Committee) and management team.

## Economic results of Telefónica, S.A.

Telefónica, S.A. obtained net profit of 24 million euros in 2016. Highlights of the 2016 income statement include:

- Revenue from operations, amounting to 2,710 million euros has decreased year on year, primarily due to the lower dividend distributions from Group companies and associates. In 2016, Telefónica Internacional, S.A.U and Telefónica de España, S.A.U. have not distributed any dividends as of December 31, 2016. The 2015 dividend incomes were 2,601 million euros coming from these two companies.
- The figure of “Impairment losses and other losses” amounting to a reversion of 2,049 million euros in 2016 has changed its sign considerably compared to 2015 due to the reversal of impairment charges of investments in Telefónica Brasil, S.A. and Sao Paulo Telecomunicações, Ltda totalling 3,196 million euros (in 2015 the write down was 2,625 million euros) and the reversal of a write down from Telefónica Internacional, S.A.U., merged with Telefónica Latinoamérica Holding, S.L., in 2015 amounting to 1,133 million euros.
- Net financial expense totaled 2,227 million euros in 2016, compared to 1,902 million euros in 2015. This was mainly due to finance costs with Group companies and associates, principally from Telefónica Europe, B.V. amounting to 452 million euros (471 million euros in 2015) and Telefónica Emisiones, S.A.U. totalling 1,337 million euros (1,589 million euros in 2015).
- Corporate Tax expense amounts to 2,842 million euros, mainly due to the reversal of deferred tax assets related to the write down of investments (-3,626 million euros), disposals of tax loss carryforwards (-866 million euros) and recognition of tax deductions (+639 million euros).

## Investment activity

### 2016

Following the decision of the European Commission to prohibit the sale of Telefónica Europe, plc to the Hutchison Whampoa group, and as a consequence of the strategy approved by the Board of Directors of Telefónica at its meeting on June 29, 2016, the investment in the company which was previously considered as a "Held for sale asset" has been reclassified to the "Long Term investment in Group companies and associates" caption on January 1, 2016 amounting to a book value of 12,501 million euros.

During the first semester of 2016, Telefónica has decided to rearrange the assets related to infrastructures of the Group, including the telecommunication towers as well as the network of underwater and terrestrial optic fiber unifying the concept within the same holding company (Telxius Telecom, S.A.U.). In the framework of this reorganization the following investing transactions have been made by Telefónica, S.A.:

- On January 29, 2016, Telefónica Internacional, S.A.U. sold the 50% of its stake in Telefónica América, S.A. to Telefónica, S.A. After this transaction Telefónica, S.A. became the sole stakeholder of Telefónica América, S.A.U. On March 7<sup>th</sup>, 2016, the company's denomination was changed to Telxius Telecom, S.A.U. Telxius Telecom, S.A.U. was thus designated to be the parent company of the rearranged group of the above mentioned infrastructure entities.
- On February 16, 2016 Telefónica Móviles España, S.A.U. carried out a partial split-off of Wireless Towers, S.L.U. (a newly-incorporated company renamed after as Telxius Torres España, S.L.U.) with the aim of placing in this new company the business line of ownership and exploitation of mobile phone towers. Telefónica, S.A. has recorded the split-off transaction at book value of the assets (214 million euros).
- On March 28, 2016 Telefónica International Wholesale Services América, S.A. executed a capital increase of 187 million dollars fully subscribed and paid pro-rata by the shareholders. The transaction implied a disbursement of 122 million euros for Telefónica, S.A. The funds were used to compensate prior years' negative reserves before the non-monetary contribution of the company to Telxius Telecom, S.A.U. The contribution was completed on March 31 at its book value (448 million euros).
- On March 30, 2016 Telxius Telecom, S.A.U. made a capital increase of 1,450 million euros fully subscribed and paid by the Company. On May 27, 2016 an additional capital increase was carried forward amounting to 502 million euros, also fully subscribed and paid by Telefónica, S.A.
- On March 31, 2016, Telxius Telecom, S.A.U. entered into a purchase agreement to acquire all the shares of Telxius Torres España, S.L.U. from Telefónica, S.A. at fair value (1,210 million euros). The profit of the transaction amounts to 996 million euros in the income statement of Telefónica, S.A.

On the other hand, with respect to the investment of Telefónica, S.A. in Colombia Telecomunicaciones, S.A., this company and its shareholders are analyzing the most appropriate steps to strengthen their equity position.

### 2015

Once the pertinent regulatory authorizations were obtained on April 27, 2015, and with the aim of raising the funds needed to complete the acquisition of Global Village Telecom, S.A. and its parent company GVT Participações, S.A. the General Shareholders' Meeting of Telefónica Brasil, S.A. launched a capital increase of 15,812 million reales. Telefónica, S.A. subscribed 3,995 million reales (equivalent to 1.262 million euros). On the same date, and with the object of subscribing the above mentioned capital increase, SP Telecomunicações Participações, Ltda approved a capital increase of 3,223 million reales. Telefónica, S.A. paid 1,270 million reales (equivalente to 401 million euros).

On June 24, 2015 and in compliance with the undertakings assumed in the agreement entered into for the acquisition of Global Village Telecom, S.A. (GVT), it has, through its 100% subsidiary Telco TE S.p.A., delivered 1,110 million ordinary shares of Telecom Italia S.p.A. (representing 8.2% of its ordinary shares) to Vivendi, S.A. and has received from Vivendi, S.A. all the ordinary shares and part of the preferred shares of Telefónica Brasil, S.A. that Vivendi S.A. received as consideration for the sale of GVT, which together represent 4.5% of the total share capital of Telefónica Brasil, S.A. The fair value of Telecom Italia shares contributed to Vivendi has been calculated using the quoted price at the approval date

amounting to 1,264 million euros. This same amount has been used to value the 4.5% additional investment in Telefónica Brasil, S.A.

On July 29, 2015, Telefónica, S.A. entered into an agreement with Vivendi, S.A. through which Telefónica has committed to deliver 46 million of its treasury shares in exchange for 58.4 million of Telefónica Brasil, S.A. shares, representing approximately 3.5% of the share capital of Telefónica Brasil, S.A. The execution of the agreement was performed on September 16, 2015 and valued at the quoted price of Telefónica's shares at that date, 538 million euros.

As a consequence of the aforementioned transactions, the direct stake of Telefónica, S.A. in Telefónica Brasil, S.A. was increased to 29.77% and the stake at SP Telecomunicações Participações, Ltda is 39.4% of its capital.

On June 18, 2015 the public deed of Telco, S.p.A.'s spin off transaction was filed to the Companies Register. As a result of the process, Telecom Italia, S.p.A. ordinary shares owned by Telco, S.p.A. (equivalent to a 22.3% of the company's share capital) were transferred to its stakeholders. Therefore, Telefónica, S.A. through a 100% owned newly incorporated subsidiary, Telco TE, S.p.A. received ordinary shares representing 14.72% of Telecom Italia's share capital. In this same spin off process, Telco TE, S.p.A. registered the part of the liability that Telco, S.p.A. owed its stakeholders, pro-rata their percentage of ownership. The net book value of assets and liabilities registered was 603 million euros and it is included as "additions" in the table of movements above (Note 9.3.).

On the other hand, Telco TE S.p.A. entered into a purchase agreement with a financing institution for the sale of 872 million ordinary shares of Telecom Italia S.p.A., representing 6.5% of the ordinary shares of this company, for an amount of 1,025 million euros.

Likewise, Telefónica has arranged several hedging instruments which will allow Telefónica to repurchase the shares of Telecom Italia S.p.A. that are necessary to meet its exchange obligations under the mandatory exchangeable bonds for shares of Telecom Italia S.p.A., issued by Telefónica, S.A. in July 2014.

Telefónica, S.A. has therefore ended the divesting process of its indirect stake at Telecom Italia, S.p.A., in accordance with the regulatory and competence requirements.

#### Assessment of impairment of investments

At each year end, the Company re-estimates the future cash flows derived from its investments in Group companies and associates. The estimate is made based on the discounted cash flows to be received from each subsidiary in its functional currency, net of the liabilities associated with each investment (mainly net borrowings and provisions), considering the percentage of ownership in each subsidiary and translated to euros at the official closing rate of each currency at December 31.

As a result of these estimations and the effect of the net investment hedge in 2016, a reversal of the impairment provision of 2,049 million euros was recognized (5,309 million euros of impairment in 2015, including the write down regarding Telefónica Europe, plc, which was previously recognized under the caption "net assets held for sale"). This amount derives mainly from the following companies: (a) reverse of the write down by 2,491 million euros for Telefónica Brasil, S.A. (1,872 million euros in 2015) and reverse of 705 million euros for Sao Paulo Telecomunicações, Ltda (753 million euros in 2015).

(b) write down, net of hedges, of 582 million euros for Telefónica Europe, plc (852 million euros, net of hedges, in 2015).

(c) write down of 1,264 million euros for Telefónica México, S.A. de C.V. (233 million euros in 2015).

(d) the total reversal of the write down of 1,133 million euros for Telefónica Internacional, S.A.U. (in 2016 this company was merged with Telefónica Latinoamérica Holding, S.L.), mainly due to the revaluation of the Brazilian Real which has a positive impact in the investments of 36,01% stake in Telefónica Brasil, S.A.

(e) write down of 232 million euros for Telefónica Digital Holding, S.L.U. (267 million euros in 2015).

#### **Main hypothesis used for the calculation of the discounted cash flows of investments**

In the case of Brazil, revenues reflect the strength of Telefónica's leadership driven by its leadership and quality and capturing integration synergies; and in the United Kingdom, the drive of mobile data.

In addition, in Brazil favorable effects in the macro-finance scenario have been produced. Firstly, and most remarkable, the appreciation of the exchange rate has resolved into an increase in the value of the assets nominated in Brazilian reales by 18%. Secondly, the improvement in the macroeconomic environment of the country during the second semester of 2016, as well as the more stable political situation as a consequence of the government compromise to implement structural changes in the country, has significantly reduced the uncertainties about the economic sustainability in the middle and long term.

The OIBDA margin for Brazil is in line with the average of analysts' three year forecasts for peers in emerging markets, at approximately 36%, and also considers analysts' long-term opinions about Brazil. Over the term of the strategic plan, the operator will invest a percentage at the lower end of the range for its peers. However, this is also in line with the investment needs identified by analysts (17%). Discount rate of 11.3% is slightly lower than the rate used in 2015 (11.9%), in line with the expectations of the analysts' consensus.

In the case of Brazil, the perpetuity growth rate is in line with the Brazilian Central Bank's medium-term inflation target (4.5%, within a range of  $\pm 1.5$  p.p.) and is aligned with the analyst consensus for the Strategic Plan horizon (around 5%) and below the forecast nominal GDP growth rate (which oscillates around 7%). A conservative outlook has been maintained, in line with analysts' expectations.

Regarding the investment in México, the economic uncertainty and resultant financial volatility associated with the change of president in the United States of America (which have been concluded in a 16% exchange rate depreciation of the Mexican Peso against euro in 2016 with a subsequent negative effect on revenues) and the changing competitive environment in the Mexican telecommunications market, have led to a slowdown in the growth forecast in the business plan of the operator and a set of efficiency ratios that have improved more slowly than in previous years. This new economic scenario requires a more conservative medium-term outlook to be taken in the valuation parameters. The after-tax discount rates increased from 9.05% in 2015 to 9.86% in 2016 as a result of the financial volatility mentioned earlier.

With regard to United Kingdom, the long-term OIBDA margin for operations (26%) is somewhat lower than the average for European peers over a three year period in 34%. With respect to the ratio of CapEx over revenues, over the term of the strategic plan, in United Kingdom the ratio of invest at a percentage of revenue is aligned with the range for peers in the region (around 13%) and it is in line with analysts' estimations. The discount rate (7.1%) is considered to have greater market risk, due to the increase in uncertainty of British equity securities as a result of *Brexit*, however, this risk is in line with the estimates given by analysts. Accordingly, the currency which is the main variable used for external adjustments because of the great commercial dependance on Europe, has suffered a 16% depreciation against euro in 2016, and therefore a negative impact in the British net assets and cash flows nominated in euros. In the United Kingdom the perpetuity growth rate is a 0.8% in line with the analysts' consensus.

## Share price performance

European equity markets posted a volatile performance in 2016, a year characterized by various political events. The first months of the year were affected by doubts around economic growth in China, which negatively affected the performance of emerging countries. In June, the United Kingdom voted in a referendum not to continue in the European Union, which triggered sharp drops in the markets, reaching annual lows. In November, the elections in the United States once again generated an increase of volatility in the markets. With regard to monetary policy, the ECB expanded its debt repurchasing program and lowered interest rates to 0% with the aim of generating higher economic activity and increasing inflation levels. The Federal Reserve, in turn, delayed the expected interest rate increase until December.

In this context, the main European indexes closed 2016 with a mixed performance (EStoxx-50 +0.7%); highlighting the positive performance of the FTSE-100 (+14.4%), which was driven by the high weight of mining companies and the depreciation of the sterling pound, which favored exporters and multinational companies with limited exposure to the domestic market; DAX (+6.9%), CAC-40 (+4.9%). The Ibex-35 (-2.0%) along with the FTSEMIB (-10.2%) were the only indexes closing the year with losses as a result of their exposure to emerging markets and, in the case of the Italian index, uncertainty regarding the banking sector.

Among sectors included in the European DJ Stoxx-600 (-1.2%), basic resources (+61.9%), oil & gas (+22.9%) and construction & materials (+9.2%), led positive performances, whereas health care (-10.2%), travel & leisure (-11.1%) and telecommunications (-15.8%) posted losses. The relative worse performance of the telecommunications sector during the year is due to the cancellation of certain corporate transactions, adverse regulatory news, weak revenue growth trends, and concerns over capex increases, along with rotation towards more cyclical sectors following the elections in the United States.

Telefónica share closed 2016 at 8.82 euros per share, with a total shareholder return of -6.3%, reflecting the evolution of the share price (-13.8%) and dividends distributed in the year (0.40 euros in cash and 0.35 euros in scrip). The profitability is higher than that of the sector in Europe, which showed a total shareholder return after dividends of -11.7%.

Telefónica closed the 2016 financial year with a market capitalization of 44,433 million euros, ranking as the eleventh company in the telecommunications sector worldwide. The daily traded volume in the Spanish stock exchange amounted to 24.6 million shares.

## Research, development and innovation

Telefónica remains committed to technological innovation as a fundamental tool for being one of the main actors in the new digital universe, with the capacity to help to create a more sustainable world while achieving competitive advantages and distinctive products. By introducing new technologies and developing business solutions and processes, we aim to become a more effective, efficient and customer-oriented Group.

Telefónica bases its innovation strategy on the balance between two main models:

- Promoting our **internal research, development and innovation (R&D&i) capabilities**, for which we have developed our own innovation model, which allows us to promote the application of technical research in developing commercial products and services using the knowledge developed in research centers, technological institutes and universities, among other sources;
- Promoting the creation of **open innovation ecosystems**, in which the **Open Future** initiative stands out as a global program **designed to connect entrepreneurs, start-ups, investors, venture capital funds and public and private organizations around the world** which promote innovation in collaboration with other actors.

In parallel with these two models, Telefónica seeks to promote the development of sustainable solutions that generate a positive impact on the economic, social and technological progress of the regions in which we operate. To this effect, in addition to the investment made in promoting sustainable innovation projects and in the activities that are developed to guarantee the accessibility of our solutions to all groups, a new subsidiary has been created that is focused on product innovation and the development of disruptive technologies.

Telefónica firmly believes that competitive advantage can not be based solely on acquired technology, and so has always considered the promotion of internal innovation, research and development activities as a strategic axis, in an effort to achieve this differentiation and move forward in other activities which guarantee the sustainability of our business.

To this effect, the Telefónica Group's internal innovation policy focuses on contributing with solutions that guarantee Telefónica's commitment to developing a responsible business under the criteria of economic, social and environmental sustainability, by:

- Developing new products and services that enable growth and competition in an increasingly global environment, while being adapted to the diversity and local needs of each market;
- Encouraging the return of innovation through open innovation and creating value from the technology generated;
- Increasing our customers' loyalty and satisfaction;
- Increasing the revenues, profits and value of the Company;
- Increasing the quality of our infrastructure and services, as well as our relationship with our technology providers and solutions;
- Improving business processes and operations with the aim of optimizing resources, increasing efficiency and reducing environmental impact

More specifically, during 2016 we carried out numerous technological innovation projects focused on sustainability, process efficiency, the creation of new sources of revenue, customer satisfaction, the consolidation of our presence in new markets and technological leadership.

We also initiated projects to promote an increase in the access to information technology, new services focused on new Internet business models, advanced user interfaces, distribution of TV and multimedia contents and other value added services, taking advantage of the potential of the new infrastructures. These projects, among others, were undertaken based on our objective to quickly identify emerging technologies that may have a relevant impact on our business, and to test these technologies on pilots related to new platform services, applications and prototypes.

A significant part of the innovation activities and projects are carried out by Telefónica Investigación y Desarrollo S.A.U. (Telefónica I+D), a wholly owned subsidiary which gives support mainly to our business lines. Telefónica I+D receives support from other companies and universities in the execution of its functions. The mission of the company is focused on



improving our competitiveness through technological innovation and product development. Telefónica I+D is also responsible for experimental and applied research and for the development of products to increase our range of services and reduce operating costs.

The technological innovation activities of Telefónica I+D focus on three main areas:

1. **The development of new networks**, mainly carried out in collaboration with Telefónica's Global Resources area. These activities are related to new radio and fibre optic access technologies (technologies on the virtualization of network functions, in line with the technological trend known as SDN or defined networks via software) and on topics related to network optimization and *zero touch*, which enable us to have a much more flexible and adaptable network that is dynamically adaptable to the new requirements of digital services and customers.
2. **The development of new products and services** which are carried out within the framework of the digital services strategy. The following stand out among these activities:
  - Interpersonal communication of the future with natural access, taking advantage of the possibilities of the Internet and smartphones;
  - Services related to Big Data, regarding the concept of the Fourth Platform, whose vision is to return the value associated with the data it generates to the customer;
  - Video and multimedia services (combining text, audio, images and video) with a user experience on all connected devices;
  - Advanced solutions in emerging ICT businesses, such as *cloud computing* cloud or security;
  - Management of Internet of Things (IoT) services, related to enriched mobility, energy efficiency and smart retail;
  - Using users' communication profiles to obtain opportunities to exploit different products and business models (marketing campaigns, targeted advertising, contextual services, churn reduction, cross-selling, etc.).
3. **Experimental and applied research**: With a medium and long-term outlook, Telefónica also has **Scientific Groups** whose mission is to investigate the possibilities of new networks and services and to solve the technological, social and environmental challenges that arise.

It should be noted that in 2016, Telefónica I+D was consolidated in Chile, a 100% subsidiary of Telefónica Chile, which was launched in 2014 in collaboration with the Chilean government, withfor the development of the first products and the generation of the first patents in "enriched mobility", Smart Industry and Smart Agro.

As of 31 December 2016, Telefónica I+D had 612 employees (654 employees in 2015).

The total I+D expense in the Group for 2016 amounted to 906 million euros, down 14.1% from the 1,055 million euros incurred in 2015. This expense represents 1.7% and 1.9% of the Group's consolidated revenue for 2016 and 2015, respectively. These figures were calculated using guidelines of the Organization for Economic Co-operation and Development (OECD).

During 2016, Telefónica registered 27 new patent applications, including three through the American office (USPTO), two through the Chilean office (INAPI) and 22 through the Spanish patent and trademark office (OEPM), seven of which were international (PCT) and 15 European applications. Moreover, one utility model was registered in the Spanish patent and trademark office, also through the OEPM.

Regarding the development of open innovation in Telefónica, the company has the OPEN FUTURE\_ unit, which includes an open, global program designed to connect entrepreneurs, startups, investors, and public and private organizations from around the world.

The main objective of Open Future is to detect, develop and enhance the talent and technological entrepreneurship in all its phases, for that which drives and accelerates the growth of ideas, projects, initiatives and companies. The integral

character of Telefónica Open Future enables innovation to be developed in different stages. It is structured around seven initiatives, the objectives of which are as follows:

- **Drive** (Think Big and Talentum Startups).
- **Accelerate** (Crowdworking and Wayra).
- **Invest** (Telefónica Ventures, Amérigo and CIP Telefónica).

Telefónica Open Future is present in 16 countries, ended 2016 as one of the main investors in the Spanish area of open innovation, and positioned itself as one of the major funds in Europe and Latin America in Venture Capital investment.

## Environment

### Environmental policy, control of environmental risks and climate change

Telefónica has a global Environmental Strategy that arises from the Environmental Policy and Energy Policy approved by the Board of Directors which sets out the road map for the Company to advance towards a green economy, reducing the environmental impact of its facilities at the same time as developing the potential for digital services to reduce the environmental footprint of other sectors.

Currently more than 80% of the company has Environmental Management Systems (EMS) in accordance with Regulation ISO 14001, certified by an external body, which contribute to the proper management of its environmental aspects and to extending a culture of environmental responsibility across the whole supply chain. Telefónica has set itself the target of certifying 100% of operators under ISO 14001 by 2017.

Telefónica's environmental risks and climate change are controlled and managed under the Company's global risk model. The environmental aspects of the telecommunications operations are mainly focused on the risk of high geographical dispersion and energy consumption, which is controlled by means of environmental management based on uniform processes and a global energy efficiency programme.

Telefónica has a global environmental team made up of experts in environmental and energy management in each of the Group's companies.

We would like to emphasize the following news from the past year:

- We approved a Policy for sustainable energy use at a corporate level.
- We announced our energy and climate change goals for the 2015-2020 period as part of our plan to contribute to the Paris Agreement.
- We received ISO 50001 certification regarding energy management systems for our operations in Spain and Germany.
- We launched a plan for renewable energy.
- We brought the Eco Rating initiative to Latin America, a seal that communicates to our customers the environmental and social impact of mobile phones.
- For the third year in a row, we were included on the "A-List" for the Carbon Disclosure Project, the largest index for investment in climate change. We are one of the nine telcos to appear in this global ranking.
- We made progress in measuring the positive impact that our digital services have regarding adapting to and mitigating climate change.
- We received ISO 14001 certification for Telefónica Brazil and our Telxius submarine cable infrastructure in America.

### A Responsible Network

It is in our Network that we see the greatest environmental impact due to energy consumption, but also with physical elements, such as visual impact or waste. To implement and maintain the responsible Network, we apply the best practices available and we manage all environmental aspects of this from design to decommissioning.

Environmental legislation, which is abundant in almost all of the countries where Telefónica operates, applies mainly to our network infrastructures. Among these, it is worth mentioning the need to obtain environmental permits, waste management, noise control and measuring electromagnetic fields. Telefónica has common standards for all of its companies, in harmony with the principle of caution, establishes minimum guidelines for environmental management with the aim of minimizing the impact of infrastructures, these standards go beyond existing legislation. Also, these standards extend to all of our suppliers and contractors.

Among the activities undertaken by the Group to manage the environmental aspects of its operations is the sharing, whenever possible, of our facilities' locations with other operators or communication tower management companies. This leads to a lesser visual and energy impact and a reduction in waste creation.

### Main lines of action

Within the Responsible Business Strategic Plan, the company has established lines of action regarding the environment. This plan is also grounded in each country in order to be able to focus on the most relevant aspects at a local level. Some of the lines of action are:

- **Energy and climate change:** by means of the Corporate Climate Change Office, the Company promotes energy efficiency and the reduction of Telefónica's carbon footprint with a plan for 100% of our electricity use to come from renewable sources in 2030. The year 2016 saw the launch of the "<https://www.telefonica.com/es/web/sala-de-prensa/-/telefonica-anuncia-que-el-50-de-su-consumo-de-electricidad-provendra-de-fuentes-de-energia-renovables-en-2020>" regarding these topics. Between 2010 and 2015, we conducted 257 initiatives with which we managed to save 492 GWh, the equivalent energy consumption of 40,300 homes in one year, and 64 million euros in our annual electricity bill. In this way, we avoided the emission of more than 142 kT CO2 equivalents. Because of all this, in 2016 Telefónica was awarded the GSMA 2016 Green Mobile Award.
- **Circular economy:** the Company is committed to promoting a circular economy, in which goods used are returned to the value chain. Thus, waste and used devices from Telefónica networks and customers, with a particular focus on electrical and electronic devices, are managed by authorized entities, in compliance with environmental legislation and prioritizing management in the following order: reduce, reuse and recycle. All companies in the group have waste management programmes and recycling and/or reuse initiatives for managing customers' devices.
- **Green Services:** in the current context where environmental challenges affect the whole of society, Telefónica is developing services based on the 'Internet of Things' (IoT), Cloud Computing and Big Data to reduce the consumption of resources and the environmental impact of our customers. These will be key in the area of reduction of and adaptation to climate change. We align our business and environmental strategy, looking for opportunities linked to the search for solutions to deal with environmental questions. We want to position ourselves as a key actor in the green economy and, thus, sustainable innovation is essential.

These actions have allowed Telefónica to extend its environmental responsibility to residential and business customers and to continuously respond to the demands of responsible environmental management from investors and shareholders.

## Human rights

In our risk management and analysis process, human rights and the impact that our activities, whether directly or indirectly, may have on said rights, are taken into consideration in an inclusive and cross-departmental manner. In line with the United Nations Guiding Principles on Business and Human Rights, we regularly perform an impact analysis in relation to our activities with the goal of identifying areas where we must work with particular diligence to safeguard those rights.

In this impact analysis, we identify the areas of our activity (internal management, supply chain management, operations, client services) and the rights that could potentially be affected, with the purpose of carrying out preventative management in those fields. The growing importance of technology and information and communication services in society, the development of new data-based services, and new activities that Telefónica has undertaken (i.e. television), have led us to expand our analysis, and require that we remain aware, not only of our traditional activities such as management of our human resources and our supply chain, but also of aspects of growing concern to society such as the right to privacy, the right to freedom of speech, or rights related to access to telecommunications services and the environmental impact of our activity.

Respect for human rights is a key element in our Responsible Business Principles and our Supply Chain Sustainability Policy. We are aware of the role that information and communication technologies can play in promoting and respecting human rights and the responsibility we must take on to minimise the negative impact and highlight our positive impact.

We have implemented the necessary processes to raise and manage company risks on this matter and we provide various communication channels (employee reporting channel, supplier channel, Responsible Business channel) to our stakeholders to enable them to confidentially and anonymously communicate or report situations that entail a violation of human rights or that could result in a lack of respect for the rights of people or the communities in which we operate.

## Responsible business and fiscal responsibility

### Responsible business

The future of Telefónica is based on promoting a responsible business model that is able to generate trust in our customers, investors, employees, shareholders, and society. In order to promote this, we have the global Responsible Business Plan, approved and followed by the Board's Committee for Regulation and Institutional Affairs.

This Plan sets out priorities through year 2020 in three areas: compliance and risk management, responsible productivity and sustainability as leverage for growth to improve our business and the world.

Currently, it is focused on **Customer Promise and Digital Trust; Supply Chain; Talent and Diversity; Environmental Management and Sustainable Innovation**, with their corresponding goals and KPIs. These take form in different local plans in the countries where we are present.

The Customer Promise and Digital Trust project arises from the need to continually reinforce the relationship of trust that we have with the customer, not only in the commercial field by complying with standards of transparency and honesty, but also in the field of privacy and security. The Responsible Management of our Supply Chain is key if we want to guarantee compliance of ethical, social, and environmental standards throughout our value chain. We demand compliance of these standards from all our providers, and we perform awareness and verification actions to manage the risks, and control and implement improvement actions. The directed management of our human resources with the goal of attracting and retaining the best talent, including the management of diversity, are key aspects for the success of the company's strategy. Telefónica promotes an ambitious and very effective environmental strategy with the goal of not only managing possible risks and minimizing the impacts of the company's activities on the environment, but also of assuming its responsibility in the mitigation of climate change. Finally, Sustainable Innovation is the project with which Telefónica contributes to generate positive social and environmental impacts through commercial proposals that, within a context of global growth trends, will generate new models of sustainable business.

In 2016, in addition to the Global Responsible Business Plan, the plans for Spain, Germany, Brazil, Colombia, Ecuador, Mexico, Peru, Argentina and Chile were approved.

During the year:

- A Responsible Business Advisory Panel and an extended consulting group were put together to collect stakeholders' expectations.
- A Chief Data Officer was named, we performed training and audits on privacy and cyber security and we worked to give back citizens control over their digital lives.
- The Privacy Center, which informs our stakeholders about our privacy and publicity policies, was published.
- Telefónica's first Report on Transparency in Communications was published.
- The Chief Compliance Officer was appointed, thus reinforcing our commitment with compliance issues.
- Assessments of critical providers were increased through EcoVadis and we joined the JAC (Joint Audit Cooperation) sector initiative to audit their factories.
- The Telefónica Global Diversity Council was established to promote diversity among employees.
- New energy and climate change goals were announced for the 2015-2030 period for the purpose of contributing to the Paris Agreement.
- Telefónica brought to Latin America the Eco Rating, a seal for the environmental and social impact of mobiles.
- For the third consecutive year, Telefónica was on the CDP "A-List": we are one of nine Telcos to figure in this ranking at a global level, and the only Spanish one.
- Movistar+ 5S was launched, a pioneering proposal to bring television to people with sensory disabilities.

- Telefónica, with "la Caixa", presented the ProFuturo Project to promote digital education for children in developing countries.
- In 2016, Telefónica was one of the top nine leading companies in the world in terms of sustainability, according to the DJSI.

Some of these advances influence the Sustainable Development Objective (SDO), in which Telcos play a prominent role since the Internet and digital solutions are fundamental to being able to reach more than half of the proposed goals, with connectivity as the foundation.

### **Fiscal Responsibility**

According to the Principle of Responsible Business, Telefónica is committed to acting with honesty, transparency and respect for the law when managing our financial issues.

The Company is adhered to the Good Tax Practices Code and committed to that established in the "OECD Guidelines for Multinational Enterprises" regarding taxation. Consequently, Telefónica does not use company structures in order to cover or reduce the transparency of our activities before the tax authorities, or any other interested party. Nor is the Company present in any of the jurisdictions included in the list of tax havens established in Spanish regulations.

To calculate the total tax contribution (the list of countries can be consulted on the web) Telefónica follows the PwC CTT methodology, according to which the distributed value of a company is made up of the sum of the following elements: value for the shareholder (for example: dividends, reserves, etc.) wages and salaries (net of tax levied on employees), net interests and tax (input and levied).

## Human Resources

### Objectives and policies

At Telefónica people are important and are the core of the business, representing one of the Group's greatest assets. Our aim as HR department is to develop our employees' capacities to the maximum in order to fulfill the compromises agreed with our customers.

Our vision is based on four main pillars:

- Recruit, develop and keep the talented employees to ensure the Company meets its strategic goals.
- Support the business units' integration and the transformation process so that the companies are aligned with the business objectives.
- Build a customer-focused organization culture.
- Become a 100% online department with high self-service options in the internal HR processes and with outsourced resources and provide an integrated human resources experience for middle management and employees based on empowerment and simplification.

In 2016 the implementation of SuccessFactors (the new digital, online, multi-gadget, cloud-based and global tool for human resources management) affected all employees, unifying the performance, successions and development, recruiting and learning processes.

The most notable aspects of the change include the implementation of the central employee module in eight countries.

### Employee training

Sharing the same view of the rest of the Group's companies, in Telefónica, S.A. employees' training and learning is a key and priority aspect in order to handle our transformation process.

In 2016 a new global training process and software (SuccessFactors) has been implemented, and the most significant effort has been aimed to make the novelties understandable to the staff.

Universitas has continued offering a wide range of courses, both on-site and online, through the MOOC in the Miriadax software platform. In the on-site courses in Barcelona 217 employees from all the headquarter units were trained.

Online courses have been also set up to develop the digital capacities of the employees.

In 2016 the total cost of training for Telefónica, S.A. amounted to 3 million euros.

### Managing talent

At Telefónica we are convinced that our professionals are the Company's main asset and we believe in fully developing their potential so they can make our customers' dreams a reality. We have therefore developed a talent-based model that will accompany the employees throughout their career, identifying key skills and abilities that will help employees handle our transformation process, a line with the Company's strategy and the program "We choose it all".

This model is used when evaluating executive talent, driving a culture of meritocracy, and facilitating the decision-making process on aspects such as development, organization and compensation, among other aspects; this allows our organization to have a management talent map, as well as a structured succession plan.

Based on this model and having detected key needs for the future, we promote global talent programs that contribute to the professional development of our teams in order to better implement the Company's strategy at the various levels and segments, from young employees to executives.

Approximately 100 young people from all areas of the Company took part in the Young Leaders Program, which focused on the development of digital and transformative capacities to better prepare this group of young talent for the future. After



the 2016 edition ended in September, the selection process began for the 2017 edition, in which 86 young people from 11 countries will participate, 53% of which are women.

For the Profile for Digital Transformation project, in 2016 we also invited more than 2,300 company leaders from different levels of the organization. This allowed us to obtain solid results at the company, transaction and functional unit level, identifying specific development needs that are incorporated in the global learning and development offer.

Within the framework of the Profile for Digital Transformation, we have also worked on developing transformative and digital skills with executives and managers with high potential during the last quarter of the year. In collaboration with one of the leading digital education institutions, we organized the Digital Development Festival where more than 1,100 hours of online training were given and where we were able to gain insight into the view of renowned internal and external experts on digitalization and its impact on Telefónica's business through a series of on-site and online conferences that were attended by more than 1,600 company leaders.

### **Occupational health and safety**

One of Telefónica's priorities is to offer its staff the best possible working conditions at their place of work or when they are on the move.

As per its Business Principles, Telefónica ensures staff work in a safe environment. Appropriate mechanisms are therefore in place to avoid workplace accidents, injuries and illness associated with professional activities by fully complying with prevailing regulations, implementing safe working procedures, providing training and managing occupational risks.

The Occupational Risk Management System ensures worker health and safety is at the heart of all Telefónica's processes and services; offering an end-to-end model for rolling out joint action, procedures and policies. This system enables Telefónica to identify and disseminate practices that are proven to have an impact on staff welfare and therefore on reducing accident rates.

## Managing diversity

Telefónica understands that managing diversity is key leverage for the Company's digitalization.

Diversity is seen as an opportunity, a competitive element which, through our diverse professionals, allows us to reach out to our customers who are equally diverse. We are convinced of their capacity to generate value, their commercial impact, and their impact on innovation and, in short, on our results.

In response to this vision, in 2016 significant momentum was provided by the creation of the Global Diversity Council, which started up on March 17 and is composed of members of the management committees for operations. The purpose of the Diversity Council is to support the initiatives being developed locally and, based on this idea, a company plan was drafted that provides support and monitors the countries in order to ensure they are making progress towards the targets set. The Council also serves as a space to share good practices and to be able to replicate those initiatives that are working well in other countries.

Accordingly, it is important to highlight the approval on April 26 by the Executive Committee of the Company's Policy on Appointments and Termination of Executives, which strengthens the existing policy by guaranteeing the cap company has the best talent through meritocracy, diversity and transparency.

With regard to the total headcount, the number of employees of Telefónica at December 31, 2016 was 127,323. There were 47,933 female employees (37.6% of the total), and 79,390 male employees (62.4% of the total). 20.5% of executive positions are held by women.

It should also be noted that Telefónica employs professionals from more than 24 countries (four of which are represented on the Board of Directors), representing over 100 nationalities.

Telefónica considers the diversity project to be a strategic project that is part of its Responsible Business Plan, which is presented at the Committee on Institutional Affairs chaired by Julio Linares and which reports to the Board. Within the scope of the Board of diversity, a Global Diversity Policy was developed in 2016.

Also note worthy of mention is the career acceleration program for women (Women in Leadership) developed last year, in which 150 professional women of the Group participated in 2016.

Since 25 November, 2015, Telefónica S.A. has used a specific and verifiable Female Director Selection Policy, approved by the Board of Directors, which is aimed at ensuring that Director appointment or re-election proposals meet the Board's requirements as set out in a preliminary analysis, encouraging gender equality and diversity of knowledge and experience.

With regards to the promotion of Female Directors' presence in the Board of Directors, it is important to note that the policy expressly states that it is mandatory for Director selection procedures to encourage gender diversity, and forbids any type of underlying bias which might cause any form of discrimination. Notwithstanding the foregoing, the Nominating, Compensation and Corporate Governance Committee and the Board of Directors of the Company have taken into account this premise in all their appointment proposals, re-elections and ratifications of the directors that were presented, analysed and approved during this year 2016, and specifically the appointment proposal of Ms. Sabina Fluxà Thienemann, approved by the General Ordinary Shareholders Meeting held on May 12, 2016.

## Liquidity and capital resources

### Financing

The main financing transactions carried out in the bond market in 2016 are as follows:

Item	Date	Maturity Date	Nominal (millions)		Currency of issuance	Coupon
			Currency	Euros		
<b>Telefónica Emisiones, S.A.U. <sup>(1)</sup></b>						
EMTN Bond	04/13/16	04/13/22	1,400	1,400	EUR	0.75%
	04/13/16	04/13/26	1,350	1,350	EUR	1.46%
	10/17/16	10/17/20	1,250	1,250	EUR	0.318%
	10/17/16	10/17/31	750	750	EUR	1.93%
	12/28/16	12/28/51	150	150	EUR	4.00%
<b>Telefónica Participaciones, S.A.U. <sup>(1)</sup></b>						
Cash-settled equity -link bonds non-dilutive (*)	03/09/16	03/09/21	600	600	EUR	0%

(\*) Referenced to the trading price of Telefónica, S.A.

(1) Guaranteed by Telefónica, S.A.

The main financing transactions carried out in the bank market in 2016 are as follows:

Item	Limit	Currency	Outstanding balance		Arrangement Date	Maturity date
			(millions of euros)			
<b>Telefónica, S.A.</b>						
Bilateral loan	100	EUR	100		02/23/16	02/23/19
Bilateral loan	100	EUR	100		02/23/16	02/23/21
Loan	300	EUR	300		03/08/16	03/08/21
Loan	300	EUR	300		10/24/16	03/19/19
<b>Telefónica Europe, B.V.</b>						
Structured financing <sup>(*)</sup> (1)	1,500	EUR	-		11/28/16	11/28/24

(\*) Facility with amortization schedule.

(1) Guaranteed by Telefónica, S.A.

### Available funds

At December 31, 2016, Telefónica S.A.'s available funds from undrawn lines of credit in different financial institutions totaled 10,302 million euros (of which 9,816 million euros maturing in more than 12 months). Additionally, cash and cash equivalents as of December 31, 2016 amount to 811 million euros.

Additional information on sources of liquidity and undrawn lines of credit available to the Company, on liquidity risk management, on the Company's debt levels, and on capital management is provided in Notes 13, 14, 15 and 16 of the financial statements.

### Contractual commitments

Note 19 to the financial statements provides information on firm commitments giving rise to future cash outflows and associated with operating leases, primarily.

## Credit risk management

The credit risk in Telefónica, S.A. mainly refers to the one associated with financial derivative instruments arranged with different entities. The detailed description of how those risks are managed and hedged is included in Note 16.

## Credit rating

At December 31, 2016, Telefónica, S.A.'s long-term issuer default rating is "BBB stable outlook" from Fitch, "Baa3 stable outlook" from Moody's and "BBB stable outlook" from Standard & Poor's. During 2016, there have been changes in the credit ratings by the three agencies. Moody's downgraded the rating to "Baa3 stable" from "Baa2 negative" on November 7, 2016, Fitch downgraded the rating to "BBB stable" from "BBB+ stable" on September 5, 2016 and Standard and Poor's revised the outlook to "stable" from "positive" on May 17, 2016.

European Commission's decision to block the proposed sale of O2 U.K. to Hutchison's Three U.K. had an impact on Telefónica's credit ratings and outlooks by Moody's and Standard and Poor's, as they considered that decision would delay the Company's deleveraging process. In 2016, among the measures taken to protect the credit rating, it is noteworthy the change in the shareholder remuneration policy, together with the announcement of the commitment to maintain a solid investment grade credit rating. Relating to 2016 fiscal year dividend, Telefónica will pay 0.55 euros per share: 0.35 euros in November 2016 via a voluntary scrip dividend plus 0.20 euros in cash in the second quarter of 2017. Relating to 2017 dividend, Telefónica will pay an amount of 0.40 euros per share in cash: 0.20 euros in the fourth quarter of 2017 and 0.20 euros in the second quarter of 2018. Additionally, it is worth highlighting the strong financing activity undertaken during 2016 together with the maintenance of an appropriate level of liquidity, an active portfolio management through the announced intention to continue analyzing best strategic alternatives for O2 UK and Telxius, the executed sale of Telefé and the partial disposal of China Unicom, as well as the issuance of undated deeply subordinated securities as a solvency protection measure to mitigate negative impacts on our financial statements.

## Dividend policy

Telefónica, S.A.'s dividend policy is revised yearly based on the Group's earnings, cash generation, solvency, liquidity, flexibility to make strategic investments, and shareholder and investor expectations. In 2016, the Annual General Meeting approved to pay a dividend, via scrip dividend of approximately 0.35 euros per share to be paid in November 2016.

On October 27, 2016, the Board of Directors of Telefónica, S.A. decided to modify the dividend policy for the years 2016 and 2017, announcing for the year 2016 the payment of 0.55 euros per share, adding to the scrip approved by the Annual Shareholders Meeting, the payment of 0.20 euros in cash in the second quarter of 2017. Relating to 2017, it was announced that the dividend would amount to 0.40 euros per share: 0.20 euros in the fourth quarter of 2017 and 0.20 euros in the second quarter of 2018. Both tranches would be paid in cash.

On November 2016, Telefónica launched a scrip dividend issue to allow shareholders to choose to receive new shares in place of a cash dividend (which may be replaced by selling the associated subscription rights to the Company at a pre-established price), while enabling the Company to reduce its debt, depending on the take-up rate of the conversion.

## Treasury shares

Telefónica has performed, and may consider performing, transactions with treasury shares and financial instruments or contracts that confer the right to acquire treasury shares or assets whose underlying is Company shares.

Treasury share transactions will always be for legitimate purposes, including:

- Undertaking treasury share acquisitions approved by the Board of Directors or pursuant to General Shareholders' Meeting resolutions.
- Honoring previous legitimate commitments assumed.
- Covering requirements for shares to allocate to employees and management under stock option plans.
- Other purposes in accordance with prevailing legislation. In the past, treasury shares purchased on the stock market were exchanged for other shares-securities (as in the case of preferred capital securities), swapped for stakes in other companies (e.g. China Unicom or Telco S.p.A.), or acquired to reduce the number of shares in circulation (by redeeming the shares acquired), thereby boosting earnings per share.

Treasury share transactions will not be performed in any event based on privileged information or in order to intervene in free price formation. In particular, any of the conduct referred to in Articles 83.ter.1 of the Spanish Securities Market Law and 2 of Royal Decree 1333/2005 of November 11 implementing the Spanish Securities Market Law, with regards to market abuse will be avoided.

At December 31, 2016 and 2015, Telefónica, S.A. held the following treasury shares:

	Number of shares	Euros per share		Market value (1)	%
		Acquisition price	Trading price		
Treasury shares at 12/31/16	141,229,134	10.48	8.82	1,246	2.80339%

(1)Millions of euros

	Number of shares	Euros per share		Market value (1)	%
		Acquisition price	Trading price		
Treasury shares at 12/31/15	141,639,159	11.69	10.24	1,450	2.84690%

(1)Millions of euros

The movement in treasury shares of Telefónica, S.A. in 2016 and 2015 is as follows:

	Number of shares
<b>Treasury shares at 12/31/14</b>	<b>128,227,971</b>
Acquisitions	138,036,450
Disposals	(47,824,300)
Share redemption	(74,076,263)
PIP II share plan delivery	(2,724,699)
<b>Treasury shares at 12/31/15</b>	<b>141,639,159</b>
Acquisitions	77,087,297
Disposals	(2,869,334)
Share redemption	(74,627,988)
<b>Treasury shares at 12/31/16</b>	<b>141,229,134</b>

Acquisitions

The amount of the acquisitions of treasury shares in 2016 and 2015 was 668 million euros and 1,654 million euros, respectively.

Share redemption and disposals

On October 13, 2016, pursuant to the resolution of the share capital reduction, by the cancellation of own shares, adopted by the Annual General Shareholders' Meeting of Telefónica held on May 12, 2016, the public deed of this share capital reduction was registered in the Madrid Mercantile Registry (Registro Mercantil). Therefore, 74,627,988 of the own shares of Telefónica, S.A. totalling 813 million euros have been cancelled.

On July 24, 2015, pursuant to the resolution of the share capital reduction, by the cancellation of own shares, adopted by the Annual General Shareholders' Meeting of Telefónica held on June 12, 2015, the public deed of this share capital reduction was registered in the Madrid Mercantile Registry (Registro Mercantil). Therefore, 74,076,263 of the own shares of Telefónica, S.A. totalling 886 million euros have been cancelled.

Treasury shares sold, including share plan redemptions, in 2016 and 2015 amount to 26 million euros and 593 million euros, respectively.

The main treasury share sale transaction in 2015 was the agreement entered by Telefónica, S.A. with Vivendi, S.A. through which Telefónica has committed to deliver 46.0 million of its treasury shares, in exchange for 58.4 million preferred shares of Telefónica Brasil, S.A. The impact in equity amounted to 555 million euros.

On June 30, 2016 the third phase of the Telefónica, S.A. long-term incentive plan called "Performance and Investment Plan 2013-2016" (PIP 2013-2016") ended. No shares were delivered to Telefónica Group Management.

On June 30, 2015, the second phase of the Telefónica, S.A. long-term incentive plan called "Performance and Investment Plan 2012-2015" ("PIP 2012-2015") ended. According to the level of "Total Shareholder Return" (TSR) achieved, 77%, 2,724,699 shares were delivered.

The Company also has a derivative instrument, to be settled by offset, on a nominal value equivalent to 35.2 million of Telefónica shares in 2015 (33.8 million shares in 2015), recognized in both years under "Current interest-bearing debt" in the accompanying balance sheet.

## Risks factors associated with the issuer

The Telefónica Group's business is affected by a series of intrinsic risk factors that affect exclusively the Group, as well as a series of external factors that are common to businesses of the same sector. The main risks and uncertainties facing the Company which could affect its business, financial position, reputation, corporate image and brand and its results of operations, must be considered jointly with the information in the Annual Financial Statements, and are as follows:

### Group-Related Risks

#### **Worsening of the economic and political environment could negatively affect Telefónica's business.**

Telefónica's international presence enables the diversification of its activities across countries and regions, but it exposes Telefónica to various legislation, as well as to the political and economic environments of the countries in which it operates. Any adverse developments or even uncertainties in this regard, including exchange-rate or sovereign-risk fluctuations, may adversely affect the Company's business, financial position, cash flows and results of operations and/or the performance of some or all of the Group's financial indicators.

Economic conditions may adversely affect the level of demand of existing and prospective customers, as they may no longer deem critical the services offered by the Group.

Growth in Europe and financial stability may be affected by political uncertainty in some European countries due to upcoming general elections, a possible revival of the crisis in Greece, restructuring of the banking sector and due to the impact of steps taken towards an EU banking union and a capital markets union. In particular, the British exit process from the European Union following the vote to leave in the recent referendum, will require an adjustment of the economy to whatever new trade and investment relationships are put in place in the future, with the consequences in the meantime being uncertainty regarding investment, activity and financial market volatility. In 2016, the Telefónica Group obtained 24.5% of its revenues in Spain (22.6% in 2015), 14.4% in Germany (the same percentage as in 2015) and 13.2% in United Kingdom (14.3% in 2015).

In Latin America, there is an increasing exchange rate risk brought on by external factors such as increasing interest rates in the United States amid still low commodity prices and doubts about growth and imbalances in China; as well as internal factors as a consequence of the still high fiscal and external deficits in the most important Latin American countries or the low liquidity in exchange markets as it is the case in Argentina.

Some of the most significant macroeconomic risk factors in the region affect Mexico, as it is the country with the highest commercial and financial exposure to the United States. In this sense, increasing interest rates and the possible overhaul of trade agreements between both countries could imply higher restrictions on imports into the United States that would affect negatively the economic activity in Mexico.

Brazil is undertaking several measures principally focused on adjusting its public finances. A constitutional amendment limiting public spending has been approved and the government has submitted a new social security reform bill to Congress. However, the possibility of a new bout of political turmoil, which could weaken the support of the reforms, is not negligible. While signs of stabilization have emerged, economic growth continues to be negative and the unemployment rate has hit double digits, having a sizable effect on consumption spending. Moreover, despite financing external needs have decreased, internal needs are still high. All these elements have led to new downgrades to the country's credit rating during 2016, which now is below investment grade.

In countries such as Chile, Colombia and Peru, the recent uptick in commodity prices is having a positive impact on its fiscal and external accounts, but growth continues to be below its potential level due to the lower external inflows, which have affected investment and, to a lower extent, consumption.

In Argentina, the new government is focused on resolving Argentina's macroeconomic and financial imbalances and on recovering international confidence. Although reforms taking place may have positive effects in the medium term, short term risks persist, including exchange rate risk, especially due to the high inflation rate amid an economic contraction.

During 2016, Telefónica Hispanoamérica represented 24.2% of the Telefónica Group's revenues (26.2% in 2015), of which 23.8% proceeded from revenues in Argentina, 19.9% in Peru and 17.2% in Chile. During 2016, Telefónica Brazil represented 21.3% of the Telefónica's Group revenues (20.1% in 2015). In this respect, approximately 30.4% of the

Group's revenues were generated in countries that do not have investment grade status (in order of importance, Brazil, Argentina, Ecuador, Nicaragua, Venezuela, Guatemala, Costa Rica and El Salvador), and other countries are only one notch away from losing this threshold.

"Country risk" factors include the following, among others:

- unexpected adverse changes in regulation or administrative policies, including changes that modify the terms and conditions of licenses and concessions and their renewal (or delay their approval);
- abrupt exchange rate movements;
- high inflation rates;
- expropriation or nationalization of assets, adverse tax decisions, or other forms of state intervention;
- economic-financial downturns, political instability and civil disturbances; and
- maximum limits on profit margins imposed in order to limit the prices of goods and services through the analysis of cost structures (for example, in Venezuela, a maximum profit margin has been introduced that is set annually by the Superintendence for Defense of Socioeconomic Rights).

Any of the foregoing may adversely affect the business, financial position, results of operations and cash flows of the Group.

**The Group's financial condition and results of operations may be adversely affected if it does not effectively manage its exposure to foreign currency exchange rates or interest rates.**

At December 31, 2016, 50.8% of the Group's net debt (in nominal terms) was pegged to fixed interest rates for over a year, while 20% was denominated in a currency other than the euro. At December 31, 2016, the net financial debt ratio in Latin American currencies was 13%.

To illustrate the sensitivity of financial expenses to a change in short-term interest rates at December 31, 2016: (i) a 100 basis points increase in interest rates in all currencies in which Telefónica has a financial position at that date would lead to an increase in financial expenses of 232 million euros for the year ended December 31, 2016, (ii) whereas a 100 basis points decrease in interest rates in all currencies (even if negative interest rates are reached), would lead to a reduction in financial expenses of 201 million euros for the year ended December 31, 2016. These calculations were made assuming a constant currency and balance position equivalent to the position at year end taking into account the derivative financial instruments arranged.

According to the Group's calculations, the impact on results arising from a 10% depreciation of Latin American currencies against the US dollar and a 10% depreciation of other global currencies against the euro, excluding the pound sterling, would result in exchange losses of 43 million euros for the year ended December 31, 2016, primarily due to the depreciation of the Venezuelan bolívar and, to a lesser extent, the Argentinean peso. These calculations were made assuming a constant currency financial position with an impact on profit or loss for the year ended December 31, 2016, including derivative instruments in place.

During 2016, Telefónica Brazil represented 24.6% (27.0% in 2015), Telefónica Hispanoamérica represented 23.0% (32.9% in 2015) and Telefónica United Kingdom represented 11.3% (14.6% in 2015) of the operating income before depreciation and amortization (OIBDA) of the Telefónica Group.

The Telefónica Group uses a variety of strategies to manage this risk, among others the use of financial derivatives, which themselves are also exposed to risk, including counterparty risk. However, the Group's risk management strategies may not achieve the desired effect, which could adversely affect the Group's business, financial condition, results of operations and cash flows.

**Existing or worsening conditions in the financial markets may limit the Group's ability to finance, and consequently, the ability to carry out its business plan.**

The performance, expansion and improvement of the Telefónica Group's networks, the development and distribution of the Telefónica Group's services and products, the implementation of Telefónica's strategic plan and new technologies, the



renewal of licenses or the expansion of the Telefónica Group's business in countries where it operates, may require a substantial amount of financing.

A decrease in the liquidity of Telefónica, a difficulty in refinancing maturing debt or raising new funds as debt or equity could force Telefónica to use resources allocated to investments or other commitments to pay its financial debt, which could have a negative effect on the Group's business, financial condition, results of operations and/or cash flows.

Funding could be more difficult and costly in the event of a significant deterioration of conditions in the international or local financial markets due to the uncertainties regarding the hikes in interest rates on the part of the US Federal Reserve and the oil prices instabilities, or if there is an eventual deterioration in the solvency or operating performance of Telefónica.

At December 31, 2016, gross financial debt scheduled to mature in 2017 amounted to 13,326 million euros (which includes the net position of derivative financial instruments and certain current payables), and gross financial debt scheduled to mature in 2018 amounted to 7,195 million euros.

In accordance with its liquidity policy, Telefónica has covered its gross debt maturities over the next twelve months with cash and credit lines available at December 31, 2016. Telefónica's liquidity could be affected if market conditions make it difficult to renew existing undrawn credit lines, 8% of which, at December 31, 2016, were scheduled to mature prior to December 31, 2017.

In addition, given the interrelation between economic growth and financial stability, the materialization of any of the economic, political and exchange rate risks referred to above could lead to a negative impact on the availability and cost of Telefónica's financing and its liquidity strategy, which could have a negative effect on the Group's business, financial condition, results of operations and/or cash flows.

#### **Adoption of new accounting standards could affect reported results and financial position.**

Accounting Standardization Bodies and other authorities may periodically change accounting regulations that govern the preparation of the Annual financial statements. Those changes could have a significant impact on the way the Group accounts and presents its financial position and its operating income. In some instances, a modified standard or a new requirement with retroactive nature must be implemented, which requires the Group to restate previous financial statements.

See details of the implementation of new standards and interpretations issued in Note 3 of the Consolidated Financial Statements. In particular, Telefónica is required to adopt the new accounting standards IFRS15 Revenue from Contracts with Customers, effective from January 1, 2018, and IFRS 16 Leases, effective for the financial years from January 1, 2019. These standards present significant changes that could affect both the amount and moment of recognition of revenues and expenses related with certain sales transactions, as well as the accounting treatment for all lease contracts (other than short-term leases and leases of low-value assets). These changes could have a material impact on the Group's financial statements. Such impact is under analysis as of the date of this document.

#### **Risks relating to the Group's Industry**

##### **The Group operates in a highly regulated industry which requires government concessions for the provision of a large part of its services and the use of spectrum, which is a scarce and costly resource.**

The telecommunications sector is subject to laws and sector-specific regulations in the majority of the countries where the Group provides its services. Additionally, many of the services the Group provides require the granting of a license, concession or official approval, which usually requires certain obligations and investments to be made, such as those relating to the acquisition of spectrum. Among the main risks of this nature are those related to spectrum regulation and licenses/concessions, rates, universal service regulation, regulated wholesale services over fiber networks, privacy, functional separation of businesses and network neutrality. The fact that the Group's business is highly regulated both affects its revenues and imposes costs on its operations.

Thus, as the Group provides most of its services under licenses, authorizations or concessions, it is vulnerable to administrative bodies' decisions, such as economic fines for serious breaches in the provision of services and, potentially, revocation or failure to renew these licenses, authorizations or concessions, or the granting of new licenses to competitors for the provisions of services in a specific market.

In this regard, the Telefónica Group pursues its license renewals on the terms referred in their respective contractual conditions, though it cannot guarantee that it will always complete this process successfully or under the most beneficial terms for the Group. In many cases complying with certain obligations is required, including, among others, minimum specified quality, service and coverage standards and capital investment. Failure to comply with these obligations could result in the imposition of fines, revision of the contractual terms, or even the revocation of the license, authorization or concession.

Additionally, the Telefónica Group could be affected by regulatory actions carried out by the antitrust authorities. These authorities could prohibit certain actions, such as new acquisitions or specific practices, create obligations or lead to heavy fines. Any such measures implemented by the competition authorities could result in economic and/or reputational loss for the Group, in addition to a loss of market share and/or harm to the future growth of certain businesses. Regarding the merger of Telefónica Deutschland Holding AG and E-Plus, other providers such as United Internet and the regional cable operator Airdata lodged an appeal before the General Court against the decision of the EU which authorized such merger. Telefónica Deutschland has been accepted as an interested party of the process and it has presented its statements in both cases. United Internet has lodged a second appeal against the EC in relation to the content of the letter of commitment assumed by Telefónica Deutschland regarding the implementation of remedies for non-network operators. In December 2016, each of Mass Response Service GmbH and Multiconnect GmbH filed an appeal before the General Court against the decision of the EU that Telefónica Deutschland is not obliged to grant access to Full-Mobile Virtual Network Operators (“**MVNO**”) under the non-MNO remedy of the commitments. Telefónica Deutschland will apply for leave to intervene as an interested party.

#### *Regulation of spectrum and access to new government licenses/concessions of spectrum*

On September 14, 2016, the EC adopted, among other texts, a proposed Directive for the establishment of a European Electronic Communication Code, which could have significant implications, inter alia, for access to networks, spectrum use, auction conditions, duration and renewal of licenses, universal service, consumer protection, audiovisual services and platforms. It is estimated that the approval of such regulatory framework will take place in a year and a half.

On December 14, 2016, the European Parliament and Council agreed on a decision regarding the use and availability of the 700 MHz band. This could require new cash outflows from Telefónica between 2017 and 2022 in both the United Kingdom and Spain, where it is expected that the 700 MHz band will be available between 2020-2022. In connection with spectrum auctions for 2.3 and 3.4 GHz band, in the United Kingdom, Ofcom issued a consultation document on November 21, 2016. Responses were due by January 30, 2017, and a decision is expected in the second quarter of 2017. In Germany, the regulatory agency for electricity, gas, telecommunications, post and railway (“**BNetzA**”) initiated a proceeding for the demand-oriented allocation of new frequencies for the further rollout of digital 5G infrastructures, which include the timely allocation of the 2 GHz spectrum expiring at the end of 2020 and 2025 (so called UMTS spectrum) and further spectrum (inter alia 3.5 GHz). A decision about the allocation procedure is expected towards the end of 2017 and an auction may take place in 2018 or 2019.

In Latin America, spectrum auctions are expected to take place requiring potential cash outflows to obtain additional spectrum or to meet the coverage requirements associated with these licenses. Specifically, the procedures expected to take place in 2017-2018, in the relevant jurisdiction for the Group, are:

- Mexico: An auction spectrum in the 2500 MHz band is expected to take place between the third quarter of 2017 and the second quarter of 2018. A wholesale network tender, which will offer services in the 700 MHz band was concluded on November 17, 2016. Altán was the tender winner and the commercial operations must begin no later than March 31, 2018.
- Colombia: During 2017, the Ministry of Information Technologies and Communications published for commentaries until March 7, 2017, the project of resolution with the conditions for an auction of 70 MHz of spectrum band in 700 MHz and 5 MHz in 1900 MHz. In addition, the Ministry published a project of decree increasing the spectrum cap for lower bands to 45 MHz and 90 MHz for upper bands. The schedule for the auction has not been set yet.
- Argentina: The Government instructed the regulatory authority to issue new regulations during 2017 to ensure the reassignment of frequencies of the radio spectrum for the provision of wireless or fixed wireless services and enables the reassignment of frequencies previously granted to other provider.

However, it is likely that some of these spectrum tender procedures will not be completed, or even initiated in the mentioned dates. In addition to the above, it may be the case that certain administrations may not yet have announced their intention to release new spectrum but may do so during 2017. The above does not include processes announced via general statements by administrations, which involve bands not key to Telefónica's needs. Furthermore, Telefónica may also seek to acquire spectrum on the secondary market where opportunities might arise.

*Risks relating to concessions and licenses previously granted*

The terms of concessions and licenses granted to the Group and necessary for the provision of its services may be challenged or amended by the regulators at any time, which may materially adversely affect its business, financial condition, results of operations and cash flows.

The German regulator initiated consultations in March and July 2016 on the frequency distribution after the merger between Telefónica Deutschland and E-Plus, particularly in the 2 GHz band and on the future spectrum allocation for 5G band. The result of such consultations could lead, among others, to proposals by the regulator reorganizing the spectrum that Telefónica Deutschland holds on the 2 GHz band.

In the United Kingdom, Telefónica has an obligation in its 800 MHz spectrum license to provide indoor coverage to 98% of the United Kingdom population (and 95% of the population of each of England, Wales, Scotland and Northern Ireland) and an obligation in its 900/1800 MHz spectrum license to provide voice and text services to 90% of the United Kingdom landmass, both by the end of 2017, to be maintained, thereafter. Inherent with these obligations is a risk of Telefónica United Kingdom not meeting the required targets. Telefónica United Kingdom is actively working towards mitigating the risk through the continuous investment in an infrastructure improvement program, upgrading its 2G and 3G Networks and continued roll-out of its 4G Network.

In the state of São Paulo, Telefónica Brazil provides local and national long-distance Fixed Switched Telephony Service ("**STFC**") under the so-called public regime, through a concession agreement, which is expected to remain in force until 2025. In accordance with current regulations, Telefónica Brasil informed the Brazilian regulatory authority (Agencia Nacional de Telecomunicações or "**ANATEL**") that the net value, as of December 31, 2015, of assets assigned to the provision of STFC (which include, among others, switching and transmission equipment and public use terminals, external network equipment, energy equipment and system and operation support equipment) were estimated to total 7.8 billion Brazilian reais. At December 31, 2016, this value is estimated to total 8,813,916 Brazilian reais (this value will be updated in the second half of 2017). In principle, the assets assigned to the provision of STFC were considered reversible assets. During the last months, a bill amending the regulatory framework in Brazil has been processed, establishing, among others, that such assets will no longer be reversible under the new licenses regime in exchange for significant broadband investment commitments. Recently, the processing at the Senate of such bill has been challenged before the Federal Supreme Court. Such Court and, consequently, the Senate's governing board has decided to send the bill for voting in the plenary. With the bill being sent to the plenary, it could be understood that there is no more dispute for the Supreme Court to decide upon. In case that the bill is finally approved, ANATEL will be entitled to adopt the pertinent administrative decisions for the transformation of the respective licenses with the consequent modification of the future binding obligations to STFC providers.

In Colombia, the Ministry of Information Technologies and Communications ("**ITC**") issued Resolution 597 on March 27, 2014, to renew 850 MHz/1900 MHz licenses for 10 additional years. However, the reversion of assets (other than radio frequencies, which it is clear that must be returned) and its scope was widely discussed between the relevant mobile operators (including Telefónica Colombia) and the ITC in the context of the liquidation of the previous concession contract, taking into consideration the terms of the contract, and the Constitutional Court's interpretation of Law 422 of 1998 and Law 1341 of 2009. Discussions on the matter concluded on February 16, 2016, when the ITC convened an arbitration proceeding, in accordance with the terms of the relevant concession contract. The relevant concession holders (including Telefónica Colombia) filed a response to the claim prompted by the ITC. The arbitration process is still ongoing.

In Peru, Telefónica has concessions for the provision of the fixed-line service until November 2027. In December 2013, Telefónica filed a partial renewal request for these concessions for five more years. In December 2014 and June 2016, Telefónica also filed a renewal request for twenty more years in relation to a concession for the provision of local carrier service and one of the concessions to provide mobile-line services in provinces, respectively. As of the date of this document, the decision of the Ministry of Transport and Communications (Ministerio de Transportes y Comunicaciones) in all such proceedings is still pending and according to the legislation, the concessions subject of these procedures remain in force as long as the procedures are in progress.

Telefónica Móviles Chile, S.A. was awarded 2x10 MHz spectrum on the 700 MHz band in March 2014. A claim was brought by a consumer organization against the 700 MHz assignments. The decision by the Supreme Court on the appeal presented by such consumer organization is still pending.

During the year ended December 31, 2016, the Group's consolidated investment in spectrum acquisitions and renewals amounted to 345 million euros.

The Group's failure to obtain sufficient or appropriate spectrum capacity in the jurisdictions discussed above or any others in which it operates, or its inability to assume the related costs, could have an adverse impact on its ability to launch and provide new services and on Telefónica's ability to maintain the quality of existing services, which may adversely affect the Group's business, financial condition, results of operations and cash flows.

#### *Regulation of wholesale and retail charges*

The European Regulation 2015/2120 on Net Neutrality and Roaming was adopted on November 25, 2015. From June 15, 2017, operators may not charge roaming users within the EU an additional fee on their domestic prices for roaming calls, SMS and data services. However, in some circumstances, operators may apply consumption limits and additional surcharge under a "fair use policy". In January 2017, wholesale roaming caps have been agreed between the Council and the Parliament and the maximum wholesale caps have been set at the following limits: 0.01€/sms; 0.032€/minute; data services glide path: 7.7€/GB (June – December 2017); 6€/GB (2018); 4.5€/GB (2019); 3.5€/GB (2020); 3€/GB (2021) and 2.5€/GB (2022).

On September 14, 2016, the EC presented its proposal of the regulatory framework which, among other measures, intends to incorporate a European methodology and a European upper limit for the call-termination prices for landline phone/ mobile phone applicable in EU.

The decreases in wholesale mobile termination rates ("MTR") in Europe are also noteworthy. In the United Kingdom, the current rate is 0.503 ppm. A further cut to 0.495 ppm will come into effect from April 1, 2017.

In Germany, on August 30, 2016, BNetzA adopted a regulatory decision, which considers with pure long run incremental cost ("LRIC") a new cost model for the calculation of MTR. Telefónica Deutschland has appealed the decision in court, but the appeal has not yet been decided. BNetzA approved new MTR on November 30, 2016, in a provisional decision, which sets the rates to 0.011 euro/minute as of December 1, 2016, to 0.0107 euro/minute as of December 1, 2017, and to 0.0095 euro/minute as of December 1, 2018, until the end of November 2019. Before taking a final decision, the new MTR are nationally consulted and notified to the EC. There is consequently a risk that when the new MTR are approved (which will be retroactively enforceable from December 1, 2016), and with the new termination rates applicable from January 1, 2017, the rates will significantly decrease. Regarding fixed networks termination rates, BNetzA adopted at the end of January 2017 a provisional decision which establish a tariff of 0.0010 euro/minute.

In Spain, on July 1, 2016, the Spanish National Regulatory and Competition Authority (Comisión Nacional de los Mercados y la Competencia or "CNMC") initiated the process of reviewing the prices of mobile termination, with a final decision expected to be adopted during 2017.

Additionally, on January 17, 2017, the CNMC issued the analysis of the market for access and call origination on fixed networks. The CNMC maintains the obligation of Telefónica, as an operator with significant market power, to provide a wholesale interconnection offer and a wholesale line rental ("WLR"), both with cost-oriented prices regarding manufacturing costs and the adoption of a management accounting system. Telefónica is equally obliged to non-discrimination, transparency and separation of accounts. In Latin America, it is likely that MTRs will also be reduced in the short to medium term.

In Brazil, ANATEL has issued ex-ante regulations to ensure competition in the wholesale market, which includes reductions of the MTR. In this regard, the Plano Geral de Metas de Competição ("PGMC"), amended by Resolution 649/2015, established that mobile termination fees are subject to successive yearly reductions from 2016 until 2019, when the definitive cost-oriented-model fees are expected to be in force (such Resolution has been challenged in courts without a definitive outcome). On December 5, 2016, ANATEL issued a public consultation for the revision of the PGMC, which addresses changes in the relevant wholesale markets regulated by the PGMC and also in the cost-oriented model. The mentioned public consultation is available for comments until March 22, 2017.

In Mexico, on September 23, 2016, the Instituto Federal de Telecomunicaciones ("IFT") announced that the MTRs applicable to operators different from the so-called Prevailing Economic Agent for 2017 will be 0.1906 pesos per minute,

as long as the regulatory asymmetry of the Prevailing Economic Agent introduced by Mexico with the constitutional reform on 2014 and the new Federal Telecommunication Law on 2014 remains in effect.

In Colombia, the Comisión de Regulación de Comunicaciones (“**CRC**”) published a regulatory project for public comments in November 2016. In the project the CRC proposes a symmetric termination rate of 11.17 COP per minute and 4.3 million COP per monthly capacity from 2017 for established operators and an asymmetric termination rate of 19.01 COP per minute and 7.6 million COP per monthly capacity for challenger operators in a five-year period. The CRC also proposes regulatory measures to promote the entry of mobile virtual network operators (“**MVNOs**”), including the regulation of prices for the access to the mobile networks. The project is still in debate.

In Peru, the Organismo Supervisor de las Telecomunicaciones (“**OSIPTEL**”) started the process for the revision of the values on charges of interconnection for mobile termination of calls in telecommunication services networks in November 2016. The new values established by OSIPTEL will apply as of the fourth quarter of 2017.

As a result of the foregoing regulatory actions, Telefónica may receive lower prices for certain of its services, which may materially adversely affect its business, financial condition, results of operations and cash flows.

#### *Regulation of Universal Services*

The Universal Service (“**US**”) is an economic and legal term which refers to the obligation imposed to telecommunication operators to provide a basic service to all inhabitants of a country. In general, the goal is to promote quality services availability at affordable, reasonable and fair prices, to increase the access to advanced telecommunication services (such as broadband) and to move forward with the availability of such services to all customers. On its reform proposal for the regulatory framework issued on September 14, 2016, the EC seeks to modernize the Universal Services area in Europe, removing the mandatory inclusion of the traditional services (telephone boxes, directories and information services) and focusing on the provision of affordable broadband services. The EC also proposed that the US must be funded from general budgets and not from sectorial budgets. However, if this funding method does not thrive, the affordable broadband inclusion could result more expensive for the sector. In any case, it is estimated that the new regulation will not be applicable before 2020.

In Spain, the licenses of Telefónica de España and Telefónica Telecomunicaciones Públicas for the provision of USs expired on December 31, 2016. Both companies have been designated for the provision of these services from January 1, 2017.

In Brazil, on December 15, 2016, a proposal of the General Plan for Universalisation of Fixed Switched Telephony Services (“**PGMU**”) was approved by ANATEL.

The imposition on the Telefónica Group of additional or more onerous obligations to provide US services in the jurisdictions where it operates could have a material adverse effect on its business, financial condition, results of operations and cash flows.

#### *Regulation of fiber networks*

On February 24, 2016, the Spanish CNMC adopted a final resolution on the wholesale broadband market regulation, which raises a geographical segmentation in competitive (66 cities, 34% of total population) and non-competitive areas. It is anticipated that this resolution will last for at least four years. Its implementation is expected to result in a moderate increase of the current regulatory obligations of Telefónica in Spain, in terms of its granting of access to other operators to its fiber network and with respect to certain aspects relating specifically to the business segment (high quality bitstream service for business customers with national coverage). This Resolution has been appealed by Telefónica España. Additionally, on January 18, 2016, the CNMC adopted a resolution which approves the reference offer of the new wholesale unbundled virtual access service to Telefónica's new broadband Ethernet service (local NEBA). The NEBA service should be operative in 12 months from the date of the resolution's adoption.

Any of such obligations and restrictions could raise costs and limit Telefónica's freedom to provide the mentioned services, which could materially adversely affect Telefónica's business, financial condition, results of operations and cash flows.

#### *Regulations on privacy*

An intense data protection and privacy regulation may result in limitations to offer innovative digital services such as Big Data services. In Europe the new General Data Protection Regulation (“**GDPR**”) of April 27, 2016, will be directly

applicable in all member States from May 25, 2018. The GDPR introduces administrative fines of up to 4% of an undertaking's annual global turnover for breaching the new data protection rules.

On January 10, 2017, the EC presented its proposal for a regulation on ePrivacy, which will replace the current Directive 2002/58/EC on privacy in the electronic communications sector and will complement the recently approved GDPR. The proposal also introduces administrative fines of up to 4% of an undertaking's annual global turnover for breaching new regulations.

In October 2015, the Court of Justice of the European Union declared invalid the decision of the EC as regards the "Safe Harbor Agreement" relating to the transfer of personal data from the EU to the United States. Subsequently, the EC adopted a new decision on Privacy Shield on July 12, 2016, which considers that there is an adequate level of protection of personal data transferred from the EU to US self-certified companies complying with the Privacy Shield principles. Telefónica USA, Inc. has self-certified itself as Privacy Shield compliant. The Privacy Shield has been challenged before the EU's General Court by civil-society groups, but the admission of their appeals is still pending.

In Brazil, the adoption of a Personal Data Protection Act is still pending, this could lead to further obligations and restrictions for operators in relation to the collection of personal data and its treatment.

Any of such obligations and restrictions could raise costs and limit Telefónica's ability to provide certain services, which could materially adversely affect Telefónica's business, financial condition, results of operations and cash flows.

#### *Regulation of network neutrality*

Under the principle of network neutrality applicable to Internet access services area, network operators could not establish technical or commercial restrictions regarding the terminals that can be connected or the services, or applications and contents that can be accessed or distributed through the Internet by the end user. It also refers to the non-discriminatory behaviour (e.g. non-anticompetitive) to be adopted by operators regarding the different types of Internet traffic circulating through their networks.

In Europe, the application of the so-called "net neutrality Regulation" (Regulation (EU) 2015/2120 of November 25, 2015) will be monitored by national regulatory authorities following guidance to be delivered by the European Regulatory Authority ("BEREC") on August 30, 2016. This guidance could directly impact internet access service commercial practices (for example, some zero rating offers) and it may limit network management practices or increase transparency requirements on the Internet Access Service.

Telefónica operates in Latin American countries where net neutrality is being implemented, such as Chile, Colombia, Mexico and Peru, where OSIPTEL adopted regulations aimed at providing clear guidelines on the implementation of the net neutrality regime adopted in 2012 and in force since January 1, 2017. In Brazil, the President approved a net neutrality decree (regulating Marco Civil) on May 11, 2016. In Mexico, the IFT scheduled a public consultation to be carried out in August 2016 in respect of the guidelines that will be issued regarding net neutrality, which was postponed to the first quarter 2017. In Chile, on November 22, 2016, the Commission of Telecommunications submitted a bill for amending the Network Neutrality Act. The main changes are the establishment of rules more restricted to apply measures for traffic management and restrictive rules for "Zero Rating". If changes to regulation such as those described above, or otherwise, occur in the various jurisdictions where the Telefónica Group operates, it could have a material adverse effect on its business, financial condition, results of operations and cash flows.

#### **The Telefónica Group is exposed to risks in relation to compliance with anti-corruption laws and regulations and economic sanctions programs.**

The Telefónica Group is required to comply with the laws and regulations of various jurisdictions where it conducts operations. In particular, the Group's international operations are subject to various anti-corruption laws, including the US Foreign Corrupt Practices Act of 1977 and the United Kingdom Bribery Act of 2010, and economic sanctions programs, including those administered by the United Nations, the European Union and the United States, including the US Treasury Department's Office of Foreign Assets Control. The anti-corruption laws generally prohibit providing anything of value to government officials for the purposes of obtaining or retaining business or securing any improper business advantage. As part of the Telefónica Group's business, it may deal with entities, the employees of which are considered government officials. In addition, economic sanctions programs restrict the Group's business dealings with certain sanctioned countries, individuals and entities.

Although the Group has internal policies and procedures designed to ensure compliance with applicable anti-corruption laws and sanctions regulations, there can be no assurance that such policies and procedures will be sufficient or that the Group's employees, directors, officers, partners, agents and service providers will not take actions in violation of the Group's policies and procedures (or otherwise in violation of the relevant anti-corruption laws and sanctions regulations) for which the Group or they may be ultimately held responsible. Violations of anti-corruption laws and sanctions regulations could lead to financial penalties, exclusion from government contracts, damage to the Group's reputation and other consequences that could have a material adverse effect on the Group's business, results of operations and financial condition.

Telefónica is currently conducting internal investigations covering various countries regarding possible violations of applicable anti-corruption laws. Telefónica has been in contact with governmental authorities about these matters and intends to cooperate with those authorities as the investigations continue. It is not possible at this time to predict the scope or duration of these matters or their likely outcome.

**Customers' perceptions of services offered by the Company may put it at a disadvantage compared to competitors' offerings.**

Customers' perceptions of the assistance and services offered are critical to operating in highly-competitive markets. The ability to predict and respond to the changing needs and demands of customers affects the Company's competitive position relative to other technology sector companies, and its ability to extract the value generated during this process of transformation. Failure to do so adequately could have an adverse impact on the Group's business, financial condition, results of operations and cash flows.

**Telefónica may not be able to adequately foresee and respond to technological changes and sector trends.**

In a sector characterized by rapid technological change, it is essential to be able to offer the products and services demanded by the market and consider the impacts of changes in the life cycle of technical assets, secure margins and select the right investments to make.

The Telefónica Group operates in markets that are highly competitive and subject to constant technological development. Therefore, as a consequence of both of these characteristics, it is subject to the effects of actions by competitors in these markets and to its ability to anticipate and adapt, in a timely manner, to constant technological changes, changes in customer preferences that are taking place in the industry, as well as economic, political and social circumstances.

Failure to do so adequately could have an adverse effect on the Group's business, financial condition, results of operations and cash flows.

New products and technologies arise constantly, and their development can render obsolete the products and services the Telefónica Group offers and the technology it uses. This means that Telefónica must invest in the development of new products, technology and services so it can continue to compete effectively with current or future competitors, which may result in the decrease of the Group's profits and revenue margins. In this respect, margins from traditional voice and data business are shrinking, while new sources of revenues are deriving from mobile Internet and connectivity services that are being launched. Research and development costs amounted to 906 million euros in 2016, representing a decrease of 14.1% from 1,055 million euros in 2015 (1,111 million euros in 2014). These expenses represented 1.7%, 1.9% and 2.2% of the Group's consolidated revenues in 2016, 2015 and 2014, respectively. These figures have been calculated using the guidelines established in the Organization for Economic Cooperation and Development ("OECD") manual. One technology that telecommunications operators, including Telefónica (in Spain and Latin America), are focused on is the new FTTx-type network, which offers broadband access using optical fiber with superior services, such as Internet speed of up to 300MB or HD television services. However, substantial investment is required to deploy these networks, which entails fully or partially substituting copper loop access with optic fiber. While an increasing demand for the capabilities offered by these new networks to end users exists, the high level of the investments requires a continuous analysis of the return on investment.

The explosion of the digital market and entry of new players in the communications market, such as MVNOs, Internet companies or device manufacturers, may cause the loss of value of certain assets, and affect the Group's ability to generate income. Therefore, it is necessary to update the business model, encouraging the pursuit of incomes and additional efficiencies to those followed traditionally. Failure to do so adequately could have an adverse effect on the Group's business, financial condition, results of operations and cash flows.

In addition, the ability of the Telefónica Group's IT systems (operational and backup) to respond to Telefónica's operating requirements is a key factor to be taken into account with respect to the commercial development, customer satisfaction and business efficiency. Any failure by the Telefónica Group's IT systems to adequately respond to the Group's evolving operating requirements could have an adverse effect on the Group's business, financial condition and results of operations.

**Telefónica depends on its suppliers.**

The existence of critical suppliers in the supply chain, especially in areas such as network infrastructure, information systems or handsets, with a high concentration in a small number of suppliers, poses risks that may affect Telefónica's operations, and may cause legal contingencies or damages to its image in the event that inappropriate practices are produced by a participant in the supply chain.

As of December 31, 2016, the Telefónica Group depended on three handset suppliers and 12 network infrastructure suppliers, which together accounted for 80% of the awarded contracts for the year then ended. These suppliers may, among other things, extend delivery times, raise prices and limit supply due to their own stock shortfalls and business requirements.

If these suppliers fail to deliver products and services to the Telefónica Group on a timely basis, it could jeopardize network deployment and expansion plans, which in some cases could adversely affect the Telefónica Group's ability to satisfy its license terms and requirements, or otherwise have an adverse effect on the Group's business, financial condition, results of operations and cash flows.

**Unanticipated network interruptions can lead to quality loss or the interruption of the service.**

Unanticipated network interruptions as a result of system failures, including those due to network, hardware or software, stealing of infrastructure elements or cyber-attacks, which affect the quality of or cause an interruption in the Telefónica Group's service, could lead to customer dissatisfaction, reduced revenues and traffic, costly repairs, penalties or other measures imposed by regulatory authorities and could harm the Telefónica Group's image and reputation.

Telecommunications companies worldwide face increasing cybersecurity threats as businesses become increasingly dependent on telecommunications and computer networks and adopt cloud computing technologies. Cybersecurity threats include gaining unauthorized access to Telefónica's systems or inserting computer viruses or malicious software in its systems to misappropriate consumer data and other sensitive information, corrupt Telefónica's data or disrupt its operations. Unauthorized access may also be gained through traditional means such as the theft of laptop computers, portable data devices and mobile phones and intelligence gathering on employees with access.

Telefónica attempts to mitigate these risks through a number of measures, including backup systems and protective systems such as firewalls, virus scanners and other physical and logical security. However, these measures are not always effective. Although the Telefónica Group has insurance policies to cover these types of incidents, and the claims and loss in revenue caused by service interruptions to date have been covered by these policies, these policies may not be sufficient to cover all possible monetary losses.

**The telecommunications industry may be affected by the possible effects that electromagnetic fields, emitted by mobile devices and base stations, may have on human health.**

In some countries, there is a concern regarding potential effects of electromagnetic fields, emitted by mobile devices and base stations, on human health. This public concern has caused certain governments and administrations to take measures that have hindered the deployment of the infrastructures necessary to ensure quality of service, and affected the deployment criteria of new networks and digital services such as smart meters development.

There is a consensus between certain expert groups and public health agencies, including the World Health Organization that states that currently there are no established risks associated with exposure to low frequency signals in mobile communications. However, the scientific community is still investigating this issue especially with respect to mobile devices. Exposure limits for radio frequency suggested in the guidelines of the Protection of Non-Ionizing Radiation Protection Committee have been internationally recognized. The mobile industry has adopted these exposure limits and works to request authorities worldwide to adopt these standards.

Worries about radio frequency emissions may discourage the use of mobile devices and new digital services, which could cause the public authorities to implement measures restricting where transmitters and cell sites can be located, how they



operate, the use of mobile telephones and the massive deployment of smart meters and other products using mobile technology. This could lead to Telefónica being unable to expand or improve its mobile network.

The adoption of new measures by governments or administrations or other regulatory interventions in this respect, and any future assessment on the adverse impact of electromagnetic fields on health, may adversely affect the business, financial conditions, results of operations and cash flows of the Telefónica Group.

**Possible regulatory, business, economic or political changes could lead to asset impairment.**

The Telefónica Group reviews on an annual basis, or more frequently when the circumstances require it, the value of assets and cash-generating units, to assess whether their carrying values can be supported by the future expected cash flows, including, in some cases synergies allowed for in acquisition costs. Potential changes in the regulatory, business, economic or political environment may result in the need to introduce changes to estimates made and to recognize impairments in goodwill, intangible assets or fixed assets. Although the recognition of impairments of property, plant and equipment, intangible assets and financial assets results in a non-cash charge on the income statement, it could adversely affect the results of the Telefónica Group's operations. In this respect, the Telefónica Group has experienced impairments on certain of its investments, affecting its results of operations in the year in which they were experienced. In 2016, impairment losses in goodwill were recognized amounting to 215 million euros for Telefónica operations in Venezuela (124 million euros) and Mexico (91 million euros).

**The Telefónica Group's networks carry and store large volumes of confidential, personal and corporate data, and its Internet access and hosting services may lead to claims for illegal or illicit use of the Internet.**

The Telefónica Group's networks carry and store large volumes of confidential, personal and business data, through both voice and data traffic. The Telefónica Group stores increasing quantities and types of customer data in both business and consumer segments. Despite its best efforts to prevent it, the Telefónica Group may be found liable for any loss, transfer, or inappropriate modification of the customer data or general public data stored on its servers or transmitted through its networks, any of which could involve many people and have an impact on the Group's reputation, or lead to legal claims and liabilities that are difficult to measure in advance.

In addition, the Telefónica Group's Internet access and hosting servers could lead to claims for illegal or unlawful use of the Internet. Telefónica, like other telecommunications providers, may be held liable for any loss, transfer or inappropriate modification of the customer data stored on its servers or carried by its networks.

In most countries in which the Telefónica Group operates, the provision of its Internet access and hosting services (including the operation of websites with shelf-generated content) are regulated under a limited liability regime applicable to the content that it makes available to the public as a technical service provider, particularly content protected by copyright or similar laws. However, regulatory changes have been introduced imposing additional obligations on access providers (such as blocking access to a website) as part of the struggle against some illegal or illicit uses of the Internet, notably in Europe.

Any of the foregoing could have an adverse effect on the business, financial position, results of operations and cash flows of the Group.

**Telefónica and Telefónica Group companies are party to lawsuits, tax claims, antitrust and other legal proceedings.**

Telefónica and Telefónica Group companies are party to lawsuits, tax claims, antitrust and other legal proceedings in the ordinary course of their businesses, the financial outcome of which is unpredictable. An adverse outcome or settlement in these or other proceedings could result in significant costs and may have a material adverse effect on the Group's business, financial condition, results of operations, reputation and cash flows. In particular, the Telefónica Group is party to certain judicial tax proceedings in Peru concerning the clearance of certain previous years' income tax, in respect of which a contentious-administrative appeal is currently pending and to certain tax proceedings in Brazil, primarily relating to the ICMS (a Brazilian tax on telecommunication services) and to the Corporate Tax. Further details on these matters are provided in Notes 17 and 20 of the annual accounts.

## Trend evolution

In 2016, Telefónica made great progress towards long-term sustainable and profitable growth in service revenues, continuing to increase efficiencies and capturing synergies thanks to the integrated vision of the businesses, processes and technologies. This allowed us to maintain a strong investment effort in order to be able to offer our customers excellent connectivity. In recent years, the Company has moved forward in its business transformation:

- Firstly, Telefónica has defined a new business model with data-oriented offers, bundled services, including converged fixed and mobile services, as well as digital capabilities as part of the global transformation focused on responding to the change in our customers' consumer habits. An essential part of our effort has been the investment in fiber- and LTE networks, which we believe will allow the monetization of data as well as of digital services. In this way, Telefónica has significantly increased data accesses, including 82 million smartphones accesses, 4.8 million Pay TV accesses and 6.6 million fiber accesses during the 2014-2016 period. Additionally, average revenue per access increased by 2.8% year-on-year over the 2015-2016 period, from a year-on-year increase of 1.9% over the 2014-2015 period.
- Secondly, changing consumer habits have resulted in a decreasing demand for voice services and an increasing demand for data, due to video downloads and internet connectivity through smartphones. This new trend has allowed us since 2015 to compensate the drop in voice revenues (excluding falls in interconnection tariffs) with higher data and service over connectivity, to be able to start seeing a positive trend in average revenue per access in the majority of our markets.
- Thirdly, Telefónica has reinforced its competitive position thanks to an active management of the asset portfolio and to the consolidation of its participation in key markets in 2015: Germany (with the acquisition of E-Plus), Brazil (with the acquisition of GVT) and Spain (with the acquisition of DTS). These strategic acquisitions in key markets coupled with divestments in non-strategic markets, have allowed Telefónica to capture significant synergies.
- Lastly, Telefónica launched in 2014 a simplification program focused on increasing growth and capturing synergies across the board; commercial offer simplification; IT network and global process modernization (through higher investments in IT and commercial systems as well as call centre costs reduction); and improving sales channels with a more efficient back office. All these measures allow resource liberation, for the liberalization of resources that can be used for transformation, as improving network and accelerating the digitalization process.

On the other hand, various factors have contributed to the fact that Telefónica has experienced a downward trend in some key financial performance indicators during the 2014-2016 period.

- First, changes in foreign exchange rates, particularly in 2015 with the depreciation of the Brazilian real against the euro and the effects of the depreciation of the Venezuelan bolivar. In 2016 such currencies continued to depreciate and the Company's results were also affected by devaluations in the United Kingdom, Argentina and Mexico, adversely and significantly affecting revenue growth.
- Second, the high inflation in certain countries affected cost growth in numerous markets where Telefónica is present which were not offset by the increase in tariffs.
- Third, after a period of significant expansion, Telefónica has generally reduced the scope of its activities and exited certain countries in recent years to reduce its level of indebtedness and strengthen Telefónica's capacity for future growth.
- Fourth, Telefónica's business is highly regulated, which affects its revenues and imposes costs on its operations. For example, regulation sets the fixed rates that Telefónica charges for calls received from other companies' networks, and regulators have progressively lowered these rates in recent years.
- Fifth, in recent years Telefónica has experienced an intense competition in the markets where it operates, resulting in more bundled offers and making it difficult to monetize value added services.

- In the last two years, within the above mentioned simplification process, Telefónica has redefined its processes, readapting its resource necessities, resulting in various provisions which have affected, results in 2015 as well as in 2016.

In the 2014-2016 period these negative factors have contributed to a downward trend in some of Telefónica's key market indicators, such as the Profit for the year (-26.2% during the period). On the other hand, the positive result of the strategy a focus on sustainable and profitable growth is reflected in the Revenue trend during the 2014-2016 period, up 3.3%.

## Events after the reporting period

The following events regarding the Company took place between the reporting date and the date of preparation of the accompanying financial statements:

### Financing

On January 10, 2017, Telefónica, S.A. redeemed 300 million euros of its 2,500 million euros syndicated credit facility signed on February 19, 2015 and maturing in 2021.

On January 17, 2017, Telefónica Emisiones S.A.U. issued notes under its EMTN Programme filed on September 13, 2016 in an aggregate nominal amount of 1,750 million euros. This issuance was split into two series: one series, amounting to 1,250 million euros, maturing on January 17, 2025 and an annual coupon of 1.53% and the other series, amounting to 500 million euros maturing on October 17, 2028 and with an annual coupon of 2.32%. Both series of notes are guaranteed by Telefónica, S.A.

On January 17, 2017, Telefónica, S.A. amended the bilateral loan, signed originally on June 26, 2014 for an amount of 2,000 million euros and with an outstanding amount of 1,500 million euros, divided in two tranches with a new amortization schedule: tranche A for 500 million euros maturing on June 26, 2017 and tranche B for 1,000 million euros maturing on June 26, 2019. Later, on February 17, 2017, Telefónica, S.A. signed a new amended to its bilateral loan extending the maturity date of the tranche A for 500 million euros until June 26, 2019.

On January 25, 2017, Telefónica Emisiones S.A.U. issued notes under its EMTN Programme filed on September 13, 2016 in an aggregate nominal amount of 150 million euros, maturing on January 25, 2019. The notes are guaranteed by Telefónica, S.A.

On February 7, 2017, Telefónica Emisiones, S.A.U. redeemed 1,200 million euros, 100 million euros and 120 million euros of its notes, issued on February 7, 2011, March 21, 2011, February 7, 2012, respectively. The notes were guaranteed by Telefónica, S.A.

On February 15, 2017, Telefónica Europe, B.V. drew down an aggregate principal amount of 750 million euros of its long term financing of 1,500 million euros signed on November 28, 2016 and maturing in 2024. This financing is guaranteed by Telefónica, S.A.

### Investing in Group and affiliated companies

On January 12, 2017 Telefónica Móviles México, S.A. de C.V. has completed a capital increase of 3,000 million Mexican pesos (equivalent to 130 million euros) which has been subscribed and paid in full by Telefónica, S.A. on January 17, 2017.

In order to provide adequate financing funds to Telefónica Digital Holding, S.L.U. to enable the company refinancing its subsidiaries, on January 12, 2017 Telefónica, S.A. completed a capital increase of 301 million euros. This contribution has been paid in full.

On January 26, 2017 Telefónica Latinoamérica Holding, S.L. has executed a capital increase of 747 million euros which has been fully subscribed and paid by the Company.

### Telxius

On February 20, 2017 Telefónica reached an agreement for the sale of up to 40% of the total share capital of Telxius Telecom, S.A.U. to Taurus Bidco S.à.r.l. (hereafter, "KKR", an entity managed by Kohlberg Kravis Roberts & Co. L.P.), for a total amount of 1,275 million euros (12.75 euros per share).

The aforementioned agreement includes a purchase agreement for the sale of 62 million shares (representing 24.8% of the share capital) of Telxius Telecom, S.A.U. for a price of 790.5 million euros, as well as options over 38 million shares (representing 15.2% of the share capital) for a price of at least 484.5 million euros.

These options correspond to a call option exercisable by KKR and to a put option exercisable by Telefónica upon maturity of the call option.

The closing is subject to obtaining the corresponding regulatory approvals. The exercise window of the options would take place during the fourth quarter of 2017, provided that regulatory approvals have been obtained on that date.

After the transaction Telefónica will continue to maintain control over Telxius.

# Annual Corporate Governance Report for Listed Companies

## A. Ownership structure

### A.1 Complete the following table on the company's share capital:

Date of last modification	Share capital (€)	Number of shares	Number of voting rights
2016/12/07	5,037,804,990.00	5,037,804,990	5,037,804,990

Indicate whether different types of shares exist with different associated rights:

No

### A.2 List the direct and indirect holders of significant ownership interests in your company at year-end, excluding directors:

Name or corporate name of shareholder	Number of direct voting rights	Number of indirect voting rights	% of total voting rights
Banco Bilbao Vizcaya Argentaria, S.A.	318,861,940	0	6.33%
Fundación Bancaria Caixa d'Estalvis i Pensions de Barcelona, "la Caixa"	0	259,651,258	5.15%
Blackrock, Inc.	0	262,747,410	5.22%

Name or corporate name of indirect holder	Through: Name or corporate name of direct holder	Number of voting rights
Fundación Bancaria Caixa d'Estalvis i Pensions de Barcelona, "la Caixa"	Vidacaixa, S.A. de Seguros y Reaseguros	189,470
Fundación Bancaria Caixa d'Estalvis i Pensions de Barcelona, "la Caixa"	Caixabank, S.A.	259,461,788
Blackrock, Inc	Blackrock Group	262,747,410

Indicate the most significant movements in the shareholding structure during the year.

Name or corporate name of shareholder	Date of transaction	Description of transaction
Blackrock, Inc	2016/09/14	Exceeded 5% of the share capital

**A.3 Complete the following tables on company directors holding voting rights through company shares.**

Name or corporate name of director	Number of direct voting rights	Number of indirect voting rights	% of total voting rights
Mr. José María Álvarez-Pallete López	1,230,745	0	0.02%
Mr. Isidro Fainé Casas	595,382	0	0.01%
Mr. José María Abril Pérez	157,077	158,211	0.01%
Mr. Julio Linares López	480,889	8,440	0.01%
Mr. César Alierta Izuel	5,505,144	0	0.11%
Ms. Eva Castillo Sanz	113,594	0	0.00%
Mr. José Javier Echenique Landiribar	31,850	75,712	0.00%
Mr. Peter Erskine	42,733	0	0.00%
Mr. Luiz Fernando Furlán	38,423	0	0.00%
Mr. Gonzalo Hinojosa Fernández de Angulo	51,135	206,815	0.01%
Mr. Pablo Isla Álvarez de Tejera	10,294	0	0.00%
Mr. Antonio Massanell Lavilla	2,743	0	0.00%
Mr. Ignacio Moreno Martínez	18,311	0	0.00%
Mr. Francisco Javier de Paz Mancho	64,862	0	0.00%

Name or corporate name of indirect shareholder	Through: Name or corporate name of direct shareholder	Number of voting rights
Mr. José María Abril Pérez	Other company shareholders	158,211
Mr. Julio Linares López	Other company shareholders	8,440
Mr. José Javier Echenique Landiribar	Other company shareholders	75,712
Mr. Gonzalo Hinojosa Fernández de Angulo	Other company shareholders	206,815
<b>% of total voting rights held by the Board of Directors</b>		0.17%

Complete the following tables on share options held by directors:

Name or corporate name of director	Number of direct voting rights	Number of indirect voting rights	Equivalent number of shares	% of total voting rights
Mr. José María Álvarez-Pallete López	384,000	0	600,000	0.01%
Mr. César Alierta Izuel	648,000	0	1,012,500	0.01%

**A.4** Indicate, as applicable, any family, commercial, contractual or corporate relationships between owners of significant shareholdings, insofar as these are known by the company, unless they are of little relevance or arise from ordinary trading or exchange activities.

**A.5** Indicate, as applicable, any commercial, contractual or corporate relationships between owners of significant shareholdings, and the company and/or its group, unless they are of little relevance or arise from ordinary trading or exchange activities.

Name or company name of related party	Type of relationship	Brief description
Banco Bilbao Vizcaya Argentaria, S.A.	Corporate	Shareholding of Banco Bilbao Vizcaya Argentaria, S.A. (or any of the companies of its Group), together with Telefónica, S.A. and with Caixabank, S.A., in Telefónica Factoring España, S.A., Telefónica Factoring Perú, S.A.C. (TFP Perú), Telefónica Factoring Colombia, S.A., Telefónica Factoring do Brasil, Ltda., Telefónica Factoring México, S.A. de C.V., SOFOM, E.N.R., and Telefónica Factoring Chile, S.A.
Banco Bilbao Vizcaya Argentaria, S.A.	Corporate	Shareholding of Ciérvana, S.L. (a company which belongs to Grupo BBVA), together with Telefónica Compras Electrónicas, S.A.U., in Adquiria España, S.A.



Fundación Bancaria Caixa d'Estalvis i Pensions de Barcelona, "la Caixa"	Corporate	Shareholding of Caixabank, S.A., with Telefónica, S.A. and with Banco Bilbao Vizcaya Argentaria, S.A. (or with any of the companies of its Group), in Telefónica Factoring España, S.A., Telefónica Factoring Perú, S.A.C. (TFP Perú), Telefónica Factoring Colombia, S.A., Telefónica Factoring do Brasil, Ltda., Telefónica Factoring México, S.A. de C.V., SOFOM, E.N.R., and Telefónica Factoring Chile, S.A.
Fundación Bancaria Caixa d'Estalvis i Pensions de Barcelona, "la Caixa"	Corporate	Shareholding of Caixabank consumer Finance, E.F.C., S.A. (subsidiary of Caixabank, S.A.) together with Telefónica, S.A., in Telefónica Consumer Finance, E.F.C., S.A.

**A.6 Indicate whether any shareholders' agreements have been notified to the company pursuant to Articles 530 and 531 of the Spanish Corporations Act (Ley de Sociedades de Capital, hereinafter "LSC" in Spanish). Provide a brief description and list the shareholders bound by the agreement, as applicable.**

**Yes**

**Parties to the shareholders' agreement**

Vivendi, S.A.

Telefónica, S.A.

**% of share capital affected**

0.98%

**Brief description of the agreement:**

See heading H "Other information of interest", Note 5 to Section A.6.

**Parties to the shareholders' agreement**

Telefónica, S.A.

China Unicom (Hong Kong) Limited

**% of share capital affected**

1.27%

**Brief description of the agreement:**

See heading H "Other information of interest", Note 5 to Section A.6.

**Indicate whether the company is aware of the existence of any concerted actions among its shareholders. Give a brief description as applicable.**

**No**

Expressly indicate any amendments to or termination of such agreements or concerted actions during the year.

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**A.7 Indicate whether any individuals or bodies corporate currently exercise control or could exercise control over the company in accordance with Article 5 of the Spanish Securities' Market Act (Ley del Mercado de Valores). If so, identify.**

No

**A.8 Complete the following tables on the company's treasury shares.**

**At year end:**

Number of shares held directly	Number of shares held indirectly (*)	% of total share capital
141,229,134	0	2.80%

(\*) Through:

-

**Detail any significant changes during the year, in accordance with Royal Decree 1362/2007.**

**Explain any significant changes**

On January 15, 2016, Telefónica notified the Spanish National Securities Market Commission, (Comisión Nacional del Mercado de Valores, CNMV), the direct acquisition of 53,265,917 shares, which represented 1.071% of the company's share capital.

In accordance with the resolution for reduction in share capital through the cancellation of treasury shares approved by the Ordinary General Shareholders Meeting on May 12, 2016, and after the resolution to that effect adopted by the Board of Directors of the Company, the deed of the share capital reduction was registered in the Companies Registry of Madrid on October 11, 2016. Consequently, 74,627,988 treasury shares of Telefónica, S.A., which represented 1.50% of its share capital, were cancelled.

On October 18, 2016, Telefónica notified the Spanish National Securities Market Commission, (Comisión Nacional del Mercado de Valores, CNMV), the direct acquisition of 49,405,408 shares, which represented 1.008% of the company's share capital.

On December 9, 2016, Telefónica notified the Spanish National Securities Market Commission, (Comisión Nacional del Mercado de Valores, CNMV), the acquisition of 5,431,889 shares, which represented 0.108% of the company's share capital, as consequence of the execution of the share capital increase approved by the Ordinary General Shareholders Meeting of Telefónica, S.A. on May 12, 2016, under the item VIII.2 of its Agenda.

**A.9 Give details of the applicable conditions and time periods governing any resolutions of the General Shareholders Meeting authorizing the Board of Directors to repurchase or transfer the treasury shares.**

At Telefónica's Ordinary General Shareholders Meeting held on May 30, 2014, the shareholders resolved to renew the authorisation granted at the General Shareholders Meeting of June 2, 2010, for the derivative acquisition of treasury stock, either directly or through Group companies, in the terms literally transcribed below:

"A) Authorise, pursuant to articles 144 and the articles thereunder of the Spanish Corporations Act, the derivative acquisition, at any point and as many times as it might be deemed necessary, by Telefónica, S.A. –either directly, or through any of its subsidiaries – of treasury stock, fully-paid, by purchase and sale, by exchange or by any other legal transaction.

The minimum acquisition price or minimum value of the consideration shall be equal to the par value of the shares of its own stock acquired, and the maximum acquisition price or maximum consideration value shall be equal to the listing price of the shares of its own stock acquired by the Company on an official secondary market at the time of the acquisition.

Such authorization is granted for a period of 5 years as from the date of this General Shareholders' Meeting and is expressly subject to the limitation that the par value of the Company's own shares acquired directly or indirectly pursuant to this authorization added to those already held by Telefónica, S.A. and all its controlled subsidiaries shall at no time exceed the maximum amount permitted by the Law at any time, and the limitations on the acquisition of the Company's own shares established by the regulatory Authorities of the markets on which the shares of Telefónica, S.A. are traded shall also be observed.

It is expressly stated for the record that the authorization granted to acquire shares of its own stock may be used in whole or in part to acquire shares of Telefónica, S.A. that it must deliver or transfer to directors or employees of the Company or of companies of its Group, directly or as a result of the exercise by them of option rights owned by them, all within the framework of duly approved compensation systems referencing the listing price of the Company's shares.

B) To authorize the Board of Directors, as broadly as possible, to exercise the authorisation granted by this resolution and to implement the other provisions contained therein; such powers may be delegated by the Board of Directors to the Executive Commission, the Executive Chairman of the Board of Directors, the Chief Operating Officer or any other person expressly authorized by the Board of Directors for such purpose.

C) To deprive of effect, to the extent of the unused amount, the authorization granted under Item III on the Agenda by the Ordinary General Shareholders Meeting of the Company on June 2, 2010."

#### A.9.bis. Estimated free-float capital:

Estimated free-float capital	%
	78.08

**A.10 Indicate, as applicable, any restrictions on the transfer of securities and/or any restrictions on voting rights. In particular, indicate any type of restrictions that could impose obstacles to the takeover of the company by means of share purchases on the market.**

Yes

#### Description of the restrictions

See heading H "Other information of interest", Note 7 to Section A.10.

**A.11 Indicate whether the General Shareholders' Meeting has agreed to take neutralisation measures to prevent a public takeover bid by virtue of the provisions of Act 6/2007.**

No

If applicable, explain the measures adopted and the terms under which these restrictions may be lifted.

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**A.12 Indicate whether the company has issued securities not traded in a regulated market of the European Union.****Yes**

If so, identify the various classes of shares and, for each class of shares, the rights and obligations they confer.

Shares of Telefónica, S.A. are traded on the Spanish electronic trading system (the "Continuous Markets"), and also on the stock exchanges of New York, London, Lima and Buenos Aires, and they all have the same characteristics, rights and obligations.

On the New York and Lima stock exchanges, Telefónica, S.A. shares are traded through American Depositary Shares (ADSs), where each ADS represents a Company share.

## B. General Shareholders Meeting

**B.1 Indicate and, as applicable, describe any difference between the system of minimum quorums for constitution of the General Shareholders Meeting established in the Spanish Corporations Act (Ley de Sociedades de Capital, hereinafter "LSC" in Spanish).**

No

**B.2 Indicate and, as applicable, describe any differences between the company's system of adopting corporate resolutions and the framework established in the LSC:**

No

Describe how they differ from the rules established in the LSC.

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**B.3 Indicate the rules governing amendments to the company's Bylaws. In particular, indicate the majorities required to amend the Bylaws and, if applicable, the rules for protecting shareholders' rights when changing the Bylaws.**

The Bylaws and Regulations for the General Shareholders Meeting of Telefónica confer upon the General Shareholders Meeting the power to agree to amend the Corporate By-laws (articles 15 and 5, respectively), being subject to legal provisions applicable for all other matters.

The procedure for amending the Bylaws is governed by Articles 285 and following articles of the revised text of the Spanish Corporations Act, and needs to be approved at the General Shareholders Meeting with the majorities stated in Articles 194 and 201 of the same law. In particular, if the Shareholders Meeting is convened to deliberate on Bylaw amendments, including capital increases or decreases, on eliminating or restricting the preferential acquisition right for new shares, and the transformation, merger, spin-off, or the global assignment of assets and liabilities and the relocation of the registered offices abroad, then shareholders which own at least fifty per cent of the subscribed capital with voting rights will have to be present or be represented by proxy on first call. If there is no sufficient quorum, then the Shareholders' Meeting will be held on second call, on this occasion at least twenty-five per cent of the subscribed capital with voting rights will need to be present, either in person or by proxy. When shareholders which represent less than fifty per cent of the subscribed capital with voting rights are present at the Shareholders Meeting, either in person or by proxy, the resolutions referred to above can only be approved when two thirds of the capital, present or represented by proxy at the Shareholders Meeting, vote in favour of the resolution.

Pursuant to article 286 of the Spanish Corporations Act, if the Bylaws are amended, then the Directors, or, if applicable, the shareholders who have made the proposal, will have to draw up in full the text of their proposed amendment, and a written report in which they justify the amendment, which will have to be submitted to the shareholders which are taking part in the Shareholders' Meeting to deliberate on that amendment.

Furthermore, pursuant to article 287 of the Spanish Corporations Act, the announcement calling the General Shareholders Meeting will have to clearly state the questions which might have to be amended, and note that all the shareholders are entitled to analyse the full text of the proposed amendment and the report on such an amendment at the registered offices, and also to request that such documents be delivered to them or sent free of charge.

According to article 291 of the Spanish Corporations Act, when new obligations are established for shareholders due to amendment of the Bylaws, the resolution will have to be passed with the approval of the affected shareholders. Furthermore, if the amendment directly or indirectly affects a type of shares, or part of them, then the provisions of article 293 of that Act will be applicable.

The procedure for voting on proposed resolutions by the Shareholders' Meeting is also regulated in Article 197 bis of the Spanish Corporations Act, in the internal regulations of Telefónica (in particular, in Article 23 of the Regulations of the General Shareholders Meeting). This Article states that, when amendments are made to the Bylaws, each article or group of articles which are materially different will be voted for separately.

**B.4 Indicate the attendance figures for the General Shareholders' Meetings held during the year:**

Date of general meeting	Attendance data				Total
	% attending in person	% by proxy	% remote voting Electronic means	Other	
2015/06/12	11.55%	46.36%	0.01%	0.48%	58.40%
2016/05/12	0.21%	55.34%	0.03%	0.55%	56.13%

**B.5 Indicate whether the Bylaws impose any minimum requirement on the number of shares required to attend the General Shareholders Meetings.**

Yes

Number of shares required to attend the General Shareholders Meetings
300

**B.6 Section eliminated.****B.7 Indicate the address and mode of accessing corporate governance content on your company's website as well as other information on General Meetings which must be made available to shareholders on the website.**

Telefónica complies with applicable legislation and best practices in terms of the content of its website concerning Corporate Governance. In this respect, it fulfils both the technical requirements for access and for content for the Company website, including information on General Shareholders Meetings, through direct access from the homepage of Telefónica, S.A. ([www.telefonica.com](http://www.telefonica.com)) in the section "Shareholders and Investors" ([www.telefonica.com/accionistaseinversores](http://www.telefonica.com/accionistaseinversores)), which includes not only all of the information that is legally required, but also information that the Company considers to be of interest.

All the available information included on the Company website, except for certain specific documents, is available in two languages: Spanish and English.

## C. Company management structure

### C.1 Board of Directors

C.1.1 List the maximum and minimum number of directors included in the Bylaws:

Maximum number of directors	20
Minimum number of directors	5

C.1.2 Complete the following table with board members' details.

Name or corporate name of director	Representative	Type of director	Position on the board	Date of first appointment	Date of last appointment	Election procedure
Mr. José María Álvarez-Pallete López	-	Executive	Chairman	2006/07/26	2012/05/14	Resolution of General Shareholders' Meeting
Mr. Isidro Fainé Casas	-	Proprietary	Vice Chairman	1994/01/26	2016/05/12	Resolution of General Shareholders' Meeting
Mr. José María Abril Pérez	-	Proprietary	Vice Chairman	2007/07/25	2013/05/31	Resolution of General Shareholders' Meeting
Mr. Julio Linares López	-	Other external directors	Vice Chairman	2005/12/21	2016/05/12	Resolution of General Shareholders' Meeting
Mr. César Alierta Izuel	-	Other external directors	Director	1997/01/29	2012/05/14	Resolution of General Shareholders' Meeting
Ms. Eva Castillo Sanz	-	Other external directors	Director	2008/01/23	2013/05/31	Resolution of General Shareholders' Meeting
Mr. Juan Ignacio Cirac Sasurain	-	Independent	Director	2016/04/08	2016/05/12	Resolution of General Shareholders' Meeting
Mr. José Javier Echenique Landiribar	-	Independent	Director	2016/04/08	2016/05/12	Resolution of General Shareholders' Meeting
Mr. Peter Erskine	-	Independent	Director	2006/01/25	2016/05/12	Resolution of General Shareholders' Meeting
Ms. Sabina Fluxà Thienemann	-	Independent	Director	2016/04/08	2016/05/12	Resolution of General Shareholders' Meeting
Mr. Luiz Fernando Furlán	-	Independent	Director	2008/01/23	2013/05/31	Resolution of General Shareholders' Meeting
Mr. Gonzalo Hinojosa Fernández de Angulo	-	Independent	Director	2002/04/12	2012/05/14	Resolution of General Shareholders' Meeting
Mr. Pablo Isla Álvarez de Tejera	-	Independent	Director	2002/04/12	2012/05/14	Resolution of General Shareholders' Meeting
Mr. Peter Löscher	-	Independent	Director	2016/04/08	2016/05/12	Resolution of General Shareholders' Meeting

Mr. Antonio Massanell Lavilla	-	Proprietary	Director	1995/04/21	2016/05/12	Resolution of General Shareholders' Meeting
Mr. Ignacio Moreno Martínez	-	Proprietary	Director	2011/12/14	2012/05/14	Resolution of General Shareholders' Meeting
Mr. Francisco Javier de Paz Mancho	-	Independent	Director	2007/12/19	2013/05/31	Resolution of General Shareholders' Meeting
Mr. Wang Xiaochu	-	Proprietary	Director	2015/09/30	2016/05/12	Resolution of General Shareholders' Meeting

**Total number of directors**

18

Indicate any board members who left during this period.

Name or corporate name of director	Type of directorship at time of leaving	Leaving date
Mr. José Fernando de Almansa Moreno-Barreda	Other external Directors	2016/04/08
Mr. Carlos Colomer Casellas	Independent	2016/04/08
Mr. Santiago Fernández Valbuena	Executive	2016/04/08
Mr. Alfonso Ferrari Herrero	Independent	2016/04/08

C.1.3 Complete the following tables on board members and their respective categories:

**EXECUTIVE DIRECTORS**

Name or corporate name of director	Post held in the company
Mr. José María Álvarez-Pallete López	Executive Chairman
<b>Total number of executive directors</b>	1
<b>% of the Board</b>	5.56%

**EXTERNAL PROPRIETARY DIRECTORS**

Name or corporate name of director	Name or corporate name of significant shareholder represented or proposing appointment
Mr. José María Abril Pérez	Banco Bilbao Vizcaya Argentaria, S.A.
Mr. Ignacio Moreno Martínez	Banco Bilbao Vizcaya Argentaria, S.A.
Mr. Isidro Fainé Casas	Fundación Bancaria Caixa d'Estalvis i Pensions de Barcelona, "la Caixa"
Mr. Antonio Massanell Lavilla	Fundación Bancaria Caixa d'Estalvis i Pensions de Barcelona, "la Caixa"
Mr. Wang Xiaochu	China Unicom (Hong Kong) Limited
<b>Total number of proprietary directors</b>	5
<b>% of the Board</b>	27.78%



## INDEPENDENT EXTERNAL DIRECTORS

Name or corporate name of director	Profile
Mr. Francisco Javier de Paz Mancho	Graduate in Information and Advertising, Law Studies, IESE Business Management Program. Formerly Chairman of the State-owned company MERCASA.
Mr. Gonzalo Hinojosa Fernández de Angulo	Industrial Engineer. Formerly Chairman and CEO of Cortefiel Group.
Mr. Pablo Isla Álvarez de Tejera	Law Graduate. Member of the Body of State Lawyers (on sabbatical). Chairman and CEO of Inditex, S.A.
Mr. Peter Erskine	Psychology Graduate. Was General manager of Telefónica Europe until 2007. Was Chairman of Ladbrokes, Plc until December 2015.
Mr. Luiz Fernando Furlán	Degrees in chemical engineering and business administration, specialising in financial administration. From 2003 to 2007 he was Minister of Development, Industry and Foreign Trade of Brazil.
Ms. Sabina Fluxà Thienemann	Business Management and Administration graduate. MBA from ESADE. High Business Management Program at IESE. Co-Vice Executive President and CEO of Iberostar Group.
Mr. José Javier Echenique Landiribar	Economic and Actuarial Sciences graduate. Vice-Chairman of Banco Sabadell, S.A.
Mr. Peter Löscher	Degree in Economics and Business. MBA at Vienna University of Economics. Advanced Management Program at Harvard Business School. Chairman of the Supervisory Board of OMV Aktiengesellschaft and Sulzer AG
Mr. Juan Ignacio Cirac Sasurain	Graduated in Theoretical Physics. Ph. D. in Physics. Fields of Specialization in Theoretical Quantum Optics, Quantum Information, Atomic Physics, Quantum Many-Body Physics.
<b>Total number of independent directors</b>	<b>9</b>
<b>% of the Board</b>	<b>50.00%</b>

List any independent directors who receive from the company or group any amount or payment other than standard director remuneration or who maintain or have maintained during the period in question a business relationship with the company or any group company, either in their own name or as a significant shareholder, director or senior manager of an entity which maintains or has maintained the said relationship.

**No**

If applicable, include a statement from the board detailing the reasons why the said director may carry on their duties as an independent director.

## OTHER EXTERNAL DIRECTORS

Identify the other external directors and list the reasons why these cannot be considered proprietary or independent directors and detail their relationships with the company, its executives or shareholders.

Name or corporate name of director	Reasons	Company, executive or shareholder with whom the relationship is maintained
Mr. Julio Linares López	On September 17, 2012, Mr. Julio Linares López resigned from his post as Chief Operating Officer (C.O.O.) of Telefónica, S.A. and his managerial post in the Telefónica Group, and therefore went from being an Executive Director to being classified in the "Other External Directors" category.	Telefónica, S.A.

Ms. Eva Castillo Sanz	On February 26, 2014, Ms. Eva Castillo Sanz resigned as Chairwoman of Telefónica Europa, and was therefore included in the "Other external Directors" category.	Telefónica, S.A.
Mr. César Alierta Izuel	On April 8, 2016, Mr. César Alierta Izuel resigned from his post as Executive Chairman of Telefónica, S.A. and his executive duties in the Telefónica Group, and therefore went from being an Executive Director to being classified in the "Other External Directors" category.	Telefónica, S.A.
<b>Total number of other external directors</b>		<b>3</b>
<b>% of the Board</b>		<b>16.67%</b>

List any changes in the category of each director which have occurred during the year.

Name or corporate name of director	Date of change	Former category	Current category
Mr. César Alierta Izuel	2016/04/08	Executive	Other External

C.1.4 Complete the following table on the number of female directors over the past four years and their category.

	Number of female directors				% of total directors of each type			
	Year 2016	Year 2015	Year 2014	Year 2013	Year 2016	Year 2015	Year 2014	Year 2013
Executive	0	0	0	1	0.00%	0.00%	0.00%	25.00%
Proprietary	0	0	0	0	0.00%	0.00%	0.00%	0.00%
Independent	1	0	0	0	11.11%	0.00%	0.00%	0.00%
Other External	1	1	1	0	33.33%	33.33%	50.00%	0.00%
<b>Total:</b>	<b>2</b>	<b>1</b>	<b>1</b>	<b>1</b>	<b>11.11%</b>	<b>5.56%</b>	<b>5.56%</b>	<b>5.56%</b>

C.1.5 Explain the measures, if applicable, which have been adopted to ensure that there is a sufficient number of female directors on the board to guarantee an even balance between men and women.

#### Explanation of measures

The search for women who meet the necessary professional profile is a question of principle and, in this regard, it is clear that Telefónica has taken this concern on board. In this regard, it should be noted that, on January 23, 2008, the Board of Directors unanimously agreed to co-opt, at the proposal of the Nominating, Compensation and Corporate Governance Committee, Ms. Eva Castillo Sanz as a Director of Telefónica. This appointment was ratified by the Ordinary General Shareholders Meeting held on April 22, 2008, and she was re-elected to serve in this position by the Ordinary General Shareholders' Meeting on May 31, 2013.

Likewise, on April 8, 2016, the Board of Directors unanimously agreed to co-opt, at the proposal of the Nominating, Compensation and Corporate Governance Committee, Ms. Sabina Fluxà Thienemann as a Director of Telefónica. The Ordinary General Shareholders Meeting, held on May 12, 2016, ratified this appointment.

Similarly, on December 19, 2007, the Board of Directors unanimously agreed, following a recommendation from the Nominating, Compensation and Corporate Governance Committee, to appoint Ms. María Luz Medrano Aranguren as the Deputy Secretary General and Secretary to the Board of Directors.

Article 10.3 of the Regulations of the Board of Directors stipulates that the Board of Directors and the Nominating, Compensation and Corporate Governance Committee shall ensure, within the scope of their respective powers, that the candidates chosen are persons of recognised calibre, qualifications and experience, who are willing to devote a sufficient portion of their time to the Company, and shall take extreme care in the selection of the persons to be appointed as Independent Directors.

Article 10.4 of the Regulations of the Board of Directors also provides that the Board will have to ensure that Board members are selected using procedures that guarantee gender equality and diversity of knowledge and experience, that prevent any underlying bias which could cause any kind of discrimination, and, in particular, that the procedures should favour the selection of female directors.

In its meeting on November 25, 2015, the Board of Directors approved a Director Selection Policy which is aimed at ensuring that appointment or re-election proposals meet the Board's requirements as set out in a preliminary analysis, encouraging gender equality and diversity of knowledge and experience, without any underlying bias would could cause any kind of discrimination. This Director Selection Policy is available on the Company's corporate website.

In accordance with the aforesaid Policy, candidates to be Telefónica Directors will be selected using the following principles:

- 1.- The Company will ensure that the Board of Directors has a balanced structure, with an ample majority of non-executive Directors and an adequate proportion between Proprietary and Independent Directors.
- 2.- The Board of Directors will ensure that Board members are selected using procedures that favour gender equality and diversity of knowledge and experience, and which prevent any underlying bias which could cause any kind of discrimination. It will also ensure that candidates put forward to be non-executive Directors have enough time available to be able to adequately perform their duties.
- 3.- A preliminary analysis of the Company's and of the Group's requirements will be used in the process of selecting candidates to be Directors. This analysis will be made by the Company's Board of Directors, which will be advised and which will receive a mandatory preliminary report by the Nominating, Compensation and Corporate Governance Committee.
- 4.- This report by the Nominating, Compensation and Corporate Governance Committee will be published when calling the General Shareholders Meeting at which each Director will be submitted for confirmation, appointment or re-election.
- 5.- Every year, the Nominating, Compensation and Corporate Governance Committee will check that the Director Selection Policy is complied with, and will report with such information in the Annual Corporate Governance Report.

As far as candidates put forward as Directors are concerned, the Director Selection Policy establishes that the Board of Directors and the Nominating, Compensation and Corporate Governance Committee shall ensure, in fulfilling their respective duties, that all persons proposed for appointment as Directors should be persons of acknowledged solvency, competence and experience who are willing to devote the time and effort necessary to the discharge of their functions, with particular attention paid to the selection of independent Directors.

Candidates put forward as Directors will be persons with a high level of reputation, solvency, experience and training, particularly in the field of telecommunications, economics-finance, accounting, auditing, risk management, and/or business administration, who are able to lead teams consisting of people from different fields of activity, and with extensive experience in major corporations.

Therefore, the selection procedure described above is based exclusively on the personal merits of the candidates ("recognised calibre, qualifications and experience") and their ability to dedicate themselves to the functions of members of the Board, so there is no implicit bias capable of impeding the selection of women directors, if, within the potential candidates, there are women candidates who meet the professional profile sought at each moment.

- C.1.6 Explain the measures taken, if applicable, by the Nominating Committee to ensure that the selection processes are not subject to implicit bias that would make it difficult to select female directors, and whether the company makes a conscious effort to search for female candidates who have the required profile.

### Explanation of measures

In accordance with Article 10.3 of the Board Regulations, the Board of Directors and the Nominating, Compensation and Corporate Governance Committee shall ensure, within the scope of their respective powers, that the candidates chosen are persons of recognized calibre, qualifications and experience, who are willing to devote a sufficient portion of their time to the Company, and shall take extreme care in the selection of the persons to be appointed as Independent Directors.

The Nominating, Compensation and Corporate Governance Committee analysed and returned a positive opinion of the Director Selection Policy of Telefónica, S.A. approved by the Board of Directors of the company in its meeting held on November 25, 2015.

Furthermore, subject to Article 10.4 of the Regulations of the Board of Directors, the results of the preliminary analysis of the needs of the Board of Directors will be set out in the report of the Nominating, Compensation and Corporate Governance Committee, which will be published on calling the General Shareholders Meeting at which each Director will be submitted for ratification, appointment or re-election.

When, despite the measures taken, there are few or no female directors, explain the reasons.

### Explanation of the reasons.

All the measures and processes agreed and adopted by the Board of Directors and the Nominating, Compensation and Corporate Governance Committee to ensure the number of female directors on the Board guarantee an even balance and to ensure that the selection processes are not subject to implicit bias that would make it difficult to select female directors have been implemented and initiated by the Company.

Thus, in the amendment carried out during the year 2016 in the composition of the Company's Board of Directors, Ms. Sabina Fluxà Thienemann was appointed unanimously by the Board of Directors, at the proposal of the Nominating, Compensation and Corporate Governance, as Independent Director of Telefónica. The Ordinary General Shareholders Meeting of Telefónica, held on May 12, 2016, ratified this appointment.

In the appointment proposal of Ms. Sabina Fluxà Thienemann, the Nominating, Compensation and Corporate Governance Committee considered the solvency, competence, experience, professional merits and willingness of Ms. Fluxà for the effective performance of her functions, only when considering her personal and professional features. This is all to take place within the framework of the Director Selection Policy of the Company which expressly states, with regard to the promotion of Female Directors' presence in the Board of Directors, that it is mandatory for Director's selection procedures to encourage gender diversity, and forbids any type of underlying bias which might cause any form of discrimination.

C.1.6.bis Explain the conclusions of the Nominating Committee regarding verification of compliance with Director selection policy. And, in particular, how this policy is being used towards the target that at least 30% of the total members of the Board of Directors should be female directors by 2020.

### Explanation of conclusions.

Since 25 November, 2015, Telefónica S.A. has used a specific and verifiable Director Selection Policy, approved by the Board of Directors, which is aimed at ensuring that Director appointment or re-election proposals meet the Board's requirements as set out in a preliminary analysis, encouraging gender equality and diversity of knowledge and experience.

This policy is public and can be consulted at the corporate website ([www.telefonica.com](http://www.telefonica.com)).

Within the framework of such policy, during the year 2016, the Nominating, Compensation and Corporate Governance Committee proposed and informed about the appointment of Directors of Telefónica, S.A., on the basis of solvency, competence, experience, professional merits and willingness of the candidates to devote the time and effort needed for the effective performance of their functions, only when considering their personal and professional features.

On its meeting held on April 7, 2016, the Committee proposed to the Company's Board of Directors, the appointment by co-optation of Ms. Sabina Fluxà Thienemann, Mr. José Javier Echenique Landiribar, Mr. Peter Löscher and Mr. Juan

Ignacio Cirac Sasturain as Independent Directors, replacing Mr. Carlos Colomer Casellas, Mr. Alfonso Ferrari Herrero, Mr. José Fernando de Almansa Moreno-Barreda and Mr. Santiago Fernández Valbuena, respectively.

Likewise, the Committee informed and/or proposed the re-election and ratification of the Directors of Telefónica, S.A. by the General Ordinary Shareholders Meeting of the Company, considering and analysing the functions performed and the commitment of the Directors, basing all the proposals on a prior analysis of the Board of Director's needs, and promoting the knowledge, experience and gender diversity.

Thus, the General Ordinary Shareholders Meeting held on May 12, 2016, on the proposal of the Board of Directors, approved the re-election of Mr. Isidro Fainé Casas, Mr. Julio Linares López, Mr. Peter Erskine, and Mr. Antonio Massanell Lavilla, as well as the ratification of the appointment of Ms. Sabina Fluxà Thienemann, Mr. José Javier Echenique Landiribar, Mr. Peter Löscher, Mr. Juan Ignacio Cirac Sasturain and Mr. Wang Xiaochu.

Furthermore, with regards to the promotion of Female Directors' presence in the Board of Directors, it is important to note that the Director Selection Policy expressly states that it is mandatory for Director selection procedures to encourage gender diversity, and forbids any type of underlying bias which might cause any form of discrimination. Notwithstanding the foregoing, the Nominating, Compensation and Corporate Governance Committee and the Board of Directors of the Company have taken into account this premise in all their appointment proposals, re-elections and ratifications of the Directors that were presented, analysed and approved during this year 2016, and specifically the appointment proposal of Ms. Sabina Fluxà Thienemann, approved by the General Ordinary Shareholders Meeting held on May 12, 2016.

C.1.7 Explain how shareholders with significant holdings are represented on the board.

As stated in section C.1.3 of this Annual Corporate Governance Report, at December 31, 2016, the group of external Directors of Telefónica, S.A. was composed of 17 members (out of a total of 18 Members), of whom 5 are proprietary Directors, 9 are independent and 3 fall under the "Other external Directors" category.

Of the five proprietary Directors, two act in representation of Fundació Bancaria Caixa d'Estalvis i Pensions de Barcelona, "la Caixa", which holds 5.15% of the capital stock of Telefónica, S.A., and two act in representation of Banco Bilbao Vizcaya Argentaria, S.A. (BBVA), which holds 6.33% of the capital; and one in representation of China Unicom (Hong Kong) Limited (China Unicom), which owns 1.27% of the capital stock. The percentages mentioned above refer to December 31, 2016.

C.1.8 Explain, when applicable, the reasons why proprietary directors have been appointed upon the request of shareholders who hold less than 3% of the share capital:

Name or corporate name of shareholder	Reasons
China Unicom (Hong Kong) Limited	<p>As explained in Section H "Other information of interest", Note 5 to Section A.6 of this report, on January 23, 2011, expanding on their existing strategic alliance, Telefónica, S.A. and China Unicom (Hong Kong) Limited ("China Unicom") signed an extension to their Strategic Partnership Agreement, in which both companies agreed to strengthen and deepen their strategic cooperation in certain business areas, and committed to investing the equivalent of 500 million US dollars in ordinary shares of the other party. Telefónica also agreed to propose the appointment of a board member nominated by China Unicom in the next General Shareholders Meeting, in accordance with prevailing legislation and the Company's Bylaws.</p> <p>On May 18, 2011, the General Shareholders' Meeting approved the appointment of Mr. Chang Xiaobing as Company Director, acting on the proposal made by China Unicom, for the purpose of executing the addendum to the Strategic Partnership Agreement agreed in January 2011. On September 30, 2015, the Board of Directors approved by co-option to appoint Mr. Wang Xiaochu, as a new member of the Board of Directors, as a proprietary Director, to replace Mr. Chang Xiaobing, who decided to step down from his position as Director of Telefónica, S.A., after ceasing in his duties as Chairman and CEO of China Unicom (Hong Kong) Limited, and once Mr. Wang Xiaochu had been appointed to those positions.</p> <p>This commitment to China Unicom is a consequence of the Strategic Partnership, which is intended to strengthen Telefónica's position in the global communications market</p>

Provide details of any rejections of formal requests for board representation from shareholders whose equity interest is equal to or greater than that of other shareholders who have successfully requested the appointment of proprietary directors. If so, explain why these requests have not been entertained.

No

C.1.9 Indicate whether any director has resigned from office before their term of office has expired, whether that Director has given the board his/her reasons and through which channel. If made in writing to the whole board, list below the reasons given by that director.

Yes

Name of director	Reasons for resignation
Mr. Carlos Colomer Casellas	Mr. Carlos Colomer Casellas, in order to refresh the Board of Directors, formally stated his voluntary resignation to the Board of Directors, at its meeting held on April 8, 2016, effective as of this particular time, from its respective position as Director of Telefónica, S.A., and thus from all of his positions within the Board of Directors and within the Committees of such Board.

Name of director	Reasons for resignation
Mr. José Fernando de Almansa Moreno-Barreda	Mr. José Fernando de Almansa Moreno-Barreda, in order to refresh the Board of Directors, formally stated his voluntary resignation to the Board of Directors, at its meeting held on April 8, 2016, effective as of this particular time, from its respective position as Director of Telefónica, S.A., and thus from all of his positions within the Board of Directors and within the Committees of such Board.

Name of director	Reasons for resignation
Mr. Santiago Fernández Valbuena	Mr. Santiago Fernández Valbuena, in order to refresh the Board of Directors, formally stated his voluntary resignation to the Board of Directors, at its meeting held on April 8, 2016, effective as of this particular time, from its respective position as Director of Telefónica, S.A., and thus from all of his positions within the Board of Directors and within the Committees of such Board.

Name of director	Reasons for resignation
Mr. Alfonso Ferrari Herrero	Mr. Alfonso Ferrari Herrero, in order to refresh the Board of Directors, formally stated his voluntary resignation to the Board of Directors, at its meeting held on April 8, 2016, effective as of this particular time, from its respective position as Director of Telefónica, S.A., and thus from all of his positions within the Board of Directors and within the Committees of such Board.

C.1.10 Indicate what powers, if any, have been delegated to the Chief Operating Officer:

Name or corporate name of director	Brief description
Mr. José María Álvarez-Pallete López – Executive Chairman (Chief Executive Officer)	The Chairman of the Company, as the Executive Chairman, has been expressly delegated all the powers of the Board of Directors, except those that cannot be delegated by Law, by the Corporate Bylaws, or by the Regulations of the Board of Directors which establishes, in Article 5.4, the powers that the Board of Directors reserves itself, and may not delegate.

C.1.11 List the directors, if any, who hold office as directors or executives in other companies belonging to the listed company's group:

Name or corporate name of director	Corporate name of the group company	Position	Does he or she have executive functions?
Mr. César Alierta Izuel	Telefónica Audiovisual Digital, S.L.U.	Director	No
Ms. Eva Castillo Sanz	Telefónica Deutschland Holding, AG	Chairman of	No
		Supervisory Board	
Mr. Peter Erskine	Telefónica Deutschland Holding, AG	Member of	No
Mr. Luiz Fernando Furlán	Telefónica Brasil, S.A.	Supervisory Board	
Mr. Gonzalo Hinojosa Fernández de Angulo		Director	No
	Telefónica del Perú, S.A.A.	Director	No
	Telefónica de Argentina, S.A.	Director	No
	Telefónica Brasil, S.A.	Director	No
	Telefónica Móviles de México, S.A. de C.V.	Director	No
Mr. Francisco Javier de Paz Mancho	Telefónica Ingeniería de Seguridad, S.A.	Chairman	No

C.1.12 List any company board members who sit on the boards of directors of other non-group companies that are listed on official securities markets in Spain, insofar as these have been disclosed to the company:

Name or corporate name of director	Name of listed company	Position
Mr. César Alierta Izuel	China Unicom (Hong Kong) Limited	Director
Ms. Eva Castillo Sanz	Bankia, S.A.	Director
	Banco Sabadell, S.A.	Vice Chairman
	Repsol, S.A.	Director
	ACS, Actividades de Construcción y Servicios, S.A.	Director
Mr. José Javier Echenique Landiribar	Ence, Energía y Celulosa, S.A.	Director
	Gas Natural SDG, S.A.	Chairman
	The Bank of East Asia	Director
Mr. Isidro Fainé Casas	Suez Environnement Company	Director
	Brasil Food, S.A. (BRF)	Director
Mr. Luiz Fernando Furlán	AGCO Corporation	Director
Mr. Pablo Isla Álvarez de Tejera	Inditex, S.A.	Chairman - CEO
	OMV Aktiengesellschaft	Chairman
	Sulzer AG	Chairman
Mr. Peter Löscher	Deutsche Bank AG	Director
	Caixabank, S.A.	Vice Chairman
	Repsol, S.A.	Director
Mr. Antonio Massanell Lavilla	Erste Group Bank AG	Director
Mr. Ignacio Moreno Martínez	Secuoya, Grupo de Comunicación, S.A.	Director
	China United Network Communications Limited	Chairman
Mr. Wang Xiaochu	China Unicom (Hong Kong) Limited	Chairman - CEO

C.1.13 Indicate and, where appropriate, explain whether the Board Regulations establish rules about the maximum number of company boards on which its directors may sit

Yes

### Explanation of rules

As set forth in Article 28.2 of the Regulations of the Board of Directors, the Directors will devote the time and efforts required to perform their duties and, to such end, shall report to the Nominating, Compensation and Corporate Governance Committee on their other professional obligations if they might interfere with the performance of their duties as Directors.

In this regard, persons who belong to over five Board of Directors of other corporations other than Telefónica, S.A. and its Group companies cannot be appointed as Directors.

For these purposes, a) all the Boards of companies which form part of the same Group will be counted as a single Board; and b) Boards of asset-holding companies or companies which are vehicles or complements for the Director's own professional activity, of his/her spouse or person with an analogous affective relationship, or his/her closest relatives, will not be counted.

On an exceptional basis, for justified reasons, the Board will be able to exempt the Director from this prohibition.

C.1.14 Section eliminated.

C.1.15 List the total remuneration paid to the Board of Directors in the year:

Board remuneration (thousands of euros)	10,855
Amount of total remuneration by current directors in accumulated pension rights (thousands of euros)	63,149
Amount of total remuneration by former directors in accumulated pension rights (thousands of euros)	450

C.1.16 List any members of senior management who are not executive directors and indicate total remuneration paid to them during the year:

Name or corporate name	Position(s)
Mr. Ramiro Sánchez de Lerín García-Ovies	General Secretary and of the Board of Directors
Mr. Àngel Vilà Boix	General Manager of Strategy and Finance
Mr. Guillermo Ansaldo Lutz	General Manager of Global Resources
Mr. Eduardo Navarro de Carvalho	Chief Commercial Digital Officer (CCDO)
Mr. Juan Francisco Gallego Arrechea	Director Internal Audit
<b>Total remuneration received by senior management (in thousands of euros)</b>	
	11,075

C.1.17 List, if applicable, the identity of those directors who are likewise members of the boards of directors of companies that own significant holdings and/or group companies:

Name or corporate name of director	Name or corporate name of significant shareholder	Position
		Chairman of Criteria Caixa, S.A.U.
Mr. Isidro Fainé Casas	Fundación Bancaria Caixa d'Estalvis i Pensions de Barcelona, "la Caixa"	Chairman of Fundació Bancaria Caixa d'Estalvis i Pensions de Barcelona, "la Caixa"
Mr. Antonio Massanell Lavilla	Fundación Bancaria Caixa d'Estalvis i Pensions de Barcelona, "la Caixa"	Vice-Chairman of Caixabank, S.A.



List, if appropriate, any relevant relationships, other than those included under the previous heading, that link members of the Board of Directors with significant shareholders and/or their group companies:

Name or company name of director with relationship	Name or company name of significant shareholder with relationship	Description of relationship
Mr. César Alierta Izuel	Fundación Bancaria Caixa d'Estalvis i Pensions de Barcelona, "la Caixa"	Trustee of Fundació Bancaria Caixa d'Estalvis i Pensions de Barcelona, "la Caixa"
Mr. José María Abril Pérez	Banco Bilbao Vizcaya Argentaria, S.A.	Early retirement. Formerly General manager of Wholesale and Investment Banking
Mr. Juan Ignacio Cirac Sasurain	Fundación Banco Bilbao Vizcaya Argentaria Fundación Bancaria Caixa d'Estalvis i Pensions de Barcelona, "la Caixa"	Member of the Scientific Advisory Committee Member of the Advisory Board
Ms. Sabina Fluxà Thienemann	Banco Bilbao Vizcaya Argentaria, S.A.	Member of Regional Advisory Board Formerly General Manager of Chairman's Office
Mr. Ignacio Moreno Martínez	Banco Bilbao Vizcaya Argentaria, S.A.	Office

C.1.18 Indicate whether any changes have been made to the board regulations during the year:

**No**

C.1.19 Indicate the procedures for appointing, re-electing, appraising and removing directors. List the competent bodies and the processes and criteria to be followed for each procedure.

See heading H "Other information of interest", Note 11 to Section C.1.19

C.1.20 Explain, if applicable, to what extent this annual evaluation of the Board has prompted significant changes in its internal organization and the procedures applicable to its activities:

#### Outline of changes

In a meeting on February 23, 2016, the Nominating, Compensation and Corporate Governance Committee revised and analysed the results of the Directors of Telefónica, S.A.'s evaluation in 2015 of the Board of Directors and its Committees and of the Company's General Meeting, concluding that, on the whole, they were highly satisfied with the organisation and activities of these governing bodies.

Furthermore, and as a result of this Evaluation, certain improvement points were identified. In view of this and after an exhaustive examination and analysis of the results obtained, the Board followed the Nominating, Compensation and Corporate Governance Committee's proposal and approved the suggested improvements described hereon in order to optimize the operation of the Company's governing bodies:

- i. Wherever possible, mechanisms will be put in place so that the documentation and information pertaining to the matters to be discussed in the meetings of the Board of Directors and its Committees is provided earlier.
- ii. Identify matters relating to the Committees of the Board of Directors in order to optimise how they are run.
- iii. Continue implementing measures to ensure that the General Meeting of Shareholders is run as effectively as possible.

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- iv. Broaden the scope of the topics discussed in the Board, and take a more detailed look at the Board's composition.
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C.1.20.bis Describe the evaluation process and the evaluated areas performed by the Board of Directors, assisted, if applicable, by an external advisor, with regard to diversity in the Board's composition and skills, in the functioning and composition of its Committees, the performance of the Chairman of the Board of Directors and the company CEO, and each Director's performance and contribution.

Every year, all the Company Directors assess the working of the Board of Directors of Telefónica, S.A., that of the Board Committees, the Senior Management and of the General Shareholders Meeting.

Subsequently, the Nominating, Compensation and Corporate Governance Committee reviews and analyses the results of the Directors' assessment, identifying any areas where there is room for improvement. Once it has scrutinised and analysed the results in depth, the Nominating, Compensation and Corporate Governance Committee makes a proposal to the Board of Directors to implement the suggestions and recommendations deemed pertinent.

In the Board of Directors meeting held on 30 November, all the Directors were handed a questionnaire in order to carry out the assessment for 2016.

The questionnaire includes a broad range of questions divided into the following five sections:

- Composition (quantitative and qualitative), working and powers of the Board, expressly including adequate performance and the Directors' contribution to the Board of Directors.
- Composition and working of the Committees, expressly including the performance and contribution of the Chairpersons of the Board of Directors' Committees.
- Adequacy of the performance of the Executive Chairman.
- Directors' Rights and Duties.
- General Shareholders Meeting.

As referred to above, once the questionnaires - filled in with the Directors' opinion and suggestions - were received, action plans regarding the areas where improvement was considered to be needed were set in motion.

The Board of Directors unanimously approved the proposed improvements made by the Nominating, Compensation and Corporate Governance, aimed at optimising the working of the Company's Governance Bodies.

In accordance with the Director Selection Policy, every three years an external consultancy firm will assist the Board of Directors in performing the assessment. The independence of the consultancy firm will be verified by the Nominating, Compensation and Corporate Governance Committee.

C.1.20.ter Details, if applicable, of the business relations which the consulting firm or any Group company has with the company or any company in its group.

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C.1.21 Indicate the cases in which directors must resign.

In accordance with Article 12 of the Regulations of the Board of Directors, Directors must tender their resignation to the Board of Directors and formalise such resignation in the following cases:

- a) When they cease to hold the executive positions to which their appointment as Directors is linked, or when the reasons for which they were appointed no longer exist.

- b) When they are affected by any of the cases of incompatibility or prohibition established by Law.
- c) When they are severely reprimanded by the Nominating, Compensation and Corporate Governance Committee for having failed to fulfil any of their obligations as Directors.
- d) When their remaining on the Board might affect the Company's credit or reputation in the market or otherwise jeopardise its interests.

The conditions listed above under Recommendation C.1.19 ("Removal") above must also be taken into consideration.

C.1.22 Section eliminated.

C.1.23 Are qualified majorities, other than legal majorities, required for any type of decisions?

**No**

If applicable, describe the differences.

C.1.24 Indicate whether there are any specific requirements, apart from those relating to the directors, to be appointed Chairman of the Board of Directors.

**Yes**

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#### Description of requirements

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In accordance with Article 31.4 of the Corporate Bylaws, in order for a Director to be appointed Chairman, such Director must have served on the Board for at least three years prior to any such appointment. However, such length of service shall not be required if the appointment is made with the favourable vote of at least 85 percent of the members of the Board of Directors.

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C.1.25 Indicate whether the Chairman has the casting vote:

**No**

C.1.26 Indicate whether the Bylaws or the regulations of the Board of Directors set any age limit for directors:

**No**

C.1.27 Indicate whether the Bylaws or the regulations of the Board of Directors set a limited term of office for independent directors:

**No**

C.1.28 Indicate whether the Bylaws or board regulations stipulate specific rules on appointing a proxy to the board, the procedures thereof and, in particular, the maximum number of proxy appointments a director may hold. Also provide details if any restriction in the categories in which a proxy may be delegated has been established, beyond the restrictions imposed by applicable legislation. If so, give brief details.

In accordance with Article 19 of the Regulations of the Board of Directors, Directors must attend meetings of the Board in person, and when unable to do so in exceptional cases, they shall endeavour to ensure that the proxy they grant to another member of the Board includes, as far as is practicable, appropriate instructions. Non-executive Directors may only delegate their proxy in another non-executive Director. Such proxies may be granted by letter or any other means that, in the Chairman's opinion, ensures the certainty and validity of the proxy granted.

Article 34.4 of the Bylaws also establishes that all Directors who are absent may grant a proxy in writing to another Director who is in attendance, with the right to speak and to vote, at the meeting or session to which the proxy refers. The Director granting the proxy shall endeavour, to the extent possible, to include voting instructions in the proxy document.

C.1.29 Indicate the number of Board meetings held during the year and how many times the board has met without the Chairman's attendance. Attendance will also include proxies appointed with specific instructions.

Number of Board meetings	12
Number of Board meetings held without the Chairman's attendance	0

If the Chairman is a non-executive Director, indicate the number of meetings held, without attendance or proxy of any executive Director and under the Chairmanship of the Lead Independent Director.

Number of meetings	0
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Indicate the number of meetings of the various board committees held during the year.

Executive Commission	17
Audit and Control Committee	13
Nominating, Compensation and Corporate Governance Committee	11
Service Quality and Customer Service Committee	4
Regulation and Institutional Affairs Committee	7
Strategy and Innovation Committee	7

C.1.30 Indicate the number of board meetings held during the year with all members in attendance. Attendance will also include proxies appointed with specific instructions.

Directors' attendance	11
% of attendances of the total votes cast during the year	99.54%

C.1.31 Indicate whether the consolidated and individual financial statements submitted for authorization by the board are certified previously:

**No**

Identify, where applicable, the person(s) who certified the company's individual and consolidated financial statements prior to their authorisation for issue by the board.

C.1.32 Explain the mechanisms, if any, established by the Board of Directors to prevent the individual and consolidated financial statements it prepares from being submitted to the General Shareholders Meeting with a qualified Audit Report.

Through the Audit and Control Committee, the Board of Directors plays an essential role in supervising the preparation of the Company's financial information, controlling and coordinating the various players that participate in this process.

To achieve this objective, the Audit and Control Committee's work addresses the following basic issues:

- A. Supervise internal audit and, in particular:
- a) Safeguard the independence and efficiency of the internal audit function;
  - b) Propose the selection, appointment and removal of the person responsible for internal audit;
  - c) Propose the budget for such service;
  - d) Review the internal audit work plan and its annual activities report;
  - e) Receive regular information on its activities; and
  - f) Verify that the senior executive officers take into account the conclusions and recommendations of its reports.
- B. Oversee the process of preparing and presenting mandatory financial reporting and submitting recommendations of proposals to the administrative body aimed at safeguarding its integrity. With respect thereto, it shall be responsible for supervising the process of preparation and the completeness 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.
- C. Monitoring the effectiveness of the Company's internal control, internal audit and risk management systems, including fiscal risks, and discuss with the auditors significant weaknesses in the internal control system detected during the audit, without compromising their independence at any time. For that purposes, if deemed necessary, it can submit recommendations or proposals to the Board of Directors and an appropriate monitoring period. 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 risk level that the Company deems acceptable; the measures to mitigate the impact of the identified risks, should they materialise; and
  - c) The control and information systems to be used to control and manage these risks.
- D. Establish and maintain appropriate relations with the Auditor in order to receive, for review by the Committee, information on all matters that could jeopardise the Auditor's independence, and, when applicable, the authorisation of permitted services, according to current legislation, and such other communications as may be provided for in auditing legislation and in technical auditing regulations.
- In any event, the Audit and Control Committee must receive, on an annual basis, written confirmation from the Auditor of its independence vis-à-vis the entity or entities directly or indirectly related thereto, as well as in-depth and individualised information regarding additional services of any kind provided as well as the fees received to such entities by the Auditor or by the persons or entities related thereto pursuant to the provisions of prevailing legislation.
- E. 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 is compromised. This report will focus on the assessment of the provision of each and every one of the additional services referred to in the section above, considered individually and as a whole, other than legal audit and in relation to the regime of independence or laws regulating auditing activities.
- F. Analyse and report on economic conditions, the accounting impact, and, if applicable, the proposed exchange ratio in structural and corporative modification transactions which the Company intends to perform, before being submitted to the Board of Directors.
- G. Preliminary reporting to the Board of Directors regarding all matters set out in prevailing legislation and in the Bylaws, and, in particular, concerning:
1. The financial information that the Company must periodically disclose;
  2. The creation or acquisition of shareholdings in special purpose entities or companies with registered addresses in countries or territories considered to be tax havens; and

### 3. Related party transactions.

The Audit and Control Committee verifies both the periodical financial information and the Annual Financial Statements, ensuring that all financial information is drawn up according to the same professional principles and practices. To this effect, the Audit and Control Committee meets whenever appropriate, having held thirteen (13) meetings in the course of 2016.

Furthermore, the External Auditor participates regularly in the Audit and Control Committee meetings, when called to do so by the Committee, to explain and clarify different aspects of the audit reports and other aspects of its work. Additionally and when requested by the Committee, other members of the Company's management and its subsidiaries' management have attended Committee meetings to explain specific matters that are directly within their scope of competence. In particular, managers from the financial department, as well as those in charge of internal audit, have attended these meetings. The members of the Committee have held separate meetings with each of these when it was deemed necessary to closely monitor the preparation of the Company's financial information.

The above notwithstanding, Article 40 of the Regulations of the Board of Directors establishes that the Audit and Control Committee shall ensure that the Board of Directors prepares the final financial statements in a manner that will give no reason for the Auditor to issue a qualified or reserved opinion. However, whenever the Board considers that it should maintain its standards, the Chairman of the Audit and Control Committee shall publicly explain the contents and scope of the discrepancies.

#### C.1.33 Is the Secretary of the Board also a Director?

**No**

If the Secretary is not a member of the Board, fill in the following table:

Name or corporate name of Secretary	Representative
Mr. Ramiro Sánchez de Lerín García-Ovies	--

#### C. 1.34 Section eliminated.

#### C.1.35 Indicate, where applicable, the specific mechanisms implemented by the company to preserve the independence of the auditor, financial analysts, investment banks and rating agencies.

With regards to the independence of the External Auditor of the Company, Article 40 of the Regulations of the Board of Directors establishes that the Board shall, through the Audit and Control Committee, establish a stable and professional relationship with the Company's Auditor, strictly respecting the independence thereof.

The Audit and Control Committee has a fundamental responsibility, as specified in Article 22 of the Regulations of the Board, to establish and maintain appropriate relations with the Auditor in order to receive, for review by the Committee, information on all matters that could jeopardise the Auditor's independence, and, when applicable, the authorisation of permitted services, according to current legislation, and such other communications as may be provided for in auditing legislation and in technical auditing regulations.

In any event, the Audit and Control Committee must receive, on an annual basis, written confirmation from the Auditor of its independence vis-à-vis the entity or entities directly or indirectly related thereto, as well as in-depth and individualised information regarding additional services of any kind provided as well as the fees received to such entities by the Auditor or by the persons or entities related thereto pursuant to the provisions of prevailing legislation.

The Committee must also issue on an annual basis, prior to the issuance of the audit report, a report stating an opinion as to whether the independence of the Auditor is compromised. This report will focus on the assessment of the provision of each and every one of the additional services referred to in the section above, considered individually and as a whole, other than legal audit and in relation to the regime of independence or laws regulating auditing activities.

Article 22 of the Regulations of the Board of Directors stipulates that the Audit and Control Committee submits proposals for the selection, appointment, re-election and replacement of the external auditor to the Board of Directors, and that it shall be held responsible for the selection process in accordance with prevailing laws, and also the conditions for recruiting the external auditor, regularly gathering information about the audit plan and its execution from the auditor, as well as safeguarding its independence in exercising its functions.

Furthermore, the External Auditor has direct access to the Audit and Control Committee and participates regularly in its meetings, in the absence of the Company's management team when this is deemed necessary. To this effect, and in keeping with US legislation on this matter, the External Auditor must inform the Audit and Control Committee at least once a year on the most significant generally accepted auditing policies and practices followed in the preparation of the Company's financial and accounting information affecting key elements in the financial statements which may have been discussed with the management team, and of all relevant communications between the Auditor and the Company's management team. Likewise, as established in Article 40 of the Regulations of the Board of Directors, every year the Auditor will have a meeting with the Board of Directors in plenary session to inform it of the work conducted and about the pattern of the Company's accounting and risks situation.

In accordance with internal company regulations and in line with the requirements imposed by US legislation, the engagement of any service from the Company's External Auditors must always have the prior approval of the Audit and Control Committee. Moreover, the engagement of non-audit services must be done in strict compliance with the Auditing Act (Ley de Auditoría de Cuentas) and the Sarbanes-Oxley Act published in the United States and subsequent regulations. For this purpose, and prior to the engagement of the Auditors, the Audit and Control Committee studies the content of the work to be performed, evaluating any situations that may compromise the External Auditor's independence, and specifically supervises the percentage the fees paid for such services represent in the total revenue of the auditing firm. In this respect, the Company reports the fees paid to the External Auditor, including those paid for non-audit services, in its Notes to the Financial Statements, in accordance with prevailing legislation.

C.1.36 Indicate whether the company has changed its external audit firm during the year. If so, identify the incoming audit firm and the outgoing auditor:

**No**

Explain any disagreements with the outgoing auditor and the reasons for the same:

C.1.37 Indicate whether the audit firm performs other non-audit work for the company and/or its group. If so, state the amount of fees received for such work and the percentage they represent of the fees billed to the company and/or its group:

**No**

C.1.38 Indicate whether the audit report on the previous year's financial statements is qualified or includes reservations. Indicate the reasons given by the Chairman of the Audit Committee to explain the content and scope of those reservations or qualifications.

**No**

C.1.39 Indicate the number of consecutive years during which the current audit firm has been auditing the financial statements of the company and/or its group. Likewise, indicate how many years the current firm has been auditing the accounts as a percentage of the total number of years over which the financial statements have been audited:

	Company	Group
Number of consecutive years	12	12
	Company	Group

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Number of years audited by current audit firm/Number of years the company's financial statements have been audited (%)

35.30

46.20

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C.1.40 Indicate and give details of any procedures through which directors may receive external advice:

**Yes**

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**Procedures**

Article 27 of the Regulations of the Board of Directors stipulates that in order to receive assistance in the performance of their duties, the Directors or any of the Committees of the Board may request that legal, accounting, financial or other experts be retained at the Company's expense. The engagement must necessarily be related to specific problems of a certain significance and complexity that arise in the performance of their duties.

The decision to retain such services must be communicated to the Chairman of the Board of Directors and shall be formalised through the Secretary to the Board, unless the Board of Directors does not consider such engagement to be necessary or appropriate.

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C.1.41 Indicate whether there are procedures for directors to receive the information they need in sufficient time to prepare for meetings of the governing bodies:

**Yes**

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**Procedures**

The Company, where possible, adopts the measures necessary to ensure that the Directors receive the necessary information, specially drawn up and geared to preparing the meetings of the Board and its Committees, sufficiently in advance. Under no circumstances shall such a requirement not be fulfilled, on the grounds of the importance or the confidential nature of the information, apart from in absolutely exceptional cases.

In this regard, and in accordance with Articles 18 and 20 of the Regulation of the Board of Directors, at the beginning of each year the Board of Directors and its Committees set the calendar of ordinary meetings to be held during the year. The calendar may be amended by resolution of the Board itself, or by decision of the Chairman, in which case the Directors shall be made aware of the amendment as soon as practicable.

Also, at the beginning of the year the Board and its Committees shall prepare an Action Plan detailing the actions to be carried out and their timing for each year, as per their assigned powers and duties.

Likewise, all the meetings of the Board and the Board Committees have a pre-established agenda, which is communicated at least three days prior to the date scheduled for the meeting together with the call for the session. The Agenda for each meeting will clearly state points on which the Board of Directors, or the Executive Committee, have to adopt a decision or resolution.

For the same purpose, the Directors are sent the documentation related to the agenda of the meetings sufficiently in advance. Such information is subsequently supplemented with the written documentation and presentations handed out to the Directors at the meeting. In accordance with Article 19 of the Regulations of the Board of Directors, the Chairman of the Board of Directors organises the debates, promoting and encouraging all Directors to play an active role in the deliberations, safeguarding their right to freely adopt their own position on all matters. Moreover, with the assistance of the Secretary, he shall ensure that the Directors are sent sufficient information to discuss the points set out in the agenda sufficiently in advance of the meeting. He also ensures that sufficient time is given over to discussing strategic matters, and shall encourage debate during meetings, safeguarding the Directors' right to adopt their positions freely on all points discussed.

To provide all the information and clarifications necessary in relation to certain points deliberated, the Group's senior executive officers attend nearly all the Board and Committee meetings to explain the matters within their powers.



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Furthermore, and as a general rule, the Regulations of the Board of Directors (Article 26) expressly establish that Directors are granted the broadest powers to obtain information about all aspects of the Company, to examine its books, records, documents and other data regarding corporate transactions. Exercising of this right to receive information shall be channelled through the Chairman or Secretary to the Board of Directors, who shall respond to the requests made by the Directors, providing them with the requested information directly or offering them the proper contacts at the appropriate level of the organisation.

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- C.1.42 Indicate and, where appropriate, give details of whether the company has established rules obliging directors to inform the board of any circumstances that might harm the organization's name or reputation, tendering their resignation as the case may be:

**Yes**

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#### Details of rules

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In accordance with Article 12 of the Regulations of the Board of Directors, Directors must tender their resignation to the Board of Directors and formalise such resignation when their remaining on the Board might affect the Company's credit or reputation in the market or otherwise jeopardises its interests.

Likewise, Article 30.h) of the Regulations establishes that Directors must report to the Board any circumstances related to them that might damage the credit or reputation of the Company as soon as possible.

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- C.1.43 Indicate whether any member of the Board of Directors has notified the company that they have been indicted or tried for any of the offences stated in Article 213 of the Spanish Corporations Act

**No**

Indicate whether the Board of Directors has examined this matter. If so, provide a justified explanation of the decision taken as to whether or not the director should continue to hold office or, if applicable, detail the actions taken or to be taken by the board.

- C.1.44 List the significant agreements entered into by the company which come into force, are amended or terminate in the event of a change of control of the company due to a takeover bid, and their effects.

1. On April 29, 2013, Telefónica, S.A. and TLK Investment, CV (which belongs to Corporación Multi-Inversiones, or "CMI", a Business Group domiciled in Guatemala) signed an agreement whereby Telefónica and CMI incorporated a joint business venture called Telefónica Centroamérica Inversiones, S.L.U. ("TCI"), in which Telefónica contributed its assets in Central America (except for its Costa Rica assets) and CMI made a monetary contribution of USD 500,000,000. As a result of these contributions, Telefónica owns a 60% interest in the share capital of TCI, while CMI's stake is 40%. This arrangement was completed on August 2, 2013.

Telefónica and CMI also entered into a Shareholders' Pact in TCI, which includes a change of control clause stipulating that if there was a change of control of CMI or Telefónica, the other party would be fully entitled to: (i) exercise the right to acquire (call option) the entire stake held in TCI by the shareholder over which control has changed at the date control changed; or (ii) exercise the right to sell (put option) the entire stake the former held in TCI to the latter. In both cases, the purchase price of the stake shall be TCI's market value calculated by an independent expert.

For the purposes of the Shareholders' Pact, a change of control shall be: (i) in the case of CMI, when the last natural person or corporate body controlling CMI ceases to do so; and (ii) for Telefónica, when a natural person or corporate body not controlling Telefónica assumes control. In both instances, "control" shall be as specified in the International Financial Reporting Standards (IFRS).

2. - Financing agreements:

On February 19, 2015, Telefónica, S.A., as borrower, and a group of credit entities, as lenders, with Citibank International Limited as the agent bank, entered into a syndicated loan amounting to EUR 2,500 million. On the same date, Telefónica, S.A. executed an amendment of another syndicated loan of EUR 3,000 million, formalized on February 18, 2014, with The Royal Bank of Scotland, Plc as the agent bank.

Likewise, on November 17, 2015, Telefónica, S.A. and a group of credit entities, with Banco Bilbao Vizcaya Argentaria, S.A. as the agent bank, formalized a syndicated loan of EUR 3,000 million, which was modified on November 15, 2016 to reflect certain agreements reached between the parties with respect to its economic terms, including a reduction in its amount up to EUR 1,500 million.

On December 11, 2015, Telefónica, S.A., as borrower, and Banco Bilbao Vizcaya Argentaria, S.A. Niederlassung Deutschland, the Bank of Tokyo-Mitsubishi UFJ, Ltd., sucursal en España, Mizuho Bank Ltd, AB Svensk Exportkredit and Société Générale S.A., as lenders, and with the support of Exportkreditnämnden, signed a financing agreement amounting to USD 750 million. Also on that same date, Telefónica, S.A., as borrower, and Banco Santander, S.A. and Crédit Agricole Corporate and Investment Bank as lenders, with the support of Finnvera Plc, entered into a financing agreement amounting to EUR 500 million.

On March 8, 2016, Telefónica, S.A., as borrower, Export Development Canada and AB Svensk Exportkredit, as lenders, and Banco Bilbao Vizcaya Argentaria, S.A. Niederlassung Deutschland, as the agent, entered into a financing agreement amounting to EUR 300 million.

As provided for in all of the aforementioned contracts, in the event of a change of control in Telefónica, S.A., lenders may, under certain circumstances, require the early termination of these financing agreements.

The financing contracts consider the usual criteria in these types of agreement to determine if there has effectively been a change of control, such as obtaining control of the majority of voting rights, on the appointment of the majority of members of the board of directors, or on the Company's financial and operational policies.

C.1.45 Identify, in aggregate form and provide detailed information on agreements between the company and its officers, executives and employees that provide indemnities for the event of resignation, unfair dismissal or termination as a result of a takeover bid or other.

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#### Number of beneficiaries

40

#### Type of beneficiary

Executive Directors, Senior Managers and other Employees

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#### Description of the resolution

With regards to the conditions applicable to termination of contracts, the Executive Chairman Mr. José María Álvarez-Pallete López maintains the conditions of his previous contract which provided for agreed economic compensation for the termination of the employment relationship, where applicable, that can amount to four years' of remuneration at the most. Annual remuneration on which the indemnity is based is the last fixed remuneration and the arithmetic mean of the last two variable remuneration payments received by contract.

Regarding the contracts of members of Senior Management, in general, they are contractually entitled the right to receive the economic compensation indicated below in the event that their employment relationship is ended for reasons attributable to the Company or, in some instances, is due to objective reasons such as a change of control in the Company. However, if the employment relationship is terminated because of a breach attributable to the Executive, he/she will not be entitled to any compensation whatsoever. That notwithstanding, in certain cases the severance benefit to be received by the member of Senior Management according to their contract is not calculated as per these general criteria, but rather is based on other circumstances of a personal or professional nature or on the time when the contract was signed. The agreed economic compensation for the termination of the employment relationship, where applicable, consists of a maximum of three times annual remuneration plus another year based on length of service at the Company. Annual remuneration on which the indemnity is based is the last fixed remuneration and the arithmetic mean of the last two variable remuneration payments received by contract.

Meanwhile, contracts that tie employees to the Company under a common employment relationship do not include

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indemnity clauses for the termination of their employment. In these cases, the employee is entitled to any indemnity set forth in prevailing labour legislation. However, contracts of some company employees, depending on their level and seniority, as well as their personal or professional circumstances or when they signed their contracts, establish their right to receive compensation in the same cases as in the preceding paragraph, generally consisting of a year and a half of salary. The annual salary on which the indemnity is based is the last fixed salary and the average amount of the last two variable payments received by contract.

Indicate whether these agreements must be reported to and/or authorized by the governing bodies of the company or its group:

	Board of Directors	General Shareholders Meeting
Body authorizing clauses	Yes	No
Is the General Shareholders' Meeting informed of such clauses?		Yes

## C.2. Board committees

C.2.1 Give details of all the Committees of the Board of Directors, their members and the proportion of executive, proprietary, independent and other external directors:

### EXECUTIVE COMMISSION

Name	Position	Professional category
Mr. José María Álvarez-Pallete López	Chairman	Executive
Mr. Isidro Fainé Casas	Vice Chairman	Proprietary
Mr. José María Abril Pérez	Vice Chairman	Proprietary
Mr. José Javier Echenique Landiribar	Member	Independent
Mr. Peter Erskine	Member	Independent
Mr. Gonzalo Hinojosa Fernández de Angulo	Member	Independent
Mr. Francisco Javier de Paz Mancho	Member	Independent
% of Executive Directors		14.29%
% of Proprietary Directors		28.57%
% of Independent Directors		57.14%
% of Other External Directors		0.00%

Explain the functions attributed to this committee, outline the procedures and rules for its organisation and working and summarise the most significant actions taken over the course of the year.

The Board of Directors, always subject to the legal provisions in force, delegates all its powers to an Executive Commission, except those that cannot be delegated by Law, by the Corporate Bylaws, or by the Regulations of the Board of Directors.

The Executive Commission provides the Board of Directors with a greater efficiency and effectiveness in the execution of its tasks, since it meets more often.

Pursuant to the provisions of Article 38 of the Corporate Bylaws of Telefónica, S.A., Article 21 of the Regulations of the Board of Directors regulates the Executive Commission in the following terms:

## a) Composition.

The Executive Commission shall consist of the Chairman of the Board of Directors, once appointed as a member of the Executive Commission, and not less than three or more than ten Directors appointed by the Board of Directors.

The Board of Directors shall seek to have External Directors constitute a majority over the Executive Directors.

In all cases, the affirmative vote of at least two-thirds of the members of the Board of Directors shall be required in order for the appointment or re-appointment of the members of the Executive Commission to be valid.

## b) Operation.

The Executive Commission shall meet whenever called by the Chairman, and shall normally meet every fifteen days.

The Chairman and Secretary to the Board of Directors shall act as the Chairman and Secretary to the Executive Commission. One or more Vice Chairmen and a Deputy Secretary may also be appointed.

A valid quorum of the Executive Commission shall exist with the presence, in person or by proxy, of more than one-half of its members.

Resolutions shall be adopted by a majority of the Directors attending the meeting (in person or by proxy), and in the case of a tie, the Chairman shall cast the deciding vote.

## c) Relationship with the Board of Directors.

The Executive Commission shall report to the Board in a timely manner on the matters dealt with and the decisions adopted at the meetings thereof, with a copy of the minutes of such meetings made available to the members of the Board (Article 21.C) of the Regulations of the Board of Directors).

Most significant actions during the year.

During the 2016 year, the Executive Commission of the Board of Directors of Telefónica, S.A. has analysed, reviewed, deliberated upon and adopted resolutions on a range of matters concerning, inter alia:

- The business activity performed by the Telefónica Group: i) products and services (E2E Digitalization, Internet of Things, Security B2B, Network, Terminals, Business Intelligence, Big Data, voice and data, video services, etc.), ii) business performance in the countries in which the Telefónica Group operates, and iii) operational trends.
- Status of regulations in the telecommunications sector (such as regulatory amendments and spectrum auctions).
- Corporate and financing transactions of the Telefónica Group.

Indicate whether the composition of the Executive Commission reflects the participation within the board of the different types of directors:

**Yes**

#### AUDIT AND CONTROL COMMITTEE

Name	Position	Professional category
Mr. José Javier Echenique Landiribar	Chairman	Independent
Mr. Gonzalo Hinojosa Fernández de Angulo	Member	Independent
Mr. Antonio Massanell Lavilla	Member	Proprietary
Mr. Ignacio Moreno Martínez	Member	Proprietary
Mr. Francisco Javier de Paz Mancho	Member	Independent
<b>% of Proprietary Directors</b>		40.00%
<b>% of Independent Directors</b>		60.00%
<b>% of Other External Directors</b>		0.00%

Explain the functions attributed to this committee, outline the procedures and rules for its organisation and working and summarise the most significant actions taken over the course of the year.

See heading H “Other information of interest”, Note 17 to Section C.2.1.

Indicate the Director who sits on the Audit Committee who has been appointed, taking into account his/her knowledge and experience in accounting, auditing or in both, and state how many years the Chairman of this Committee has held this position.

<b>Name or Director with experience</b>
Mr. José Javier Echenique Landiribar
<b>No. years Chairman has held this position</b>
1

#### NOMINATING, COMPENSATION AND CORPORATE GOVERNANCE COMMITTEE

<b>Name</b>	<b>Position</b>	<b>Professional category</b>
Mr. Francisco Javier de Paz Mancho	Chairman	Independent
Mr. Peter Erskine	Member	Independent
Ms. Sabina Fluxà Thienemann	Member	Independent
Mr. Gonzalo Hinojosa Fernández de Angulo	Member	Independent
Mr. Pablo Isla Álvarez de Tejera	Member	Independent

<b>% of Proprietary Directors</b>	0.00%
<b>% of Independent Directors</b>	100.00%
<b>% of Other External Directors</b>	0.00%

Explain the functions attributed to this committee, outline the procedures and rules for its organisation and working and summarise the most significant actions taken over the course of the year.

See heading H “Other information of interest”, Note 18 to Section C.2.1.

#### SERVICE QUALITY AND CUSTOMER SERVICE COMMITTEE

<b>Name</b>	<b>Position</b>	<b>Type</b>
Mr. Antonio Massanell Lavilla	Chairman	Proprietary
Ms. Eva Castillo Sanz	Member	Other External
Mr. Julio Linares López	Member	Other External
Mr. Gonzalo Hinojosa Fernández de Angulo	Member	Independent
Mr. Ignacio Moreno Martínez	Member	Proprietary

<b>% of Proprietary Directors</b>	40.00%
<b>% of Independent Directors</b>	20.00%
<b>% of Other External Directors</b>	40.00%

Explain the functions attributed to this committee, outline the procedures and rules for its organisation and working and summarise the most significant actions taken over the course of the year.

Pursuant to the provisions of Article 25 of the Regulation of the Board of Directors of the Company, the Service Quality and Customer Service Committee is regulated in the following terms:

a) Composition.

The Service Quality and Customer Service Committee shall consist of such a number of members, all of them Directors, as the Board of Directors determines at any given time, who shall in no case be less than three and the majority of whom must be External Directors.

The Chairman of the Service Quality and Customer Service Committee shall be appointed from among its members.

b) Duties.

Without prejudice to any other duties that the Board of Directors may assign thereto, the Service Quality and Customer Service Committee shall have at least the following duties:

- 1) To periodically examine, review and monitor the quality indices of the principal services provided by the companies of the Telefónica Group.
- 2) To evaluate levels of customer service provided by the companies of the Group to their customers.

Most significant actions during the year.

In the 4 meetings held by the Quality Committee in 2016, it analysed the quality metrics of the main services provided by Telefónica Group companies, while the levels of commercial attention these companies provide to their customers was assessed.

As with the other Board Committees, the relations between the Committee and the Board of Directors are based on a full transparency principle. At the beginning of each one of the monthly meetings of the Board of Directors, the Chairman of the Committee informs about the most important matters addressed, and the activities and tasks performed by the Committee; providing the Directors with the necessary documentation, so that it can take such actions into account when performing its duties.

## REGULATION AND INSTITUTIONAL AFFAIRS COMMITTEE

Name	Position	Professional category
Mr. Julio Linares López	Chairman	Other External
Ms. Eva Castillo Sanz	Member	Other External
Mr. Gonzalo Hinojosa Fernández de Angulo	Member	Independent
Mr. Antonio Massanell Lavilla	Member	Proprietary
Mr. Ignacio Moreno Martínez	Member	Proprietary
Mr. Francisco Javier de Paz Mancho	Member	Independent
<b>% of Proprietary Directors</b>		33.33%
<b>% of Independent Directors</b>		33.33%
<b>% of Other External Directors</b>		33.33%

Explain the functions attributed to this committee, outline the procedures and rules for its organisation and working and summarise the most significant actions taken over the course of the year.

Subject to article 20.b) of the Board of Directors' Regulation, the Board has created the Regulation and Institutional Affairs Committee:

## a) Composition.

The Board of Directors shall determine the number of members of this Committee.

The Chairman of the Regulation and Institutional Affairs Committee shall be appointed from among its members.

## b) Duties.

Without prejudice to any other duties that the Board of Directors may assign thereto, the Regulation and Institutional Affairs Committee shall have, at least, the following duties:

- 1) To carry out, through study, analysis and discussion, permanent monitoring of the main matters and themes of the regulatory order that affect the Telefónica Group at all times.
- 2) To provide a channel for communication and information between the management team and the Board of Directors in statutory matters and, when appropriate, to bring to the knowledge of the latter matters that are considered relevant to the Company, or to any of the companies in the Group and on which it may be necessary or convenient to adopt a decision or to establish a specific strategy.
- 3) To review, report and propose to the Board of Directors the principles that must guide the Group's Sponsorship and Patronage policy, monitor such policy and individually approve all sponsorships or patronages that exceed the limit set by the Board, and that have to be approved by the Board.
- 4) To promote the development of the Telefónica Group's Corporate Reputation and Responsibility project and the implementation of the core values of such Group.

Most significant actions during the year.

The Regulation and Institutional Affairs Committee held 7 meetings in the 2016 year (prior to the reorganization of this Committee –see heading H “Other information of interest”, Note 12-, the Regulatory Committee held one meeting in 2016, and the Institutional Affairs Committee held 4 meetings), have been analysed and debated:

- The regulatory matters of most significance for the Telefónica Group, were set out in the Regulatory Agenda; at global and European Union level, by regions (Europe and Latin America) and by countries. The most significant developments, as set out in the aforementioned Regulatory Agenda, are updated in each meeting, and in the specific documents or reports submitted to the Committee, when deemed advisable.
- A continuous monitoring of, on the one hand, the Sponsorship and Patronage Policy, and the Sponsorships presented by the Institutional Relations and Sponsorships area of Telefónica, S.A., and, on the other hand, the Corporate Social Responsibility of the Telefónica Group and of the most significant issues in this field.

As with the other Board Committees, the relations between this Committee and the Board of Directors are based on a full transparency principle. At the beginning of each one of the monthly meetings of the Board of Directors, the Chairman of the Committee informs about the most important matters addressed, and the activities and tasks performed by the Committee; providing the Directors with the necessary documentation, so that it can take such actions into account when performing its duties.

## STRATEGY AND INNOVATION COMMITTEE

Name	Position	Professional category
Mr. Peter Erskine	Chairman	Independent
Mr. José María Abril Pérez	Member	Proprietary
Ms. Eva Castillo Sanz	Member	Other External
Mr. Juan Ignacio Cirac Sasturain	Member	Independent
Mr. Peter Löscher	Member	Independent
Mr. Gonzalo Hinojosa Fernández de Angulo	Member	Independent
Mr. Antonio Massanell Lavilla	Member	Proprietary

% of Proprietary Directors	28.57%
% of Independent Directors	57.14%
% of Other External Directors	14.29%

Explain the functions attributed to this committee, outline the procedures and rules for its organisation and working and summarise the most significant actions taken over the course of the year.

Subject to article 20.b) of the Board of Directors' Regulation, the Board has created the Strategy and Innovation Committee:

a) Composition.

The Board of Directors shall determine the number of members of this Committee.

The Chairman of the Strategy and Innovation Committee shall be appointed from among its members.

b) Duties.

Without prejudice to any other duties that the Board of Directors may assign thereto, the primary duty of the Strategy and Innovation Committee shall be:

- 1) To support the Board of Directors in the analysis and follow up of the global strategy policy of the Telefónica Group.
- 2) To advise and assist in all matters regarding innovation. Its main object is to perform an examination, analysis and periodic monitoring of the Company's innovation projects, to provide guidance and to help ensure its implementation and development across the Group.

Most significant actions during the year.

The Strategy and Innovation Committee held 7 meetings in the 2016 year (prior to the reorganization of this Committee - see heading H "Other information of interest", Note 12-, the Strategy Committee held 4 meetings in 2016, and the Innovation Committee held 3 meetings), in which it analysed a number of different issues, which mainly concerned the telecommunications sector, in keeping with the strategic policy of the Telefónica Group and its business, and questions relating to these matters.

Likewise, it performed a regular monitoring of the Company's innovation projects, providing guidance and offering its support to help ensure its implementation and development across the Group.

As with the other Board Committees, the relations between the Committee and the Board of Directors are based on a full transparency principle. At the beginning of each one of the monthly meetings of the Board of Directors, the Chairman of the Committee informs about the most important matters addressed, and the activities and tasks performed by the Committee; providing the directors with the necessary documentation, so that it can take such actions into account when performing its duties.

### Action Plan and Report

As for the Board itself, at the beginning of each year and in accordance with Article 20 b) 3. of the Regulations of the Board of Directors, all Committees shall prepare an Action Plan detailing the actions to be taken and their timing for each year in each of their fields of action.

All Committees shall also draw up an internal Activities Report summarizing the main activities and actions taken during the previous year, detailing the issues discussed at its meetings and highlighting certain aspects regarding its powers and duties, composition and operation.



As per Article 20 b) 3. of the Regulations of the Board of Directors, in order that it may properly exercise its duties, the Board of Directors is kept fully informed of the issues addressed by the Committees.

C.2.2 Complete the following table on the number of female directors on the various board committees over the past four years:

	Number of female directors			
	2016 Number %	2015 Number %	2014 Number %	2013 Number %
Executive Commission	0	0	0	0
Audit and Control Committee	0	0	0	0
Nominating, Compensation and Corporate Governance Committee	1 (20.00%)	0	0	0
Service Quality and Customer Service Committee	1 (20.00%)	1 (14.29%)	1 (14.29%)	1 (14.29%)
Regulation and Institutional Affairs Committee	1 (16.67%)	0	0	0
Strategy and Innovation Committee	1(14.29%)	0	0	0

C.2.3 Section eliminated.

C.2.4 Section eliminated.

C.2.5 Indicate, as appropriate, whether there are any regulations governing the board committees. If so, indicate where they can be consulted, and whether any amendments have been made during the year. Also indicate whether an annual report on the activities of each committee has been prepared voluntarily.

The organization and operation of the Board of Directors Committees are governed by the Regulations of the Board of Directors. In particular, the Executive Commission is regulated in Article 38 of the Bylaws, the Audit and Control Committee in Article 39 of the Bylaws, and the Nominating, Compensation and Corporate Governance Committee in Article 40 of the said Bylaws. These documents are available for consultation on the Company's website.

As mentioned in Section C.2.1 above, the Board Committees draw up an internal Activities Report summarising the main activities and actions taken during the year detailing the issues discussed at their meetings and highlighting certain aspects regarding their powers and duties, composition and operation.

C.2.6 Section eliminated.

## D. Related-party and intragroup transactions

### D.1 Explain, if applicable, the procedures for approving related-party or intragroup transactions.

#### Procedure for reporting on approval of related-party transactions.

Article 5 of the Regulations of the Board of Directors includes a number of powers of the Board which cannot be delegated, including the following:

The approval, based on a favourable report by the Audit and Control Committee, of the transactions which the company carries out with directors, significant shareholders or representatives on the board, or related parties.

Also, as set forth in Article 30.f) of the Regulations of the Board of Directors, Directors shall not directly or indirectly enter into professional or commercial transactions with the Company or with any of the companies of the Group, if such transactions are unrelated to the ordinary course of business of the Company or not performed on an arm's length basis, unless the Board of Directors is informed thereof in advance and, on the recommendation of the Audit and Control Committee, it approves the transaction upon the affirmative vote of at least 90% of the Directors (present in person or by proxy).

Also, Article 38 of the Regulations of the Board of Directors specifically regulates transactions performed with significant shareholders, and establishes that the Board of Directors, based on a favourable report by the Audit and Control Committee, will approve the transactions which the Company or its Group perform with directors, individual or together with others, of a significant shareholding, including shareholders represented in the Board of Directors of the Company or other Group companies or with persons related to them, unless this power is attributable by law to the General Shareholders Meeting.

Directors affected or which represent or which are related to affected shareholders will have to refrain from taking part in the deliberation and voting on the resolution in question.

This approval does not include transactions which, according to prevailing laws, do not require such approval or exemption, i.e. according to Article 529 ter of the Spanish Corporations Act, the transactions which simultaneously fulfil the three following requirements:

- 1.º they are performed by virtue of contracts whose conditions are standardised and are applied on an across-the-board basis to a large number of clients,
- 2.º they are performed at prices or tariffs generally set by the person supplying the goods or services, and
- 3.º their amount is not more than one per cent of the company's annual revenues.

The transactions referred to above shall be assessed from the point of view of equal treatment of shareholders and the arm's-length basis of the transaction, and shall be included in the Annual Corporate Governance Report and in the periodic public information of the Company upon the terms provided by law.

For the transaction to be approved, it will be necessary to ensure that the transaction does not compromise the capital, or, if applicable, that it is performed on an arm's-length basis and that the process is transparent.

Only where there are imperative grounds of urgency, duly justified, decisions mentioned above could be adopted by delegated bodies or persons, and subsequently ratified by the Board of Directors (article 5.5 of the Regulations of the Board of Directors).

**D.2 List any relevant transactions, by virtue of their amount or importance, between the company or its group of companies and the company's significant shareholders.**

Name or corporate name of significant shareholder	Name or corporate name of the company or its group company	Nature of the relationship	Type of transaction	Amount (Thousands of euros)
Banco Bilbao Vizcaya Argentaria, S.A.	Telefónica, S.A.	Contractual	Interest paid	8,662
Banco Bilbao Vizcaya Argentaria, S.A.	Telefónica, S.A.	Contractual	Receipt of services	2,089
Banco Bilbao Vizcaya Argentaria, S.A.	Telefónica, S.A.	Contractual	Interest charged	67
Banco Bilbao Vizcaya Argentaria, S.A.	Telefónica, S.A.	Contractual	Others	14,923
Banco Bilbao Vizcaya Argentaria, S.A.	Telefónica, S.A.	Contractual	Finance arrangements: loans	349,833
Banco Bilbao Vizcaya Argentaria, S.A.	Telefónica, S.A.	Contractual	Guarantees	327
Banco Bilbao Vizcaya Argentaria, S.A.	Telefónica, S.A.	Contractual	Finance arrangements: other	243,992
Banco Bilbao Vizcaya Argentaria, S.A.	Telefónica, S.A.	Contractual	Dividends and other distributed earnings	242,783
Banco Bilbao Vizcaya Argentaria, S.A.	Rest of Telefónica Group	Contractual	Interest paid	27,012
Banco Bilbao Vizcaya Argentaria, S.A.	Rest of Telefónica Group	Contractual	Operating lease contracts	266
Banco Bilbao Vizcaya Argentaria, S.A.	Rest of Telefónica Group	Contractual	Receipt of services	2,611
Banco Bilbao Vizcaya Argentaria, S.A.	Rest of Telefónica Group	Contractual	Purchase of goods (finished or in progress)	254
Banco Bilbao Vizcaya Argentaria, S.A.	Rest of Telefónica Group	Contractual	Interest charged	21,946
Banco Bilbao Vizcaya Argentaria, S.A.	Rest of Telefónica Group	Contractual	Management contracts	523
Banco Bilbao Vizcaya Argentaria, S.A.	Rest of Telefónica Group	Contractual	Services rendered	40,308
Banco Bilbao Vizcaya Argentaria, S.A.	Rest of Telefónica Group	Contractual	Sale of goods (finished or in progress)	3,278
Banco Bilbao Vizcaya Argentaria, S.A.	Rest of Telefónica Group	Contractual	Others	544,596
Banco Bilbao Vizcaya Argentaria, S.A.	Rest of Telefónica Group	Contractual	Finance arrangements: loans	46,013
Banco Bilbao Vizcaya Argentaria, S.A.	Rest of Telefónica Group	Contractual	Guarantees	313,839
Banco Bilbao Vizcaya Argentaria, S.A.	Rest of Telefónica Group	Contractual	Purchase options commitments	218
Banco Bilbao Vizcaya Argentaria, S.A.	Rest of Telefónica Group	Contractual	Operating lease contracts	14
Fundación Bancaria Caixa d'Estalvis i Pensions de Barcelona	Telefónica, S.A.	Contractual	Interest paid	1,584
Fundación Bancaria Caixa d'Estalvis i Pensions de Barcelona	Telefónica, S.A.	Contractual	Receipt of services	1,643
Fundación Bancaria Caixa d'Estalvis i Pensions de Barcelona	Telefónica, S.A.	Contractual	Interest charged	343
Fundación Bancaria Caixa d'Estalvis i Pensions de Barcelona	Telefónica, S.A.	Contractual	Finance arrangements: loans	44,800
Fundación Bancaria Caixa d'Estalvis i Pensions de Barcelona	Telefónica, S.A.	Contractual	Guarantees	8,236
Fundación Bancaria Caixa d'Estalvis i Pensions de Barcelona	Telefónica, S.A.	Contractual	Finance arrangements: other	202,904
Fundación Bancaria Caixa d'Estalvis i Pensions de Barcelona	Telefónica, S.A.	Contractual	Dividends and other distributed earnings	185,083
Fundación Bancaria Caixa d'Estalvis i Pensions de Barcelona	Rest of Telefónica Group	Contractual	Receipt of services	2,138
Fundación Bancaria Caixa d'Estalvis i Pensions de Barcelona	Rest of Telefónica Group	Contractual	Services rendered	66,447
Fundación Bancaria Caixa d'Estalvis i Pensions de Barcelona	Rest of Telefónica Group	Contractual	Sale of goods (finished or in progress)	42,264
Fundación Bancaria Caixa d'Estalvis i Pensions de Barcelona	Rest of Telefónica Group	Contractual	Operating lease contracts	10,355
Fundación Bancaria Caixa d'Estalvis i Pensions de Barcelona	Rest of Telefónica Group	Contractual	Guarantees	41,826
Fundación Bancaria Caixa d'Estalvis i Pensions de Barcelona	Rest of Telefónica Group	Contractual	Purchase options commitments	83,910
Fundación Bancaria Caixa d'Estalvis i Pensions de Barcelona	Rest of Telefónica Group	Contractual	Other	250,031
Fundación Bancaria Caixa d'Estalvis i Pensions de Barcelona	Rest of Telefónica Group	Contractual	Interest paid	402
Fundación Bancaria Caixa d'Estalvis i Pensions de Barcelona	Rest of Telefónica Group	Contractual	Operating lease contracts	42
Fundación Bancaria Caixa d'Estalvis i Pensions de Barcelona	Rest of Telefónica Group	Contractual	Purchase of goods (finished or in progress)	65,362

**D.3 List any relevant transactions, by virtue of their amount or importance, between the company or its group of companies and the company's managers or directors.**

**D.4 List any relevant transactions undertaken by the company with other companies in its group that are not eliminated in the process of drawing up the consolidated financial statements and whose subject matter and terms set them apart from the company's ordinary trading activities.**

**In any case, list any intragroup transactions carried out with entities in countries or territories considered to be tax havens.**

**D.5 Indicate the amount from other related-party transactions:**

43,000 thousands euros

**D.6 List the mechanisms established to detect, determine and resolve any possible conflicts of interest between the company and/or its group, and its directors, management or significant shareholders.**

Company policy establishes the following principles governing possible conflicts of interest that may affect Directors, senior executives or significant shareholders:

- With respect to Directors, Article 30 of the Regulations of the Board of Directors establishes that Directors shall inform the Board of Directors of any situation of direct or indirect conflict they may have with the interest of the company. In the event of conflict, the Director affected shall refrain from participating in the deliberation to which the conflict refers.

Moreover, and in accordance with the provisions set out in the Regulations of the Board, Directors shall refrain from participating in votes that affect matters in which they or persons related to them have a direct or indirect interest.

Likewise, the aforementioned Regulations establish that Directors shall not directly or indirectly enter into professional or commercial transactions with the Company or with any of the companies of the Group, if such transactions are unrelated to the ordinary course of business of the Company or not performed on an arm's length basis, unless the Board of Directors is informed thereof in advance and, on the recommendation of the Nominating, Compensation and Corporate Governance Committee, it approves the transaction upon the affirmative vote of at least 90% of the Directors (present in person or by proxy).

Directors must also report with respect to themselves as well as the persons related thereto (a) the direct or indirect interests held by them and (b) the offices held or duties performed at any company that is in a situation of actual competition with the Company.

For purposes of the provisions of this paragraph, the following shall not be deemed to be in a situation of actual competition with the Company, even if they have the same or a similar or complementary corporate purpose: (i) companies controlled thereby (within the meaning of Article 42 of the Commercial Code); and (ii) companies with which Telefónica, S.A. has established a strategic alliance. Likewise, for purposes of the provisions hereof, proprietary directors of competitor companies appointed at the request of the Company or in consideration of the Company's interest in the capital thereof shall not be deemed to be in a situation of prohibition of competition.

Transactions arising from the duty of loyalty and its exemption regime shall also be subject to prevailing laws.

- Also, Article 38 of the Regulations of the Board of Directors specifically regulates transactions performed with significant shareholders, and establishes that the Board of Directors, based on a favourable report by the Audit and Control Committee, will approve the transactions which the Company or its Group perform with directors, individual or together with others, of a significant shareholding, including shareholders represented in the Board of Directors of the Company or other Group companies or with persons related to them, unless this power is attributable by law to the General Shareholders Meeting.

This approval does not include transactions which, according to prevailing laws, do not require such approval or exemption, i.e. according to Article 529 ter of the Spanish Corporations Act, the transactions which simultaneously fulfil the three following requirements:

- 1.º they are performed by virtue of contracts whose conditions are standardised and are applied on an across-the-board basis to a large number of clients,
- 2.º they are performed at prices or tariffs generally set by the person supplying the goods or services, and
- 3.º their amount is not more than one per cent of the company's annual revenues.

The transactions referred to above shall be assessed from the point of view of equal treatment of shareholders and the arm's-length basis of the transaction, and shall be included in the Annual Corporate Governance Report and in the periodic public information of the Company upon the terms provided by law.

For the transaction to be approved, it will be necessary to ensure that the transaction does not compromise the capital, or, if applicable, that it is performed on an arm's-length basis and that the process is transparent.

- With respect to senior executives, the Internal Code of Conduct for Securities Markets Issues sets out the general principles of conduct for the persons subject to the said regulations who are involved in a conflict of interest. The aforementioned Code includes all the Company's management personnel within the concept of affected persons.

In accordance with the provisions of this Code, senior executives are obliged to: (a) act at all times with loyalty to the Telefónica Group and its shareholders, regardless of their own or other interests; (b) refrain from interfering in or influencing the making of decisions that may affect individuals or entities with whom there is a conflict; and (c) refrain from receiving information classified as confidential which may affect such conflict. Furthermore, these persons are obliged to inform the Company's Regulatory Compliance function of all transactions that may co-ally give rise to conflicts of interest.

#### **D.7 Is more than one group company listed in Spain?**

**No**

Please specify the subsidiary companies listed in Spain:

##### **Subsidiary company listed**

Indicate whether they have provided detailed disclosure on the type of activity they engage in, and any business dealings between them, as well as between the subsidiary and other group companies:

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**Define possible business relations between the parent company and the listed subsidiary, and between the latter and the other Group companies**

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Indicate the mechanisms in place to resolve possible conflicts of interest between the listed subsidiary and other group companies:

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**Mechanisms to resolve possible conflicts of interest**

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## E. Risk control and management systems

### E.1 Describe the risk management system in place at the company, including with relation to taxes.

Telefónica continually monitors the most significant risks in the main companies comprising its Group. The Company therefore has a Corporate Risk Management Model based on the model established by the Treadway Commission's Committee of Sponsoring Organizations (COSO), which allows to assess both the impact and the likelihood of occurrence of the various risks arising.

One of the features of this Model is a map prioritizing risks according to their importance, thereby facilitating their management and appropriate response to mitigate them. In accordance with this Model, and based on best practices and benchmarks in risk management, the following four risk categories have been identified:

- i) Business risk: Possible loss of value or earnings as a result of strategic uncertainty or uncertainty about competitors, changes in the business, competition and market scenario, or changes in the legal framework.
- ii) Operational risk: Possible loss of value or earnings as a result of events caused by inadequacies or failures in customer service, processes, human resources, business teams and IT systems, security, compliance with contracts, laws and regulations, or due to external factors.
- iii) Financial risk: Possible loss of value or earnings as a result of adverse movements in financial variables and the inability of the Company to meet its obligations or convert its assets into cash. Additionally the risks of a fiscal nature are included in this category.
- iv) Global risk: Possible loss of value or earnings as a result of events that affect in a transversal way the entire Telefónica Group in terms of its corporate reputation and responsibility, corporate public relations, marketing strategy, brand, sponsorship and innovation.

### E.2 Identify the bodies responsible for preparing and implementing the risk management system, including tax matters.

Telefónica, S.A.'s Board of Directors reserves the power to approve the general risk policy. The Audit and Control Committee analyzes and evaluates risks and then proposes to the Board of Directors the risk control and management policy to be adopted, identifying the categories of risks to which the Company is exposed, the level of acceptable risk, measures to mitigate the impacts of identified risks, control systems and the reporting to be used to control and manage said risks. The powers and duties of the Audit and Control Committee also include the supervision of the Company's risk management system.

As stated by the Group's Risk Management Policy, various local and corporate units are involved in the risk management process.

The entire organization is responsible for contributing to the identification and management of risks, following the procedures defined to implement and ensure the effectiveness of the Group's risk management processes.

In order to coordinate and report these activities, there is an internal Risk Management function, within the Internal Audit department, reporting functionally to the Audit and Control Committee.

The Group's Fiscal Control Policy establishes the rules for the prevention and management of fiscal risk. The development of the fiscal control function corresponds to the Group's Fiscal Management, which performs this task through the Regional Fiscal Directorates and the local fiscal control officers in the different subsidiaries in accordance with the principles defined in said document.

### E.3 Indicate the main risks, including tax risks, which may prevent the company from achieving its targets.

Information regarding this point is contained in the Annex to this Report.

**E.4. State whether the company has a risk tolerance level, including tax risk.**

The Company has a level of risk tolerance or acceptable risk level established at a corporate level. This threshold represents the extent to which it is prepared to assume a certain level of risk, insofar as it may contribute to generating value and developing the business, achieving an appropriate balance between growth, performance and risk.

The range of risks to which the Company may be exposed described below is considered when evaluating risk:

- Generally, albeit mainly related to operational and business risks, tolerance thresholds are defined pursuant to the impact and probability of the risk. These thresholds are revised annually based on the performance of the main financials for both the Group as a whole and the business lines and main companies therein.
- The tolerance level for financial risks (including fiscal risks) is set in terms of their economic impact.
- A zero-tolerance level is established for global risks, principally those affecting corporate reputation and responsibility.

**E.5 Identify any risks, including fiscal risks, which have occurred during the year.**

The Telefónica Group reviews on an annual basis, or more frequently when the circumstances require it, the value of assets and cash-generating units, to assess whether their carrying values can be supported by the future expected cash flows, including, in some cases synergies allowed for in acquisition costs. Potential changes in the regulatory, business, economic or political environment may result in the need to introduce changes to estimates made and to recognize impairment in goodwill, intangible assets or fixed assets. Although the recognition of impairments of property, plant and equipment, intangible assets and financial assets results in a non-cash charge on the income statement, it could adversely affect the results of the Telefónica Group's operations. In this respect, the Telefónica Group has experienced impairments on certain of its investments, affecting its results of operations in the year in which they were experienced. In the year 2016, corrections due to impairment of goodwill amounted to 215 million euros were recorded, corresponding to the operations of Telefónica in Venezuela (124 million euros) and in México (91 million euros).

Further details on Income tax matters are provided by Telefónica in its Annual Accounts (Note 17 of the Individual and Consolidated Financial Statements).

**E.6 Explain the response and monitoring plans for the main risks the company is exposed to, including fiscal risks.**

The Corporate Risk Management Model, which has been devised in accordance with the main international best practices and guidelines, involves identifying and evaluating risks to respond to and monitor them.

Given the diverse range of risks, the mechanisms for responding to risks include overarching initiatives that are developed and coordinated as standard across the Group's main operations and/or specific measures aimed at managing certain risks at company level.

Overarching measures, mainly involving the use of financial derivatives, are taken to mitigate certain financial risks such as those relating to exchange-rate and interest-rate fluctuations. Regarding fiscal risks, the key issues identified are monitored, the Group uses Multinational Programs for insurance or insurance arranged locally in each country to cover operational risks, depending on the type of risk and cover required.

## F. Internal Control over Financial Reporting (ICFR) Systems

Describe the mechanisms which comprise the internal control over financial reporting (ICFR) risk control and management system at the company.

### F.1 The company's control environment

**Specify at least the following components with a description of their main characteristics:**

#### F.1.1 The bodies and/or functions responsible for: (i) the existence and regular updating of a suitable, effective ICFR; (ii) its implementation; and (iii) its monitoring.

The Board of Directors of Telefónica, S.A. (hereinafter Telefónica) assumes ultimate responsibility of ensuring that an adequate and effective internal control over financial reporting system (ICFR) exists and is updated.

The Board of Directors is, in accordance with prevailing laws and the Bylaws, the highest administrative and representative body of the Company, and basically consists of a supervisory and control body, while the executive bodies and management team are responsible for the day-to-day management of the Company's businesses.

The Bylaws and Regulations of the Board of Directors state that 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:

- Oversee the process of preparing and presenting mandatory financial reporting and submitting recommendations of proposals to the administrative body aimed at safeguarding its integrity. With respect thereto, it shall be responsible for supervising the process of preparation and the completeness 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.
- Monitoring the effectiveness of the Company's internal control, internal audit and risk management systems, including fiscal risks, and discuss with the auditors significant deficiencies in the internal control system detected during the audit, without compromising their independence at any time. For that purposes, if deemed necessary, it can submit recommendations or proposals to the Board of Directors and an appropriate monitoring period. 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 types of risk (operational, technological, financial, legal and reputational) which the Company faces; the level of risk which the Company deems acceptable; the measures for mitigating the impact of the identified risks should they materialise; and the control and information systems to be employed to control and manage said risks.
- Establish and maintain appropriate relations with the Auditor in order to receive, for review by the Committee, information on all matters that could jeopardise the Auditor's independence, and, when applicable, the authorisation of permitted services, according to current legislation, and such other communications as may be provided for in auditing legislation and in technical auditing regulations. In any event, the Audit and Control Committee must receive, on an annual basis, written confirmation from the Auditor of its independence vis-à-vis the entity or entities directly or indirectly related thereto, as well as in-depth and individualised information regarding additional services of any kind provided as well as the fees received to such entities by the Auditor or by the persons or entities related thereto pursuant to the provisions of prevailing legislation.
- 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 is compromised. In this report will focus on the assessment of the provision of each and every one of the additional services referred to in previous point, considered individual and in their entirety, other than legal audit, and in relation to the regime of independence or laws regulating auditing activities.

According to the Regulation of the Board of Directors, the Audit and Control Committee must meet at least once every quarter. In practice, the Committee meets every month, and in fact every time it is considered appropriate.

In order to carry out this supervisory function, the Audit and Control Committee is assisted by the entire Company management, including Internal Audit.

All the different areas and functional units of the Telefónica Group are important in ICFR (internal control over financial reporting), the Strategy and Financial areas playing a key role, as they are responsible for preparing, maintaining and



updating the different procedures that govern their operations and identify the tasks to be carried out, as well as the persons in charge of the same.

**F.1.2 The existence or otherwise of the following components, especially in connection with the financial reporting process:**

- **The departments and/or mechanisms in charge of: (i) the design and review of the organizational structure; (ii) defining clear lines of responsibility and authority, with an appropriate distribution of tasks and functions; and (iii) deploying procedures so this structure is communicated effectively throughout the company.**

The Board of Directors is responsible for designing and reviewing the Company's organizational structure, ensuring there is an adequate separation of functions and that satisfactory coordination mechanisms among the different areas are established. The Human Resources Division carries out the deployment of the organizational structure in the respective fields.

Use of the Telefónica Group's economic-financial information system is regulated through several manuals, instructions and internal rules and regulations, internally made available, the most noteworthy of which are as follows:

1. **Corporate Regulations on the Control, Registration and Reporting of Financial and Accounting Information**, which sets out the basic principles of the Telefónica Group's financial and accounting reporting system, and the procedures and mechanisms in place to oversee this system.
2. **Accounting Policies and Measurement Criteria Manual**, designed to unify and standardise the accounting criteria and policies used by all the Group companies to ensure Telefónica operates as a consolidated and uniform group.
3. **Manual for Completion of the Reporting for Consolidation**, which is updated annually and establishes specific instructions for compliance with reporting forms necessary for the preparation of consolidated financial statements and interim consolidated financial information.
4. **Instructions for annual and quarterly accounting closes**, published annually or quarterly to establish the procedures and schedule all Telefónica Group companies must follow when reporting financial and accounting information to enable the Telefónica Group's Consolidation Department to prepare the Group's consolidated financial information, so that Telefónica, S.A. complies with legal and reporting requirements in Spain and the other countries in which its shares are listed.
5. **Annual calendar of financial accounting information**, applicable to all Telefónica Group companies to establish the monthly accounting-financial reporting dates at the start of each period.

These documents define and delimit responsibilities at each level of the organization regarding the reliability of the information published.

The Management levels of the Company are also available on the Group Intranet.

- **Code of conduct, approving body, dissemination and instruction, principles and values covered (stating whether it makes specific reference to record keeping and financial reporting), body in charge of investigating breaches and proposing corrective or disciplinary action.**

In December 2006, Telefónica's Board of Directors approved the unification of the Codes of Ethics of the Group's companies, in the so-called Responsible Business Principles. The Responsible Business Principles, are applied as standard in all countries where the Telefónica Group operates, and for all its employees (affect at all levels of the organization, directors and non-directors).

The Responsible Business Principles are based on a series of general criteria which concern honesty and trust, abidance by prevailing laws, integrity and respect for human rights. It also sets out specific principles focused on ensuring the trust of customers, professionals, shareholders, suppliers and of society at large.

They expressly mention issues related to recording transactions and preparation of financial information: "*We prepare financial and accounting records in an accurate and reliable manner*".

This Code of Ethics is accessible to all employees via the intranet, and procedures are in place in the Telefónica Group to update, monitor adherence to and disseminate these Responsible Business Principles.

Telefónica has an Office of Business Principles, which comprises the most senior representatives of the General Secretary's Office, Human Resources, Public Affairs and Regulation, Chief Commercial Digital Officer (CCDO), Operations, Purchases, Compliance and Internal Audit.

The Office is in charge of:

- 1) Guaranteeing that Telefónica conducts business in an ethical and responsible manner, and that the Company's reputation is not tarnished.
- 2) Developing the mechanisms need to ensure the Code of Ethics is followed to the letter in all regions/countries/business units.
- 3) Overseeing, reviewing and contemplating the implementation of the Responsible Business Principles across the entire Telefónica Group.

Training courses are provided to all employees through the online training platform to reinforce knowledge of these Responsible Business Principles.

- 4) Examining any matters or proposals in the Group that could represent a risk to the Business Principles and associated policies and therefore, the brand and reputation.

On a different issue should any type of conduct which does not comply with applicable laws, the Responsible Business Principles or internal regulations come to light, then, after the pertinent analysis, disciplinary measures will be applied in accordance with the regime established in the applicable labour laws, distinguishing between minor, serious and very serious sanctions, depending on the circumstances.

Training programmes are also regularly organised to ensure employees are aware of these rules and principles.

Telefónica also has an "Internal Code of Conduct" for Securities Markets issues, setting out the general guidelines and principles of conduct for the persons involved in securities and financial instrument transactions entered into by the Company and its subsidiaries. The Board of Directors on its meeting held on December 14, 2016, approved a new version of the Internal Code of Conduct in order to adapt it to the regulatory changes on this matter.

- **Whistle-blowing channel, for the reporting to the Audit Committee of any irregularities of a financial or accounting nature, as well as breaches of the code of conduct and malpractice within the organisation, stating whether reports made through this channel are confidential.**

With regard to the whistle-blowing channel, as specified in Article 22 of Telefónica, S.A.'s Regulations for the Board of Directors, the Audit and Control Committee's duties include: "Establishing and maintaining a mechanism to allow employees to confidentially and anonymously report potentially significant irregularities, particularly any financial or accounting irregularities detected within the Company".

The Telefónica Group has two whistle-blowing channels:

**SOX Whistle-blowing Channel:** this channel was approved by the Audit and Control Committee in April 2004 to fulfil the obligations laid down in the Sarbanes-Oxley Act (SOX), as a listed company on the New York Stock Exchange. It is open to all Telefónica Group employees. Any irregularities reported through the channel must only be related with financial-accounting information, internal controls thereof, and/or audit-related matters.

This channel is confidential and anonymous, since the contents of any reports are sent automatically to the Compliance Department, removing the sender's name, and the source of the message cannot be traced in any event.

The channel is accessible through the Internal Audit webpage on Telefónica's intranet, through the section: Rules of Telefónica's Group, Control over the financial report process.

The Compliance and Internal Audit Departments, as delegate areas of the Audit and Control Committee of Telefónica, S.A., to these purposes, receive all complaints made through this channel regarding internal controls, accounting or the audit of the financial statements, therefore these Departments will be aware about these complaints, will solve them or give the complaints the treatment they deem convenient.

**Responsible Business Principles Whistle-blowing Channel:** through this channel, professionals can notify the Company of any behaviour, actions or events that could breach the ethical code, the Company's internal rules, or any regulations governing its activity, and jeopardise the contractual relationship between the Company and the accused party. Questions, advice and information on compliance with the Business Principles and associated policies and rules can also be submitted through this channel.

As a general rule, the policy of the Responsible Business Principles Whistle-blowing Channel is not to promote anonymous messages. However the confidentiality of the complainant's identity is safeguarded at all times.

Telefónica S.A.'s Compliance Department is responsible for the Responsible Business Principles Whistle-blowing Channel.

- **Training and refresher courses for personnel involved in preparing and reviewing financial information or evaluating ICFR, which address, at least, accounting rules, auditing, internal control and risk management.**

With regard to employee training in financial and control issues, we would note that in 2007 the Telefónica Corporate University (Universitas Telefónica) was opened to help contribute to the Telefónica Group's advancement through lifelong learning. All the University's training programs are based on developing the corporate culture, the business strategy and management and leadership skills.

Likewise, the Consolidation and Accounting Polices Area offers training plans and seminars to all personnel working in the Group's financial areas and other pertinent areas (tax, M&A, etc.), with the aim of informing them of any accounting or financial changes which are applicable to their job of preparing consolidated financial information. This area also publishes IFRS (International Financial Reporting Standards) information bulletins summarising the main changes to accounting methodology, as well as clarifications on various other related issues.

Financial reporting personnel also attend technical sessions run by external consultancy firms and covering developments in accounting.

Lastly, the Telefónica Group also has an on-line training platform which includes a finance school providing specific training and refresher courses on financial information, as well as an internal control school providing instruction on auditing, internal control and risk management.

## **F.2. Risk assessment in financial reporting**

### **Report, at least:**

#### **F.2.1 The main characteristics of the risk identification process, including risks of error or fraud, stating whether:**

- **The process exists and is documented.**

Given the vast number of processes involved in financial reporting at the Telefónica Group, a model has been developed to select the most significant processes by applying a so-called Scope Definition Model, which is documented. This model is applied to the financial information reported by subsidiaries or companies managed by Telefónica. The model selects the accounts with the largest contribution to the Group's consolidated financial information and then identifies the processes used to generate this information. Once the processes have been identified, the risks affecting financial reporting are analysed.

- **The process covers all financial reporting objectives, (existence and occurrence; completeness; valuation; presentation, disclosure and comparability; and rights and obligations), is updated and with what frequency.**

This identification procedure covers all the financial reporting objectives of existence and occurrence, completeness, valuation, presentation, disclosure and fraud. Risk identification is carried out on an annual basis.

- **A specific process is in place to define the scope of consolidation, with reference to the possible existence of complex corporate structures, special purpose vehicles, holding companies, etc.**

In the process of identifying the consolidation scope, the Strategy and Financial Areas regularly updates the consolidation scope, verifying additions and removals of companies with the legal and financial departments of the different companies which are part of the Group, including the corporate departments.

- **The process addresses other types of risk (operational, technological, financial, legal, fiscal, reputational, environmental, etc.) insofar as they may affect the financial statements.**

As indicated above, Telefónica also has a Risk Management Model covering four key areas of risk:

- 1) Business risks
- 2) Operational risks, including, among others Compliance risks
- 3) Global risks
- 4) Financial risks

Financial risks include risks associated with the accuracy, completeness and publication of reporting information. Tax risks are also included within this category:

- **Which of the company's governing bodies is responsible for overseeing the process.**

Pursuant to the provisions of Article 22 of the Regulation of the Board of Directors of Telefónica, S.A., the Board of Directors, through the Audit and Control Committee, supervises this process.

### **F.3 Control activities.**

**Indicate the existence of at least the following components, and specify their main characteristics:**

#### **F.3.1 Procedures for reviewing and authorizing the financial information and description of ICFR to be disclosed to the markets, stating who is responsible in each case and documentation and flow charts of activities and controls (including those addressing the risk of fraud) for each type of transaction that may materially affect the financial statements, including procedures for the closing of accounts and for the separate review of critical judgments, estimates, evaluations and projections.**

On March 26, 2003 Board of Directors of Telefónica, S.A. approved the "Regulations Governing Disclosure and Reporting to the Markets". These regulate the basic principles of operation of the financial disclosure control processes and systems which guarantee that all relevant consolidated financial information of Telefónica, S.A. is communicated to the Company's senior executives and its management team, assigning to the Internal Audit the duty of periodically assessing the functioning of these processes and systems.

Each quarter the Consolidation and Accounting Policies Department submits the periodic financial information to the Audit and Control Committee, highlighting the main events and accounting criteria applied and clarifying any major events which occurred during the period.

Likewise, the Telefónica Group has documented financial processes in place which stipulate common criteria for preparing financial information in all Group companies, as well as any outsourced activities.

The Company also follows documented procedures for preparing consolidated financial information whereby those employees responsible for the different areas are able to verify this information.

Also, and pursuant to the internal regulations, the Executive Chairmen and the Finance Directors of Group companies must submit a certificate to the Corporate Consolidation and Accounting Policies Department stating that they have reviewed the financial information being presented, that the financial statements give a true and fair view, in all material respects, of the financial position, results and cash position, and that there are no significant risks to the business or unhedged risks which may have a material impact on the Company's equity and financial position.

In relation to the accounting close, the Consolidation and Accounting Policies Department issues mandatory instructions setting out the calendar and contents for the financial reporting period for the preparation of the consolidated annual financial statements.

The Corporate Consolidation and Accounting Policies Department reviews the key judgments, estimates, valuations and forecasts to identify critical accounting policies that require the use of estimates and value judgments. In these cases, the Corporate Consolidation and Accounting Policies Department also establishes the necessary operational co-ordination actions with the rest of the Telefónica Group units for their specific areas of activity and knowledge before presenting them to the Audit and Control Committee. The most relevant are dealt with by the Audit and Control Committee. Senior management defines the format for presenting the annual financial statements prior to approval by the Board.

Lastly, Internal Audit, as part of its annual audit plan, among others actions, sets out work plans every year to assess the internal control of financial reporting model.

**F.3.2. Internal control policies and procedures for information systems (including secure access, control of changes, system operation, continuity and segregation of duties) giving support to key company processes regarding the preparation and publication of financial information.**

The Global Information Systems Department of the Telefónica Group is responsible for the global management of Information Systems for all the Group's businesses, defining strategy and technological planning, ensuring quality in service, cost and security required by the Group.

One of its duties is to develop and implement systems to improve the efficiency, efficacy and profitability of Group processes, the definition and implementation of policies and security standards for applications and infrastructures (in conjunction with the Security and Networks departments), which includes IT aspects of the internal control model.

The Global Security Policy considers human resources and the information, and technological and material resources that support them, to be fundamental assets. For this reason, guaranteeing their security is considered to be an essential asset within the Telefónica strategy, and an essential enabler of the organization's activity.

With the approval of this Policy, the Board of Directors expresses its determination and commitment to reaching a level of security that is adequate to the needs of the business and that homogeneously guarantees the protection of the assets in all Telefónica Group companies.

The security activities developed by the different environments, organizational structures, parties responsible for assets, and employees will be governed by the principles of legality, efficiency, corresponsibility, cooperation, and coordination. Any and all adequate promotion, conduction, control, and improvement measures will be established to this end.

- **Principle of Legality:** the necessary compliance of all national and international laws and regulations regarding the matter of security that may be valid at any given time in any of the territories where the Telefónica Group operates, shall be ensured.
- **Principle of Efficiency:** in order to efficiently reach the required level of security, the anticipatory and preventive nature of said actions shall rule over any passive and reactionary nature. To this end, knowledge of potential threats as well as the analysis of potential risks shall be privileged as part of an intelligence process that identifies and understands the most relevant threats that affect the organization. In order to get ahead of their action and evolution, and to safeguard the Telefónica Group's global organization from their potentially harmful effects, mitigating these risk's damages down to an acceptable level for the business.

A Global Corporate Security Regulations Framework is defined for the purpose of reaching a standardized level of security. This framework will take into account the analyses of risks and threats and will also establish the precise preventive or corrective protection measures.

In addition, strategic plans will be conceived and prepared in order to identify and prioritize the projects and budgets necessary for reaching those adequate levels of security, minimizing the security risks identified in the corresponding analyses, and maximizing the effectiveness of the investment made and the resources used.

- **Principle of Corresponsibility:** users must preserve the security of the assets that Telefónica makes available to them in accordance to the security criteria, requirements, procedures, and technologies defined in the Security Regulations Framework, as well as the applicable laws and regulations regarding the matter of security. At the same time, users must exclusively use the assets for the performance of activities that correspond to their workstation and assigned tasks.
- **Principle of Cooperation and Coordination:** in order to reach the levels of efficiency required by Telefónica business project, the global action and comprehensive concept of security activities shall be preserved together with the aforementioned requirements of anticipation and prevention, cooperation and coordination between all business units and employees will be prioritized, in order to generate the adequate synergies and to jointly reinforce the capabilities.

The Security Organization coordinates the security responsibilities of the different Telefónica Group structures, promoting cooperation between them in order to guarantee the efficient and joint protection of the assets.

Lastly, Internal Audit unit, as part of its annual audit plan, sets out work plans to verify the efficacy and efficiency of the IT governance model, the information security Policy, suitability of controls and data integrity.

**F.3.3. Internal control policies and procedures for overseeing the management of outsourced activities, and of the appraisal, calculation or valuation services commissioned from independent experts, when these may materially affect the financial statements.**

If a process or part of a process is outsourced to an independent party, controls are still required to ensure the entire process is adequately controlled. Given the importance of outsourcing services and the impacts that this can have on the opinion about ICFR, measures are taken in the Telefónica Group to demonstrate a minimum level of control in the independent party. Actions taken to achieve this objective are three-fold:

- **Certification of internal control by an independent third party:** ISAE3402 and/or SSAE16 certifications.
- **Implementation of specific controls:** identified, designed, implemented and assessed by the Company.
- **Direct assessment:** an assessment carried out by internal audit on certain administrative outsourced processes.

When Telefónica, S.A. or any of its subsidiaries engage the services of an independent expert whose findings may materially affect the consolidated financial statements, as part of the selection process the competence, training, credentials and independence of the third party as regards the methods and main hypothesis used, is verified directly by the area contracting the service and, if applicable with the procurement department. The Strategy and Financial department has established control activities geared towards guaranteeing the validity of data, the methods used, and the reasonability of the assumptions used by the third party using regular monitoring of each function's own KPIs in order to ensure compliance of the outsourced process according to the Group's different policies and guidelines.

Likewise, there is an internal procedure for engaging independent experts which requires specific levels of approval.

**F.4 Information and communication**

**Indicate the existence of at least the following components, and specify their main characteristics:**

**F.4.1 A specific function in charge of defining and maintaining accounting policies (accounting policies area or department) and settling doubts or disputes over their interpretation, which is in regular communication with the team in charge of operations, and a manual of accounting policies regularly updated and communicated to all the company's operating units.**

The Consolidation and Accounting Policies Department of the Group is charged with defining and updating the accounting policies used for preparing the consolidated financial information.

Thus, this area publishes IFRS (International Financial Reporting Standards) information bulletins summarising the main changes to accounting methodology, as well as clarifications on various other related issues, which are systematically monitored by the Accounting Policies area. This bulletins are published on a monthly basis.

Also, the Telefónica Group has an Accounting Policies Manual which is updated annually, the last update took place in December 2016. The objectives of this manual are: to align the corporate accounting principles and policies with IFRS; to maintain accounting principles and policies which ensure that the information is comparable within the Group and offers optimum management of the source of information; to improve the quality of the accounting information of the various Group companies and of the Consolidated Group by disclosing, agreeing and introducing accounting principles which are unique to the Group; and to facilitate the accounting integration of acquired and newly-created companies into the Group's accounting system by means of a reference manual.

This Manual is mandatory for all companies belonging to the Telefónica Group, and shall be applied to their reporting methods when preparing the consolidated financial statements.

This documentation is regularly sent by email and is available for the entire Group on the Telefónica intranet.

The accounting policies area maintains a constant dialogue with the accounting heads of the Group's main operations, both proactively and reactively. This dialogue is useful not only for resolving doubts or conflicts but also to ensure that accounting criteria in the Group are uniform and also for sharing best practices between operators.

**F.4.2 Mechanisms in standard format for the capture and preparation of financial information, which are applied and used in all units within the entity or group, and support its main financial statements and accompanying notes as well as disclosures concerning ICFR.**

There is a Compliance Manual for Consolidation Reporting which includes specific instructions on preparing the disclosures which comprise the reporting pack reported by all components of the Telefónica Group for the preparation of the Telefónica Group's consolidated financial statements and the consolidated explanatory notes.

Likewise, the Telefónica Group has implemented a specific software system for the reporting of the individual financial statements at its various subsidiaries, as well as the necessary notes and disclosures for preparing the consolidated annual financial statements. This tool is also used to carry out the consolidation process and its subsequent analysis. The system is managed centrally and all components of the Telefónica Group use the same accounts plan.

**F.5 System function monitoring**

**Indicate the existence of at least the following components, describing their main characteristics:**

**F.5.1 The ICFR monitoring activities undertaken by the Audit Committee and the Company has an internal audit function whose powers include supporting the Audit Committee in its role of monitoring the internal control system, including ICFR. Describe the scope of the ICFR assessment conducted in the year and the procedure for the person in charge to communicate its findings. State also whether the company has an action plan specifying corrective measures for any flaws detected, and whether it has taken stock of their potential impact on its financial information.**

As mentioned beforehand, the Corporate Bylaws and Regulations of the Board of Directors state that the primary duty of the Audit and Control Committee shall be to support the Board of Directors in its supervisory duties, with its main functions including: supervising the effectiveness of the Company's internal control system and risk management systems, and discussing with the Auditors significant weaknesses in the internal control system detected during the audit.

The Audit and Control Committee is responsible for supervising the effectiveness of the internal controls carried out by the Telefónica Group's Internal Audit function.

The Internal Audit function reports functionally to the Audit and Control Committee, with the primary goal of lending them support in their responsibilities concerning ensuring governance, risk management, and the Group's Internal Control System. Internal Control comprises all process which may reasonably ensure compliance with laws, regulations and internal rules, reliability of information, efficiency and efficacy of operations, and the integrity of the organisation's net worth.

Internal Audit is responsible for implementing the International Standards for the Professional Practice of Internal Auditing and has been awarded a Quality Certificate from the Institute of Internal Auditors.

With regard to supervision of Internal Control over Financial Reporting (ICFR), Telefónica, S.A. is listed on the New York Stock Exchange and is therefore subject to the regulatory requirements established by the US authorities applicable to all companies trading on this exchange.

Among these requirements is the aforementioned Sarbanes-Oxley Act and, specifically, Section 404 which stipulates that all listed companies in the US market must evaluate on an annual basis the effectiveness of their ICFR procedures and internal control structure.

The External Auditor issues its own independent opinion on the effectiveness of financial reporting (ICFR).

Additionally, to fulfil this requirement, the Telefónica Group uses a three-tier (next detailed) internal control of financial reporting evaluation model, while every year the Internal Audit function is responsible for evaluating its performance.

**Review of processes and specific controls**

In certain companies, in addition to filling out the self-appraisal questionnaire, taking into account the significance of their contribution to the Group's key economic-financial figures and other risk factors considered, their processes and controls are directly reviewed applying the General Assessment Model of the Telefónica Group, which in turn uses the Definition of Scopes Model, in order to identify the critical accounts of each company of the Telefónica Group in accordance with previously established criteria.

Once these critical accounts are identified for review, the General Evaluation Model is applied as follows:

- The processes and systems associated with the critical accounts are determined.

- Risks affecting the financial reporting vis-à-vis these processes are identified.
- Checks and, where necessary, process controls are put in place to provide reasonable assurance that the documentation and design of controls over financial reporting are adequate.
- Audit tests are carried out to assess the effectiveness of the controls.

### **Review on IT general controls**

The Group's general controls are evaluated at least once a year, largely taking into account questions regarding regulations and guidelines applied at global level across the Group.

Supervision of general controls on IT systems is designed to review management of changes to programmes, data and systems access and the operation (management of changes to infrastructure, back ups, scheduled tasks and issues).

If deficiencies in control and/or areas for improvement come to light during the review tasks, the Management will be informed using the reports prepared by the Internal Audit unit, analyzing the impact on the assessment on the internal control system over financial reporting, where appropriate. Once they receive the report, the managers responsible for controls will state the action plans to resolve the identified control deficiencies, and also the estimated periods for them to be implemented.

These Action Plans will have as main objectives:

- Mitigating the deficiency originally defined so that the control works as expected.
- Defining compensatory controls which validate supported processes in case that the original controls cannot be remediated.

### **Self-appraisal Questionnaires**

All the Group's subsidiaries complete self-appraisal questionnaires every year, the responses to which are certified by officers in charge of internal control over financial reporting (ICFR) in each company (Chief Executive Officer (CEO) and Chief Financial Officer (CFO)). These questionnaires cover those aspects of ICFR that are deemed to be minimum requirements to achieve reasonable assurance of the reliability of the financial information. A sample of responses is audited by the Internal Audit unit.

**F.5.2 If it has a discussion procedure whereby the auditor (pursuant to TAS), the internal audit function and other experts can report any significant internal control weaknesses encountered during their review of the financial statements or other assignments, to the company's senior management and its Audit Committee or Board of Directors. State also whether the entity has an action plan to correct or mitigate the weaknesses found.**

As explained beforehand, the Internal Audit unit also provides support to the Audit and Control Committee in monitoring the correct functioning of the ICFR system. The Internal Audit unit participates in the Audit and Control Committee meetings, and reports regularly on the findings of the performed tasks, as well as action plans established to mitigate and of the degree of implementation thereof. This includes to communicate significant internal control weaknesses which have been identified.

Furthermore, the External Auditor participates in the Audit and Control Committee meetings, when called to do so by the Audit and Control Committee, to explain and clarify different aspects of the audit reports and other aspects of its work, including tasks performed to guarantee the effectiveness of the system of internal control over financial reporting (ICFR). The External Auditor is obliged to communicate the significant internal control weaknesses identified and, for this purpose, has immediate access to the Senior management and the Chairman of the Audit and Control Committee.

### **F.6 Other relevant information**

Not applicable

### **F.7 External auditor review**

**State whether:**



**F.7.1 The ICFR information supplied to the market has been reviewed by the external auditor, in which case the corresponding report should be attached. Otherwise, explain the reasons for the absence of this review. Otherwise, explain the reasons for the absence of this review.**

The attached information on ICFR has been submitted to review by the External Auditor, whose report is attached as an appendix to this document.

## G Degree of Compliance with Corporate Governance Recommendations

Indicate the extent to which the company follows the recommendations of the Good Governance Code of listed companies.

Should any recommendation not be followed or be only partially followed, a detailed explanation should be given of the reasons so that the shareholders, investors and the market in general have sufficient information to assess the way the company works. General explanations will not be acceptable.

1. The bylaws of listed companies should not place an upper limit on the votes that can be cast by a single shareholder, or impose other obstacles to the takeover of the company by means of share purchases on the market.

### Explain

In accordance with Article 26 of the Corporate Bylaws, no shareholder may cast a number of votes in excess of 10 percent of the total voting capital existing at any time, regardless of the number of shares held by such shareholder and in full compliance with mandatory requirements of law. In determining the maximum number of votes that each shareholder may cast, only the shares held by each such shareholder shall be computed. It does not include additional votes cast on behalf of other shareholders who may have appointed them as proxy, who are themselves likewise restricted by the 10 percent voting ceiling.

The limitation established in the preceding paragraphs shall also apply to the maximum number of votes that may be collectively or individually cast by two or more shareholder companies belonging to the same group of entities, as well as to the maximum number of votes that may be cast by an individual or corporate shareholder and the entity or entities that are shareholders themselves and which are directly or indirectly controlled by such individual or corporate shareholder.

In addition, Article 30 of the Corporate Bylaws stipulates that no person may be appointed as Director unless they have held, for more than three years prior to their appointment, a number of shares of the Company representing a nominal value of at least 3,000 euros, which the Director may not transfer while in office. These requirements shall not apply to those persons who, at the time of their appointment, are related to the Company under an employment or professional relationship, or when the Board of Directors resolves to waive such requirements with the favorable vote of at least 85 percent of its members.

Article 31 of the Corporate Bylaws establishes that, in order for a Director to be appointed Chairman, Vice-Chairman, Chief Executive Officer or member of the Executive Commission, it shall be necessary for such Director to have served on the Board for at least the three years immediately prior to any such appointment. However, such length of service shall not be required if the appointment is made with the favorable vote of at least 85 percent of the members of the Board of Directors.

The Corporate Bylaws (Article 26) restrict the number of shares that may be cast by a single shareholder or by shareholders belonging to the same group in order to achieve a suitable balance and protect the position of minority shareholders, thus avoiding a potential concentration of votes among a reduced number of shareholders, which could impact on the guiding principle that the General Shareholders' Meeting must act in the interest of all the shareholders. Telefónica believes that this measure does not constitute a blocking mechanism of takeover bids but rather a guarantee that the acquisition of control required in the interests of all shareholders, an offer for one hundred percent of the capital, because, naturally, and as taught by experience, potential offerors may make their offer conditional upon the removal of the defense mechanism.

In relation to the above and in accordance with the provisions of Article 527 of the Spanish Corporations Act, any clauses in the Bylaws of listed corporations that directly or indirectly restrict the number of shares that may be cast by a single shareholder by shareholders belonging to the same group or by any parties acting together with the aforementioned, will be rendered null and void when, subsequent to a takeover bid, the offeror has a stake equal to or over 70% of the share capital which confers voting rights, unless the offeror was not subject to neutralization measures to prevent a takeover bid or had not adapted these measures accordingly.

In addition, the special requirements for appointment as Director (Article 30 of the Corporate Bylaws) or as Chairman, Vice-Chairman, Chief Executive Officer or member of the Executive Commission (Article 31 of the Corporate Bylaws) are justified by the desire that access to the management decision-making body and to the most significant positions thereon is reserved to persons who have demonstrated their commitment to the Company and who, in addition, have adequate experience as members of the Board, such that continuity of the management model adopted by the Telefónica Group may be assured in the interest of all of its shareholders and stakeholders. In any event, these special requirements may be waived by broad consensus among the members of the Board of Directors, namely, with the favorable vote of at least 85 percent of its members, as provided by the aforementioned Articles of the Corporate Bylaws.

2. **When a dominant and a subsidiary company are both listed, they should provide detailed disclosure on:**
  - a) **The activity they engage in and any business dealings between them, as well as between the listed subsidiary and other group companies.**
  - b) **The mechanisms in place to resolve possible conflicts of interest.**

**Not applicable**

3. **During the annual general meeting the Chairman of the Board should verbally inform shareholders in sufficient detail of the most relevant aspects of the company's corporate governance, supplementing the written information circulated in the Annual Corporate Governance Report. In particular:**
  - a) **Changes taking place since the previous annual general meeting.**
  - b) **The specific reasons for the company not following a given Good Governance Code recommendation and any alternative procedures followed in its stead.**

**Complies**

4. **The company should draw up and implement a policy of communication and contacts with shareholders, institutional investors and proxy advisors that complies in full with market abuse regulations and accords equitable treatment to shareholders in the same position.**

**This policy should be disclosed on the company's website, complete with details of how it has been put into practice and the identities of the relevant interlocutors or those charged with its implementation.**

**Complies**

5. **The Board of Directors should not make a proposal to the general meeting for the delegation of powers to issue shares or convertible securities without pre-emptive subscription rights for an amount exceeding 20% of capital at the time of such delegation.**

**When a board approves the issuance of shares or convertible securities without pre-emptive subscription rights, the company should immediately post a report on its website explaining the exclusion as envisaged in company legislation.**

**Complies**

6. Listed companies drawing up the following reports on a voluntary or compulsory basis should publish them on their website well in advance of the annual general meeting, even if their distribution is not obligatory:
- a) Report on auditor independence.
  - b) Reviews of the operation of the Audit Committee and the Nomination and Remuneration Committee.
  - c) Audit Committee report on third-party transactions.
  - d) Report on corporate social responsibility policy.

**Complies**

7. The company should broadcast its general meetings live on the corporate website.

**Explain**

The Company decided not to offer a live webcast of its 2016 General Shareholders Meeting, for organisational reasons and owing to the way the Meeting was developed (possible changes which could arise). Nonetheless, Telefónica is analysing the possibility of broadcasting future General Shareholders meetings live on its website.

8. The Audit Committee should strive to ensure that the Board of Directors can present the company's accounts to the general meeting without limitations or qualifications in the auditor's report. In the exceptional case that qualifications exist, both the Chairman of the Audit Committee and the auditors should give a clear account to shareholders of their scope and content.

**Complies**

9. The company should disclose its conditions and procedures for admitting share ownership, the right to attend general meetings and the exercise or delegation of voting rights, and display them permanently on its website.

Such conditions and procedures should encourage shareholders to attend and exercise their rights and be applied in a non-discriminatory manner.

**Complies**

10. When an accredited shareholder exercises the right to supplement the agenda or submit new proposals prior to the general meeting, the company should:
- a) Immediately circulate the supplementary items and new proposals.

- b) Disclose the model of attendance card or proxy appointment or remote voting form duly modified so that new agenda items and alternative proposals can be voted on in the same terms as those submitted by the Board of Directors.
- c) Put all these items or alternative proposals to the vote applying the same voting rules as for those submitted by the Board of Directors, with particular regard to presumptions or deductions about the direction of votes.
- d) After the general meeting, disclose the breakdown of votes on such supplementary items or alternative proposals.

Not applicable

11. In the event that a company plans to pay for attendance at the general meeting, it should first establish a general, long-term policy in this respect.

Not applicable

12. The Board of Directors should perform its duties with unity of purpose and independent judgement, according the same treatment to all shareholders in the same position. It should be guided at all times by the company's best interest, understood as the creation of a profitable business that promotes its sustainable success over time, while maximising its economic value.

In pursuing the corporate interest, it should not only abide by laws and regulations and conduct itself according to principles of good faith, ethics and respect for commonly accepted customs and good practices, but also strive to reconcile its own interests with the legitimate interests of its employees, suppliers, clients and other stakeholders, as well as with the impact of its activities on the broader community and the natural environment.

Complies

13. The Board of Directors should have an optimal size to promote its efficient functioning and maximize participation. The recommended range is accordingly between five and fifteen members.

Explain

The complexity of the Telefónica Group organizational structure, given the considerable number of companies it comprises, the variety of sectors it operates in, its multinational nature, as well as its economic and business relevance, justify the fact that the number of members of the Board is adequate to achieve an efficient and operative operation.

It is important to bear in mind that the Board of Directors of the Company have six Committees (the Executive Commission and five Advisory Committees), which ensures the active participation of all its Directors.

14. The Board of Directors should approve a Director selection policy that:

- a) Is concrete and verifiable.

- b) Ensures that the appointment or reelection proposals are based on a prior analysis of the Board's needs.
- c) Favours a diversity of knowledge, experience and gender.

The results of the prior analysis of board needs should be written up in the Nomination Committee's explanatory report, to be published when the general meeting is convened that will ratify the appointment and re-election of each Director.

The director selection policy should pursue the goal of having at least 30% of total board places occupied by women Directors before the year 2020.

The Nomination Committee should run an annual check on compliance with the director selection policy and set out its findings in the Annual Corporate Governance Report.

**Complies**

15. Proprietary and independent Directors should constitute an ample majority on the Board of Directors, while the number of Executive Directors should be the minimum practical bearing in mind the complexity of the corporate group and the ownership interests they control.

**Complies**

16. The percentage of Proprietary Directors out of all Non-executive Directors should be no greater than the proportion between the ownership stake of the shareholders they represent and the remainder of the company's capital.

This criterion can be relaxed:

- a) In large cap companies where few or no equity stakes attain the legal threshold for significant shareholdings.
- b) In companies with a plurality of shareholders represented on the Board but not otherwise related.

**Explain**

The aforementioned recommendation 16 refers to the composition of the group of External Directors. As stated in Section C.1.3 of this Annual Corporate Governance Report, at 31 December 2016, the group of External Directors of Telefónica, S.A. was composed of 17 members (of a total of 18 Members), of whom 5 are Proprietary Directors, 9 are Independent Directors and 3 falls under the "Other External Directors" category.

Of the five Proprietary Directors, two act in representation of Fundación Bancaria Caixa d'Estalvis i Pensions de Barcelona, "la Caixa", which holds 5.15% of the capital of Telefónica, S.A., two act in representation of Banco Bilbao Vizcaya Argentaria, S.A. (BBVA), which holds 6.33% of the capital, and one acts in representation of China Unicom (Hong Kong) Limited (China Unicom) which holds a 1.27% stake.

Applying the proportional criterion established in Article 243 of the LSC regarding the total number of Directors, the stakes held by "la Caixa" and BBVA are sufficient to entitle each entity to appoint a Director.

Moreover, it must be taken into account that recommendation 16 stipulates that this strict proportionality criterion can be relaxed so the weight of Proprietary Directors is greater than would strictly correspond to the total percentage of capital they represent in large cap companies where few or no equity stakes attain the legal threshold for significant shareholdings.

In this regard, Telefónica ranks among the top listed companies on Spanish stock exchanges in terms of stock market capitalization, reaching the figure of 44,433 million euros at December 31, 2016, which means a very high absolute value of the stakes of “la Caixa” and BBVA in Telefónica (that of “la Caixa” is 2,288 million euros, and that of BBVA is 2,319 million euros). This justifies the overrepresentation of these entities on the Board of Directors, rising from one member of the Board each (to which they would strictly have the right in accordance with Article 243 of the Spanish Corporations Act) to two members, i.e. permitting the appointment of just one more Proprietary Director over the strictly legal proportion.

On January 23, 2011, China Unicom and Telefónica, S.A. expanded on their existing strategic alliance and signed an extension to their Strategic Partnership Agreement, in which both companies agreed to strengthen and deepen their strategic cooperation in certain business areas, and committed to investing the equivalent of 500 million US dollars in ordinary shares of the other party. In recognition of China Unicom's stake in Telefónica, approval was given at Telefónica's General Shareholders' Meeting held on May 18, 2011 for the appointment of a board member named by China Unicom.

**17. Independent Directors should be at least half of all board members.**

**However, when the company does not have a large market capitalisation, or when a large cap company has shareholders individually or concertedly controlling over 30 percent of capital, independent Directors should occupy, at least, a third of board places.**

**Complies**

**18. Companies should disclose the following Director particulars on their websites and keep them regularly updated:**

- a) **Background and professional experience.**
- b) **Directorships held in other companies, listed or otherwise, and other paid activities they engage in, of whatever nature.**
- c) **Statement of the Director class to which they belong, in the case of proprietary Directors indicating the shareholder they represent or have links with.**
- d) **Dates of their first appointment as a board member and subsequent re-elections.**
- e) **Shares held in the company, and any options on the same.**

**Complies**

**19. Following verification by the Nomination Committee, the Annual Corporate Governance Report should disclose the reasons for the appointment of proprietary Directors at the urging of shareholders controlling less than 3 percent of capital; and explain any rejection of a formal request for a board place from shareholders whose equity stake is equal to or greater than that of others applying successfully for a proprietary Directorship.**

**Complies**

20. Proprietary Directors should resign when the shareholders they represent dispose of their ownership interest in its entirety. If such shareholders reduce their stakes, thereby losing some of their entitlement to proprietary Directors, the latter's number should be reduced accordingly.

Complies

21. The Board of Directors should not propose the removal of independent Directors before the expiry of their tenure as mandated by the Bylaws, except where they find just cause, based on a proposal from the Nomination Committee. In particular, just cause will be presumed when Directors take up new posts or responsibilities that prevent them allocating sufficient time to the work of a board member, or are in breach of their fiduciary duties or come under one of the disqualifying grounds for classification as independent enumerated in the applicable legislation.

The removal of independent Directors may also be proposed when a takeover bid, merger or similar corporate transaction alters the company's capital structure, provided the changes in board membership ensue from the proportionality criterion set out in recommendation 16.

Complies

22. Companies should establish rules obliging Directors to disclose any circumstance that might harm the organisation's name or reputation, tendering their resignation as the case may be, and, in particular, to inform the Board of any criminal charges brought against them and the progress of any subsequent trial.

The moment a Director is indicted or tried for any of the offences stated in company legislation, the Board of Directors should open an investigation and, in light of the particular circumstances, decide whether or not he or she should be called on to resign. The Board should give a reasoned account of all such determinations in the Annual Corporate Governance Report.

Complies

23. Directors should express their clear opposition when they feel a proposal submitted for the Board's approval might damage the corporate interest. In particular, independents and other Directors not subject to potential conflicts of interest should strenuously challenge any decision that could harm the interests of shareholders lacking board representation.

When the Board makes material or reiterated decisions about which a Director has expressed serious reservations then he or she must draw the pertinent conclusions. Directors resigning for such causes should set out their reasons in the letter referred to in the next recommendation.

The terms of this recommendation also apply to the secretary of the Board, even if he or she is not a Director.

Complies



24. Directors who give up their place before their tenure expires, through resignation or otherwise, should state their reasons in a letter to be sent to all members of the Board. Whether or not such resignation is disclosed as a material event, the motivating factors should be explained in the Annual Corporate Governance Report.

Complies

25. The Nomination Committee should ensure that Non-executive Directors have sufficient time available to discharge their responsibilities effectively.

The Board of Directors regulations should lay down the maximum number of company boards on which Directors can serve.

Complies

26. The Board should meet with the necessary frequency to properly perform its functions, eight times a year at least, in accordance with a calendar and agendas set at the start of the year, to which each Director may propose the addition of initially unscheduled items.

Complies

27. Director absences should be kept to a strict minimum and quantified in the Annual Corporate Governance Report. In the event of absence, Directors should delegate their powers of representation with the appropriate instructions.

Complies

28. When Directors or the secretary express concerns about some proposal or, in the case of Directors, about the company's performance, and such concerns are not resolved at the meeting, they should be recorded in the minute book if the person expressing them so requests.

Complies

29. The company should provide suitable channels for Directors to obtain the advice they need to carry out their duties, extending if necessary to external assistance at the company's expense.

Complies

30. Regardless of the knowledge Directors must possess to carry out their duties, they should also be offered refresher programmes when circumstances so advise.

**Complies**

31. The agendas of board meetings should clearly indicate on which points Directors must arrive at a decision, so they can study the matter beforehand or gather together the material they need.

For reasons of urgency, the Chairman may wish to present decisions or resolutions for board approval that were not on the meeting agenda. In such exceptional circumstances, their inclusion will require the express prior consent, duly minuted, of the majority of Directors present.

**Complies**

32. Directors should be regularly informed of movements in share ownership and of the views of major shareholders, investors and rating agencies on the company and its group.

**Complies**

33. The Chairman, as the person charged with the efficient functioning of the Board of Directors, in addition to the functions assigned by law and the company's bylaws, should prepare and submit to the Board a schedule of meeting dates and agendas; organise and coordinate regular evaluations of the Board and, where appropriate, the company's chief executive officer; exercise leadership of the Board and be accountable for its proper functioning; ensure that sufficient time is given to the discussion of strategic issues, and approve and review refresher courses for each Director, when circumstances so advise.

**Complies**

34. When a lead independent Director has been appointed, the Bylaws or Board of Directors regulations should grant him or her the following powers over and above those conferred by law: chair the Board of Directors in the absence of the Chairman and Vice-Chairman give voice to the concerns of Non-executive Directors; maintain contacts with investors and shareholders to hear their views and develop a balanced understanding of their concerns, especially those to do with the company's corporate governance; and coordinate the Chairman's succession plan.

**Complies**

35. The Board Secretary should strive to ensure that the Board's actions and decisions are informed by the governance recommendations of the Good Governance Code of relevance to the company.

**Complies**

36. The Board in full should conduct an annual evaluation, adopting, where necessary, an action plan to correct weakness detected in:

- a) The quality and efficiency of the Board's operation.
- b) The performance and membership of its Committees.
- c) The diversity of board membership and competences.
- d) The performance of the Chairman of the Board of Directors and the company's chief executive.
- e) The performance and contribution of individual Directors, with particular attention to the chairmen of board committees.

The evaluation of board committees should start from the reports they send the Board of Directors, while that of the Board itself should start from the report of the nomination committee.

Every three years, the Board of Directors should engage an external facilitator to aid in the evaluation process. This facilitator's independence should be verified by the nomination committee.

Any business dealings that the facilitator or members of its corporate group maintain with the company or members of its corporate group should be detailed in the Annual Corporate Governance Report.

The process followed and areas evaluated should be detailed in the Annual Corporate Governance Report.

Complies

37. When an Executive Committee exists, its membership mix by Director class should resemble that of the Board. The Secretary of the Board should also act as secretary to the Executive Committee.

Complies

38. The Board of Directors should be kept fully informed of the business transacted and decisions made by the Executive Committee. To this end, all board members should receive a copy of the committee's minutes.

Complies

39. All members of the Audit Committee, particularly its Chairman, should be appointed with regard to their knowledge and experience in accounting, auditing and risk management matters. A majority of Committee places should be held by independent Directors.

Complies

40. Listed companies should have a unit in charge of the internal audit function, under the supervision of the Audit Committee, to monitor the effectiveness of reporting and control systems. This unit should report functionally to the Board's Non-executive Chairman or the Chairman of the Audit Committee.

Complies

41. The head of the unit handling internal audit function should present an annual work programme to the Audit Committee, inform it directly of any incidents arising during its implementation and submit an activities report at the end of each year.

Complies

42. The Audit Committee should have the following functions over and above those legally assigned:

1° With respect to internal control and reporting systems:

- a) Monitor the preparation and the integrity of the financial information prepared on the company and, where appropriate, the group, checking for compliance with legal provisions, the accurate demarcation of the consolidation perimeter, and the correct application of accounting principles.
- b) Ensure the independence of the unit handling the internal audit function; propose the selection, appointment, re-election and removal of the head of the internal audit service; propose the service's budget; approve its priorities and work programmes, ensuring that it focuses primarily on the main risks the company is exposed to; receive regular report-backs on its activities; and verify that senior management are acting on the findings and recommendations of its reports.
- c) Establish and supervise a mechanism whereby staff can report, confidentially and, if appropriate and feasible, anonymously, any significant irregularities that they detect in the course of their duties, in particular financial or accounting irregularities.

2° With regard to the external auditor:

- a) Investigate the issues giving rise to the resignation of the external auditor, should this come about.
- b) Ensure that the remuneration of the external auditor does not compromise its quality or independence.
- c) Ensure that the company notifies any change of external auditor to the CNMV as a material event, accompanied by a statement of any disagreements arising with the outgoing auditor and the reasons for the same.
- d) Ensure that the external auditor has a yearly meeting with the Board in full to inform it of the work undertaken and developments in the company's risk and accounting positions.
- e) Ensure that the company and the external auditor adhere to current regulations on the provision of non-audit services, limits on the concentration of the auditor's business and other requirements concerning auditor independence.

Complies

43. The Audit Committee should be empowered to meet with any company employee or manager, even ordering their appearance without the presence of another senior officer.

**Complies**

44. The Audit Committee should be informed of any fundamental changes or corporate transactions the company is planning, so the committee can analyse the operation and report to the Board beforehand on its economic conditions and accounting impact and, when applicable, the exchange ratio proposed.

**Complies**

45. Risk control and management policy should identify at least:
- a) The different types of financial and non-financial risk the company is exposed to (including operational, technological, financial, legal, social, environmental, political and reputational risks), with the inclusion under financial or economic risks of contingent liabilities and other off-balance sheet risks.
  - b) The determination of the risk level the company sees as acceptable.
  - c) The measures in place to mitigate the impact of identified risk events should they occur.
  - d) The internal control and reporting systems to be used to control and manage the above risks, including contingent liabilities and off-balance sheet risks.

**Complies**

46. Companies should establish a risk control and management function in the charge of one of the company's internal department or units and under the direct supervision of the Audit Committee or some other dedicated board committee. This function should be expressly charged with the following responsibilities:
- a) Ensure that risk control and management systems are functioning correctly and, specifically, that major risks the company is exposed to are correctly identified, managed and quantified.
  - b) Participate actively in the preparation of risk strategies and in key decisions about their management.
  - c) Ensure that risk control and management systems are mitigating risks effectively in the frame of the policy drawn up by the Board of Directors.

**Complies**

47. Appointees to the Nomination and Remuneration Committee – or of the Nomination Committee and Remuneration Committee, if separately constituted – should have the right balance of knowledge, skills and experience for the functions they are called on to discharge. The majority of their members should be independent Directors.

**Complies**

**48. Large cap companies should operate separately constituted Nomination and Remuneration Committees.**

**Explain**

Article 40 of the Bylaws, and Article 23 of the Regulation of the Board of Directors, expressly state, on regulating the Nominating, Compensation and Corporate Governance Committees, that the Board of Directors shall be entitled to set up two Committees, separately giving each of them powers for appointments, and the other the powers for remuneration, while the corporate governance powers may be included in either one of them.

The Board of Directors of Telefónica, S.A. has not considered appropriate, so far, separating the functions of the Nominating, Compensation and Corporate Governance Committee) because it believes that by putting the powers to assess Directors and determine their remuneration in the same Committee, is helpful to coordinate and to produce a results-driven remuneration system (pay for performance). Furthermore, it is noted that the Board of Directors currently has five Consultative Committees (Audit and Control Committee, the Nominating, Compensation and Corporate Governance Committee, Regulation and Institutional Affairs Committee, Service Quality and Customer Care Committee and the Strategy and Innovation Committee), in addition to the Executive Commission.

In this context, the separation of the Nominating, Compensation and Corporate Governance Committee would not have been appropriate with the facilitating objective of the recent reorganization, generating unnecessary inefficiencies and needs for additional allocations.

Furthermore, the Board of Directors, on its meeting held on April 27, 2016, after a favourable report of the Nominating, Compensation and Corporate Governance Committee and a formal deliberation, approved a new setting of the Advisory or Control Committees of the Company in with regards to its organization, structure and composition in order to increase the efficiency and to optimize the management of the corporate governance structure of Telefónica, S.A.

**49. The Nomination Committee should consult with the company's Chairman and chief executive, especially on matters relating to Executive Directors.**

**When there are vacancies on the Board, any Director may approach the Nomination Committee to propose candidates that it might consider suitable.**

**Complies**

**50. The Remuneration Committee should operate independently and have the following functions in addition to those assigned by law:**

- a) **Propose to the Board the standard conditions for senior officer contracts.**
- b) **Monitor compliance with the remuneration policy set by the company.**
- c) **Periodically review the remuneration policy for Directors and senior officers, including share-based remuneration systems and their application, and ensure that their individual compensation is proportionate to the amounts paid to other Directors and senior officers in the company.**
- d) **Ensure that conflicts of interest do not undermine the independence of any external advice the Committee engages.**

- e) **Verify the information on Director and senior officers' pay contained in corporate documents, including the annual Directors' remuneration statement.**

**Complies**

51. **The Remuneration Committee should consult with the company's Chairman and chief executive, especially on matters relating to Executive Directors and senior officers.**

**Complies**

52. **The terms of reference of supervision and control committees should be set out in the Board of Directors regulations and aligned with those governing legally mandatory board committees as specified in the preceding sets of recommendations. They should include at least the following terms:**

- a) **Committees should be formed exclusively by Non-executive Directors, with a majority of independents.**
- b) **They should be chaired by independent Directors.**
- c) **The Board should appoint the members of such committees with regard to the knowledge, skills and experience of its Directors and each committee's terms of reference; discuss their proposals and reports; and provide report-backs on their activities and work at the first board plenary following each committee meeting.**
- d) **They may engage external advice, when they feel it necessary for the discharge of their functions.**
- e) **Meeting proceedings should be minuted and a copy made available to all board members.**

### **Explain**

1. The supervision and control committees which are attributed the powers referred to in recommendation 52 are the Audit and Control Committee and the Nominating, Compensation and Corporate Governance Committee. The composition and operation rules of the two Committees are set out in the Regulation of the Board of Directors and are not only consistent with legally dispositions applicable but are also an improvement upon them, in certain areas. For example, according to the Regulation of the Board of Directors, the Nominating, Compensation and Corporate Governance Committee must have a majority of independent members, as opposed to the minimum of two according to prevailing laws. In fact, in practice the five members of this committee are all independent.

2. The Board of Directors has other Consultative Committees which are allocated other functions (Regulation and Institutional Affairs Committee, Service Quality and Customer Service Committee, Strategy and Innovation Committee), which are strongly linked with the businesses developed by the Company and with management aspects.

These Committees are not expressly regulated in the Regulation of the Board of Directors or they are regulated with fewer details as those which are legally mandatory.

In particular, it has been decided that Committees with powers in matters linked to the Company's businesses and management aspects do not necessarily have to be chaired by independent Directors nor do most of the members of the committees need to have independent directors, but that it is preferable to take into account the

technical knowledge and specific expertise of their members when appointing the Director to chair them and the other Directors who should sit on these committees.

53. The task of supervising compliance with corporate governance rules, internal codes of conduct and corporate social responsibility policy should be assigned to one board committee or split between several, which could be the Audit Committee, the Nomination Committee, the Corporate social responsibility Committee, where one exists, or a dedicated committee established ad hoc by the Board under its powers of self-organisation, with at the least the following functions:
- a) Monitor compliance with the company's internal codes of conduct and corporate governance rules.
  - b) Oversee the communication and relations strategy with shareholders and investors, including small and medium-sized shareholders.
  - c) Periodically evaluate the effectiveness of the company's corporate governance system, to confirm that it is fulfilling its mission to promote the corporate interest and catering, as appropriate, to the legitimate interests of remaining stakeholders.
  - d) Review the company's corporate social responsibility policy, ensuring that it is geared to value creation.
  - e) Monitor corporate social responsibility strategy and practices and assess compliance in their respect.
  - f) Monitor and evaluate the company's interaction with its stakeholder groups.
  - g) Evaluate all aspects of the non-financial risks the company is exposed to, including operational, technological, legal, social, environmental, political and reputational risks.
  - h) Coordinate non-financial and diversity reporting processes in accordance with applicable legislation and international benchmarks.

#### Complies

54. The corporate social responsibility policy should state the principles or commitments the company will voluntarily adhere to in its dealings with stakeholder groups, specifying at least:
- a) The goals of its corporate social responsibility policy and the support instruments to be deployed.
  - b) The corporate strategy with regard to sustainability, the environment and social issues.
  - c) Concrete practices in matters relative to: shareholders, employees, clients, suppliers, social welfare issues, the environment, diversity, fiscal responsibility, respect for human rights and the prevention of illegal conducts.
  - d) The methods or systems for monitoring the results of the practices referred to above, and identifying and managing related risks.
  - e) The mechanisms for supervising non-financial risk, ethics and business conduct.
  - f) Channels for stakeholder communication, participation and dialogue.
  - g) Responsible communication practices that prevent the manipulation of information and protect the company's honour and integrity.



Complies

55. The company should report on corporate social responsibility developments in its Directors' report or in a separate document, using an internationally accepted methodology.

Complies

56. Director's remuneration should be sufficient to attract individuals with the desired profile and compensate the commitment, abilities and responsibility that the post demands, but not so high as to compromise the independent judgement of Non-executive Directors.

Complies

57. Variable remuneration linked to the company and the Director's performance, the award of shares, options or any other right to acquire shares or to be remunerated on the basis of share price movements, and membership of long-term savings schemes such as pension plans should be confined to Executive Directors.

The company may consider the share-based remuneration of Non-executive Directors provided they retain such shares until the end of their mandate. This condition, however, will not apply to shares that the Director must dispose of to defray costs related to their acquisition.

Complies

58. In the case of variable awards, remuneration policies should include limits and technical safeguards to ensure they reflect the professional performance of the beneficiaries and not simply the general progress of the markets or the company's sector, or circumstances of that kind.

In particular, variable remuneration items should meet the following conditions:

- a) Be subject to predetermined and measurable performance criteria that factor the risk assumed to obtain a given outcome.
- b) Promote the long-term sustainability of the company and include non-financial criteria that are relevant for the company's long-term value, such as compliance with its internal rules and procedures and its risk control and management policies.
- c) Be focused on achieving a balance between the delivery of short, medium and long-term objectives, such that performance-related pay rewards ongoing achievement, maintained over sufficient time to appreciate its contribution to long-term value creation. This will ensure that performance measurement is not based solely on one-off, occasional or extraordinary events.

Complies

59. A major part of variable remuneration components should be deferred for a long enough period to ensure that predetermined performance criteria have effectively been met.

**Complies**

60. Remuneration linked to company earnings should bear in mind any qualifications stated in the external auditor's report that reduce their amount.

**Not applicable**

61. A major part of Executive Directors' variable remuneration should be linked to the award of shares or financial instruments whose value is linked to the share price.

**Complies**

62. Following the award of shares, share options or other rights on shares derived from the remuneration system, Directors should not be allowed to transfer a number of shares equivalent to twice their annual fixed remuneration, or to exercise the share options or other rights on shares for at least three years after their award.

**The above condition will not apply to any shares that the Director must dispose of to defray costs related to their acquisition.**

**Explain**

On December 31, 2016, the only Executive Director of the company, Mr. José María Álvarez-Pallete López held a shareholding at Telefónica, S.A., which amounted to 1,230,745 voting rights, which were valued with a price of 8.82 euros per share, represented 564% of his fixed remuneration. In this regard, it is noted that since his appointment as Executive Chairman, Mr. Álvarez-Pallete, as a demonstration of his commitment with Telefónica, has acquired a total of 677,491 shares.

This shareholding owned demonstrate his commitment to Telefónica, and show that his own interests are aligned with the other shareholders' interests.

63. Contractual arrangements should include provisions that permit the company to reclaim variable components of remuneration when payment was out of step with the Director's actual performance or based on data subsequently found to be misstated.

**Partially complies**

The Nominating, Compensation and Corporate Governance Committee is empowered to propose that the Board of Directors cancels a variable remuneration payment in the event of circumstances such as those described in this recommendation. The Nominating, Compensation and Corporate Governance Committee will also assess if exceptional circumstances of this kind may even entail the termination of the relationship with the person responsible, proposing measures which are deemed pertinent to the Board of Directors.

- 64. Termination payments should not exceed a fixed amount equivalent to two years of the Director's total annual remuneration and should not be paid until the company confirms that he or she has met the predetermined performance criteria.**

**Explain**

With regards to the conditions applicable to termination of contracts, the Executive Chairman Mr. José María Álvarez-Pallete López maintains the conditions of his previous contract which provided for agreed economic compensation for the termination of the employment relationship, where applicable, that can amount to four years' of remuneration at the most. Annual remuneration on which the indemnity is based is the last fixed remuneration and the arithmetic mean of the last two variable remuneration payments received by contract.

## H Other information of interest

1. If you consider that there is any material aspect or principle relating to the corporate governance practices followed by your company that has not been addressed in this report and which is necessary to provide a more comprehensive view of the corporate governance structure and practices at the company or group, explain briefly.

--

2. You may include in this Section any other information, clarification or observation related to the above sections of this report, provided that they are relevant and non-reiterative.

**Specifically indicate whether the company is subject to corporate governance legislation from a country other than Spain and, if so, include the compulsory information to be provided when different to that required by this report.**

3. The company may also state whether it voluntarily subscribes to other international, sectorial or other ethical principles or standard practices. If applicable, identify the name of the code and the date of subscription.

GENERAL CLARIFICATION: It is hereby stated that the details contained in this report refer to the financial year ended on December 31, 2016, except in those issues in which a different date of reference is specifically mentioned.

### - Note 1 to Section A.2.]

In accordance with the submitted communication by Blackrock, Inc. to the CNMV on September 16 and 23, 2016, the details of the control chain through this entity owns the voting right and/or the financial instruments is the following:

- 1.- BlackRock, Inc, BlackRock Holdco 2, Inc, BlackRock Financial Management, Inc, BlackRock International Holdings, Inc, BR Jersey International Holdings, L.P., BlackRock Group Limited, BlackRock Investment Management (UK) Limited.
- 2.- BlackRock, Inc, BlackRock Holdco 2, Inc, BlackRock Financial Management, Inc, BlackRock International Holdings, Inc, BR Jersey International Holdings, L.P., BlackRock (Singapore) Holdco Pte. Ltd., BlackRock Asia-Pac Holdco, LLC, BlackRock HK Holdco Limited, BlackRock Cayco Limited, BlackRock Trident Holding Company Limited, BlackRock Japan Holdings GK, BlackRock Japan Co, Ltd.
- 3.- BlackRock, Inc, BlackRock Holdco 2, Inc, BlackRock Financial Management, Inc, BlackRock Holdco 4, LLC, BlackRock Holdco 6, LLC, BlackRock Delaware Holdings Inc, BlackRock Fund Advisors, BlackRock Institutional Trust Company, National Association.
- 4.- BlackRock, Inc, BlackRock Holdco 2, Inc, BlackRock Financial Management, Inc, BlackRock International Holdings, Inc, BR Jersey International Holdings, L.P., BlackRock, Inc Australia Holdco Pty. Ltd., BlackRock, Inc Investment Management (Australia) Limited.
- 5.- BlackRock, Inc, BlackRock Holdco 2, Inc, BlackRock Financial Management, Inc, BlackRock International Holdings, Inc, BR Jersey International Holdings, L.P., BlackRock Group Limited, BlackRock Advisors (UK) Limited.
- 6.- BlackRock, Inc, BlackRock Holdco 2, Inc, BlackRock Financial Management, Inc, BlackRock International Holdings, Inc, BR Jersey International Holdings, L.P., BlackRock Group Limited, BlackRock International Limited.
- 7.- BlackRock, Inc, BlackRock Holdco 2, Inc, BlackRock Financial Management, Inc, BlackRock International Holdings, Inc, BR Jersey International Holdings, L.P., BlackRock Holdco 3, LLC, BlackRock Canada Holdings LP, BlackRock Canada Holdings ULC, BlackRock Asset Management Canada Limited.

8. - BlackRock, Inc, Trident Merger, LLC, BlackRock Investment Management, LLC.
- 9.- BlackRock, Inc, BlackRock Holdco 2, Inc, BlackRock Financial Management, Inc, BlackRock Holdco 4, LLC, BlackRock Holdco 6, LLC, BlackRock Delaware Holdings Inc., BlackRock Fund Advisors.
- 10.- BlackRock, Inc, BlackRock Holdco 2, Inc, BlackRock Financial Management, Inc, BlackRock International Holdings, Inc, BR Jersey International Holdings, L.P., BlackRock (Singapore) Holdco Pte. Ltd., BlackRock Asia-Pac Holdco, LLC, BlackRock HK Holdco Limited, BlackRock Asset Management North Asia Limited.
- 11.- BlackRock, Inc, BlackRock Holdco 2, Inc, BlackRock Financial Management, Inc, BlackRock International Holdings, Inc, BR Jersey International Holdings, L.P., BlackRock Group Limited, BlackRock Investment Management (UK) Limited, BlackRock Asset Management Deutschland AG.
- 12.- BlackRock, Inc, BlackRock Holdco 2, Inc, BlackRock Financial Management, Inc, BlackRock International Holdings, Inc, BR Jersey International Holdings, L.P., BlackRock Group Limited, BlackRock (Netherlands) B.V.
13. - BlackRock, Inc, BlackRock Holdco 2, Inc, BlackRock Financial Management, Inc.
- 14.- BlackRock, Inc, BlackRock Holdco 2, Inc, BlackRock Financial Management, Inc, BlackRock International Holdings, Inc, BR Jersey International Holdings, L.P., BlackRock (Singapore) Holdco Pte. Ltd, BlackRock (Singapore) Limited.
- 15.- BlackRock, Inc, BlackRock Holdco 2, Inc, BlackRock Financial Management, Inc, BlackRock Capital Holdings, Inc, BlackRock Advisors, LLC.

Likewise, on January 30, 2017, Blackrock, Inc. informed to the Securities Exchange Commission that its shareholding on the share capital of Telefónica, S.A. was 6.7%.

**- Note 2 to Section A.3.]**

It should be noted that the Company has an Internal Code of Conduct for Securities Markets Issues setting out, among other issues, the general operating principles for Directors and senior executives when carrying out personal trades involving securities issued by Telefónica, S.A. and financial instruments and contracts whose underlying securities or instruments are issued by the Company. The Board of Directors on its meeting held on December 14, 2016, approved a new version of the Internal Code of Conduct in order to adapt it to the regulatory changes on this matter.

The general operating principles of this Internal Code of Conduct include transactions subject to notification, action limitations as well as the minimum holding period when acquiring securities in the Company, during which time these may not be transferred, except in the event of extraordinary situations that justify their transfer, subject to authorisation by the Regulatory Compliance Committee.

**- Note 3 to Section A.3.]**

The General Shareholders' Meeting on May 30, 2014, shareholders approved the introduction of a long-term incentive plan for managers of the Group (including Executive Directors), also known as the Performance & Investment Plan ("PIP"). Under this plan, participants who met the qualifying requirements were also awarded a certain number of Telefónica, S.A. shares as a form of variable remuneration. This General Shareholders' Meeting approved the maximum number of shares to be awarded to Executive Directors subject to their meeting the co-investment requirement established in the Plan and the maximum target total shareholder return (TSR) established for each phase.

In accordance with the above, the amounts appearing in Section A.3. of this report under "Number of direct votes" and "Equivalent number of shares" (i.e. Mr. José María Álvarez-Pallete López, 384,000-600,000 and Mr. César Alierta Izuel, 648,000-1,012,500 ) relate to the theoretical number of shares assigned and the maximum possible number of shares in the first and second phase of the Plan approved by the General Shareholders Meeting of 30 May 2014, if the co-investment requirement established in the Plan and the maximum target TSR established for each phase are met.

Regarding the third phase of this Plan (2016-2019), the Board of Directors of the Company, after a favourable report from the Nominating, Compensation and Corporate Governance Committee, agreed not to execute nor implement, it due to it was not aligned enough with the strategic plan of Group Telefónica, considering the circumstances and the macroeconomic environment.

**- Note 4 to Section A.5.]**

Until December 23, 2016, Telefónica Digital España, S.L.U. held a shareholding, together with CaixaBank Payments, Establecimiento Financiero de Crédito E.P., S.A.U., and Banco Santander, S.A., at Yaap Digital Services, S.L. On December 23, 2016, the liquidation deed for Yaap Digital Services, S.L. was granted.

**- Note 5 to Section A.6.]**Shareholder Pact between Telefónica, S.A. – Vivendi, S.A.

In September 2015, after the regulatory approval from Conselho Administrativo de Defesa Econômica (CADE), Telefónica, S.A. delivered to Vivendi, S.A. 46.0 million of its treasury shares representing, in that moment, 0.95% of its share capital, in exchange for 58.4 million preference shares of Telefónica Brasil, S.A. (received by Vivendi, S.A. as part of the acquisition of GVT Participações, S.A.), accounting for approximately 3.5% of the share capital of Telefónica Brasil, S.A.

By virtue of this agreement, Vivendi, S.A. has agreed to a number of obligations, including the following: (i) to refrain from selling shares of Telefónica during certain periods (lock up), and (ii) accept certain restrictions which, in the event of transfer, once the lock up periods have elapsed, guarantee that such shares are sold in an orderly manner.

At the date of this Report, the shareholding of Vivendi on the share capital of Telefónica, S.A. is 0.978%.

Shareholder Pact between Telefónica, S.A. – China Unicom (Hong Kong) Limited

In accordance with the provisions of Article 112, Section 2 of the Securities Market Act 24/1988, of July 28 (currently replaced by Article 531 Section 1 of the revised text of the Spanish Corporations Act approved by Royal Decree Law 1/2010, of July 2), on October 22, 2009, the Company notified the Spanish Securities Market Commission (Comisión Nacional del Mercado de Valores, "CNMV") that on September 6, 2009 Telefónica had entered into a mutual share exchange agreement with China Unicom (Hong Kong) Limited, whose clauses 8.3 and 9.2 are considered a shareholder agreement as per Article 530 of the Spanish Corporations Act. By virtue of these clauses, Telefónica may not, while the strategic partnership agreement is in force, offer, issue or sell a significant number of its shares or any convertible security or security that confers the right to subscribe or acquire a significant number of shares of Telefónica, S.A. to any of the main competitors of China Unicom (Hong Kong) Limited. In addition, China Unicom (Hong Kong) Limited undertook not to sell, use or transfer, directly or indirectly, for a period of one year its share in Telefónica's voting share capital (excluding intragroup transfers). This undertaking was rendered null and void when the aforementioned period of one year had elapsed.

At the same time, both parties also undertook similar obligations with respect to the share capital of China Unicom (Hong Kong) Limited.

This mutual share exchange agreement, which includes the shareholder agreement, was filed with the Madrid Mercantile Registry on November 24, 2009.

On January 23, 2011, Telefónica, S.A. and China Unicom (Hong Kong) Limited ("China Unicom") signed an extension to their Strategic Partnership Agreement, in which both companies agreed to strengthen and deepen their strategic cooperation in certain business areas, and committed to investing the equivalent of 500 million US dollars in ordinary shares of the other party. Through its subsidiary Telefónica Internacional, S.A.U., Telefónica acquired a number of China Unicom shares amounting to 500 million US dollars from third parties, within nine months of signature of this agreement. In recognition of China Unicom's stake in Telefónica, the latter commits to proposing the appointment of a board member nominated by China Unicom in the next General Shareholders' Meeting, in accordance with prevailing legislation and the Company's By-laws. The General Shareholders' Meeting held on May 18, 2011 duly approved the appointment of China Unicom's nominee, Mr. Chang Xiaobing, as member of the Board of Directors.

China Unicom completed the acquisition of Telefónica shares on January 28, 2011, giving it ownership of 1.37% of the Company's capital.

The Telefónica Group purchased China Unicom shares during 2011 to the amount of 358 million euros. At December 31, 2011, the Telefónica Group held a 9.57% stake in the company.

On June 10, 2012, Telefónica, S.A. through its wholly-owned subsidiary Telefónica Internacional, S.A.U., and China United Network Communications Group Company Limited, through a wholly-owned subsidiary, signed an agreement for the purchase by the latter of 1,073,777,121 shares in China Unicom (Hong Kong) Limited owned by Telefónica, equivalent to 4.56% of its capital.

After securing the requisite regulatory authorizations, the sales transaction was completed on July 30, 2012.

Subsequent to the transaction, Telefónica and China Unicom remained firmly committed to their Strategic Partnership.

Telefónica agreed not to sell the shares it holds directly and indirectly in China Unicom for a period of 12 months as from the date of the agreement.

On November 10, 2014 Telefónica sold 597,844,100 shares in China Unicom, representing 2.5% of the capital of the latter, in a block trade process, at a price of HK \$ 11.14 per share, in a total amount of HK \$ 6,660 million, approximately 687 million euros at exchange rates on that date.

Telefónica undertook not to sell any shares held directly or indirectly in China Unicom on the market for a period of 12 months from the selling date.

Likewise, on July 13, 2016, Telefónica through its 100% subsidiary, Telefónica Internacional, S.A.U. proceeded with the sale of 361,794,559 shares of China Unicom, representing 1.51% of the share capital of the company, by a block trade process, at a price of HK \$ 7.80 per share, for a total amount of HK \$ 2,822 million, approximately € 322 million,

Telefónica committed not to transfer to the market the shares of China Unicom, which it may own directly or indirectly, over a period of 90 days from the sales date.

Telefónica maintains its commitment to the Strategic Partnership with China Unicom, recently strengthened through cooperation in digital areas such as the big data joint venture between both companies.

#### **- Note 6 to Section A.9.bis]**

As stated in Section A.6 of this report, in September 2015, after the regulatory approval from Conselho Administrativo de Defesa Econômica (CADE), Telefónica, S.A. delivered to Vivendi 46.0 million of its treasury shares, representing, in that moment, 0.95% of its share capital, in exchange for 58.4 million preference shares of Telefónica Brasil, S.A. (received by Vivendi, S.A. as part of the acquisition of GVT Participações, S.A.), accounting for approximately 3.5% of the share capital of Telefónica Brasil, S.A.

By virtue of this agreement, Vivendi, S.A. has agreed to a number of obligations, including the following: (i) refrain from selling shares of Telefónica during certain periods (lock up), and (ii) accept certain restrictions which, in the event of transfer, once the lock up periods have elapsed, guarantee that such shares are sold in an orderly manner.

At the date of this Report, the shareholding of Vivendi on the share capital of Telefónica, S.A. is 0.978%.

However, the aforementioned percentage of 0.978% of share capital has not been included in the percentage of "estimated free-float capital" set out in section A.9.bis of this Report.

#### **- Note 7 to Section A.10.]**

In accordance with Article 26 of the Corporate By-laws, no shareholder may cast a number of votes in excess of 10% of the total voting capital existing at any time, regardless of the number of shares held by such shareholder and in full compliance with mandatory requirements of law. In determining the maximum number of votes that each shareholder may cast, only the shares held by each such shareholder shall be computed. It does not include additional votes cast on behalf of other shareholders who may have appointed them as proxy, who are themselves likewise restricted by the 10% voting ceiling.

The limit described above also applies to the number of votes that can be cast either jointly or separately by two or more legal entity shareholders belonging to the same corporate group and to the number of votes that may be cast altogether by an individual or legal entity shareholder and any entity or entities that they directly or indirectly control and which are also shareholders.

For the purposes of the provisions contained in the preceding paragraph, the provisions of Section 18 of the current Spanish Corporations Act shall apply in order to decide whether or not a group of entities exists and to examine the situations of control indicated above.

In relation to the above and in accordance with the provisions of Article 527 of the Spanish Corporations Act, any clauses in the By-laws of listed corporations that directly or indirectly restrict the number of shares that may be cast by a single shareholder by shareholders belonging to the same group or by any parties acting together with the aforementioned, will be rendered null and void when, subsequent to a takeover bid, the buyer has a stake equal to or over 70% of share capital which confers voting rights, unless the buyer was not subject to neutralization measures to prevent a takeover bid or had not adapted these measures accordingly.

**- Note 8 to Section C.1.12.]**

Mr. Isidro Fainé Casas was Chairman of Caizabank, S.A. until June 2016.

Mr. Peter Löscher is Chairman of the Supervisory Board of OMV Aktiengesellschaft and Chairman of Sulzer AG and member of the Supervisory Board of Deutsche Bank AG.

Mr. Antonio Massanell Lavilla is member of the Supervisory Board of Erste Group Bank AG.

Mr. Ignacio Moreno Martínez of Secuoya, Grupo de Comunicación, S.A., is the individual representing the Board member Cardomana Servicios y Gestiones, S.L.

**- Note 9 to Section C.1.16.]**

For these purposes, Senior Executives are understood to be individuals who perform senior management functions reporting directly to the management bodies, or their Executive Commissions or CEOs. For the purposes of annual remuneration, the head of Internal Audit is also included.

With effect from January 1, 2017, Mr. Mariano de Beer assumed the position of Chief Commercial Digital Officer (CCDO) of the Company, replacing Mr. Eduardo Navarro de Carvalho.

Mr. Juan Francisco Gallego Arrechea was appointed Director Internal Audit on May 2016, therefore, it is reflected the compensation received from that date. Until May 2016, the Director of Internal Audit was Mr. Ignacio Cuesta Marín-Gil, therefore, it is reflected the compensation received until that date.

It is included the compensation received by Mr. Santiago Fernández Valbuena as a member of Senior Executives, since his resignation as Director of the Company on April 8, 2016. It is noted that Mr. Santiago Fernández Valbuena received an amount of 10,560,000 euros in compensation as a result of his cessation as an Officer of Telefónica, S.A. in May 2016.

**- Note 10 to Section C.1.17.]**

Mr. Juan Ignacio Cirac Sasurain is member of the Scientific Advisory Committee of the Fundación Banco Bilbao Vizcaya Argentaria, and member of the Advisory Board of Fundación Bancaria Caixa d'Estalvis i Pensions de Barcelona, "la Caixa", to whom he advises as a Physics expert on their investigation activities, without receiving any compensation for such positions (except 1,000 euros as Attendance fees of each one of the meetings - three meetings per year - of the Advisory Board of Fundación Bancaria Caixa d'Estalvis i Pensions de Barcelona, "la Caixa").

Ms. Sabina Fluxà Thienemann is member of the Regional Advisory Board of the East (joining Valencia, Murcia and Baleares) of Banco Bilbao Vizcaya Argentaria, S.A., to whom she advises as prominent businesswoman on their objective to keep on approaching their business strategy to the current social-economic situation of such regions, without receiving any remuneration for such position.

**- Note 11 to Section C.1.19.]**

**Selection and appointment**

Telefónica's Bylaws state that the Board of Directors shall be composed of a minimum of five members and a maximum of twenty, to be appointed at the General Shareholders Meeting. Directors are appointed for a period of no longer than four years, and may be re-elected for one or more subsequent periods of no longer than four years at a time. The Board



of Directors may, in accordance with the Spanish Corporations Act and the Company Bylaws, provisionally co-opt Directors to fill any vacancies.

The Board of Directors shall have the power to fill, on an interim basis, any vacancies that may occur therein, by appointing, in such manner as is legally allowed, the persons who are to fill such vacancies until the holding of the next General Shareholders Meeting.

Also, in all cases, proposed appointments of Directors must follow the procedures set out in the Company's Bylaws and Regulations of the Board of Directors and be preceded by the appropriate favourable report by the Nominating, Compensation and Corporate Governance Committee and in the case of independent Directors, by the corresponding proposal by the Committee. Proposals for individuals to represent legal entities (companies) have to be made following a report by the Nominating, Compensation and Corporate Governance Committee.

Therefore, in exercise of the powers delegated to it, the Nominating, Compensation and Corporate Governance Committee must assess the skills, knowledge and experience required in the Board of Directors, defining the functions and abilities needed by candidates to cover each vacancy, and evaluating the time and dedication needed for them to efficiently perform their duties. It will also have to escalate proposed appointments of independent Directors to the Board of Directors by co-option or for the decision to be made by the General Shareholders Meeting, as well as proposals for the re-election or removal of said Directors by the General Shareholders Meeting. It will also have to escalate proposed appointments of other Company Directors to the Board of Directors for appointment by co-option or for the design to be made by the General Shareholders Meeting, as well as proposals for the re-election or removal of said Directors by the General Shareholders Meeting.

In line with the provisions of its Regulations, the Board of Directors, exercising the right to fill vacancies by interim appointment and to propose appointments to the shareholders at the General Shareholders Meeting, shall ensure that, in the composition of the Board of Directors, external or non-executive Directors represent an ample majority over executive Directors. Similarly, the Board shall ensure that the total number of independent Directors represents at least one third of the total number of Board members.

The nature of each Director shall be explained by the Board of Directors to the shareholders at the General Shareholders Meeting at which the appointment thereof must be made or ratified. Furthermore, such nature shall be reviewed annually by the Board after verification by the Nominating, Compensation and Corporate Governance Committee, and reported in the Annual Corporate Governance Report.

In any event, and in the event of re-election or ratification of Directors by the General Shareholders Meeting, the report of the Nominating, Compensation and Corporate Governance Committee, or, in the case of independent Directors, the proposal of said Committee, will contain an assessment of the work and effective time devoted to the post during the last period in which it was held by the proposed Director.

Both the Board of Directors and the Nominating, Compensation and Corporate Governance Committee shall ensure, within the scope of their respective powers, that those proposed for the post of Director should be persons of recognised calibre, qualifications and experience, who are willing to devote the time and effort necessary to carrying out their functions, and shall take extreme care in the selection of persons to be appointed as independent Directors.

The Board of Directors will have to ensure that Board members are selected using procedures that guarantee gender equality and diversity of knowledge and experience, that prevent any underlying bias would could cause any kind of discrimination, and, in particular, that the procedures should favour the selection of female directors.

In its meeting on November 25, 2015, the Board of Directors approved a Director Selection Policy which is aimed at ensuring that appointment or re-election proposals meet the Board's requirements as set out in a preliminary analysis, encouraging gender equality and diversity of knowledge and experience, preventing any underlying bias would could cause any kind of discrimination. This Director Selection Policy is available on the Company's corporate website.

The result of the preliminary analysis of the needs of the Board of Directors will be set out in the report of the Nominating, Compensation and Corporate Governance Committee, which will be published on calling the General Shareholders Meeting at which each Director will be submitted for ratification, appointment or re-election.

Every year, the Nominating, Compensation and Corporate Governance Committee will check that the Director selection policy is complied with, and will report with such information in the Annual Corporate Governance Report.

## Re-election

Directors can be re-elected once or several times for the same periods as the initial period.

As with appointments, proposals for the reappointment of Directors must be preceded by the corresponding report by the Nominating, Compensation and Corporate Governance Committee, and in the case of independent Directors, by the corresponding proposal by the Committee.

## Appraisal

In accordance with the Regulations of the Board of Directors, the Nominating, Compensation and Corporate Governance Committee has the powers to organise and coordinate, together with the Chairman of the Board of Directors, the regular assessment of said body, after which the Board of Directors approves the assessment of its function and the functioning of its Committees.

In accordance with the above, it should be noted that the Board of Directors and its Committees carry out a periodic evaluation of the operation of the Board of Directors and of the Committees thereof in order to determine the opinion of Directors regarding the workings of these bodies and to establish any proposals for improvements to ensure the optimum working of the company's governing bodies.

## Removal and dismissal

Directors' shall cease to hold office when the term for which they were appointed expires, or when so resolved by the shareholders at the General Shareholders Meeting in the exercise of the powers legally granted to them.

Directors who give up their place before their tenure expires, should state their reasons in a letter to be sent to all members of the Board of Directors.

The Board of Directors shall not propose the removal of any independent Director prior to the end of the Bylaw-mandated period for which they have been appointed, unless there are due grounds therefore acknowledged by the Board after a report from the Nominating, Compensation and Corporate Governance Committee. Specifically, due grounds shall be deemed to exist when the Director has failed to perform the duties inherent to his position.

The removal of independent Directors may also be proposed as a result of Takeover Bids, mergers or other similar corporate transactions that represent a change in the structure of the Company's capital.

### - Note 12 to Section C.1.29]

The Board of Directors at its meeting held on April 27, 2016, on a favourable report from the Nominating, Compensation and Corporate Governance Committee, adopted a new setting for the Advisory or Control Committees of the Company in with regards to its organization, structure and composition in order to increase its efficiency and to optimize the administration of the corporate governance structure of Telefónica, S.A.

Within this context, the Board of Directors unanimously adopted the following resolutions: i) to reorganize the then-existing Regulation and Institutional Affairs Committees, which became a single Committee called the Regulation and Institutional Affairs Committee, the powers, duties and responsibilities of which are those that until such time corresponded to each of such Committees; and ii) to reorganize the then-existing Strategy and Innovation Committees, which became a single Committee called the Strategy and Innovation Committee, the powers, duties and responsibilities of which are those that until such time corresponded to each of such Committees.

Until April 27, 2016, Regulation Committee has met once, Institutional Affairs Committee has met 4 times, Strategy Committee has met 4 times and Innovation Committee has met 3 times.

### - Note 13 to Section C.1.31.]

In accordance with US securities market regulations, the information contained in the Annual Report in 20-F format (which includes the Consolidated Financial Statements of the Telefónica Group), filed with the Securities and Exchange

Commission, is certified by the Executive Chairman of the Company and by the CFO. This certification is made after the Financial Statements have been prepared by the Board of Directors of the Company.

**- Note 14 to Section C.1.36.]**

The Board of Directors of Telefónica, S.A. at its meeting held April 8, 2016, on a proposal from its Audit and Control Committee and as a result of a transparent competitive process, has resolved to propose to the next Ordinary General Shareholders Meeting the appointment of PricewaterhouseCoopers Auditores S.L. as statutory auditor for the Annual Accounts of Telefónica, S.A. and its Consolidated Group of Companies for the years 2017, 2018 and 2019. Such appointment was approved by the General Shareholders Meeting held on May 12, 2016.

**- Note 15 to Section C.1.39.]**

Financial year 1983 was the first audited by an External Auditor. Previously the financial statement were revised by chartered accountants (known at the time as "censores de cuentas"). Therefore, 1983 is the base year taken for calculating the percentage in the case of audits of the Financial Statements of Telefónica, S.A., while 1991 is the date taken for the calculation of the percentage in the case of the Consolidated Financial Statements, as 1991 was the first year in which the Telefónica Group prepared Consolidated Financial Statements.

**- Note 16 to Section C.2.1]**

The Board of Directors at its meeting held on April 27, 2016, on a favourable report from the Nominating, Compensation and Corporate Governance Committee, adopted a new setting for the Advisory or Control Committees of the Company in with regards to its organization, structure and composition in order to increase its efficiency and to optimize the administration of the corporate governance structure of Telefónica, S.A.

Within this context, the Board of Directors unanimously adopted the following resolutions: i) to reorganize the then-existing Regulation and Institutional Affairs Committees, which became a single Committee called the Regulation and Institutional Affairs Committee, the powers, duties and responsibilities of which are those that until such time corresponded to each of such Committees; and ii) to reorganize the then-existing Strategy and Innovation Committees, which became a single Committee called the Strategy and Innovation Committee, the powers, duties and responsibilities of which are those that until such time corresponded to each of such Committees.

**- Note 17 to Section C.2.1]**

Pursuant to the provisions of Article 39 of the Corporate Bylaws of Telefónica, S.A., Article 22 of the Regulations of the Board of Directors of the Company regulates the Audit and Control Committee in the following terms:

a) Composition.

The Audit and Control Committee shall consist of such a number of members as the Board of Directors determines at any given time, who shall in no case be less than three and shall be appointed by the Board of Directors. All members thereof must be external or non-executive Directors, and most of them must be at least Independent Directors. When appointing its members, and, in particular, when appointing its Chairman, the Board of Directors shall take into account the appointees' knowledge and experience in matters of accounting, auditing or both, as well as in risk management. Overall, the members of the Committee will have the adequate technical knowledge in relation to the Company's sector of activity.

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 one year from the date when he ceased to hold office.

b) Duties.

Without prejudice to any other tasks that the Board of Directors may assign thereto, 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) Report to the General Shareholders Meeting regarding matters addressed in the Committee for which it is responsible, and, in particular, regarding the result of the audit, and explain how the audit has improved the integrity of the financial information and the function played by the Committee in this process.
- 2) Escalate proposals for selection, appointment, re-election and replacement of the external auditor to the Board of Directors, taking responsibility for the selection process as established in prevailing laws, as well as the recruitment conditions, and regularly gather information from the auditor about the audit plan and its execution, as well as safeguarding its independence in exercising its functions.
- 3) To supervise internal audit and, in particular:
  - a) Ensure the independence and efficiency of the internal audit function;
  - b) Propose the selection, appointment and removal of the person responsible for the internal audit;
  - c) Propose the budget for such service;
  - d) Review the annual internal audit work plan and the annual activities report;
  - e) Receive periodic information on its activities; and
  - f) Verify that the senior executive officers take into account the conclusions and recommendations of its reports.
- 4) Oversee the process of preparing and presenting mandatory financial reporting and submitting recommendations of proposals to the administrative body aimed at safeguarding its integrity. With respect thereto, it shall be responsible for supervising the process of preparation and the completeness 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) Monitor the effectiveness of the Company's internal control, internal audit and risk management systems, including fiscal risks, and discuss with the Auditors significant weaknesses in the internal control system detected during the audit, without compromising their independence at any time. For that purposes, if deemed necessary, it can submit recommendations or proposals to the Board of Directors and an appropriate monitoring period. 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 risk level that the Company deems acceptable; the measures to mitigate the impact of the identified risks, should they materialise; and
  - c) the control and information systems to be used to control and manage these risks.
- 6) Establish and supervise a system that allows employees to confidentially and anonymously report potentially significant irregularities, particularly any financial and accounting irregularities detected within the Company.
- 7) Establish and maintain appropriate relations with the Auditor in order to receive, for review by the Committee, information on all matters that could jeopardize the Auditor's independence, and, when applicable, the authorisation of permitted services, according to current legislation, and such other communications as may be provided for in auditing legislation and in technical auditing regulations. In any event, the Audit and Control Committee must receive, on an annual basis, written confirmation from the Auditor of its independence vis-à-vis the entity or entities directly or indirectly related thereto, as well as in-depth and individualised information regarding additional services of any kind provided as well as the fees received to such entities by the Auditor or by the persons or entities related thereto pursuant to the provisions of prevailing legislation.
- 8) 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 is compromised. This report will focus on the assessment of the provision of each and every one of the additional services referred to in point 7) above, considered individual and in their entirety, other than legal audit, and in relation to the regime of independence or laws regulating auditing activities.

9) Analyse and report on economic conditions, the accounting impact, and, if applicable, the proposed exchange ratio in structural and corporative modification transactions which the Company intends to perform, before being submitted to the Board of Directors.

10) Preliminary reporting to the Board of Directors regarding all matters set out in prevailing legislation and in the Bylaws, and, in particular, concerning:

1. The financial information that the Company must periodically disclose;
2. The creation or acquisition of shareholdings in special purpose entities or companies with registered addresses in countries or territories considered to be tax havens; and
3. Related party transactions.

11) Exercise all the pertinent functions of the Audit Committee established at any given time by prevailing laws in regard to Group companies which are considered to be Public Interest Entities (as these are defined in applicable laws), provided that they are fully owned, either directly or indirectly, by the Company pursuant to applicable laws, and whose administration is not attributed to a Board of Directors.

The dispositions of sections 2, 7 and 8 are understood to be without prejudice to general auditing regulations.

c) Operation.

The Audit and Control Committee shall meet at least once every quarter and as often as appropriate, when called by its Chairman.

In the performance of its duties, the Audit and Control Committee may require that the Company's Auditor and the person responsible for internal audit, and any employee or senior executive officer of the Company, attend its meetings.

Most significant actions during the year.

The main activities and actions carried out by the Audit and Control Committee of the Board of Directors of Telefónica, S.A. during 2016 concerned the powers and duties of the Committee, due to both legal requirements and also to the interest arising according to the nature of such powers. The Audit and Control Committee has analysed and reviewed a number of questions which include the following:

- In financial matters: i) review of the Company's financial reporting (2015 Annual Accounts and Management Reports, and the regular quarterly and half-yearly financial information), ii) review of prospectuses presented by the Company to different supervisory Bodies (which include the 20-F Financial Report and a number of Prospectuses for financing (shares and debt) arrangements), and iii) review of single-theme presentations on financial matters and changes in accounting standards.
- Regarding the external auditor: i) proposed appointment and fees to be received by Ernst & Young as Statutory Auditor for the year 2016, ii) review of audit tasks and limited reviews conducted by the external auditor with regard to the financial reporting referred to above; iii) selection process of the new Statutory Auditor of Telefónica, S.A. for the years 2017, 2018 and 2019, which concluded with the appointment of PricewaterCoopers (PwC) by the General Shareholders Meeting held on May 12, 2016, on a proposal from the Board of Directors, all in accordance with the Law 22/2015, of July 20, Audit of Accounts; and iv) selection process for the new Statutory Auditor for the Public Interest Entities for Group Telefónica (for the years 2017, 2018 and 2019), in respect of which the Audit and Control Committee of Telefónica, S.A. has assumed the functions of its respective Audit Committees (Telefónica de España, S.A.U., Telefónica Móviles España, S.A.U., Seguros de Vida y Pensiones Antares, S.A., Telefónica Emisiones, S.A.U., Telefónica Participaciones, S.A.U. and Telefónica Europe, B.V.).
- Regarding internal control: i) of cross-cutting processes, investigations and inspections, ii) risk management system, and iii) inspection, investigation and fraud tasks in the field of regulatory compliance, including anti-corruption rules.

Furthermore, regarding to the Director member of the Audit and Control Committee who has been appointed based on his knowledges and experience in accounting, audit or both, apart from Mr. José Javier Echenique Landiribar, the Directors Mr. Antonio Massanell Lavilla and Mr. Ignacio Moreno Martínez have been appointed.

**- Note 18 to Section C.2.1.]**

Pursuant to the provisions of Article 40 of the Corporate Bylaws of Telefónica, S.A., Article 23 of the Regulations of the Board of Directors of the Company regulates the Nominating, Compensation and Corporate Governance Committee in the following terms:

a) Composition.

The Nominating, Compensation and Corporate Governance Committee shall consist of such a number of members as the Board of Directors determines at any given time, who shall in no case be less than three and shall be appointed by the Board of Directors. All members thereof must be external or non-executive Directors, and most of them must be at least Independent Directors.

The Chairman of the Nominating, Compensation and Corporate Governance Committee, who shall in all events be an Independent Director, shall be appointed from among its members.

b) Duties.

Notwithstanding other duties entrusted it by the Board of Directors, the Nominating, Compensation and Corporate Governance Committee shall have the following duties:

1) Assess the skills, knowledge and experience necessary in the Board of Directors. For these purposes, it will define the roles and capabilities required of the candidates to fill each vacancy, and assess the time and dedication necessary for them to efficiently perform their duties.

2) Set a target of representation for the least represented gender on the Board of Directors and provide guidelines about how this target might be reached.

3) Escalate proposed appointments of independent Directors to the Board of Directors by co-option or for the decision to be made by the General Shareholders Meeting, as well as proposals for the re-election or removal of said Directors by the General Shareholders Meeting.

4) Submit proposed appointments of other Company Directors to the Board of Directors for appointment by co-option or for the decision to be made by the General Shareholders Meeting, as well as proposals for the re-election or removal of said Directors by the General Shareholders Meeting. It will also have to escalate proposals for appointments or termination of the Secretary, and, if applicable, of the Deputy Secretary of the Board of Directors, and also proposals for the appointment, re-election and termination of Directors in their subsidiary companies.

5) Report on proposals to appoint or to terminate the Senior Management of the Company and their subsidiaries.

6) To report on the proposals for appointment of the members of the Executive Commission and of the other Committees of the Board of Directors, as well as the respective Secretary and, if applicable, the respective Deputy Secretary.

7) To propose to the Board of Directors the appointment of the Lead Director from among the Independent Directors.

8) To organise and coordinate, together with the Chairman of the Board of Directors, a periodic assessment of the Board, pursuant to the provisions of these Regulations.

9) To inform on the periodic assessment of the performance of the Chairman of the Board of Directors.

10) To examine or organize the succession of the Chairman of the Board of Directors and, if applicable, to make proposals to the Board of Directors so that such succession occurs in an orderly and well-planned manner.

11) To propose to the Board of Directors, within the framework established in the Corporate Bylaws, the compensation for the Directors and review it periodically to ensure that it is in keeping with the tasks performed by them, as provided in Article 34 of the Regulations of the Board.

12) To propose to the Board of Directors, within the framework established in the Bylaws, the extent and amount of the compensation, rights and remuneration of a financial nature of the Chairman of the Board of Directors, the Executive

Directors and the senior executives of the Company, as well as the basic terms of their contracts, for purposes of contractual implementation thereof.

- 13) To prepare and propose to the Board of Directors an annual report regarding the Directors' compensation policy.
- 14) To verify information on the remuneration of Directors and senior management contained in the various corporate documents, including the annual report on Directors' remuneration.
- 15) To supervise compliance with the Company's internal rules of conduct and the corporate governance rules thereof in effect from time to time.
- 16) To exercise other powers assigned to the Nominating, Compensation and Corporate Governance Committee in this Regulation.

c) Operation.

In addition to the meetings provided for in the annual schedule, the Nominating, Compensation and Corporate Governance Committee shall meet whenever the Board of Directors of the Company or the Chairman of the Board of Directors requests the issuance of a report or the making of a proposal within the scope of its powers and duties, provided that, in the opinion of the Chairman of the Committee, it is appropriate for the proper implementation of its duties.

The Nominating, Compensation and Corporate Governance Committee will consult with the Chairman of the Board of Directors particularly when concerning matters relating to executive directors and senior officers.

Most significant actions during the year.

The main activities and actions carried out by the Nominating, Compensation and Corporate Governance Committee of the Board of Directors of Telefónica, S.A. during 2016 concerned the powers and duties of the Committee, due to both legal requirements and also to the interest of the matter arising in each case in accordance with such powers. The Nominating, Compensation and Corporate Governance Committee has analysed and informed a number of questions which include the following:

- The policy and remuneration system for Directors and Executives of the Telefónica Group (fixed and variable remuneration, and action plans).
- Proposed appointments relating to the Board of Directors of Telefónica, S.A. and its Committees, and to the Boards of its Subsidiaries.

In this respect, in the year 2016, the Nominating, Compensation and Corporate Governance Committee proposed and informed about the appointment of the Directors of Telefónica, S.A., based on solvency, competence, experience, professional merits and willingness of the appointees to devote the time and effort needed for the effective performance of their functions, and only when considering their personal and professional features.

Consequently, on its meeting held on April 7, 2016, the Committee proposed to the Company's Board of Directors, the appointment by co-optation of Ms. Sabina Fluxà Thienemann, Mr. José Javier Echenique Landiribar, Mr. Peter Löscher and Mr. Juan Ignacio Cirac Sasturain as independent Directors, replacing Mr. Carlos Colomer Casellas, Mr. Alfonso Ferrari Herrero, Mr. José Fernando de Almansa Moreno-Barreda and Mr. Santiago Fernández Valbuena.

Likewise, the Committee informed and/or proposed the re-election and ratification of the directors of Telefónica, S.A. by the General Ordinary Shareholders Meeting of the Company, considering and analysing the functions performed and the commitment of the Directors, basing all the proposals on a prior analysis of the Board of Director's needs, and promoting the knowledge, experience and gender diversity.

Thus, the General Ordinary Shareholders Meeting held on May 12, 2016, approved the re-election of Mr. Isidro Fainé Casas, Mr. Julio Linares López, Mr. Peter Erskine, and Mr. Antonio Massanell Lavilla, as well as the ratification of the appointment by co-optation of Ms. Sabina Fluxà Thienemann, Mr. José Javier Echenique Landiribar, Mr. Peter Löscher, Mr. Juan Ignacio Cirac Sasturain, and Mr. Wang Xiaochu.

Furthermore, on its meeting held on April 7, 2016, the Committee informed and presented to the Board of Directors its proposal to appoint Mr. José María Álvarez-Pallete López as Executive Chairman, replacing Mr. César Alierta Izuel, who was the Executive Chairman.

Likewise, the Committee on such meeting of April 7, 2016, proposed to appointment Mr. Francisco Javier de Paz Mancho as Lead Director, replacing Mr. Alfonso Ferrari Herrero.

Besides, the Committee analysed the proposal regarding the new setting of the Advisory and Control Committees which support the Board of Directors of the Company, with regard to its organization, structure and composition in order to reach the greater efficiency possible and to optimize the administration of the corporate governance structure of Telefónica, S.A.

Additionally, the Committee informed during the meetings held about several appointment proposals of Directors in the main Subsidiary Companies of Group Telefónica.

- Proposed modifications in the organisational structure of the Telefónica Group.
- 2015 Corporate Governance Report and Remuneration Report.

#### **- Note 19 to Section C. 2.2.]**

The presence of women in the extinct Regulatory, Institutional Affairs, Strategy and Innovation Committees, while were operational, were the following:

- Regulation Committee:  
2016 Year: 1(16.67%), 2015 Year: 1(16.67%), 2014 Year: 1(16.67%), 2013 Year: 1(14.29%).
- Affairs Institutionals Committee:  
2016 Year: 0, 2015 Year: 0, 2014 Year: 0, 2013 Year: 0.
- Strategy Committee:  
2016 Year: 1(16.67%), 2015 Year: 1(16.67%), 2014 Year: 1(16.67%), 2013 Year: 1(16.67%).
- Innovation Committee:  
2016 Year: 0, 2015 Year: 0, 2014 Year: 0, 2013 Year: 0.

#### **- Note 20 to Section D. 2.]**

It is important to note that

Transactions included in this section under 'Other', amounting to 14,923 with BBVA, S.A. refer to Dividends received.

Transactions included in this section under 'Other', for the sum of 544,596 with BBVA, S.A. refer to Other Revenues (10,664), to Outstanding factoring operations (533,037), to Other Transactions (7), to Other Expenses (881) and to Gains from derecognition or disposal of assets (7).

Transactions included in this section under 'Other', for the sum of 250,031 with "la Caixa" Group, refer to Other Expenses (31) and Outstanding factoring operations (250,000)

In addition, the nominal value of outstanding derivatives held with BBVA and la Caixa in 2016 amounted to 18,047 and 392 million euros, respectively. As explained in Derivatives policy in Note 16 of the 2016 Consolidated Annual Accounts, this figure is inflated by the use in some cases of several levels of derivatives applied to the nominal value of a single underlying. The fair value of these same derivatives in the statement of financial position is 988 and -35 million euros,



respectively, in 2016. Additionally, at December 31, 2016 there were collateral guarantees on derivatives with BBVA amounting to 240 million euros.

**- Note 21 to Section D.5.]**

On December 18, 2015, a joint venture was set up between China Unicom for the development of Big Data services in China, using Smart Steps technology developed by Telefónica. Telefónica has a stake of 45% through Telefónica Digital España, S.L.; China Unicom Broadband Online Limited Corp. owns the remaining 55%. In 2016, Telefónica disbursed 7 million euros corresponding to its shareholding in the capital of the company. The company is already commercially operational and obtained a turnover of 4 million euros.

It is also stated that certain Telefónica Group subsidiaries carried out in the 2016 financial year, with the Inditex Group, operations derived from the Group's ordinary traffic or business related to telecommunications and related services, amounting to 36 million euros.

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Finally, it should be said that as of the year 2010, Telefónica, S.A. adheres to the Code of Good Fiscal Practices, as approved by the Large Companies' Forum –a body in which major Spanish companies and the Spanish tax authorities participate–, and complies with the content of the same.

Similarly, Telefónica Group is committed to the application of other international regulations and initiatives in the area of sustainability as well as, among others, the Universal Declaration of Human Rights, the United Nations Global Compact, and other conventions and treaties agreed by international bodies such as the Organization for Economic Cooperation and Development and the International Labor Organization.

**This annual corporate governance report was approved by the company's Board of Directors at its meeting held on February 22, 2017.**

**List whether any directors voted against or abstained from voting on the approval of this report.**

**No**

Name or corporate name of director	Reasons (voted against, abstention, non-attendance)	Explain the reasons
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## **APPENDIX TO THE TELEFÓNICA, S.A. 2016 ANNUAL CORPORATE GOVERNANCE REPORT**

### **E.3 Indicate the main risks, including tax risks, which may prevent the company from achieving its targets.**

The Telefónica Group's business is affected by a series of intrinsic risk factors that affect exclusively the Group, as well as a series of external factors that are common to businesses of the same sector. The main risks and uncertainties facing the Company which could affect its business, financial position, reputation, corporate image and brand and its results of operations, must be considered jointly with the information in the Consolidated Financial Statements, and are as follows:

#### **Group-Related Risks**

##### **Worsening of the economic and political environment could negatively affect Telefónica's business.**

Telefónica's international presence enables the diversification of its activities across countries and regions, but it exposes Telefónica to various legislation, as well as to the political and economic environments of the countries in which it operates. Any adverse developments or even uncertainties in this regard, including exchange-rate or sovereign-risk fluctuations, may adversely affect the Company's business, financial position, cash flows and results of operations and/or the performance of some or all of the Group's financial indicators.

Economic conditions may adversely affect the level of demand of existing and prospective customers, as they may no longer deem critical the services offered by the Group.

Growth in Europe and financial stability may be affected by political uncertainty in some European countries due to upcoming general elections, a possible revival of the crisis in Greece, restructuring of the banking sector and due to the impact of steps taken towards an EU banking union and a capital markets union. In particular, the British exit process from the European Union following the vote to leave in the recent referendum, will require an adjustment of the economy to whatever new trade and investment relationships are put in place in the future, with the consequences in the meantime being uncertainty regarding investment, activity and financial market volatility. In 2016, the Telefónica Group obtained 24.5% of its revenues in Spain (22.6% in 2015), 14.4% in Germany (the same percentage as in 2015) and 13.2% in United Kingdom (14.3% in 2015).

In Latin America, there is an increasing exchange rate risk brought on by external factors such as increasing interest rates in the United States amid still low commodity prices and doubts about growth and imbalances in China; as well as internal factors as a consequence of the still high fiscal and external deficits in the most important Latin American countries or the low liquidity in exchange markets as it is the case in Argentina.

Some of the most significant macroeconomic risk factors in the region affect Mexico, as it is the country with the highest commercial and financial exposure to the United States. In this sense, increasing interest rates and the possible overhaul of trade agreements between both countries could imply higher restrictions on imports into the United States that would affect negatively the economic activity in Mexico.

Brazil is undertaking several measures principally focused on adjusting its public finances. A constitutional amendment limiting public spending has been approved and the government has submitted a new social security reform bill to Congress. However, the possibility of a new bout of political turmoil, which could weaken the support of the reforms, is not negligible. While signs of stabilization have emerged, economic growth continues to be negative and the unemployment rate has hit double digits, having a sizable effect on consumption spending. Moreover, despite financing external needs have decreased, internal are still high. All these elements have led to new downgrades to the country's credit rating during 2016, which now is below investment grade.

In countries such as Chile, Colombia and Peru, the recent uptick in commodity prices is having a positive impact on its fiscal and external accounts, but growth continues to be below its potential level due to the lower external inflows, which have affected investment and, to a lower extent, consumption.

In Argentina, the new government is focused on resolving Argentina's macroeconomic and financial imbalances and on recovering international confidence. Although reforms taking place may have positive effects in the medium term, short term risks persist, including exchange rate risk, especially due to the high inflation rate amid an economic contraction.

During 2016, Telefónica Hispanoamérica represented 24.2% of the Telefónica Group's revenues (26.2% in 2015), of which 23.8% proceeded from revenues in Argentina, 19.9% in Peru and 17.2% in Chile. During 2016, Telefónica Brazil represented 21.3% of the Telefónica's Group revenues (20.1% in 2015). In this respect, approximately 30.4% of the Group's revenues were generated in countries that do not have investment grade status (in order of importance, Brazil, Argentina, Ecuador, Nicaragua, Venezuela, Guatemala, Costa Rica and El Salvador), and other countries are only one notch away from losing this threshold.

"Country risk" factors include the following, among others:

- unexpected adverse changes in regulation or administrative policies, including changes that modify the terms and conditions of licenses and concessions and their renewal (or delay their approval);
- abrupt exchange rate movements;
- high inflation rates;
- expropriation or nationalization of assets, adverse tax decisions, or other forms of state intervention;
- economic-financial downturns, political instability and civil disturbances; and
- maximum limits on profit margins imposed in order to limit the prices of goods and services through the analysis of cost structures (for example, in Venezuela, a maximum profit margin has been introduced that is set annually by the Superintendence for Defense of Socioeconomic Rights).

Any of the foregoing may adversely affect the business, financial position, results of operations and cash flows of the Group.

**The Group's financial condition and results of operations may be adversely affected if it does not effectively manage its exposure to foreign currency exchange rates or interest rates.**

At December 31, 2016, 50.8% of the Group's net debt (in nominal terms) was pegged to fixed interest rates for over a year, while 20% was denominated in a currency other than the euro. At December 31, 2016, the net financial debt ratio in Latin American currencies was 13%.

To illustrate the sensitivity of financial expenses to a change in short-term interest rates at December 31, 2016: (i) a 100 basis points increase in interest rates in all currencies in which Telefónica has a financial position at that date would lead to an increase in financial expenses of 232 million euros for the year ended December 31, 2016, (ii) whereas a 100 basis points decrease in interest rates in all currencies (even if negative interest rates are reached), would lead to a reduction in financial expenses of 201 million euros for the year ended December 31, 2016. These calculations were made assuming a constant currency and balance position equivalent to the position at year end taking into account the derivative financial instruments arranged.

According to the Group's calculations, the impact on results arising from a 10% depreciation of Latin American currencies against the US dollar and a 10% depreciation of other global currencies against the euro, excluding the pound sterling, would result in exchange losses of 43 million euros for the year ended December 31, 2016, primarily due to the depreciation of the Venezuelan bolívar and, to a lesser extent, the Argentinean peso. These calculations were made assuming a constant currency financial position with an impact on profit or loss for the year ended December 31, 2016, including derivative instruments in place.

During 2016, Telefónica Brazil represented 24.6% (27.0% in 2015), Telefónica Latin America represented 23.0% (32.9% in 2015) and Telefónica United Kingdom represented 11.3% (14.6% in 2015) of the operating income before depreciation and amortization (OIBDA) of the Telefónica Group.

The Telefónica Group uses a variety of strategies to manage this risk, among others the use of financial derivatives, which themselves are also exposed to risk, including counterparty risk. However, the Group's risk management strategies may not achieve the desired effect, which could adversely affect the Group's business, financial condition, results of operations and cash flows.

**Existing or worsening conditions in the financial markets may limit the Group's ability to finance, and consequently, the ability to carry out its business plan.**

The performance, expansion and improvement of the Telefónica Group's networks, the development and distribution of the Telefónica Group's services and products, the implementation of Telefónica's strategic plan and new technologies, the renewal of licenses or the expansion of the Telefónica Group's business in countries where it operates, may require a substantial amount of financing.

A decrease in the liquidity of Telefónica, a difficulty in refinancing maturing debt or raising new funds as debt or equity could force Telefónica to use resources allocated to investments or other commitments to pay its financial debt, which could have a negative effect on the Group's business, financial condition, results of operations and/or cash flows.

Funding could be more difficult and costly in the event of a significant deterioration of conditions in the international or local financial markets due to the uncertainties regarding the hikes in interest rates on the part of the US Federal Reserve and the oil prices instabilities, or if there is an eventual deterioration in the solvency or operating performance of Telefónica.

At December 31, 2016, gross financial debt scheduled to mature in 2017 amounted to 13,326 million euros (which includes the net position of derivative financial instruments and certain current payables), and gross financial debt scheduled to mature in 2018 amounted to 7,195 million euros.

In accordance with its liquidity policy, Telefónica has covered its gross debt maturities over the next twelve months with cash and credit lines available at December 31, 2016. Telefónica's liquidity could be affected if market conditions make it difficult to renew existing undrawn credit lines, 8% of which, at December 31, 2016, were scheduled to mature prior to December 31, 2017.

In addition, given the interrelation between economic growth and financial stability, the materialization of any of the economic, political and exchange rate risks referred to above could lead to a negative impact on the availability and cost of Telefónica's financing and its liquidity strategy which could have a negative effect on the Group's business, financial condition, results of operations and/or cash flows.

**Adoption of new accounting standards could affect reported results and financial position.**

Accounting Standardization Bodies and other authorities may periodically change accounting regulations that govern the preparation of the Group's consolidated financial statements. Those changes could have a significant impact on the way the Group accounts and presents its financial position and its operating income. In some instances, a modified standard or a new requirement with retroactive nature must be implemented, which requires the Group to restate previous financial statements.

See details of the implementation of new standards and interpretations issued in Note 3 of the Consolidated Financial Statements. In particular, Telefónica is required to adopt the new accounting standards IFRS15 Revenue from Contracts with Customers, effective from January 1, 2018, and IFRS 16 Leases, effective for the financial years from January 1, 2019. These standards present significant changes that could affect both the amount and moment of recognition of revenues and expenses related with certain sales transactions, as well as the accounting treatment for all lease contracts (other than short-term leases and leases of low-value assets). These changes could have a material impact on the Group's financial statements. Such impact is under analysis as of the date of this document.

**Risks relating to the Group's Industry****The Group operates in a highly regulated industry which requires government concessions for the provision of a large part of its services and the use of spectrum, which is a scarce and costly resource.**

The telecommunications sector is subject to laws and sector-specific regulations in the majority of the countries where the Group provides its services. Additionally, many of the services the Group provides require the granting of a license, concession or official approval, which usually requires certain obligations and investments to be made, such as those relating to the acquisition of spectrum. Among the main risks of this nature are those related to spectrum regulation and licenses/concessions, rates, universal service regulation, regulated wholesale services over fiber networks, privacy, functional separation of businesses and network neutrality. The fact that the Group's business is highly regulated both affects its revenues and imposes costs on its operations.

Thus, as the Group provides most of its services under licenses, authorizations or concessions, it is vulnerable to administrative bodies' decisions, such as economic fines for serious breaches in the provision of services and, potentially, revocation or failure to renew these licenses, authorizations or concessions, or the granting of new licenses to competitors for the provisions of services in a specific market.

In this regard, the Telefónica Group pursues its license renewals on the terms referred in their respective contractual conditions, though it cannot guarantee that it will always complete this process successfully or under the most beneficial terms for the Group. In many cases complying with certain obligations is required, including, among others, minimum specified quality, service and coverage standards and capital investment. Failure to comply with these obligations could result in the imposition of fines, revision of the contractual terms, or even the revocation of the license, authorization or concession.

Additionally, the Telefónica Group could be affected by regulatory actions carried out by the antitrust authorities. These authorities could prohibit certain actions, such as new acquisitions or specific practices, create obligations or lead to heavy fines. Any such measures implemented by the competition authorities could result in economic and/or reputational loss for the Group, in addition to a loss of market share and/or harm to the future growth of certain businesses. Regarding the merger of Telefónica Deutschland Holding AG and E-Plus, other providers such as United Internet and the regional cable operator Airdata lodged an appeal before the General Court against the decision of the EU which authorized such merger. Telefónica Deutschland has been accepted as an interested party of the process and it has presented its statements in both cases. United Internet has lodged a second appeal against the EC in relation to the content of the letter of commitment assumed by Telefónica Deutschland regarding the implementation of remedies for non-network operators. In December 2016, each of Mass Response Service GmbH and Multiconnect GmbH filed an appeal before the General Court against the decision of the EU that Telefónica Deutschland is not obliged to grant access to Full-Mobile Virtual Network Operators ("MVNO") under the non-MNO remedy of the commitments. Telefónica Deutschland will apply for leave to intervene as an interested party.

#### *Regulation of spectrum and access to new government licenses/concessions of spectrum*

On September 14, 2016, the EC adopted, among other texts, a proposed Directive for the establishment of a European Electronic Communication Code, which could have significant implications, inter alia, for access to networks, spectrum use, auction conditions, duration and renewal of licenses, universal service, consumer protection, audiovisual services and platforms. It is estimated that the approval of such regulatory framework will take place in a year and a half.

On December 14, 2016, the European Parliament and Council agreed on a decision regarding the use and availability of the 700 MHz band. This could require new cash outflows from Telefónica between 2017 and 2022 in both the United Kingdom and Spain, where it is expected that the 700 MHz band will be available between 2020-2022. In connection with spectrum auctions for 2.3 and 3.4 GHz band, in the United Kingdom, Ofcom issued a consultation document on November 21, 2016. Responses were due by January 30, 2017, and a decision is expected in the second quarter of 2017. In Germany, the regulatory agency for electricity, gas, telecommunications, post and railway ("BNetzA") initiated a proceeding for the demand-oriented allocation of new frequencies for the further rollout of digital 5G infrastructures, which include the timely allocation of the 2 GHz spectrum expiring at the end of 2020 and 2025 (so called UMTS spectrum) and further spectrum (inter alia 3.5 GHz). A decision about the allocation procedure is expected towards the end of 2017 and an auction may take place in 2018 or 2019.

In Latin America, spectrum auctions are expected to take place requiring potential cash outflows to obtain additional spectrum or to meet the coverage requirements associated with these licenses. Specifically, the procedures expected to take place in 2017-2018, in the relevant jurisdiction for the Group, are:

- Mexico: An auction spectrum in the 2500 MHz band is expected to take place between the third quarter of 2017 and the second quarter of 2018. A wholesale network tender, which will offer services in the 700 MHz band was concluded on November 17, 2016. Altán was the tender winner and the commercial operations must begin no later than March 31, 2018.
- Colombia: The Ministry of Information Technologies and Communications during 2017 published for commentaries until March 7, the project of resolution with the conditions for an auction of 70 MHz of spectrum band in 700 MHz and 5 MHz in 1900 MHz. In addition, the Ministry published a project of decree increasing the spectrum cap for lower bands to 45 MHz and 90 MHz for upper bands. The schedule for the auction has not been set yet.

- Argentina: The Government instructed the regulatory authority to issue new regulations during 2017 to ensure the reassignment of frequencies of the radio spectrum for the provision of wireless or fixed wireless services and enables the reassignment of frequencies previously granted to other provider.

However, it is likely that some of these spectrum tender procedures will not be completed, or even initiated in the mentioned dates. In addition to the above, it may be the case that certain administrations may not yet have announced their intention to release new spectrum but may do so during 2017. The above does not include processes announced via general statements by administrations, which involve bands not key to Telefónica's needs. Furthermore, Telefónica may also seek to acquire spectrum on the secondary market where opportunities might arise.

#### *Risks relating to concessions and licenses previously granted*

The terms of concessions and licenses granted to the Group and necessary for the provision of its services may be challenged or amended by the regulators at any time, which may materially adversely affect its business, financial condition, results of operations and cash flows.

The German regulator initiated consultations in March and July 2016 on the frequency distribution after the merger between Telefónica Deutschland and E-Plus, particularly in the 2 GHz band and on the future spectrum allocation for 5G band. The result of such consultations could lead, among others, to proposals by the regulator reorganizing the spectrum that Telefónica Deutschland holds on the 2 GHz band.

In the United Kingdom, Telefónica has an obligation in its 800 MHz spectrum license to provide indoor coverage to 98% of the United Kingdom population (and 95% of the population of each of England, Wales, Scotland and Northern Ireland) and an obligation in its 900/1800 MHz spectrum license to provide voice and text services to 90% of the United Kingdom landmass, both by the end of 2017, to be maintained, thereafter. Inherent with these obligations is a risk of Telefónica United Kingdom not meeting the required targets. Telefónica United Kingdom is actively working towards mitigating the risk through the continuous investment in an infrastructure improvement program, upgrading its 2G and 3G Networks and continued roll-out of its 4G Network.

In the state of São Paulo, Telefónica Brazil provides local and national long-distance Fixed Switched Telephony Service ("**STFC**") under the so-called public regime, through a concession agreement, which is expected to remain in force until 2025. In accordance with current regulations, Telefónica Brasil informed the Brazilian regulatory authority (Agencia Nacional de Telecomunicações or "**ANATEL**") that the net value, as of December 31, 2015, of assets assigned to the provision of STFC (which include, among others, switching and transmission equipment and public use terminals, external network equipment, energy equipment and system and operation support equipment) were estimated to total 7.8 billion Brazilian reais. At December 31, 2016, this value is estimated to total 8,813,916 Brazilian reais (this value will be updated in the second half of 2017). In principle, the assets assigned to the provision of STFC were considered reversible assets. During the last months, a Bill amending the regulatory framework in Brazil has been processed, establishing, among others, that such assets will no longer be reversible under the new licenses regime in exchange for significant broadband investment commitments. Recently, the processing at the Senate of such bill has been challenged before the Federal Supreme Court. Such Court and, consequently, the Senate's governing board has decided to send the Telecom bill for voting in Plenary. With the Bill being sent to the plenary, it could be understood that there is no more dispute for the Supreme Court to decide upon. In case that the bill is finally approved, ANATEL will be entitled to adopt the pertinent administrative decisions for the transformation of the respective licenses with the consequent modification of the future binding obligations to STFC providers.

In Colombia, the Ministry of Information Technologies and Communications ("**ITC**") issued Resolution 597 on March 27, 2014, to renew 850 MHz/1900 MHz licenses for 10 additional years. However, the reversion of assets (other than radio frequencies, which it is clear that must be returned) and its scope was widely discussed between the relevant mobile operators (including Telefónica Colombia) and the ITC in the context of the liquidation of the previous concession contract, taking into consideration the terms of the contract, and the Constitutional Court's interpretation of Law 422 of 1998 and Law 1341 of 2009. Discussions on the matter concluded on February 16, 2016, when the ITC convened an arbitration proceeding, in accordance with in the terms of the relevant concession contract. The relevant concession holders (including Telefónica Colombia) filed a response to the claim prompted by the ITC. The arbitration process is still ongoing.

In Peru, Telefónica has concessions for the provision of the fixed-line service until November 2027. In December 2013, Telefónica filed a partial renewal request for these concessions for five more years. In December 2014 and June 2016,

Telefónica also filed a renewal request for twenty more years in relation to a concession for the provision of local carrier service and one of the concessions to provide mobile-line services in provinces, respectively. As of the date of this document, the decision of the Ministry of Transport and Communications (Ministerio de Transportes y Comunicaciones) in all such proceedings is still pending and according to the legislation, the concessions subject of these procedures remain in force as long as the procedures are in progress.

Telefónica Móviles Chile, S.A. was awarded 2x10 MHz spectrum on the 700 MHz band in March 2014. A claim was brought by a consumer organization against the 700 MHz assignments. The decision by the Supreme Court on the appeal presented by such consumer organization is still pending.

During the year ended December 31, 2016, the Group's consolidated investment in spectrum acquisitions and renewals amounted to 345 million euros.

The Group's failure to obtain sufficient or appropriate spectrum capacity in the jurisdictions discussed above or any others in which it operates, or its inability to assume the related costs, could have an adverse impact on its ability to launch and provide new services and on Telefónica's ability to maintain the quality of existing services, which may adversely affect the Group's business, financial condition, results of operations and cash flows.

#### *Regulation of wholesale and retail charges*

The European Regulation 2015/2120 on Net Neutrality and Roaming was adopted on November 25, 2015. From June 15, 2017, operators may not charge roaming users within the EU an additional fee on their domestic prices for roaming calls, SMS and data services. However, in some circumstances, operators may apply consumption limits and additional surcharge under a "fair use policy". In January 2017, wholesale roaming caps have been agreed between the Council and the Parliament and the maximum wholesale caps have been set at the following limits: 0.01€/sms; 0.032€/minute; data services glide path: 7.7€/GB (June – December 2017); 6€/GB (2018); 4.5€/GB (2019); 3.5€/GB (2020); 3€/GB (2021) and 2.5€/GB (2022).

On September 14, 2016, the EC presented its proposal of the regulatory framework which, among other measures, intends to incorporate a European methodology and a European upper limit for the call-termination prices for landline phone/ mobile phone applicable in EU.

The decreases in wholesale mobile termination rates ("MTR") in Europe are also noteworthy. In the United Kingdom, the current rate is 0.503 ppm. A further cut to 0.495 ppm will come into effect from April 1, 2017.

In Germany, on August 30, 2016, BNetzA adopted a regulatory decision, which considers with pure long run incremental cost ("LRIC") a new cost model for the calculation of MTR. Telefónica Deutschland has appealed the decision in court, but the appeal has not yet been decided. BNetzA approved new MTR on November 30, 2016, in a provisional decision, which sets the rates to 0.011 euro/minute as of December 1, 2016, to 0.0107 euro/minute as of December 1, 2017, and to 0.0095 euro/minute as of December 1, 2018, until the end of November 2019. Before taking a final decision, the new MTR are nationally consulted and notified to the EC. There is consequently a risk that when the new MTR are approved (which will be retroactively enforceable from December 1, 2016), and the new termination rates applicable from January 1, 2017, the rates will significantly decrease. Regarding fixed networks termination rates, BNetzA adopted end of January 2017 a provisional decision which establish a tariff of 0.0010 €/minute.

In Spain, on July 1, 2016, the Spanish National Regulatory and Competition Authority (Comisión Nacional de los Mercados y la Competencia or "CNMC") initiated the process of reviewing the prices of mobile termination, with a final decision expected to be adopted during 2017.

Additionally, on January 17, 2017, the CNMC issued the analysis of the market for access and call origination on fixed networks. The CNMC maintains the obligation of Telefónica, as an operator with significant market power, to provide a wholesale interconnection offer and a wholesale line rental ("WLR"), both with cost-oriented prices regarding manufacturing costs and the adoption of a management accounting system. Telefónica is equally obliged to non-discrimination, transparency and separation of accounts. In Latin America, it is likely that MTRs will also be reduced in the short to medium term.

In Brazil, ANATEL has issued ex-ante regulations to ensure competition in the wholesale market, which includes reductions of the MTR. In this regard, the Plano Geral de Metas de Competição ("PGMC"), amended by Resolution 649/2015, established that mobile termination fees are subject to successive yearly reductions from 2016 until 2019, when the definitive cost-oriented-model fees are expected to be in force (such Resolution has been challenged in courts

without a definitive outcome). On December 5, 2016, ANATEL issued a public consultation for the revision of the PGMC, which addresses changes in the relevant wholesale markets regulated by the PGMC and also in the cost-oriented model. The mentioned public consultation is available for comments until March 22, 2017.

In Mexico, on September 23, 2016, the Instituto Federal de Telecomunicaciones (“IFT”) announced that the MTRs applicable to operators different from the so-called Prevailing Economic Agent for 2017 will be 0.1906 pesos per minute, as long as the regulatory asymmetry of the Prevailing Economic Agent introduced by Mexico with the constitutional reform on 2014 and the new Federal Telecommunication Law on 2014 remains in effect.

In Colombia, the Comisión de Regulación de Comunicaciones (“CRC”) published a regulatory project for public comments in November 2016. In the project the CRC proposes a symmetric termination rate of 11.17 COP per minute and 4.3 million COP per monthly capacity from 2017 for established operators and an asymmetric termination rate of 19.01 COP per minute and 7.6 million COP per monthly capacity for challenger operators in a five-year period. The CRC also proposes regulatory measures to promote the entry of mobile virtual network operators (“MVNOs”), including the regulation of prices for the access to the mobile networks. The project is still in debate.

In Peru, the Organismo Supervisor de las Telecomunicaciones (“OSIPTEL”) started the process for the revision of the values on charges of interconnection for mobile termination of calls in telecommunication services networks in November 2016. The new values established by OSIPTEL will apply as of the fourth quarter of 2017.

As a result of the foregoing regulatory actions, Telefónica may receive lower prices for certain of its services, which may materially adversely affect its business, financial condition, results of operations and cash flows.

#### *Regulation of Universal Services*

The Universal Service (“US”) is an economic and legal term, which refers to the obligation imposed to telecommunication operators to provide a basic service to all inhabitants of a country. In general, the goal is to promote quality services availability at affordable, reasonable and fair prices, to increase the access to advanced telecommunication services (such as broadband) and to move forward with the availability of such services to all customers. On its reform proposal for the regulatory framework issued on September 14, 2016, the EC seeks to modernize the Universal Services area in Europe, removing the mandatory inclusion of the traditional services (telephone boxes, directories and information services) and focusing on the provision of affordable broadband services. The EC also proposed that the US must be funded from general budgets and not from sectorial budgets. However, if this funding method does not thrive, the affordable broadband inclusion could result more expensive for the sector. In any case, it is estimated that the new regulation will not be applicable before 2020.

In Spain, the licenses of Telefónica de España and Telefónica Telecomunicaciones Públicas for the provision of USs expired on December 31, 2016. Both companies have been designated for the provision of these services from January 1, 2017.

In Brazil, on December 15, 2016, a proposal of the General Plan for Universalisation of Fixed Switched Telephony Services (“PGMU”) was approved by ANATEL.

The imposition on the Telefónica Group of additional or more onerous obligations to provide US services in the jurisdictions where it operates could have a material adverse effect on its business, financial condition, results of operations and cash flows.

#### *Regulation of fiber networks*

On February 24, 2016, the Spanish CNMC adopted a final resolution on the wholesale broadband market regulation, which raises a geographical segmentation in competitive (66 cities, 34% of total population) and non-competitive areas. It is anticipated that this resolution will last for at least four years. Its implementation is expected to result in a moderate increase of the current regulatory obligations of Telefónica in Spain, in terms of its granting of access to other operators to its fiber network and with respect to certain aspects relating specifically to the business segment (high quality bitstream service for business customers with national coverage). This Resolution has been appealed by Telefónica España. Additionally, on January 18, 2016, the CNMC adopted a resolution which approves the reference offer of the new wholesale unbundled virtual access service to Telefónica's new broadband Ethernet service (local NEBA). The NEBA service should be operative in 12 months from the date of the resolution's adoption.



Any of such obligations and restrictions could raise costs and limit Telefónica's freedom to provide the mentioned services, which could materially adversely affect Telefónica's business, financial condition, results of operations and cash flows.

#### *Regulations on privacy*

An intense data protection and privacy regulation may result in limitations to offer innovative digital services such as Big Data services. In Europe the new General Data Protection Regulation ("**GDPR**") of April 27, 2016, will be directly applicable in all member States from May 25, 2018. The GDPR introduces administrative fines of up to 4% of an undertaking's annual global turnover for breaching the new data protection rules.

On January 10, 2017, the EC presented its proposal for a regulation on ePrivacy, which will replace the current Directive 2002/58/EC on privacy in the electronic communications sector and will complement the recently approved GDPR. The proposal also introduces administrative fines of up to 4% of an undertaking's annual global turnover for breaching new regulations.

In October 2015, the Court of Justice of the European Union declared invalid the decision of the EC as regards the "Safe Harbor Agreement" relating to the transfer of personal data from the EU to the United States. Subsequently, the EC adopted a new decision on Privacy Shield on July 12, 2016, which considers that there is an adequate level of protection of personal data transferred from the EU to US self-certified companies complying with the Privacy Shield principles. Telefónica USA, Inc. has self-certified itself as Privacy Shield compliant. The Privacy Shield has been challenged before the EU's General Court by civil-society groups, but the admission of their appeals is still pending.

In Brazil, the adoption of a Personal Data Protection Act is still pending, this could lead to further obligations and restrictions for operators in relation to the collection of personal data and its treatment.

Any of such obligations and restrictions could raise costs and limit Telefónica's ability to provide certain services, which could materially adversely affect Telefónica's business, financial condition, results of operations and cash flows.

#### *Regulation of network neutrality*

Under the principle of network neutrality applicable to Internet access services area, network operators could not establish technical or commercial restrictions regarding the terminals that can be connected or the services, or applications and contents that can be accessed or distributed through the Internet by the end user. It also refers to the non-discriminatory behaviour (e.g. non-anticompetitive) to be adopted by operators regarding the different types of Internet traffic circulating through their networks.

In Europe, the application of the so-called "net neutrality Regulation" (Regulation (EU) 2015/2120 of November 25, 2015) will be monitored by national regulatory authorities following guidance to be delivered by the European Regulatory Authority ("**BEREC**") on August 30, 2016. This guidance could directly impact internet access service commercial practices (for example, some zero rating offers) and it may limit network management practices or increase transparency requirements on the Internet Access Service.

Telefónica operates in Latin American countries where net neutrality is being implemented, such as Chile, Colombia, Mexico and Peru, where OSIPTEL adopted regulations aimed at providing clear guidelines on the implementation of the net neutrality regime adopted in 2012 and in force since January 1, 2017. In Brazil, the President approved a net neutrality decree (regulating Marco Civil) on May 11, 2016. In Mexico, the IFT scheduled a public consultation to be carried out in August 2016 in respect of the guidelines that will be issued regarding net neutrality, which was postponed to the first quarter 2017. In Chile, on November 22, 2016, the Commission of Telecommunications submitted a bill for amending the Network Neutrality Act. The main changes are the establishment of rules more restricted to apply measures for traffic management and restrictive rules for "Zero Rating". If changes to regulation such as those described above, or otherwise, occur in the various jurisdictions where the Telefónica Group operates, it could have a material adverse effect on its business, financial condition, results of operations and cash flows.

**The Telefónica Group is exposed to risks in relation to compliance with anti-corruption laws and regulations and economic sanctions programs.**

The Telefónica Group is required to comply with the laws and regulations of various jurisdictions where it conducts operations. In particular, the Group's international operations are subject to various anti-corruption laws, including the US Foreign Corrupt Practices Act of 1977 and the United Kingdom Bribery Act of 2010, and economic sanctions programs, including those administered by the United Nations, the European Union and the United States, including the US Treasury Department's Office of Foreign Assets Control. The anti-corruption laws generally prohibit providing anything of value to government officials for the purposes of obtaining or retaining business or securing any improper business advantage. As part of the Telefónica Group's business, it may deal with entities, the employees of which are considered government officials. In addition, economic sanctions programs restrict the Group's business dealings with certain sanctioned countries, individuals and entities.

Although the Group has internal policies and procedures designed to ensure compliance with applicable anti-corruption laws and sanctions regulations, there can be no assurance that such policies and procedures will be sufficient or that the Group's employees, directors, officers, partners, agents and service providers will not take actions in violation of the Group's policies and procedures (or otherwise in violation of the relevant anti-corruption laws and sanctions regulations) for which the Group or they may be ultimately held responsible. Violations of anti-corruption laws and sanctions regulations could lead to financial penalties, exclusion from government contracts, damage to the Group's reputation and other consequences that could have a material adverse effect on the Group's business, results of operations and financial condition.

Telefónica is currently conducting internal investigations covering various countries regarding possible violations of applicable anti-corruption laws. Telefónica has been in contact with governmental authorities about these matters and intends to cooperate with those authorities as the investigations continue. It is not possible at this time to predict the scope or duration of these matters or their likely outcome.

**Customers' perceptions of services offered by the Company may put it at a disadvantage compared to competitors' offerings.**

Customers' perceptions of the assistance and services offered are critical to operating in highly-competitive markets. The ability to predict and respond to the changing needs and demands of customers affects the Company's competitive position relative to other technology sector companies, and its ability to extract the value generated during this process of transformation. Failure to do so adequately could have an adverse impact on the Group's business, financial condition, results of operations and cash flows.

**Telefónica may not be able to adequately foresee and respond to technological changes and sector trends.**

In a sector characterized by rapid technological change, it is essential to be able to offer the products and services demanded by the market and consider the impacts of changes in the life cycle of technical assets, secure margins and select the right investments to make.

The Telefónica Group operates in markets that are highly competitive and subject to constant technological development. Therefore, as a consequence of both of these characteristics, it is subject to the effects of actions by competitors in these markets and to its ability to anticipate and adapt, in a timely manner, to constant technological changes, changes in customer preferences that are taking place in the industry, as well as economic, political and social circumstances.

Failure to do so adequately could have an adverse effect on the Group's business, financial condition, results of operations and cash flows.

New products and technologies arise constantly, and their development can render obsolete the products and services the Telefónica Group offers and the technology it uses. This means that Telefónica must invest in the development of new products, technology and services so it can continue to compete effectively with current or future competitors, which may result in the decrease of the Group's profits and revenue margins. In this respect, margins from traditional voice and data business are shrinking, while new sources of revenues are deriving from mobile Internet and connectivity services that are being launched. Research and development costs amounted to 906 million euros in 2016, representing a decrease of 14.1% from 1,055 million euros in 2015 (1,111 million euros in 2014). These expenses represented 1.7%, 1.9% and 2.2% of the Group's consolidated revenues in 2016, 2015 and 2014, respectively. These figures have been calculated using the guidelines established in the Organization for Economic Cooperation and Development ("OECD") manual. One technology that telecommunications operators, including Telefónica (in Spain and Latin America), are focused on is the new FTTx-type network, which offers broadband access using optical fiber with superior services, such as Internet speed

of up to 300MB or HD television services. However, substantial investment is required to deploy these networks, which entails fully or partially substituting copper loop access with optic fiber. While an increasing demand for the capabilities offered by these new networks to end users exists, the high level of the investments requires a continuous analysis of the return on investment.

The explosion of the digital market and entry of new players in the communications market, such as MVNOs, Internet companies or device manufacturers, may cause the loss of value of certain assets, and affect the Group's ability to generate income. Therefore, it is necessary to update the business model, encouraging the pursuit of incomes and additional efficiencies to those followed traditionally. Failure to do so adequately could have an adverse effect on the Group's business, financial condition, results of operations and cash flows.

In addition, the ability of the Telefónica Group's IT systems (operational and backup) to respond to Telefónica's operating requirements is a key factor to be taken into account with respect to the commercial development, customer satisfaction and business efficiency. Any failure by the Telefónica Group's IT systems to adequately respond to the Group's evolving operating requirements could have an adverse effect on the Group's business, financial condition and results of operations.

#### **Telefónica depends on its suppliers.**

The existence of critical suppliers in the supply chain, especially in areas such as network infrastructure, information systems or handsets, with a high concentration in a small number of suppliers, poses risks that may affect Telefónica's operations, and may cause legal contingencies or damages to its image in the event that inappropriate practices are produced by a participant in the supply chain.

As of December 31, 2016, the Telefónica Group depended on three handset suppliers and 12 network infrastructure suppliers, which together accounted for 80% of the awarded contracts for the year then ended. These suppliers may, among other things, extend delivery times, raise prices and limit supply due to their own stock shortfalls and business requirements.

If these suppliers fail to deliver products and services to the Telefónica Group on a timely basis, it could jeopardize network deployment and expansion plans, which in some cases could adversely affect the Telefónica Group's ability to satisfy its license terms and requirements, or otherwise have an adverse effect on the Group's business, financial condition, results of operations and cash flows.

#### **Unanticipated network interruptions can lead to quality loss or the interruption of the service.**

Unanticipated network interruptions as a result of system failures, including those due to network, hardware or software, stealing of infrastructure elements or cyber-attacks, which affect the quality of or cause an interruption in the Telefónica Group's service, could lead to customer dissatisfaction, reduced revenues and traffic, costly repairs, penalties or other measures imposed by regulatory authorities and could harm the Telefónica Group's image and reputation.

Telecommunications companies worldwide face increasing cybersecurity threats as businesses become increasingly dependent on telecommunications and computer networks and adopt cloud computing technologies. Cybersecurity threats include gaining unauthorized access to Telefónica's systems or inserting computer viruses or malicious software in its systems to misappropriate consumer data and other sensitive information, corrupt Telefónica's data or disrupt its operations. Unauthorized access may also be gained through traditional means such as the theft of laptop computers, portable data devices and mobile phones and intelligence gathering on employees with access.

Telefónica attempts to mitigate these risks through a number of measures, including backup systems and protective systems such as firewalls, virus scanners and other physical and logical security. However, these measures are not always effective. Although the Telefónica Group has insurance policies to cover these types of incidents, and the claims and loss in revenue caused by service interruptions to date have been covered by these policies, these policies may not be sufficient to cover all possible monetary losses.

#### **The telecommunications industry may be affected by the possible effects that electromagnetic fields, emitted by mobile devices and base stations, may have on human health.**

In some countries, there is a concern regarding potential effects of electromagnetic fields, emitted by mobile devices and base stations, on human health. This public concern has caused certain governments and administrations to take measures that have hindered the deployment of the infrastructures necessary to ensure quality of service, and affected the deployment criteria of new networks and digital services such as smart meters development.

There is a consensus between certain expert groups and public health agencies, including the World Health Organization that states that currently there are no established risks associated with exposure to low frequency signals in mobile communications. However, the scientific community is still investigating this issue especially with respect to mobile devices. Exposure limits for radio frequency suggested in the guidelines of the Protection of Non-Ionizing Radiation Protection Committee have been internationally recognized. The mobile industry has adopted these exposure limits and works to request authorities worldwide to adopt these standards.

Worries about radio frequency emissions may discourage the use of mobile devices and new digital services, which could cause the public authorities to implement measures restricting where transmitters and cell sites can be located, how they operate, the use of mobile telephones and the massive deployment of smart meters and other products using mobile technology. This could lead to Telefónica being unable to expand or improve its mobile network.

The adoption of new measures by governments or administrations or other regulatory interventions in this respect, and any future assessment on the adverse impact of electromagnetic fields on health, may adversely affect the business, financial conditions, results of operations and cash flows of the Telefónica Group.

**Possible regulatory, business, economic or political changes could lead to asset impairment.**

The Telefónica Group reviews on an annual basis, or more frequently when the circumstances require it, the value of assets and cash-generating units, to assess whether their carrying values can be supported by the future expected cash flows, including, in some cases synergies allowed for in acquisition costs. Potential changes in the regulatory, business, economic or political environment may result in the need to introduce changes to estimates made and to recognize impairments in goodwill, intangible assets or fixed assets. Although the recognition of impairments of property, plant and equipment, intangible assets and financial assets results in a non-cash charge on the income statement, it could adversely affect the results of the Telefónica Group's operations. In this respect, the Telefónica Group has experienced impairments on certain of its investments, affecting its results of operations in the year in which they were experienced. In 2016, impairment losses in goodwill were recognized amounting to 215 million euros for Telefónica operations in Venezuela (124 million euros) and Mexico (91 million euros).

**The Telefónica Group's networks carry and store large volumes of confidential, personal and corporate data, and its Internet access and hosting services may lead to claims for illegal or illicit use of the Internet.**

The Telefónica Group's networks carry and store large volumes of confidential, personal and business data, through both voice and data traffic. The Telefónica Group stores increasing quantities and types of customer data in both business and consumer segments. Despite its best efforts to prevent it, the Telefónica Group may be found liable for any loss, transfer, or inappropriate modification of the customer data or general public data stored on its servers or transmitted through its networks, any of which could involve many people and have an impact on the Group's reputation, or lead to legal claims and liabilities that are difficult to measure in advance.

In addition, the Telefónica Group's Internet access and hosting servers could lead to claims for illegal or unlawful use of the Internet. Telefónica, like other telecommunications providers, may be held liable for any loss, transfer or inappropriate modification of the customer data stored on its servers or carried by its networks.

In most countries in which the Telefónica Group operates, the provision of its Internet access and hosting services (including the operation of websites with shelf-generated content) are regulated under a limited liability regime applicable to the content that it makes available to the public as a technical service provider, particularly content protected by copyright or similar laws. However, regulatory changes have been introduced imposing additional obligations on access providers (such as blocking access to a website) as part of the struggle against some illegal or illicit uses of the Internet, notably in Europe.

Any of the foregoing could have an adverse effect on the business, financial position, results of operations and cash flows of the Group.

**Telefónica and Telefónica Group companies are party to lawsuits, tax claims, antitrust and other legal proceedings.**

Telefónica and Telefónica Group companies are party to lawsuits, tax claims, antitrust and other legal proceedings in the ordinary course of their businesses, the financial outcome of which is unpredictable. An adverse outcome or settlement in these or other proceedings could result in significant costs and may have a material adverse effect on the Group's business, financial condition, results of operations, reputation and cash flows. In particular, the Telefónica Group is party to certain judicial tax proceedings in Peru concerning the clearance of certain previous years' income tax, in respect of

which a contentious-administrative appeal is currently pending and to certain tax proceedings in Brazil, primarily relating to the ICMS (a Brazilian tax on telecommunication services) and to the Corporate Tax. Further details on these matters are provided in Notes 17 and 20 of the annual accounts.

*Translation of an independent assurance's report on the Internal Control over Financial Reporting originally issued in Spanish. In the event of a discrepancy, the Spanish-language version prevails*

## INDEPENDENT ASSURANCE 'S REPORT ON THE INTERNAL CONTROL OVER FINANCIAL REPORTING (ICFR)

To the Board of Directors of  
Telefónica, S.A., engaged by the management

### *Scope of the Work*

We have examined the description of the Internal Control over Financial Reporting (ICFR or "System") of Telefónica, S.A. (the Parent Company) and subsidiaries (the Group) contained in Section F of the Annual Corporate Governance Report for the year ended December 31, 2016.

The objective of this System is to contribute to the transactions performed being presented fairly under the aforementioned accounting framework and to provide reasonable assurance in relation to the prevention or detection of any errors that might have a material effect on the consolidated financial statements.

The aforementioned System is based on the rules and policies defined by Group management in accordance with the guidelines established by the *Committee of Sponsoring Organizations of the Treadway Commission (COSO)* in its report "*Internal Control - Integrated Framework*" (2013).

A system of internal control over financial reporting is a process designed to provide reasonable assurance on the reliability of financial information in accordance with the accounting principles and standards applicable to it. A system of internal control over financial reporting includes policies and procedures that: (i) enable the records reflecting the transactions performed to be kept accurately and with a reasonable level of detail; (ii) guarantee that these transactions are performed only in accordance with the authorizations established; (iii) provide reasonable assurance as the proper recognition of transaction to make it possible to prepare the financial information in accordance with the accounting principles and standards applicable to it; and (iv) provide reasonable assurance in relation to the prevention or timely detection of unauthorized acquisitions, uses or sales of Group assets which could have a material effect on the financial information. In view of the limitation inherent to any system of internal control over financial reporting, certain errors, irregularities of fraud may not be detected. Also, the projection to future periods of an evaluation of internal control is subject to risks, including the risk that internal control may be rendered inadequate as a result of future changes in the applicable conditions or that there may be a reduction in the future of the degree of compliance with the policies or procedures established.

### *Directors' Responsibility*

The Board of Directors of Telefónica, S.A. is responsible for maintaining internal control over the financial reporting included in the consolidated financial statements and for assessing its effectiveness.

### *Our Responsibility*

Our responsibility is to express an opinion on the effectiveness of the Internal Control over the Financial Reporting (ICFR), based on the work performed by us and the obtainment of sufficient evidences.

Our work includes an assessment of the effectiveness of the internal control over financial reporting in relation to the financial information contained in the Group's consolidated financial statements as at December 31, 2016, prepared in accordance with International Financial Reporting Standards as adopted by the European Union and other provisions of the regulatory financial reporting framework applicable to the Telefónica Group in Spain.

Our work was performed in accordance with the requirements established in Standard ISAE 3000 "Assurance Engagements Other than Audits or Reviews of Historical Financial Information" issued by the International Auditing Standards Board (IAASB) of the International Federation of Accountants (IFAC) for the issuance of reasonable assurance reports.

The work performed to obtain reasonable assurance includes obtaining an understanding of the internal control over financial reporting with respect to the financial information included in the consolidated financial statements, assessing the risk that a material weakness exists, testing and evaluation the design and operating effectiveness of internal control based on the assessed risk, and performing such other procedures as we consider necessary in the circumstances. We believe that our examination provides a reasonable basis for our opinion.

### *Independence*

Our work was performed in accordance with the independence standards required by the Code of Ethics of the International Ethics Standards Board of Accountants (IESBA), which are based on the fundamental principles of integrity, objectivity, professional competence, due care, confidentiality and professional behaviour.

In accordance with International Standard on Quality Control (ISQC) 1, our Firm has in place a global system of quality control which includes documented policies and procedures in relation to compliance with ethical requirements, professional standards and applicable legislation.

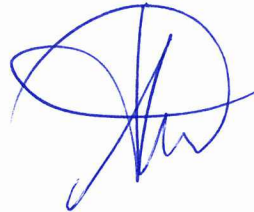
### *Conclusion*

In our opinion, Telefónica, S.A. and subsidiaries maintained, in all material respects, an effective internal control with respect to the financial information contained in the consolidated financial statements as of December 31, 2016, based on the criteria and policies defined by the Board of Directors of Telefónica, S.A. in accordance with the guidelines established by the *Committee of Organizations of the Treadway Commission (COSO)* in its report "*Internal Control-Integrated Framework*"(2013). Furthermore, the disclosures contained in the information relating to the system of ICFR which is included in Note F of the Telefónica Group's Annual Corporate Governance Report at December 31, 2016 are in compliance, in all material respects, with the requirements established by the Spanish Companies Law, the Order ECC/461/2013, of 20 March and Circular 7/2015, of 22 December, as amended by the Spanish Securities Market Commission Circular 5/2013, of 12 June.

*Other matters*

The examination indicated in the preceding paragraphs is not subject to the Spanish Audit Law, so we do not express an audit opinion in the terms provided for in the aforementioned Law. Notwithstanding, we have audited, in accordance with prevailing audit regulations in Spain, the consolidated financial statements of Telefónica, S.A. and subsidiaries at December 31, 2016, prepared by the Parent Company's Directors in accordance with International Financial Reporting Standards, as adopted by the European Union, and other provisions in the regulatory framework applicable to the Group in Spain, and our report dated February 23, 2017 expressed an unqualified opinion on the aforementioned consolidated financial statements.

ERNST & YOUNG, S.L.



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Alicia Martínez Durán

February 23, 2017