

An aerial photograph of a city and its surrounding landscape. A river flows through the city, creating a winding path. The city is densely packed with buildings, and the surrounding area is a mix of green fields and some industrial or commercial zones. The overall scene is a mix of urban and rural environments.

Introduction

We are pleased that
more than 7 out of 10.5 million
Czechs trust in our services.

Independent auditor's report

To the Shareholders of Telefónica Czech Republic, a.s.:

I. We have audited the consolidated financial statements of Telefónica Czech Republic, a.s. and its subsidiaries ("the Group") as at 31 December 2011 presented in the annual report of Telefónica Czech Republic, a.s. ("the Company") on pages 105–169 where we have issued an auditors' report dated 17 February 2012 presented in the annual report on pages 108–109. We have also audited the separate financial statements of the Company as at 31 December 2011, which are presented in the annual report of the Company on pages 171–233 on which we have issued an auditors' report dated 17 February 2012, presented in the annual report of the Company on pages 174–175 (both referred further as "financial statements").

II. We have also audited the consistency of the annual report with the financial statements described above. The management of Telefónica Czech Republic, a.s. is responsible for the accuracy of the annual report. Our responsibility is to express, based on our audit, an opinion on the consistency of the annual report with the financial statements.

We conducted our audit in accordance with International Standards on Auditing and the related implementation guidance issued by the Chamber of Auditors of the Czech Republic. Those standards require that we plan and perform the audit to obtain reasonable assurance as to whether the information presented in the annual report that describes the facts reflected in the financial statements is consistent, in all material respects, with the financial statements. We have checked that the accounting information presented in the annual report on pages 7–103 and 235–241 is consistent with that contained in the audited financial statements as at 31 December 2011. Our work as auditors was confined to checking the annual report with the aforementioned scope and did not include a review of any information other than that drawn from the audited accounting records of the Company. We believe that our audit provides a reasonable basis for our opinion.

Based on our audit, the accounting information presented in the annual report is consistent, in all material respects, with the financial statements described above.

III. In addition, we have reviewed the accuracy of the information contained in the report on related parties of Telefónica Czech Republic, a.s. for the year ended 31 December 2011 presented in the annual report of the Company on pages 243–254. The management of Telefónica Czech Republic, a.s. is responsible for the preparation and accuracy of the report on related parties. Our responsibility is to issue a report based on our review.

We conducted our review in accordance with the applicable International Standard on Review Engagements and the related Czech standard No. 56 issued by the Chamber of Auditors of the Czech Republic. Those standards require that we plan and perform the review to obtain moderate assurance as to whether the report on related parties is free from material misstatement. The review is limited primarily to enquiries of company personnel, to analytical procedures applied to financial data and to examining, on a test basis, the accuracy of information, and thus provides less assurance than an audit. We have not performed an audit and, accordingly, we do not express an audit opinion.

Based on our review, nothing has come to our attention that causes us to believe that the report on related parties of Telefónica Czech Republic, a.s. for the year ended 31 December 2011 is materially misstated.



Ernst & Young Audit, s.r.o.
License No. 401
Represented by



Brian Welsh
Partner



Petr Vácha
Auditor, License No. 1948

5 March 2012
Prague, Czech Republic

Interview with Luis Antonio Malvido, the Chairman of the Board of Directors



What was the year 2011 like for the company?

The year 2011 was full of challenges, but for us – also successes. We managed to reach several important milestones. One of the most important, in my view, is that during the year we captured over 50% market share in mobile contract customers' net additions and close to 50% market share in fixed broadband customers' net additions. We also significantly exceeded our own target in the coverage of the country with the 3rd generation mobile network signal. Whereas at the end of 2010, our 3G network reached 43% of the population, last year on the New Year's Eve, it was already 73%. Of course, we are planning to continue in the fast network rollout also in 2012. I also consider the prestigious award from Via Bona Foundation as a great achievement – we earned it for 17 years of uninterrupted partnership with the Safety Line and the start of Think Big, a social programme for young people, in the Czech Republic.

Investments in mobile networks and fast data services are considered as key, especially as the penetration of smartphones and mobile data services in the Czech Republic is lagging behind the western countries. How successful was the year 2011 in this particular area?

Together with the expansion of our 3G network coverage, we focused on promoting the benefits of smartphones to the people. In June we joined forces with leading industry partners and together launched the campaign 'Now I Know Why', in which we demonstrated to our customers the various advantages of using smart devices and mobile internet. The campaign helped to increase the penetration of smartphones in our customer base to almost 20% and led to a significant upturn in the sales of internet access in the mobile.

The year 2011 was not as kind to the Czech economy as the business sector would have wished. How did you cope with the challenging environment?

The year that has passed was a difficult one for all sectors; the sector of telecommunications was, however, among those that were hit the hardest. The financial results of the Telefónica Czech Republic Group were marked by the increasingly fiercer competition in the corporate and SME segments in particular, and by the cuts in mobile termination rates. Despite this, we delivered on our goals and achieved a robust level of financial performance. We continue to be highly profitable.

Would you say you are satisfied then?

Things can always be better, but we are doing well in a highly competitive market place and we have a number of accomplishments to show for it. It is a very good result, in my view, especially if you consider the 140% SIM card penetration.

How many new customers did you have?

We added more than 100 thousand new mobile customers, whereas in 2010 it was only about five thousand. At the end of the year we had 4.9 million customers, which is about two percent more than the year before. The xDSL internet over a fixed line did also well – despite the fierce competition from cable television providers and local WiFi providers, we added 66 thousand new clients, which is a year-on-year growth of more than eight percent. The launch and subsequent improvements of the VDSL technology, which gives customers twice as fast home internet as before, played a major part in that. That more than a hundred thousand customers, the majority of whom were existing customers, took the opportunity to subscribe the service by the end of 2011 – this helped us relieve some of the ARPU pressure and reduced customer churn. This is something I regard as essential, especially at the current level of competition in the marketplace.

Speaking of fixed access, is it possible to slow down the ongoing rate of decline due to people cancelling fixed lines and keeping only mobile phones? How well did you do in 2011 in this respect?

The fixed access results were satisfactory. Compared to the previous year we succeeded with slowing down the rate of decline – whilst in 2010, more than one hundred thousand accesses were lost; in 2011 it was under ninety thousand. At the end of the year, just fewer than 1.6 million Czech customers kept a fixed line. The slowdown was aided the O2TV proposition becoming even more attractive, in addition to improvements to our xDSL service. Bundling of O2TV with a fixed O2 internet service proved to be very effective due to the economical pricing. People who took up on the offer saved hundreds of crowns off their monthly bill.

During the year we saw a massive campaign to promote telecommunications services to businesses. Is it then a new focus of your company?

Our business clients have always been on the forefront of interest for Telefónica Czech Republic as no other operator can offer such a range of services as we can. Still, the business segment saw several major changes in the last year. In the middle of the year we launched O2 Exclusive, a commercial brand under which we offer converged fixed and mobile voice and data service to business customers. As part of our ongoing effort to improve the quality of customer service in the segment, we phased out the automated voice IVR systems, so that business customers, who are often pressed for time, are put directly through to a live operator. Thirdly, we substantially expanded our portfolio of ICT services.

The success of Telefónica Czech Republic Group is partly down to the subsidiary Telefónica Slovakia. How would you rate its performance in 2011?

The company's results in 2011 positively helped the overall group financial performance. In the fourth quarter of the year, the total number of customers in Slovakia grew 85.1 thousand, which was the largest quarterly gain in 2011; most of the growth was in the contract segment. At the end of 2011, the total number of customers reached 1.164 million, which is a growth of almost one third. In 2011 the share of contract customers continued to rally, reaching 43 % in December. Our share of the Slovak mobile market reached almost 20%.

The year 2012 is expected to be a 'turning point' in the telecommunications sector – which major developments are you expecting personally?

The auction of frequencies for the fourth generation mobile networks (LTE) will be, without doubt, the biggest milestone of the year. The technology allows for a much more efficient infrastructure rollout, with several times faster mobile internet than the present 3G networks, with a much better coverage in the rural areas. We see LTE as a huge opportunity to leapfrog the whole sector of mobile communication forward, and, help Czech business, for example, become much more competitive. We see LTE as a key technology for the future – one that has a lot of potential to affect the whole economy of a country. But whether we succeed depends largely on the conditions which the market regulator, the Czech Telecommunications Office, attaches to the auction. If done right, the frequency auction can help with spreading fast mobile internet to all corners of the Czech Republic – otherwise, if the conditions are not calibrated right, the whole telecommunications market could slow down as a result.

Are you prepared to start building the LTE network already in 2012?

If the auction is fair and conditions permit, then yes. We are interested in the licences and prepared to invest in the new and viable technology. In 2011 Telefónica Czech Republic Group invested a total of CZK 5.6 billion and in 2012 we are prepared to commit for even higher level of investment.

Which factors will influence the results of 2012?

We expect that revenues from fixed and mobile broadband internet, in conjunction with the growing revenues from Slovakia, will be the main drivers of revenue growth in 2012 compared to 2011. At the same time, our performance will be negatively impacted by the expected cuts in mobile interconnection rates and the highly competitive marketplace. We will continue to focus on efficient operating expenditure (simplifying and making more efficient our organisation structure and processes, consolidation and optimisation of our call centre operations), with the view to maintain the best levels of the operating margin. We will also continue to channel our investments to improvements to our broadband data network and increasing the network capacity, in the interest of future growth.

Financial and operational highlights

Financial data is based on audited consolidated financial statements prepared in accordance with International Financial Reporting Standards.

All figures, unless otherwise stated, are in CZK millions as at 31 December of each year.

Financials	2011	2010
Revenues	52,388	55,562
OIBDA – Operating income before finance costs, tax, depreciation and amortization ¹	21,790	27,380
Operating income	10,139	15,524
Income before taxes	10,008	15,318
Net income	8,684	12,280
Total assets	88,892	92,792
Property, plant and equipment	51,525	56,651
Total equity	69,097	73,176
Financial debts	3,061	3,024
Capital expenditure	5,856	5,664

¹ Including impairment reversal/loss. In 2010, the Group posted an impairment reversal of CZK 4,344 million attributable to the fixed-line segment assets, and an impairment loss of CZK 18 million, while in 2011, it recorded an impairment loss of CZK 21 million.

Operations (end of period)		
Fixed accesses (x 1,000)	1,582	1,669
xDSL connections (x 1,000)	872	806
Pay TV – O2 TV (x 1,000)	136	129
Mobile registered customers in Czech Republic (x 1,000)	4,942	4,839
— of which contract	3,049	2,864
pre-paid	1,893	1,975
Active mobile customers in Slovakia (x 1,000)	1,164	880
Group headcount (end of period)	6,890	7,522

Ratios (in %)		
OIBDA margin (OIBDA/Revenues)	41.6	49.1
Net income/Revenues	16.6	22.0
Capital expenditure/Revenues	11.2	10.2
ROA (Net income/Total assets)	9.8	13.2
ROE (Net income/Equity)	12.6	16.8
Gross gearing (Financial debts/Total equity)	4.4	4.1

Macroeconomic indicators ¹		
Population (in millions)	10.5	10.5
GDP growth (in %) ²	1.7	2.2
Inflation (in %)	1.9	1.5
Unemployment (end of period, in %)	8.6	9.6
CZK/USD exchange rate – average over the period	17.7	19.1
CZK/USD exchange rate – end of period	19.9	18.8
CZK/EUR exchange rate – average over the period	24.6	25.3
CZK/EUR exchange rate – end of period	25.8	25.1

¹ Sources: Czech Statistical Office, Czech National Bank, Ministry of Labour and Social Affairs.

² At constant 1995 prices, preliminary figure.

Calendar of key events in 2011

January

Telefónica CR went live with its redesigned website www.o2.cz. Together with the redesign, Telefónica CR also introduced the electronic bill feature.

February

Telefónica CR published its audited consolidated financial results prepared under International Financial Reporting Standards for the fiscal year 2010. Consolidated revenues reached CZK 55.6 billion; net profit was up to CZK 12.3 billion.

Vladimír Dlouhý was cooped as member of the Supervisory Board, having succeeded Jaime Smith Basterra who had tendered his resignation.

Telefónica CR and T-Mobile Czech Republic signed a 3G network sharing agreement. The agreement concerned the areas not yet covered with signal. The sharing arrangement facilitated the network rollout and significantly improved the 3G coverage of both operators.

Telefónica CR took over more than 11,000 residential ADSL customers from VOLNÝ.

Telefónica CR came on board of Think Big, the ongoing pan-European social programme of Telefónica. The programme helps young people make a reality their ideas and projects to aid the communities in which they live.

March

Telefónica CR's Network Demarcation project was recognised as the IT Project of the Year 2010 by the Czech Association of Information Technology Managers.

Employees of Telefónica CR raised CZK 394,265 in aid of the victims of the earthquake and tsunami disaster in Japan. The Company matched this amount 100% to the total of CZK 788,350, and the donation was made to the humanitarian assistance organisation ADRA.

On its online portal www.chcidoo2.cz, Telefónica CR launched a Momma and Poppa application aimed at helping employees who are also parents to return back to work after maternity and parental leave.

April

According to a survey by Ipsos Tambor, Telefónica CR had the best mobile data service and the best mobile internet coverage, which made it the leader in the field of Czech mobile internet.

Telefónica CR launched VDSL, a new technology giving up to three times faster home internet.

Telefónica CR went live with its new campaign 'Martin and Lucie' for business and SME customers, which presented the benefits of products designed for this segment and improvements in customer care.

Telefónica Slovakia launched a new tariff O2 Filip with unlimited free calls within the network of O2 Slovakia.

An Ordinary General Meeting of shareholders of Telefónica CR was held. The shareholders approved, among other things, a proposal of the Board of Directors for the payment of a dividend of CZK 40 per share, before tax. Vladimír Dlouhý was elected substitute member of the Audit Committee and his co-optation as member of the Supervisory Board was confirmed.

May

Telefónica's operation in the Czech Republic changed its corporate identity to Telefónica Czech Republic, a. s. (from Telefónica O2 Czech Republic, a. s.). Analogously, Telefónica O2 Slovakia, s.r.o., changed its name to Telefónica Slovakia, s.r.o.

Dana Dvořáková joined as Director of Corporate Communications.

Telefónica CR formed a special team to assist O2 customers via social networks. The official facebook page and twitter feed, as well as the O2YouTube channel, in section O2 Guru, offer professional assistance, tips and replies to questions.

June

Telefónica CR reduced its carbon footprint by 5 thousand tons of CO2 and recycled 269 tons of waste electrical and electronic equipment.

The Company launched its 'Now I Know Why' campaign which explained to customers how to make the best use of having internet in their mobile devices.

July

Ctírad Lolek was appointed new Director, Human Resources Division.

Telefónica CR, Komerční banka, Citibank Europe, Globus ČR and VISA Europe, in collaboration with Globus hypermarket in Čakovice, Prague, debuted a pilot project of near-field mobile payments with real users.

The Czech public voted, for the second time running, that Telefónica CR had the best mobile data service and the best mobile data coverage in the country in an independent survey by Ipsos Tambor.

August

Employees of Telefónica CR raised CZK 280,000 to help the people in Somalia who, due to long-lasting drought, water and food shortages, had to take refuge from their homes. The Company matched this amount 100%, and the donation was made to the humanitarian assistance organisation People in Need.

Customers with the prepaid O2 cards could start topping up their credit at the post office. Telefónica CR now operates a network of 30,000 top-up points, the largest in the Czech Republic.

Telefónica CR expanded the features of its My O2 portal and opened an online self-service shop for its residential customers.

Home broadband internet customers can now use the function of fully automated home WiFi network configuration. The whole family can go online at the same time, without the inconvenience of cables.

Telefónica CR and Telefónica Germany signed a joint project for fixed and mobile network management, to go until 2015.

September

Telefónica CR celebrated its the 5th anniversary of the O2 brand in the Czech market.

The first 100 young teams from 276 entries were selected to receive a grant in the first round of Think Big; the call for projects was opened in May by the O2 Foundation in collaboration with the Civil Society Development Foundation. The projects received a total of CZK 5.3 million among them.

At a ceremony in the residence of the US Ambassador, Telefónica CR was presented with the prestigious Via Bona Award for its patronage, financial, material and professional help to the Safety Line. Telefónica CR has been Safety Line's general partner already for 17 years.

October

The new website www.o2.cz came first in its category (Telecommunications) in WebTop100 and came second in the open category.

In collaboration with the Czech Union of the Deaf, Telefónica CR presented the outreach programme that drew attention to issues of communication of children and young people with full or partial loss of hearing.

Almost 600 employees of Telefónica CR became volunteers for the day on the occasion of the International Volunteer Day, helping in 18 organisations of public benefits across the country. The Telefónica Group celebrates the International Volunteer Day every year in all countries where it has a presence.

November

The advertising campaign 'Smart Network from O2' won the 2011 Effie Award for the most effective advertising campaign in the category Other Services.

Luis Aldo Martin succeeded Tony Hanway as Director, Consumer Division, Telefónica CR. Tony Hanway became CEO Telefónica Ireland.

Ramiro Lafarga Brollo was appointed new CEO of Telefónica Slovakia.

December

Telefónica CR officially started offering DNSSEC, a secure domain name system, in its network, thus significantly improving the protection and security of its customers online.

Telefónica CR vastly improved its 3G network coverage, reaching 71% of the population with its signal.

As part of its Christmas campaign, Telefónica CR offered its prepaid customers calls for CZK 3.50 and SMS for CZK 1.50. Contract customers received double the amount of free units (calls, SMS) to all networks.

Telefónica CR, VISA Europe, Komerční banka, Citibank Europe and Globus ČR evaluated the six-month pilot operation of near-field mobile payments, with the unequivocal conclusion that the Czech market – customers and retailers alike – are ready for the technology.

The committee of A Greener Festival Awards gave again its global recognition to the Czech Open Air Festival.