

Telefónica Czech Republic, a.s.

**FINANCIAL STATEMENTS
FOR THE YEAR ENDED 31 DECEMBER 2013**

**PREPARED IN ACCORDANCE WITH
INTERNATIONAL FINANCIAL REPORTING STANDARDS**

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GENERAL INFORMATION

Telefónica Czech Republic, a.s., (Company) has the form of a joint stock company and is incorporated and domiciled in the Czech Republic. The address of its registered office is Za Brumlovkou 266/2, Prague 4, 140 22, Czech Republic.

The Company was a member of the Telefónica Group of companies (Telefónica Group) with the parent company, Telefónica, S.A. (Telefónica) as at 31 December 2013.

The Company is the largest integrated telecommunications provider in the Czech market providing fully converged services.

The number of employees employed by the Company amounted in average to 5,376 in 2013 (2012: 6,005).

The Company's shares are traded on the Prague Stock Exchange.

The financial statements were approved for issue by the Company's Board of Directors on 25 February 2014.

Sale to PPF Group

In November 2013 Telefónica reached an agreement with PPF Group (through PPF Arena 2 B.V.) to sell 65.9% of the Company's shares. The transaction involves all the Company's interests including Telefónica Slovakia, s.r.o. Both companies are allowed to trade under the O2 brand for a maximum of four years. They may also join Telefónica's Partners Programme, an initiative offering partner operators the opportunity to benefit from Telefónica's scale and cooperate on key business areas.

Reduction of the Company's share capital

In accordance with the resolution on reduction of the Company's share capital adopted by the Annual General Meeting of the Company held on 22 April 2013, the reduction of the Company's share capital was recorded into the Commercial Register on 15 November 2013. The Company's share capital was reduced by way of cancellation of 6,441,798 own ordinary shares with nominal value of CZK 87 (i.e. by CZK 560,436,426). Subsequently, the cancelled own ordinary shares were deleted from the statutory register. As at 31 December 2013, the amount of the Company's share capital equaled to CZK 27,461,384,874.

Share buyback

Following the resolution of the Annual General Meeting held on 19 April 2012 regarding the share buyback programme (up to 10% of ordinary shares within 5 years), the Board of Directors adopted on 26 February 2013 a resolution to continue with the acquisition of own ordinary shares (share buyback) to the extent of 6,441,798 of ordinary shares (i.e. up to 2% of the total ordinary shares issued by the Company as of that day). The Board of Directors adopted the decision to stop the acquisition of its own shares with effect from 29 October 2013.

LTE broadband mobile data network

In the year 2013 the auction part of the tender for the awarding the rights to use radio frequencies in the 800 MHz, 1800 MHz and 2600 MHz spectrum bands ended. The Company succeeded in the tender in above mentioned bands. These bands are necessary for the development of a new generation LTE network (4G). This spectrum combination will allow the Company to build the highest speed and quality network in the Czech Republic. The Company has already covered a significant part of Prague and Brno with the LTE network. The Company will start rolling out the 4G network in new locations in the Czech Republic in the first half of year 2014.

Agreement to share 2G and 3G networks

In October 2013 the Company has signed an agreement with T-Mobile Czech Republic a.s. to share their current 2G and 3G mobile networks. The deal has been made in order to achieve the optimal coverage in the Czech Republic and efficiencies in 2G and 3G networks and technologies. The transaction will bring tangible benefits to the customers, especially in the form of better services and coverage. The deal builds upon the very successful 3G network sharing scheme, which both companies already implemented in 2011-2012.

Restructuring

Over the course of 2013, the Company continued to implement its restructuring and cost-optimization activities aimed at further improving its operating efficiency. The Company launched new projects in various areas of its operations. These projects focused on streamlining of the organisation structure including the reduction of duplicate positions; call centres consolidation and optimization; reduction of the number of applications and systems in use including optimisation of the related processes. Some restructuring projects have led to a transfer of the activities to outsourcing partners. More than 800 employees were made redundant during the restructuring process, and the Company incurred restructuring costs of CZK 368 million (see Note 2).

INDEPENDENT AUDITOR'S REPORT

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

We have audited the accompanying financial statements of Telefónica Czech Republic, a.s., which comprise the statement of financial position as at 31 December 2013, and the statement of total comprehensive income, statement of changes in equity and statement of cash flows for the year then ended, and a summary of significant accounting policies and other explanatory notes.

Management's Responsibility for the Financial Statements

Management is responsible for the preparation and fair presentation of these financial statements in accordance with International Financial Reporting Standards as adopted by the European Union, and for such internal control as management determines is necessary to enable the preparation of financial statements that are free from material misstatement, whether due to fraud or error.

Auditor's Responsibility

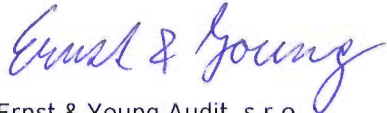
Our responsibility is to express an opinion on these financial statements based on our audit. We conducted our audit in accordance with the Act on Auditors and International Standards on Auditing as amended by implementation guidance of the Chamber of Auditors of the Czech Republic. Those standards require that we comply with ethical requirements and plan and perform the audit to obtain reasonable assurance 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 an 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 entity's preparation and fair presentation of the financial statements 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 financial statements present fairly, in all material respects, the financial position of Telefónica Czech Republic, a.s. as at 31 December 2013, and its financial performance and its cash flows for the year then ended in accordance with International Financial Reporting Standards as adopted by the European Union.



Ernst & Young Audit, s.r.o.

License No. 401

Represented by partner



Radek Pav

Auditor, License No. 2042

25 February 2014

Prague, Czech Republic

STATEMENT OF TOTAL COMPREHENSIVE INCOME

For the year ended 31 December 2013

In CZK million	Notes	Year ended 31 December 2013	Year ended 31 December 2012
Revenues	2	42,609	45,792
Other income	2	840	1,108
Expenses	2	(26,809)	(28,549)
Impairment loss		<u>(11)</u>	<u>(27)</u>
Operating income before depreciation and amortization (OIBDA)		16,629	18,324
Depreciation and amortisation	7, 8	<u>(10,413)</u>	<u>(10,919)</u>
Operating profit		6,216	7,405
Finance income	3	1,058	107
Finance costs	3	<u>(316)</u>	<u>(286)</u>
Profit before tax		6,958	7,226
Corporate income tax	4	<u>(1,215)</u>	<u>(1,301)</u>
Profit for the year		5,743	5,925
Other comprehensive income			
Other comprehensive income, net of tax		<u>-</u>	<u>-</u>
Total comprehensive income, net of tax		5,743	5,925
Profit attributable to:			
Equity holders of the Company	5	5,743	5,925
Total comprehensive income attributable to:			
Equity holders of the Company		5,743	5,925
Earnings per share (CZK) – basic*	5	18	19

*There is no dilution of earnings as no convertible instruments have been issued by the Company.

BALANCE SHEET

As at 31 December 2013

In CZK million	Notes	31 December 2013	31 December 2012
ASSETS			
Property, plant and equipment	7	39,563	44,477
Intangible assets	8	18,870	19,183
Investment in subsidiaries and associates	21	6,419	6,433
Other financial assets	10	166	108
Non-current assets		65,018	70,201
Inventories	9	472	433
Receivables	10	7,730	7,403
Income tax receivable	4	-	100
Cash and cash equivalents	11	3,844	3,017
Current assets		12,046	10,953
Total assets		77,064	81,154
EQUITY AND LIABILITIES			
Ordinary shares	19	27,461	28,022
Treasury shares	19	(1,596)	(2,483)
Share premium		19,349	24,374
Retained earnings, funds and reserves		12,816	13,274
Total equity		58,030	63,187
Long-term financial debts	13	3,000	3,000
Deferred tax liability	14	2,733	3,196
Non-current provisions for liabilities and charges	15	22	26
Non-current other liabilities	12	64	83
Non-current liabilities		5,819	6,305
Short-term financial debts	13	2,044	710
Trade and other payables	12	11,003	10,921
Income tax liability	4	152	-
Provisions for liabilities and charges	15	16	31
Current liabilities		13,215	11,662
Total liabilities		19,034	17,967
Total equity and liabilities		77,064	81,154


The financial statements were approved by the Board of Directors on 25 February 2014 and were signed on its behalf by:



Luis Antonio Malvido
Chairman
of the Board of Directors
Chief Executive Officer



Martin Bek
Member
of the Board of Directors



David Melcon Sanchez-Friera
Chief Financial Officer

STATEMENT OF CHANGES IN EQUITY

For the year ended 31 December 2013

In CZK million	Notes	Share capital	Share premium	Treasury shares	Equity settled share based payments reserve	Funds*	Retained earnings	Total
At 1 January 2012		32,209	24,374	-	53	6,450	9,306	72,392
Profit for the year		-	-	-	-	-	5,925	5,925
Total comprehensive income		-	-	-	-	-	5,925	5,925
Capital contribution and other transfers		-	-	-	(22)	-	-	(22)
Distribution declared in 2012	6	-	-	-	-	-	(8,696)	(8,696)
Treasury share transactions		-	-	(2,483)	-	-	91	(2,392)
Share capital increase/(decrease) Effect of Merger of TO2 Business Solutions	19	(4,187)	-	-	-	-	72	(4,115)
	19	-	-	-	-	-	95	95
At 31 December 2012		28,022	24,374	(2,483)	31	6,450	6,793	63,187
At 1 January 2013		28,022	24,374	(2,483)	31	6,450	6,793	63,187
Profit for the year		-	-	-	-	-	5,743	5,743
Total comprehensive income		-	-	-	-	-	5,743	5,743
Capital contribution and other transfers		-	-	-	7	-	-	7
Distribution declared in 2013	6	-	(3,221)	-	-	-	(6,442)	(9,663)
Treasury share transactions	19	-	118	(1,596)	-	-	234	(1,244)
Cancellation of treasury shares	19	(561)	(1,922)	2,483	-	-	-	-
At 31 December 2013		27,461	19,349	(1,596)	38	6,450	6,328	58,030

* Refer to Note 19 regarding amounts not available for distribution.

STATEMENT OF CASH FLOWS

For the year ended 31 December 2013

In CZK million	Notes	Year ended 31 December 2013	Year ended 31 December 2012
Cash flow from operating activities			
Cash received from operations		48,193	50,359
Cash paid to suppliers and employees		(31,263)	(32,284)
Dividends received		13	5
Net interest and other financial income/expenses paid	11	(20)	(147)
Taxes paid		<u>(1,425)</u>	<u>(1,775)</u>
Net cash from operating activities		15,498	16,158
Cash flow from investing activities			
Proceeds from disposals of property, plant and equipment and intangible assets		72	324
Payments on investments in property, plant and equipment and intangible assets		(4,981)	(5,338)
Payments made on financial investments		(10)	(218)
Returned warranty deposit for spectrum auction		250	-
Paid warranty deposit for spectrum auction		(375)	(250)
Repayments of loans made to subsidiaries and joint ventures		67	60
Provisions of loans made to subsidiaries and joint ventures		<u>(187)</u>	<u>(209)</u>
Net cash used in investing activities		(5,164)	(5,631)
Cash flow from financing activities			
Dividends paid		(6,191)	(8,598)
Capital decrease	19	(3,104)	(4,115)
Cash payments to owners for acquisition of the treasury shares	19	(1,596)	(2,483)
Proceeds from loans		1,362	3,679
Repayments of loans, borrowings and promissory notes	13	<u>-</u>	<u>(2,911)</u>
Net cash used in financing activities		(9,529)	(14,428)
Effect of foreign exchange rate changes on collections and payments		22	(23)
Net increase / (decrease) in cash and cash equivalents during the period		827	(3,924)
CASH AND CASH EQUIVALENTS AT THE BEGINNING OF THE PERIOD			
		3,017	6,941
CASH AND CASH EQUIVALENTS AT THE END OF THE PERIOD			
	11	3,844	3,017
BALANCE AT THE BEGINNING OF THE PERIOD			
		<u>3,017</u>	<u>6,941</u>
Cash on hand and at banks		3,002	6,922
Other cash equivalents		15	19
BALANCE AT THE END OF THE PERIOD	11	<u>3,844</u>	<u>3,017</u>
Cash on hand and at banks		3,833	3,002
Other cash equivalents		11	15

The accompanying notes form an integral part of the financial statements.

ACCOUNTING POLICIES

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A Basis of preparation

The principal accounting policies applied in the preparation of the financial statements are set out below. The policies have been consistently applied to all years presented, unless otherwise stated.

The financial statements were prepared in accordance with International Financial Reporting Standards (IFRS) and all applicable IFRSs adopted by the EU. IFRS comprise standards and interpretations approved by the International Accounting Standards Board (IASB) and the IFRS Interpretations Committee (IFRS IC).

Effective from 1 January 2005, a change in the Czech Act on Accounting No. 563/1991 Coll. requires the Company to prepare its financial statements in accordance with IFRS adopted by the EU (Regulation (EC) No 1606/2002). At the balance sheet date, there are no differences in the IFRS policies applied by the Company and IFRS adopted by the EU.

The financial statements are the separate financial statements of the Company and meet requirements of IFRS with respect to the preparation of parent's separate financial statements. The Company also issued consolidated financial statements prepared for the same period in accordance with IFRS, which were approved for issue by the Board of Directors.

The financial statements were prepared under the historical cost convention except for non-current assets held for sale, inventory held at net realizable value, financial derivatives, share based payment liability and certain assets and liabilities acquired during business combinations, as disclosed in the accounting policies below.

The preparation of financial statements in conformity with IFRS required the Company to use certain critical accounting estimates. It also required estimates be used in the process of applying the Company's accounting policies. The areas involving a higher degree of judgement or complexity, or areas where assumptions and estimates are significant to the financial statements are disclosed in Note T.

The amounts shown in the financial statements are presented in millions Czech crowns (CZK), if not stated otherwise.

In order to clarify and enhance quality of presented information, without changing accounting policies, the Company decided to simplify certain parts of the financial statements. Simplifications mainly concern statement of total comprehensive income, notes concerning revenues and costs and property, plant and equipment.

Adoption of new or revised IFRS standards and interpretations (includes standards and interpretations applicable for the Company)

In 2013, the Company adopted the below stated standards, interpretations and amendments, which are relevant to its operations. Adoption of the interpretations and amendments has no effect on the financial performance or position of the Company:

Amendments to IFRS 7 Disclosures – Offsetting Financial Assets and Financial Liabilities

The Group has applied the amendments to IFRS 7 Disclosures – Offsetting Financial Assets and Financial Liabilities for the first time in the current year. The amendments to IFRS 7 require entities to disclose information about rights of offset and related arrangements for financial instruments under an enforceable master netting agreement or similar arrangement.

The amendments have been reflected in notes to the financial statements.

IFRS 13 Fair Value Measurement

IFRS 13 defines fair value as the price that would be received to sell an asset or paid to transfer a liability in an orderly transaction in the principal (or most advantageous) market at the measurement date under current market conditions. Fair value under IFRS 13 is an exit price regardless of whether that price is directly observable or estimated using another valuation technique. Also, IFRS 13 includes disclosure requirements.

The application of IFRS 13 has not had any material impact on the amounts recognised in the financial statements.

Amendments to IAS 1 Presentation of Items of Other Comprehensive Income

The amendments introduce new terminology, whose use is not mandatory, for the statement of comprehensive income and income statement. The amendments to IAS 1 retain the option to present profit or loss and other comprehensive income in either a single statement or in two separate but consecutive statements. However, the amendments to IAS 1 require items of other comprehensive income to be grouped into two categories in the other comprehensive income section: (a) items that will not be reclassified subsequently to profit or loss and (b) items that may be reclassified subsequently to profit or loss when specific conditions are met.

Other than the above mentioned presentation changes, the application of the amendments to IAS 1 does not result in any impact on profit or loss, other comprehensive income and total comprehensive income.

New IFRS not effective as at 31 December 2013 (includes standards applicable for the Company)

At the date of preparation of the accompanying financial statements, the following IFRS had been published, but their application was not mandatory. The Company intends to adopt those standards when they become effective.

Standards and amendments	Mandatory application: annual periods beginning on or after
IFRS 9 Financial Instruments	1 January 2015
IFRS 10 Consolidated Financial Statements	1 January 2014
IFRS 11 Joint Arrangements	1 January 2014
IFRS 12 Disclosure of Interests in Other Entities	1 January 2014