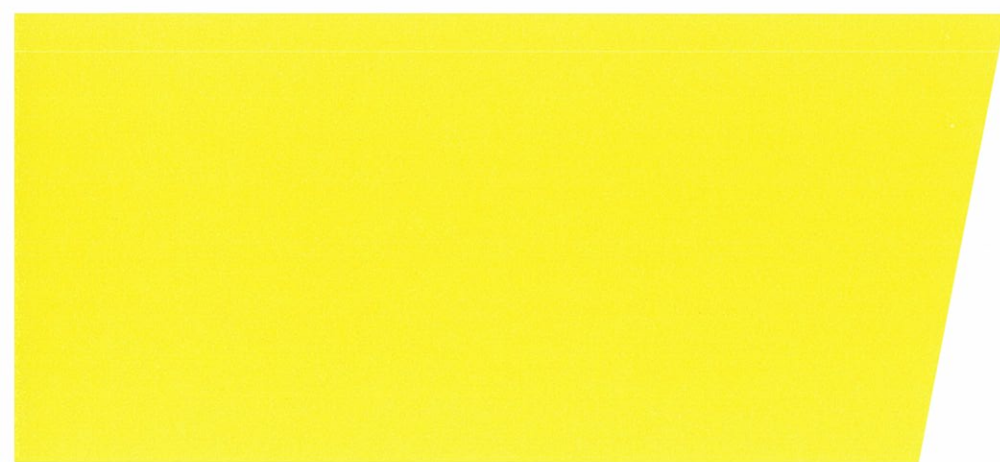


Telefónica Czech Republic, a.s.

**CONSOLIDATED FINANCIAL STATEMENTS
FOR THE YEAR ENDED 31 DECEMBER 2012**

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



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GENERAL INFORMATION

Telefónica Czech Republic, a.s. Group (Group) consists of Telefónica Czech Republic, a.s. (Company) and its subsidiaries: Telefónica Slovakia, s.r.o., Bonerix s.r.o., Internethome, s.r.o., CZECH TELECOM Germany GmbH and CZECH TELECOM Austria GmbH.

The 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 Group is a member of the Telefónica Group of companies (Telefónica Group) with the parent company, Telefónica, S.A. (Telefónica).

The Company is the principal supplier of fixed line telecommunication services and is one of three suppliers of mobile telephone services in the Czech Republic.

The number of employees employed with the Group amounted in average to 6,502 in 2012 (2011: 7,297).

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

The consolidated financial statements were approved for issue by the Company's Board of Directors on 13 February 2013.

Reduction of the Company's share capital

In accordance with the resolution on reduction of the Company's share capital adopted by the General Meeting of the Company held on 19 April 2012, the reduction of the Company's share capital was registered into the Commercial Register on 14 November 2012. The nominal value of each share with the nominal value of CZK 100 was decreased by CZK 13 per share and each share with the nominal value of CZK 1,000 was decreased by CZK 130. As at 31 December 2012, the amount of the Company's share capital equaled to CZK 28,021,821,300.

Share buyback

Following the resolution of the Company's 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 approved on 9 May 2012 the acquisition of 2% of the total number of ordinary shares issued by the Company (share buyback). On 18 May 2012, the Company instructed the selected broker to acquire 2% of the total number of ordinary shares issued by the Company (i.e. 6,441,798 ordinary shares).

Acquisition of Bonerix s.r.o.

On 31 August 2012, the Company, via its subsidiary Bonerix s.r.o., signed the agreement related to the acquisition of five parts of the enterprises of Global Care Group (Global Care, s.r.o., TMT Czech, a.s., Hermod, a.s., Česká servisní a správní, a.s., LAKENSIS, a.s.).

Acquisition of WiFi operators

During 2012, the Group continued with the process of acquisition of WiFi network infrastructure, customer portfolios and related assets from local providers of WiFi internet access by WiFi technology. The transactions were executed as acquisitions of the part of the enterprise by Internethome, s.r.o.

Restructuring

During 2012, the Group continued to implement its restructuring and cost-optimization activities aimed at further improvement of its operational efficiency. The Group launched new projects in various areas of its operations. These projects were focused on the 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 the related processes optimisation. Some restructuring projects have led to a transfer of the activities to outsourcing partners. During the restructuring process more than 500 employees were made redundant and the Group incurred restructuring costs of CZK 265 million (see Note 2).

Cooperation with Genpact Czech s.r.o.

In 2012, the Group has started a five-year cooperation with the company Genpact Czech s.r.o., one of the world's leading companies in the field of accounting and administrative services. Most of the activities carried out by the Group's accounting department were transferred to Genpact Czech s.r.o. as of 14 May 2012. Employees performing these activities were transferred to the employment of Genpact Czech s.r.o.

Research and development activities

During 2012, the Group drew on the knowledge and experience of Telefónica Digital, a division of the Telefónica Group, which seeks to exploit new growth opportunities while strengthening the portfolio of products and services. As a result of the cooperation with Telefónica Digital, the Group brought several innovations in the area of financial and ICT/Cloud services to the market in 2012. In late 2012, Telefónica Digital launched its Wayra program in the Czech Republic and Slovakia, which is aimed at supporting innovation in the segment of Internet and new information and communication technologies (ICT). In 2012, the Group made no internal investments in research and development according to IAS 38 Intangible assets.

BLESKmobil

The Company entered into an agreement with publishing house Ringier Axel Springer CZ to start up the first virtual mobil operator in the Czech Republic. The service is offered under the BLESKmobil brand through one pay-as-you-go tariff.

Informační linky, a.s.

On 1 January 2012 the subsidiary Informační linky, a.s. was founded by a non-monetary contribution of part of the enterprise. On 29 February 2012, 80% of shares of the subsidiary Informační linky, a.s. was sold to Hapalo Estates s.r.o. The share purchase agreement includes call option relating to sale of remaining 20% of shares. The Company has recognized the net profit exceeding CZK 200 million. Informační linky, a.s. provides information and assistance service on telephone numbers 1180, 1181 and 1188.

INDEPENDENT AUDITOR'S REPORT

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

We have audited the accompanying consolidated financial statements of Telefónica Czech Republic, a.s., and its subsidiaries ("the Group") which comprise the consolidated balance sheet as at 31 December 2012, and the consolidated statement of total comprehensive income, consolidated statement of changes in equity and consolidated 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 Consolidated Financial Statements

Management of Telefónica Czech Republic, a.s., is responsible for the preparation and fair presentation of these consolidated 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 consolidated financial statements that are free from material misstatement, whether due to fraud or error.

Auditor's Responsibility

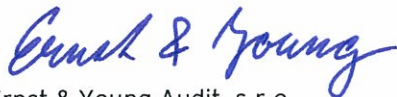
Our responsibility is to express an opinion on these consolidated financial statements based on our audit. We conducted our audit in accordance with the Act on Auditors and International Standards on Auditing as amended by implementation guidance of the Chamber of Auditors of the Czech Republic. Those standards require that we comply with ethical requirements and plan and perform the audit to obtain reasonable assurance whether the consolidated financial statements are free from material misstatement.

An audit involves performing procedures to obtain audit evidence about the amounts and disclosures in the consolidated financial statements. The procedures selected depend on the auditor's judgment, including an assessment of the risks of material misstatement of the consolidated 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 consolidated 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 consolidated 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 consolidated financial statements present fairly, in all material respects, the financial position of the Group as at 31 December 2012, 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.

A handwritten signature in blue ink that reads 'Ernst & Young'.

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

A handwritten signature in blue ink, appearing to be 'Radek Pav'.

Radek Pav
Auditor, License No. 2042

13 February 2013
Prague, Czech Republic

CONSOLIDATED STATEMENT OF TOTAL COMPREHENSIVE INCOME

For the year ended 31 December 2012

In CZK million	Notes	Year ended 31 December 2012	Year ended 31 December 2011
Revenues from voice services	2	16,913	18,218
Monthly charges		12,531	12,900
Data services	2	11,296	11,477
Other revenues	2	9,794	9,814
Revenues		50,534	52,409
Other income	2	498	487
Interconnection and roaming expenses		(8,820)	(9,165)
Cost of goods sold		(2,128)	(2,170)
Other cost of sales	2	(3,791)	(3,429)
Other expenses	2	(10,646)	(10,142)
Staff costs	2	(5,838)	(6,179)
Impairment reversal/(loss)		(28)	(21)
Operating income before depreciation and amortization ("OIBDA")		19,781	21,790
Depreciation and amortisation	7, 8	(11,437)	(11,651)
Operating profit		8,344	10,139
Finance income	3	103	313
Finance costs	3	(291)	(444)
Profit before tax		8,156	10,008
Corporate income tax	4	(1,380)	(1,324)
Profit for the year		6,776	8,684
Other comprehensive income			
Translation differences		(65)	110
Other comprehensive income, net of tax		(65)	110
Total comprehensive income, net of tax		6,711	8,794
Profit attributable to:			
Equity holders of the Company	5	6,776	8,684
Total comprehensive income attributable to:			
Equity holders of the Company		6,711	8,794
Earnings per share (CZK) – basic*	5	21	27

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


CONSOLIDATED BALANCE SHEET

As at 31 December 2012

In CZK million	Notes	31 December 2012	31 December 2011
ASSETS			
Property, plant and equipment	7	46,691	51,525
Intangible assets	8	20,330	20,658
Investment in associate	22	29	22
Other financial assets	11	112	149
Deferred tax asset	15	673	746
Non-current assets		67,835	73,100
Inventories	10	487	488
Receivables	11	7,732	8,273
Income tax receivable	4	101	165
Cash and cash equivalents	12	3,044	6,955
Current assets		11,364	15,881
Non-current assets classified as held for sale	7	-	1
Total assets		79,199	88,982
EQUITY AND LIABILITIES			
Ordinary shares	20	28,022	32,209
Treasury shares	20	(2,483)	-
Share premium		24,374	24,374
Retained earnings, funds and reserves		10,661	12,514
Total equity		60,574	69,097
Long-term financial debts	14	3,000	-
Deferred tax liability	15	3,206	3,736
Non-current provisions for liabilities and charges	16	29	26
Non-current other liabilities	13	87	108
Non-current liabilities		6,322	3,870
Short-term financial debts	14	31	3,061
Trade and other payables	13	12,235	12,882
Income tax liability	4	5	5
Provisions for liabilities and charges	16	32	67
Current liabilities		12,303	16,015
Total liabilities		18,625	19,885
Total equity and liabilities		79,199	88,982

The consolidated financial statements were approved by the Board of Directors on 13 February 2013 and were signed on its behalf by:


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


David Melcon Sanchez-Friera
 1st Vice Chairman of the Board of Directors
 Director, Finance Division

CONSOLIDATED STATEMENT OF CHANGES IN EQUITY

For the year ended 31 December 2012

In CZK million	Notes	Share capital	Share premium	Treasury shares	Foreign exchange translation reserve	Equity settled share based payments reserve	Funds*	Retained earnings	Total
At 1 January 2011		32,209	24,374	-	(162)	38	6,452	10,265	73,176
Currency translation differences – amount arising in period		-	-	-	110	-	-	-	110
Profit for the year		-	-	-	-	-	-	8,684	8,684
Total comprehensive income		-	-	-	110	-	-	8,684	8,794
Capital contribution and other transfers		-	-	-	-	18	-	(7)	11
Dividends declared in 2011	6	-	-	-	-	-	-	(12,884)	(12,884)
At 31 December 2011		32,209	24,374	-	(52)	56	6,452	6,058	69,097
At 1 January 2012		32,209	24,374	-	(52)	56	6,452	6,058	69,097
Currency translation differences – amount arising in period		-	-	-	(65)	-	-	-	(65)
Profit for the year		-	-	-	-	-	-	6,776	6,776
Total comprehensive income		-	-	-	(65)	-	-	6,776	6,711
Capital contribution and other transfers		-	-	-	-	(25)	47	(53)	(31)
Dividends declared in 2012	6	-	-	-	-	-	-	(8,696)	(8,696)
Treasury share acquisition	20	-	-	(2,483)	-	-	-	91	(2,392)
Share capital increase/(decrease)	20	(4,187)	-	-	-	-	-	72	(4,115)
At 31 December 2012		28,022	24,374	(2,483)	(117)	31	6,499	4,248	60,574

* Refer to Note 20 regarding amounts not available for distribution.

CONSOLIDATED STATEMENT OF CASH FLOWS

For the year ended 31 December 2012

In CZK million	Notes	Year ended 31 December 2012	Year ended 31 December 2011
Cash flow from operating activities			
Cash received from operations		54,592	56,452
Cash paid to suppliers and employees		(35,428)	(33,886)
Dividends received		5	5
Net interest and other financial expenses paid	12	(150)	(101)
Taxes paid		(1,783)	(1,938)
Net cash from operating activities		17,236	20,532
Cash flow from investing activities			
Proceeds from disposals of property, plant and equipment and intangible assets		322	601
Payments on investments in property, plant and equipment and intangible assets		(5,671)	(5,953)
Payments on investments in WiFi acquisition		(148)	(141)
Payments made on financial investments		(18)	(22)
Payments on temporary financial investments		(250)	-
Net cash used in investing activities		(5,765)	(5,515)
Cash flow from financing activities			
Dividends paid		(8,848)	(12,878)
Capital decrease	20	(4,115)	-
Cash payments to owners for acquisition of treasury shares	20	(2,483)	-
Proceeds from loans		3,000	-
Repayments of loans, borrowings and promissory notes	14	(2,912)	(2)
Net cash used in financing activities		(15,358)	(12,880)
Effect of foreign exchange rate changes on collections and payments		(24)	20
Net increase / (decrease) in cash and cash equivalents during the period		(3,911)	2,157
CASH AND CASH EQUIVALENTS AT THE BEGINNING OF THE PERIOD			
		6,955	4,798
CASH AND CASH EQUIVALENTS AT THE END OF THE PERIOD			
	12	3,044	6,955
BALANCE AT THE BEGINNING OF THE PERIOD			
		6,955	4,798
Cash on hand and at banks		6,932	4,774
Other cash equivalents		23	24
BALANCE AT THE END OF THE PERIOD			
	12	3,044	6,955
Cash on hand and at banks		3,025	6,932
Other cash equivalents		19	23

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

ACCOUNTING POLICIES

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A Basis of preparation

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

The consolidated 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 Group to prepare its consolidated 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 Group, and IFRS adopted by the EU.

The consolidated 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 consolidated financial statements in conformity with IFRS required the Group to use certain critical accounting estimates. It also required estimates be used in the process of applying the Group's accounting policies. The areas involving a higher degree of judgement or complexity, or areas where assumptions and estimates are significant to the consolidated financial statements are disclosed in Note U.

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

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

In 2012, the Group applied 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 Group.

IAS 12 Income Taxes – Amendment (effective 1 January 2012)

The amendment clarifies the determination of deferred tax on investment property measured at fair value and introduces a rebuttable presumption that deferred tax on investment property measured using the fair value model in IAS 40 should be determined on the basis that its carrying amount will be recovered through sale. It includes the requirement that deferred tax on non-depreciable assets that are measured using the revaluation model in IAS 16 should always be measured on a sale basis.

The adoption of the amendment did not have any impact on the Group's financial position, performance or its disclosures.

IFRS 7 Financial Instruments: Disclosures — Enhanced Derecognition Disclosure Requirements (effective 1 July 2011)

The amendment requires additional disclosure about financial assets that have been transferred but not derecognised to enable the user of the Group's financial statements to understand the relationship with those assets that have not been derecognised and their associated liabilities. In addition, the amendment requires disclosures about the entity's continuing involvement in derecognised assets to enable the users to evaluate the nature of, and risks associated with, such involvement.

The Group does not have any assets with these characteristics so there has been no effect on the presentation of its financial statements.

New IFRS not effective as at 31 December 2012 (includes standards applicable for the Group)

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

Standards and amendments		Mandatory application: annual periods beginning on or after
IAS 1	Presentation of Items of Other Comprehensive Income (Amendment)	1 July 2012
IFRS 7	Disclosures — Offsetting Financial Assets and Financial Liabilities — Amendments to IFRS 7	1 January 2013
IFRS 9	Financial Instruments: Classification and Measurement	1 January 2015
IFRS 10	Consolidated Financial Statements	1 January 2013
IFRS 11	Joint Arrangements	1 January 2013
IFRS 12	Disclosure of Interests in Other Entities	1 January 2013
IFRS 13	Fair Value Measurement	1 January 2013
IAS 19	Employee benefits (Revised)	1 January 2013
IAS 27	Separate Financial Statements (as revised in 2011)	1 January 2013
IAS 28	Investments in Associates and Joint Ventures (as revised in 2011)	1 January 2013
IAS 32	Offsetting Financial Assets and Financial Liabilities — Amendments	1 January 2014

The Group is currently assessing the impact of the application of these standards and amendments. Based on the analyses made to date, the Group estimates that their adoption will not have a significant impact on the consolidated financial statements in the initial period of application.

The Group is currently monitoring the development in the area of IFRSs being prepared in regards to leases and revenue recognition, which are planned for submission in 2013 or later.

B Group accounting

Consolidation

Subsidiary undertakings, which are those companies in which the Company, directly or indirectly, has an interest of more than one half of the voting rights or otherwise has power to exercise control over the operations, have been consolidated. Subsidiaries are consolidated from the date on which control is transferred to the Group (date of acquisition) and are no longer consolidated from the date when the Group ceases to have control.

A business combination is accounted for using the acquisition method. The consideration transferred for the acquisition of the business combination is the fair value of the assets transferred, the liabilities incurred and the equity interests issued by the Group. The consideration transferred includes the fair value of any asset or liability resulting from a contingent consideration arrangement. Acquisition related costs are expensed when incurred. The excess of the consideration transferred, the amount of any non-controlling interest in the acquiree and the acquisition-date fair value of any previous equity interest in the acquiree over the fair value of the Group's share of the identifiable net assets acquired is recorded as goodwill. The excess of the fair value of the Group's share of the identifiable net assets acquired over the considerations transferred, the amount of any non-controlling interest in the acquiree and the acquisition-date fair value of any previous equity interest in the acquiree is recorded as gain in profit or loss on the acquisition date. For detail refer to Note E Intangible assets and also to Note 8.

Intercompany transactions and balances among the Group companies are eliminated unless the transaction provides evidence of an impairment of the asset transferred. The accounting policies for subsidiaries are changed, where necessary, to ensure consistency with the policies adopted by the Group and another companies within the Group.

Intercompany transactions and balances between the Group and Telefónica companies for the period after the transfer of majority ownership to Telefónica, S.A. are not eliminated. They are identified, disclosed and measured for the disclosure purposes and elimination procedures of the majority shareholder – Telefónica, S.A. (see Note 21).

C Foreign currencies

(i) Functional and presentation currency

Items included in the financial statements of each entity in the Group are measured using the currency of the primary economic environment in which the entity operates ("the functional currency"). The consolidated financial statements are presented in Czech crowns (CZK), which is the Group's presentation currency.

(ii) Transactions and balances

Foreign currency transactions are translated into the functional currency using the exchange rates prevailing at the date of the transaction. Foreign exchange gains and losses resulting

from the settlement of such transactions and from the translation of monetary assets and liabilities denominated in foreign currencies are recognised in profit or loss, except when deferred in other comprehensive income as qualifying cash flow hedges. Such balances of monetary items are translated at period-end exchange rates. Non-monetary items that are measured in terms of historical cost in a foreign currency are translated using the exchange rate at the date of the transaction. Non-monetary items that are measured at fair value in a foreign currency are translated using the exchange rates at the date when the fair value was determined.

(iii) Group companies

Profit or loss of foreign entities are translated into the Group's reporting currency at the average exchange rates for the year and their balance sheets are translated at the exchange rates ruling on 31 December. Exchange differences arising from the translation of the net investment in foreign entities and of borrowings and other currency instruments designated as hedges of such investments are taken to other comprehensive income. When a foreign entity is sold, such exchange differences are recognised in profit or loss as part of the gain or loss on sale.

D Property, plant and equipment

All property, plant and equipment are initially recorded at cost and, except for freehold land, are subsequently carried at its cost less any accumulated depreciation and accumulated impairment losses. Freehold land is subsequently stated at cost less any accumulated impairment charges.

Property, plant and equipment acquired in business combinations are stated at their acquisition costs (which are equal to their fair value at the date of acquisition) less accumulated depreciation and accumulated impairment charges.

Property, plant and equipment include all costs directly attributable to bringing the asset to working condition for its intended use. With respect to the construction of the network, this comprises every expenditure up to the customers' premises, including the cost of contractors, materials, direct labour costs and interest cost incurred during the course of construction.

Subsequent costs are recognised as property, plant and equipment only if it is probable that future economic benefits associated with the item will flow to the Group and the cost can be measured reliably.

Repairs and maintenance costs are expensed as incurred.

Items of property, plant and equipment that are retired are not intended for sale and are not expected to create any future economic benefits or are otherwise disposed of, are eliminated from the balance sheet, along with the corresponding accumulated depreciation. Any gain or loss arising from retirement or disposal is included in net operating income, i.e. net gain or loss is determined as the difference between the net disposal proceeds, if any, and the carrying amount of the item.

Items of property, plant and equipment, excluding freehold land, are depreciated from the time they are available for use, using the straight-line method. Depreciation ceases at the earlier of the date the asset is either de-recognised or at the date the asset is classified as held for sale.

Depreciation does not cease, when the asset becomes temporarily idle or retired from active use, unless the asset is fully depreciated.

Estimated useful lives adopted in the consolidated financial statements are as follows:

	Years
Freehold buildings	up to 40
Cable and other related plant	10 to 25
Exchanges and related equipment	up to 25
Other fixed assets	up to 20

Freehold land is not depreciated as it is deemed to have an indefinite life.

The assets' residual values and useful lives are reviewed, and adjusted if appropriate, at each balance sheet date.

An asset's carrying amount is written down immediately to its recoverable amount if the asset's carrying amount is greater than its estimated recoverable amount (refer to Note G Impairment of assets).

E Intangible assets

Intangible assets include computer software, purchased goodwill, licences and customer bases. Computer software mainly represents the external acquisition costs of the Group's information systems that are intended for use within the Group. Generally, costs associated with developing or maintaining computer software programs are recognised as an expense as incurred. However, costs that are directly associated with identifiable and unique software products controlled by the Group and that have a probable economic benefit exceeding the cost beyond one year, are recognised as intangible assets. Computer software costs recognised as assets are amortised using the straight-line method over their useful lives, generally from one to five years.

Intangible assets acquired in business combinations are stated at their acquisition costs (which are equal to their fair value at the date of acquisition) less accumulated amortisation and accumulated impairment charges and are amortised on a straight-line basis over their estimated useful lives. Customer bases are amortised over a period of the remaining average terms of the binding contracts or period over which production units are generally obtained from the asset by an entity.

Acquired licences are recorded at cost and amortised on a straight-line basis over the remaining life of the licence (i.e. over 15 to 20 years), from the start of commercial service, which best reflects the pattern by which the economic benefits of the intangible assets will be utilised by the Group.

Intangible assets with an indefinite useful life are not amortised. They are subject to the regular impairment reviews (see Note 8 and Note 9).

Goodwill, arising from the purchase of subsidiary undertakings and interests in associates and joint ventures, represents the excess of the fair value of the purchase consideration over the fair value of the net assets acquired. Goodwill is not amortised but is tested for impairment at least annually or anytime there are indications of a decrease in its value.

The Group reviews at least at the balance sheet date the useful lives of intangible assets that are not amortised to determine whether events and circumstances continue to support an indefinite useful life assessment for that asset. If they do not, the change in the useful life assessment from indefinite to finite is accounted for as a change in an accounting estimate.

On the balance sheet date, carrying amounts, residual values and the useful lives of assets are reviewed, revised and if necessary prospectively amended and accounted for as a change in an accounting estimate.

Intangible assets that are no longer in use and no future economic benefits are expected or that are disposed of for any other reason are de-recognised from the balance sheet together with the corresponding accumulated amortisation (for amortised assets only). All gains or losses arising in this respect are recognised in net operating income, i.e. net gain or loss is determined as the difference between net disposal proceeds, if any, and the carrying amount of the asset.

Intangible assets, with the exception of assets with an indefinite useful life, are amortised using the straight-line method from the time they are available for use. Amortisation ceases at the earlier of the date the asset is de-recognised, the date the asset is classified as having the indefinite useful life or the date the asset is classified as held for sale.

F Non-current assets classified as held for sale

The Group classifies separately in the balance sheet a non-current asset (or disposal group) as held for sale if its carrying amount will be recovered principally through a sale transaction rather than through continuing use. For this to be the case, the asset (or disposal group) is available for immediate sale in its present condition subject only to terms that are usual and customary for sales of such assets (or disposal groups), its sale is highly probable and sale is expected within one year.

The Group measures a non-current asset (or disposal group) classified as held for sale at the lower of its carrying amount and fair value less costs to sell.

The Group recognizes an impairment loss for any initial or subsequent write-down of the asset (or disposal group) to fair value less costs to sell and is accounted for as an impairment loss with impact on profit or loss of the relevant period.

From the moment the asset is classified as held for sale and eventually revalued, it ceases to be depreciated/amortised and is reviewed only from impairment point of view.

Any gain from any subsequent increase in fair value less costs to sell, but not in excess of the cumulative impairment loss that has been recognized, is determined and is accounted for in profit or loss.

G Impairment of assets

Property, plant and equipment and other assets, including goodwill and intangible assets, are reviewed for impairment losses whenever events or changes in circumstances indicate that the carrying amount may not be recoverable or at least on an annual basis for goodwill and for intangibles with an indefinite useful life and for intangibles not yet in use. An impairment loss is recognised for the amount by which the carrying amount of the asset exceeds its recoverable amount, which is the higher of an asset's net selling price and value in use. For the purposes of assessing impairment, assets are grouped at the lowest level, for which there are separately identifiable cash flows (cash-generating units).

Impairment losses are recognised in expenses when incurred. A previously recognised impairment loss is reversed (except for the Goodwill impairment loss) only if there has been a change in the assumptions used to determine the asset's recoverable amount since the last impairment loss was recognised. If that is the case the carrying amount of the asset is increased to its recoverable amount. That increased amount cannot exceed the carrying amount that would have been determined, net of depreciation, had no impairment loss been recognised for the asset in prior years. Such reversal is recognised in profit or loss in the period in which the reversal occurs.

The Group makes an assessment at least at each balance sheet date whether there is any indication that an impairment loss may no longer exist, may have decreased or may have increased. If any such indication exists, the Group estimates a recoverable amount of the assets and compares to the carrying value (net of the impairment allowance). In assessing whether there is any indication that the impairment loss recognised in the past may no longer exist, the Group considers both external and internal sources of information (asset's market value, changes expected in the market, including technological, economic or legal changes, market interest rates, significant changes with effect on the Group in the extent to which, or manner in which, the assets are used or are expected to be used, evidence available from internal reporting indicating economic performance of assets etc.). Where an estimate of recoverable amount is calculated, there is a number of management assumptions used.

H Investments and other financial assets

The Group classifies its financial assets into the following categories: financial assets at fair value through profit or loss, held-to-maturity investments, loans and receivables and available-for-sale financial assets.

Financial assets that are acquired principally for the purpose of generating a profit from short-term fluctuations in price are classified as financial assets at fair value through profit or loss and are included in current assets. During 2012 and 2011, the Group did not hold any financial assets in this category.

Investments with a fixed maturity that management has the intent and ability to hold to maturity are classified as held-to-maturity and are disclosed as current or non-current assets, depending on the period in which the settlement will take place.

Loans and receivables are financial assets with fixed or determinable payments that are not quoted in an active market and are measured at amortised cost using an effective interest rate method and are disclosed as current or non-current assets, depending on the period in which the settlement will take place.

Investments intended to be held for an indefinite period of time, which may be sold in response to needs for liquidity or changes in interest rates, are classified as available-for-sale; these are included in non-current assets unless management has expressed the intention of holding the investment for less than 12 months from the balance sheet date or unless they will need to be sold to raise operating capital, in which case they are included in current assets.

The management determines the appropriate classification of its investments at the time of the purchase and re-evaluates such designation on a regular basis, as required under IAS 39.

All purchases and sales of investments are recognised on the trade date, which is the date that the Group commits to purchase or sell the asset. The cost of purchase includes all transaction costs. Financial assets at fair value through profit or loss and available-for-sale investments are subsequently carried at fair value, whilst held-to-maturity investments are carried at amortised cost using the effective interest rate method. Realised and unrealised gains and losses arising from changes in the fair value of financial assets at fair value through profit or loss are included in profit or loss in the period in which they arise. On the contrary, unrealised gains and losses arising from changes in the fair value of available-for-sale investments are included in other comprehensive income in the period in which they arise, except for impairment losses, until the financial asset is de-recognised, at which time the cumulative gain or loss previously recognised in other comprehensive income is recognised in profit or loss.

Impairment of financial assets

The Group assesses at each balance sheet date whether financial assets or groups of financial assets are impaired.

(1) Assets carried at amortized costs

If there is objective evidence that an impairment loss on loans and receivables or held to maturity investments carried at amortised cost has been incurred, the amount of the loss is measured as the difference between the asset's carrying amount and the present value of estimated future cash flows discounted at the financial asset's original effective interest rate. The carrying amount of the asset is reduced either directly or through use of an allowance account. The amount of the loss is recognised in profit or loss.

The Group first assesses whether objective evidence of impairment exists individually for financial assets that are individually significant, and individually or collectively for financial assets that are not individually significant. If it is determined that no objective evidence of impairment exists for individually assessed financial assets, whether significant or not, it is included in a group of financial assets with similar credit risk characteristics and that group of financial assets is collectively assessed for impairment. Assets that are individually assessed for impairment and for which an impairment loss is or continues to be recognised are not included in a collective assessment of impairment.

If, in a subsequent period, the amount of the impairment loss decreases and the decrease can be related objectively to an event occurring after the impairment was recognised, the previously recognised impairment loss is reversed. Any subsequent reversal of an impairment loss is recognised in profit or loss and only to the extent that the carrying amount of the financial asset does not exceed its amortised cost at the reversal date.

In relation to trade receivables, a provision for impairment is made when there is objective evidence (such as the probability of insolvency) that the Group will not be able to collect all of the amounts due under the original terms of the invoice. The carrying amount of the receivable is reduced through use of an allowance account. Impaired debts are derecognised when they are assessed as uncollectible or sold.

(2) Available-for-sale financial assets

If this asset is impaired, the cumulative loss that had been previously recognised (due to fair value revaluation) in other comprehensive income shall be removed from other comprehensive income and recognised in profit or loss even though the financial asset has not been derecognised.

The amount of the cumulative loss that is removed from other comprehensive income and recognised in profit or loss shall be the difference between the acquisition cost (net of any principal repayment and amortisation) and the current fair value, less any impairment loss previously recognised in profit or loss.

Reversals of impairment losses on debt instruments are reversed through profit or loss, if the increase in fair value of the instrument can be objectively related to an event occurring after the impairment loss was recognised in profit or loss.

De-recognition of financial assets

A financial asset is de-recognised when:

- a) the rights to receive cash flow from the asset have expired,
- b) the Group retains the right to receive cash flow from the asset, but has assumed an obligation to pay them in full without material delay to a third party under a “pass-through” arrangement, or

- c) the Group has transferred its rights to receive cash flows from the assets and either has transferred substantially all the risks and rewards of the asset, or has neither transferred nor retained substantially all the risks and rewards of the asset, but has transferred control of the asset.

I Leases

The determination of whether an arrangement is, or contains a lease is based on the substance of the arrangement at inception date of whether the fulfilment of the arrangement is dependent on the use of specific asset or assets and the arrangement conveys a right to use the assets.

Leases under which a significant portion of the risks and benefits of ownership are effectively retained by the lessor are classified as operating leases. Payments made under operating leases are charged to profit or loss on a straight-line basis over the period of the lease.

When an operating lease is terminated before the lease period has expired, any payment that is required to be made to the lessor by way of penalty is recognised as an expense in the period in which termination takes place.

Leases of property, plant and equipment where the Group bears substantially all the risks and rewards of ownership are classified as finance leases. Finance leases are capitalized at the inception of the lease at the lower of the fair value of the leased property or the present value of the minimum lease payments. Each lease payment is allocated between the liability and finance charges so as to achieve a constant rate of interest. The corresponding lease obligations, net of finance charges, are included in other long-term payables (depending on maturity).

The interest element of the finance cost is charged to profit or loss over the lease period so as to produce a constant periodic rate of interest on the remaining balance of the liability for each period. If there is a reasonable certainty that the lessee will obtain ownership by the end of the lease term, the period of expected use is the useful life of the asset; otherwise the property, plant and equipment acquired under finance leases are depreciated over the shorter of the useful life of the asset or the lease term.

J Inventories

Inventory is stated at the lower of cost or net realisable value. Costs of inventories include the purchase price and related costs of acquisition (transport, customs duties and insurance). The cost of inventory is determined using weighted average cost. Net realisable value is the estimate of the selling price in the ordinary course of business, less the costs of completion and selling expenses.

K Trade receivables

Trade receivables are carried at original invoice amount less allowance for impairment of these receivables. Such allowance for impairment of trade receivables is established if there is objective evidence that the Group will not be able to collect all amounts due according to the original terms of the receivables. The amount of the allowance is the difference between the carrying amount and the recoverable amount, being the present value of expected cash flows, discounted at the initial market rate of interest for similar borrowers. Cash flows relating to short-term receivables are usually not discounted. The amount of the allowance is recognized in profit or loss.

L Cash and cash equivalents

Cash and cash equivalents are carried in the balance sheet at cost. For the purposes of the statement of cash flows, cash and cash equivalents comprise cash on hand, deposits held at call with banks, other short-term highly liquid investments with original maturities of three months or less, and bank overdrafts. Bank overdrafts are shown within borrowings in current liabilities section of the balance sheet.

M Financial debt

Borrowings are recognised initially as the proceeds received, net of transaction costs incurred. In subsequent periods, borrowings are stated at amortised cost using the effective interest rate method; any difference between proceeds (net of transaction costs) and the redemption value is recognised in profit or loss over the period of the borrowings.

Borrowings are classified as current liabilities unless the Group has an unconditional right to defer settlement of the liability for at least 12 months after the balance sheet date.

Borrowing costs on debts used to finance the acquisition and construction of qualifying assets are capitalized during the period of time that is required to complete and prepare the asset for its intended use. Other borrowing costs are expensed.

N Current and deferred income taxes

Taxation expense represents both current and deferred taxation, where appropriate.

Current income tax assets and liabilities for the current and prior periods are measured at the amount expected to be recovered from or paid to the taxation authorities. The tax rates and tax laws, used to compute the amount are those that are enacted or substantively enacted by the balance sheet date in the relevant country.

Income tax relating to items recognised directly in other comprehensive income is recognised in other comprehensive income and not in profit or loss.

Deferred income taxation is calculated using the liability method applied to all temporary differences arising between the tax basis of assets and liabilities and their carrying values for financial reporting purposes. Currently enacted tax rates and laws expected to apply when the asset is realised or the liability is settled are used to determine the deferred income tax.

The principal temporary differences arise from differences in the tax and accounting values of property, plant and equipment, impairment of receivables and allowance for obsolete and slow moving inventories, non tax deductible allowances and provisions, unused tax credits and, in relation to acquisitions, on the difference between the fair values of the net assets acquired and their tax base.

Deferred income tax assets are recognised to the extent that it is probable that future taxable profit will be available against which the temporary differences can be utilised.

The Group accounts for the tax consequences of transactions and other events in the same way that it accounts for the transactions and other events themselves. Thus, for transactions and other events recognised in profit or loss, any related tax effects are also recognised in profit or loss. For transactions and other events recognised in other comprehensive income, any related tax effects are also recognised in other comprehensive income. Similarly, the recognition of deferred tax assets and liabilities in a business combination affects the amount of goodwill.

Deferred income tax assets and tax liabilities are offset, if a legally enforceable right exists to set off current tax assets against current income tax liabilities and the deferred income taxes relate to the same taxable entity and the same taxation authority. The same applies for offsetting of current tax assets and liabilities.

O Employee benefits

(1) Pension obligations

Contributions are made to the Government's health, retirement benefit and unemployment schemes at the statutory rates applicable during the period and are based on gross salary payments. The arrangements of the Government's health, retirement benefit and unemployment schemes correspond to the arrangements for defined contribution plans. The Group has no further payment obligations once the contributions have been paid. The expense for the contributions is charged to profit or loss in the same period as the related salary expense. The Group also makes contributions to defined contribution schemes operated by external pension companies. These contributions are charged to profit or loss in the period to which the contributions relate.

(2) Redundancy and termination benefits

Redundancy and termination benefits are payable when employment is terminated before the normal retirement or contract expiry date. The Group recognises provision for redundancy and termination benefits when it is demonstrably committed to terminate the employment of current employees according to a detailed formal plan without possibility of withdrawal.

Benefits falling due more than 12 months after the balance sheet date are discounted to present value. There are no redundancy and termination benefits falling due more than 12 months after the balance sheet date.

(3) Bonus plans

The Group recognises a liability for bonuses based on a formula that takes into consideration certain performance related measures, such as turnover or free cash flow, after certain adjustments. The Group recognises a provision where the Group is contractually obliged or where there is a past practice that has created a constructive obligation.

P Share-based compensation

In 2006, the Group introduced performance compensation systems linked to the market value of shares of the parent company, Telefónica, S.A. Some compensation plans are settled in cash, while others are settled via the delivery of shares.

IFRS 2 is applied to compensation schemes linked to the share price with the following accounting treatment:

Option plans that can be either cash-settled or equity-settled at the option of the employee are recognized at the fair value on the grant date of the liability and equity components of the compound instrument granted.

In the cash-settled share option plan, the total cost of the rights to granted shares are expensed over the period during which the beneficiary earns the full right to exercise the options (vesting period). The total cost of the options is initially measured based on their fair value at the grant date calculated by the Black-Scholes option pricing model, taking into account the terms and conditions established in each share option plan. At each subsequent reporting date, the Group revises its estimate of fair value and the number of options it expects to vest, booking any change in the liability through profit or loss for the period, if appropriate.

For the equity-settled share option plan, fair value at the grant date is measured using the binominal methodology. These plans are expensed during the vesting period with a credit to equity. At each subsequent reporting date, the Group revises its estimate of the number of options it expects to be exercised, with a corresponding adjustment to equity. As the plan will be settled by a physical delivery of equity instruments of the parent, Telefónica, S.A., to the employees, the personnel expense accrued is recognised against equity.

Q Provisions

Provisions are recognised when the Group has either a present legal or constructive obligation resulting from past events, and it is probable that an outflow of resources will be required to settle the obligation assuming that a reliable estimate of the amount can be made. Where the Group expects a provision to be reimbursed, the reimbursement is recognised as a separate asset but only when the reimbursement is virtually certain.

R Revenue recognition

Revenue, shown net of Value Added Tax and any discounts, and after eliminating sales within the Group, comprises goods sold and services provided. Revenues are measured at their fair value of the consideration received or receivable. The amount of revenue is recognised if it can be measured reliably and it is probable that the economic benefits associated with the transaction will flow to the Group. If necessary, revenue is split into separately identifiable components.

The Group offers customers free minutes for a selected price based on a chosen customer plan. Free unused minutes at the end of the month might be rolled over to the following month. The Group is not obliged to reimburse the customer for unused minutes and the option of rolling over any unused minutes is valid for only one month.

The Group recognises revenue for free minutes in the period when the related services are provided and consumed, if material. Any rollover minutes are deferred and recognised when the minutes are used or the option expires.

In assessing whether revenue should be recognised gross, i.e. with separate disclosure of costs to arrive at gross profit, or on a net basis, the Group considers these indicators of gross revenue reporting:

- a) the Group is the primary obligor in the arrangement,
- b) the Group has general inventory risk,
- c) the Group has price latitude,
- d) the Group changes the product or performs part of the service,
- e) the Group has discretion in supplier selection,
- f) the Group is involved in the determination of product or service specifications,
- g) the Group has credit risk,
- h) the Group has the ability to set the terms of the transaction,
- i) the Group has the managerial control over the transaction.

The relative strength of each indicator is considered while deciding the accounting treatment.

If a transaction is considered to meet conditions of an agency arrangement, the revenue is recognised only at the amount of the commission received/realised.

Revenue from fixed price construction contracts (long-term contracts) is recognised using the percentage of completion method, measured by reference to the percentage of actual cost incurred to date to estimated total costs of the contract. A loss expected from the construction contract is recognised as an expense immediately, when it is probable that total contract costs will exceed total contract revenue.

(1) Fixed line business revenues

Revenue is recognized as follows:

Domestic and international call revenues

Domestic and international call revenues are recognised in profit or loss at the time the call is made.

Universal service

The Group is obliged to render certain fixed line telephony services defined by the Act on Electronic Communications. Relevant costs are compensated by the Czech Telecommunications Office (CTO). The Group recognises the compensation using gross principle on standard accrual basis of revenue recognition.

Subscription revenues

Revenue is recognised in profit or loss in the period in which the services are rendered.

Revenues from sales of prepaid cards

Prepaid call card sales are deferred until the customer uses the stored value on the card to pay for the relevant calls. The expiry date for prepaid cards is not longer than 36 months.

Connection fees

Connection fees, arising from the connection of the customers to the Group's network, if material, are deferred and recognised in profit or loss over the estimated average customer relationship period.

Equipment sales and sale of other goods

Revenue from the sale of telephone equipment, accessories and other goods is recognised at the time of sale i.e. when the Group has transferred to the buyer the significant risks and rewards of ownership of the goods.

Local loop unbundling

Revenue from access to the local loop unbundling is deferred in profit or loss and recognised in the period in which the service is rendered. The regular monthly fee is recognised on the straight-line basis in the period when the service is consumed. Revenue from the preparation of the location (collocation) for an alternative operator is recognized upfront in profit or loss when it occurs.

Audiotex

Revenues from audiotex, service offering content to which a special tariff applies and enables to transfer money and to pay for goods or services from the third parties, are recognised using netto principle.

Information and communication technology services

Information and communication technology (ICT) services include complex customer solutions and managed services, mainly system integration, outsourcing services, project solutions and software development. Revenue recognition of such services reflects the substance of the provided service.

(2) Mobile business revenues

The Group generates mobile service revenues from the usage of the Group's network by customers, interconnection and roaming. The Group also earns revenue from the sale of mobile telephone equipment and accessories, as well as from activation fees.

Airtime revenues

Postpaid customers are billed monthly in arrears for airtime revenues. Revenue from post-paid customers is recognised at the time of usage of airtime and other services. Prepaid customers buy credit, which entitles them to a certain value of airtime and other services. Revenue from prepaid customers is deferred and recognised at the time of usage of airtime and other services.

Both post-paid and prepaid products may include deliverables such as a handset, activation and airtime and are defined as arrangements with multiple deliverables. The arrangement consideration is allocated to each deliverable, based on its fair value, but up to consideration received if future cash receipts are contingent on future deliveries. Revenues allocated to the identified deliverables in each revenue arrangement are recognized based on the same recognition criteria which were used for the individual deliverables at the time the product or service was delivered.

Connection fees

Connection fees, arising from the connection of the customers to the Group's network, if material, are deferred and recognised in profit or loss over the estimated average customer relationship period.

Equipment sales and mobile services

Monthly service revenues and revenues from handset sales are recognized as revenue when the product or service is delivered to the distributor or to the end customer. Resulting losses from sale of handsets at a discount are recognised at the date of sale.

Roaming revenues

The mobile segment derives roaming revenue as a result of airtime and other services used by the mobile segment's customers roaming on partners' networks in other countries and vice versa. Amounts receivable from and payable to roaming partners are netted and settled net on a regular basis.

Premium SMS

Revenues from premium SMS, short text messages that enable customers to use their mobile phones to send money transfer requests and pay for goods and services from third parties, are recognised using netto principle.

Costs

Discounts directly related to the sale of equipment, SIM cards and activations are netted against revenue in the period the product is sold to the dealer, distributor or the end customer. Commission payments to dealers for activations, various marketing promotions and other activities are included in the costs of sales for the period.

(3) Interconnection revenues

Interconnection revenues are derived from calls and other traffic that originate in other domestic and foreign operators' network but terminate in or transit the Group's network. These revenues are recognised in profit or loss at the time when the call is received in the Group's network. The Group pays a proportion of the call revenue it collects from its customers to the other domestic and foreign operators' for the calls and other traffic originating in the Group's network, which use other domestic and foreign operators' network. Amounts receivable from and payable to other domestic and foreign operators are netted and settled net on a regular basis.

(4) Internet, IPTV and data services

The Group derives revenue from providing Internet access service, IPTV and other data services. The revenues from such services are recognised at the time the service is provided.

(5) Dividend income

Dividend income is recognized when the right to receive payment is established.

(6) Interest income

Income is recognised as interest accrues (using the effective interest method).

(7) Instalment sales

Revenue attributable to the sales price, exclusive of interest, is recognised at the date of sale. The sale price is the present value of the consideration, determined by discounting the instalments receivable at the imputed rate of interest. The interest element is recognised as revenue as it is earned, using the effective interest method.

S Dividend distribution

Dividend distribution to the Company's shareholders is recognized as a liability in the Group's financial statements in the period in which the dividends are approved by the Company's shareholders.

T Financial instruments

Financial instruments carried on the balance sheet include cash and bank balances, investments, receivables, payables, borrowings and derivatives. Detailed figures are described in Note 14.

Financial risk management

The Group is exposed to a variety of financial risks, including the effects of changes in debt market prices, foreign currency exchange rates and interest rates as a result of ordinary business, debt taken on to finance its business and net investment in foreign operations. The Group's overall risk management focuses on the unpredictability of financial markets and seeks to minimize potential adverse effects on the financial performance of the Group. The Group uses either derivative financial instruments (such as forward and swap contracts) or non-derivative instruments (such as cash instruments) to hedge certain exposures.

The Group does not conduct any speculative trading activities.

Risk management is carried out by the treasury department under approved policies. The Board of Directors provides written principles for overall risk management. In line with these principles, policies exist for specific areas, such as foreign exchange risk, interest rate risk, credit risk, liquidity risk, use of derivative financial instruments and investing excess liquidity.

(i) Foreign currency risk

The Group is exposed to foreign currency risk arising from various currency exposures, primarily with respect to the euro and partially to US dollar:

- a) balance sheet items (such as debt, receivables, payables) denominated in foreign currency
- b) probable forecasted transactions or firm commitments (such as purchases or sales) denominated in foreign currency, and
- c) net investment in the Slovak subsidiary (functional currency differs from CZK).

The Group's objective in managing its exposure to foreign currency fluctuations is to minimize earnings and cash flow volatility associated with foreign exchange rate changes.

The Group primarily hedges the balance sheet foreign currency exposure, mainly net payables in EUR or USD. Only plain-vanilla instruments are currently used for hedging this kind of exposure.

(ii) Interest rate risk

The Group is exposed to interest rate risk arising from floating interest rate bearing cash investments and debt instruments.

The Group's income and operating cash flows are substantially independent of changes in market interest rates. The cash assets and short term debt are currently maintained on floating rates while long term debt instruments could be maintained on both floating and fixed rates. The Group may sometimes use interest rate swaps and forward rate agreements to manage a mix of fixed and variable interest rates.

(iii) Liquidity risk

The Group's essential objective of liquidity risk management is having access to the cash resources sufficient to meet all its cash payment obligations as they fall due, allowing some flexibility. The cash resources consist of generated cash position (maintained in quickly liquid instruments), and committed credit facilities arranged with banks.

The Group is particularly focused on the liquidity profile within the time horizon of the next 12 months considering projected cash flow from operations and maturity structure of both debt obligations and financial investments. The balance between the funding continuity and flexibility is managed through maintaining the option to use bank overdrafts or bilateral credit lines.

(iv) Credit risk

Credit risk concentration, with respect to trade accounts receivable, is limited due to the large number of customers. However, substantially all trade receivables are concentrated within the Czech Republic. Although the Group does not currently foresee a dramatically higher credit risk associated with these receivables, the repayment is significantly impacted by the financial stability of a particular national economy.

The Group trades only with recognized, creditworthy third parties. It is the Group's policy that all customers wishing to trade on credit terms are subject to credit verification procedures. In addition, receivable balances are monitored on an ongoing basis with the resulting into the non significant Group's exposure to bad debts. The maximum exposure is the carrying amount as disclosed in Note 11. There is no significant concentration of credit risk within the Group.

With respect to credit risk arising from the financial assets of the Group, which comprise cash and cash equivalents, available for sale investments and certain derivative instruments, the Group's exposure arises from default of the counterparty, with a maximum exposure equal to the carrying amount of these instruments.

Credit Risk is managed by the Credit Management Unit and is based on three main activities:

- a) monitoring of accounts receivables: regular monitoring of payment moral of existing customers and monitoring and analyzing of the receivable aging structure (internal and external indicators of any potential bad debts). Those activities are processed in the integrated system solution for scoring, maintenance and collection of receivables called RMCA.

- b) prevention: scoring of new customers – checking procedures (integrated Black List, Solus Debtor Register, other external information databases), limits and/or deposits applied based on the customer segments or the product. Credit limits for indirect sales partners (dealers, distributors, retailers, franchises) for the purchase of our products, collateral security (deposits, receivables insurance, bill of exchange, pledge of real estate, bank guarantee etc).
- c) collection process: Credit Management cooperates with Customer Care on the setting up of a reasonable, effective and continual collection process. Collection process competences are divided. Collection from active customers is in the competence of Customer Care; subsequent collection (after the contract is cancelled) is the responsibility of Credit Management.

Accounting for derivative financial instruments and hedging activities

Derivative financial instruments are initially recognised in the balance sheet at cost and subsequently are re-measured at their fair value. The method of recognising the resulting gain or loss is dependent on the nature of the item being hedged. On the date a derivative contract is entered into, the Group designates certain derivatives as either:

- a) hedge of the fair value of a recognised asset or liability (fair value hedge), or
- b) hedge of a forecasted transaction or of a firm commitment (cash flow hedge).

Changes in the fair value of derivatives that are designated and qualified as fair value hedges and that are highly effective are recorded in profit or loss, along with changes in the fair value of the hedged asset or liability that is attributable to the hedged risk.

Changes in the fair value of derivatives that are designated and qualified as cash flow hedges and that are highly effective are recognised in other comprehensive income. Where the forecasted transaction or firm commitment results in the recognition of an asset or of a liability, the gains and losses previously deferred in other comprehensive income are transferred from other comprehensive income and included in the initial measurement of the cost of the asset or liability. Otherwise, amounts deferred in other comprehensive income are transferred to profit or loss and classified as revenue or expense in the same periods during which the hedged firm commitment or forecasted transaction affects profit or loss.

Certain derivative transactions, while providing effective economic hedges under the Group's risk management policies, either do not qualify for hedge accounting under the specific rules in IAS 39 or the Group has elected not to apply the specific IAS 39 hedge accounting provisions. Changes in the fair value of such derivative instruments that do not qualify for hedge accounting are recognised immediately in profit or loss.

When a hedging instrument expires or is sold, or when a hedge no longer meets the criteria for hedge accounting under IAS 39, any cumulative gain or loss existing in other comprehensive income at that time remains in other comprehensive income and is recognised in profit or loss when the committed or forecasted transaction ultimately is recognised in profit or loss. However, if a committed or forecasted transaction is no longer expected to occur, the cumulative gain or loss that was reported in other comprehensive income is immediately transferred to profit or loss.

The Group documents at the inception of the transaction the relationship between the hedging instruments and the hedged items, as well as its risk management objective and strategy for undertaking various hedge transactions. The process includes linking all derivatives designated as hedges to specific assets and liabilities or to specific firm commitments or forecast transactions. The Group also documents its assessment, both at the hedge inception and on an ongoing basis, whether the derivatives that are used in hedging transactions are highly effective in offsetting changes in fair values or cash flows of hedged items.

Fair value estimation

Except for currency options, the fair values of the derivative financial instruments reflect estimates based on calculations performed using the Group's own discounted cash flow models (using market rates). The fair value of currency options is based on information obtained from external parties, including the Group's bankers.

U Use of estimates, assumptions and judgements

The Group makes forward-looking estimates and assumptions. The resulting accounting estimates will, by definition, seldom equal the related actual results.

Estimates and judgments are continually evaluated and are based on historical experience and other factors, including expectations of future events that are believed to be reasonable under the circumstances.

The estimates and assumptions that might have a significant risk of causing a material adjustment to the carrying amounts of assets and liabilities within the next years are discussed below:

(1) Income taxes and deferred taxes

The Group creates a provision for current income taxes and in consideration of the temporary differences also for deferred tax. There are many transactions and calculations for which the ultimate tax determination is uncertain during the ordinary course of business and the measurement of deferred tax assets and liabilities reflects the tax consequences that would follow from the manner in which the Group expects to recover or settle the carrying amount of assets and liabilities. Where the final tax-non-deductible/non-taxable items are different from the amounts that were calculated, such differences will impact the current income and deferred tax provisions in the period in which such determination is made (See Note 4 and Note 15).

(2) Property, plant and equipment, intangible assets and goodwill

The accounting treatment of investments in property, plant and equipment and intangible assets entails the use of estimates to determine the useful life for depreciation and amortization purposes and to assess fair value at their acquisition dates for assets acquired in business combinations.

Determining useful life requires making estimates in connection with future technological developments and alternative uses for assets. There is a significant element of judgment involved in making technological development assumptions, since the timing and scope of future technological advances are difficult to predict. Further details are described in Note D Property, plant and equipment and Note E Intangible assets.

When an item of property, plant and equipment or an intangible asset is considered to be impaired, the impairment loss is recognized in profit or loss. The decision to recognize an impairment loss involves estimates of amount of the impairment, as well as analysis of the reasons for the potential loss. Furthermore, additional factors, such as technological obsolescence, the suspension of certain services and other circumstantial changes are taken into account.

The Group evaluates the performance of its cash-generating units regularly to identify potential impairments. Determining the recoverable amount of the cash-generating units also entails the use of assumptions and estimates and requires a significant element of judgment. The Group assesses at the end of each reporting period whether there is any indication that an impairment loss recognised in prior periods for an asset other than goodwill may no longer exist or may have decreased. If any such indication exists, The Group estimates the recoverable amount where an impairment loss recognised in prior periods shall be subject to the reversal (See Note 9).

The Group tests goodwill for impairment at each reporting date. However, goodwill does not generate cash flows independently of other assets or groups of assets and the assessment of its carrying value is significantly impacted by the management's assessment of the performance and expected future performance of the operation to which the goodwill relates. In accordance with the requirement of IAS 36, goodwill is tested annually for its recoverable amount, as well as when there are indications of impairment (See Note 8).

(3) Provisions and contingent liabilities

As set out in Note 17 the Group is a participant in several lawsuits and administrative proceedings including those related to its pricing policies. The Group's treatment of obligations with uncertain timing and amount depends on the management's estimation of the amount and timing of the obligation and probability of an outflow of resources embodying economic benefits that will be required to settle the obligation (both legal or constructive). A provision is recognised when the Group has a present obligation as a result of past events, it is probable that an outflow of resources to settle the obligation will be required and a reliable estimate of the amount of the obligation can be made (See Note 16). Contingent liabilities are not recognised, because their existence will be confirmed only by

the occurrence or non-occurrence of one or more uncertain future events not wholly within the control of the Group. Contingent liabilities are assessed continually to determine whether an outflow of resource embodying economic benefits has become probable. If it becomes probable that an outflow of future economic benefits will be required for an item previously dealt with as a contingent liability, a provision is recognised in the financial statements of the period in which the change in probability occurs.

(4) Receivables

Trade receivables are carried at original amount less bad debt allowance. The bad debt provision is estimated according to historical experience and individual assessment. Details regarding the determination of receivables impairment are stated in Note K Trade receivables.

V Change in accounting policy

No significant changes in accounting policies were applied in 2012 and 2011.

W Operating profit

Operating profit is defined as profit before financial results and taxes and represents profit from the business operations. Financial results consist of interest income, interest expense, other financial expense (which includes primarily bank charges), fair value losses and gains on financial instruments and foreign exchange gains and losses.

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1 Segment information

Business segments recognised by the Group are as follows:

- fixed - network communication services using a fixed network, WiFi infrastructure and IS/ICT services provided by the Company and other consolidated subsidiaries
- mobile - mobile communication services provided by the Company and by Telefónica Slovakia, s.r.o. and Bonerix s.r.o.

Year ended 31 December 2012 In CZK million	Fixed	Mobile*	Group
Revenues from voice services	6,294	11,196	17,490
Monthly charges	3,625	8,906	12,531
Data services	8,494	2,802	11,296
Other revenues	3,177	6,617	9,794
Revenues incl. inter-segment sales	21,590	29,521	51,111
Inter-segment sales	(313)	(264)	(577)
Total consolidated revenues	21,277	29,257	50,534
Other income	444	54	498
Total consolidated costs	(13,077)	(18,146)	(31,223)
Impairment charge	(20)	(8)	(28)
Depreciation	(5,935)	(3,218)	(9,153)
Amortisation	(1,431)	(853)	(2,284)
Total consolidated depreciation and amortization	(7,366)	(4,071)	(11,437)
Operating income	1,258	7,086	8,344
Net financial loss			(188)
Profit before tax			8,156
Corporate income tax			(1,380)
Profit for the year			6,776
Assets (excluding goodwill)	38,697	27,005	65,702
Goodwill	177	13,320	13,497
Total assets	38,874	40,325	79,199
Trade and other payables	(5,108)	(7,127)	(12,235)
Other liabilities	(3,241)	(3,149)	(6,390)
Total liabilities	(8,349)	(10,276)	(18,625)
Capital expenditure including WiFi acquisition	3,077	3,289	6,366

* Standalone figures of Telefónica Slovakia, s.r.o. included.

Year ended 31 December 2011 In CZK million	Fixed	Mobile*	Group
Revenues from voice services	6,627	12,256	18,883
Monthly charges	4,298	8,602	12,900
Data services	8,878	2,599	11,477
Other revenues	3,016	6,798	9,814
Revenues incl. inter-segment sales	22,819	30,255	53,074
Inter-segment sales	(318)	(347)	(665)
Total consolidated revenues	22,501	29,908	52,409
Other income	477	10	487
Total consolidated costs	(14,101)	(16,984)	(31,085)
Impairment reversal	(9)	(12)	(21)
Depreciation	(7,164)	(2,079)	(9,243)
Amortisation	(922)	(1,486)	(2,408)
Total consolidated depreciation and amortization	(8,086)	(3,565)	(11,651)
Operating income	782	9,357	10,139
Net financial loss			(131)
Profit before tax			10,008
Corporate income tax			(1,324)
Profit for the year			8,684
Assets (excluding goodwill)	40,472	35,057	75,529
Goodwill	133	13,320	13,453
Total assets	40,605	48,377	88,982
Trade and other payables	5,793	7,089	12,882
Other liabilities	3,474	3,529	7,003
Total liabilities	9,267	10,618	19,885
Capital expenditure including WiFi acquisition	3,456	2,400	5,856

*Standalone figures of Telefónica Slovakia, s.r.o. included.

The inter-segment pricing rates applied in 2012 and 2011 were determined on the same basis as rates applicable for other mobile operators and are consistent with rates applied for pricing with other mobile operators.

Capital expenditures comprise additions to property, plant and equipment and intangible assets.

During 2012, Telefónica Slovakia, s.r.o. further strengthened its position on the Slovak mobile market. In line with its strategy to offer simple and transparent services and to focus on the acquisition of customers in residential segment with a higher spend and customers in the small and medium businesses segment, it launched new tariff O₂ Paušál and introduced an enhanced proposition of O₂ Fér, O₂ Filip and O₂ Moje Firma tariffs. Aiming to meet increasing demand of customers for mobile data services, it expanded population coverage of its 3G network to 53% as at the 2012 year-end. This helped to increase total subscribers base in 2012 16.3% year on year to 1,354 thousand. Of that, the number of contract customers grew 32.4% year on year to reach 659 thousand, while the prepaid base increased by 4.3% reaching 695 thousand at the end of 2012. Consequently, the number of contract customers reached 48.7% of the total customer base, representing a 5.9 percentage points increase year-on-year. The market share of Telefónica Slovakia, s.r.o. expressed as the number of customers, improved during 2012 from 18% to over 20%. The growth in the number of customers and improvements in the customer mix have led to an increase in revenues which reached CZK 4,834 million in 2012, compared to CZK 3,862 million in 2011. As at 31 December 2012, the net book value of fixed assets deployed in Slovakia amounted to CZK 2,591 million (2011: CZK 2,692 million).

Financial results of the company Telefónica Slovakia, s.r.o.

Due to increased significance of Telefónica Slovakia, s.r.o., the Group presents selected data for the subsidiary. Amounts are prepared in accordance with International Financial Reporting Standards.

In CZK million	Year ended 31 December 2012	Year ended 31 December 2011
Total revenue	4,834	3,862
Operating income before depreciation and amortization („OIBDA”)	1,373	685
Profit for the year	867	990

In CZK million	Year ended 31 December 2012	Year ended 31 December 2011
Total assets	4,813	3,997
Equity	3,512	2,717

2 Revenues and costs

Revenues from voice services	Year ended	Year ended
In CZK million	31 December 2012	31 December 2011
Voice - outgoing	9,631	10,453
Interconnection and other wholesale services	7,282	7,765
Total revenues from voice services	16,913	18,218
Data services	Year ended	Year ended
In CZK million	31 December 2012	31 December 2011
Leased lines and fixed data services	2,479	2,836
Internet (including monthly and one-off charges)	5,537	5,531
Mobile data	2,802	2,598
IPTV	478	512
Total revenues from data services	11,296	11,477
Other revenues	Year ended	Year ended
In CZK million	31 December 2012	31 December 2011
SMS & MMS & PRMS and Contents	4,622	4,806
Equipment and activation charges	1,587	1,667
ICT and business solutions	2,548	2,356
Other telecommunication revenues	1,037	985
Total other revenues	9,794	9,814
Other income	Year ended	Year ended
In CZK million	31 December 2012	31 December 2011
Rental and non-telco income	112	83
Gains from fixed assets disposal	285	346
Indemnities, penalties and similar income	101	58
Total other income	498	487

Revenues from related parties are disclosed in Note 21.

Other cost of sales	Year ended	Year ended
In CZK million	31 December 2012	31 December 2011
Telco services, Contents and other cost of sales	(791)	(665)
Sub-deliveries	(1,236)	(1,023)
Commissions	(1,764)	(1,741)
Total other cost of sales	(3,791)	(3,429)

Other expenses	Year ended	Year ended
In CZK million	31 December 2012	31 December 2011
Billing and collection, provision for bad and doubtful debts	(808)	(831)
Network & IT repairs and maintenance	(3,043)	(2,658)
Rentals, buildings and vehicles	(2,080)	(2,131)
Utilities supplies	(1,137)	(1,126)
Marketing and call centers	(1,663)	(1,642)
Consultancy and professional fees and other external services	(849)	(735)
Royalties and management fees	(1,138)	(1,166)
Administrative fees and other operating expenses	(557)	(524)
Capitalized own expense on fixed assets	629	671
Total other expenses	(10,646)	(10,142)
Staff costs	Year ended	Year ended
In CZK million	31 December 2012	31 December 2011
Wages and salaries	(4,043)	(4,285)
Restructuring costs	(265)	(174)
Health and Social security contributions	(1,297)	(1,434)
Staff welfare costs	(233)	(286)
Total staff costs	(5,838)	(6,179)

The Group does not participate in any pension plans.

A restructuring plan covering both employees and members of management was approved and subsequently implemented by the Group during 2012 and 2011. As a result of the restructuring process the Group incurred restructuring costs of CZK 265 million during the year ended 31 December 2012 (2011: CZK 174 million), including redundancy payments of CZK 231 million (2011: CZK 174 million) and related consultancy costs of CZK 34 million (2011: CZK 0 million).

Statutory auditor's fees were as follows:

In CZK million	Year ended	Year ended
Auditor's fees	31 December 2012	31 December 2011
	21	27

Purchases from related parties are disclosed in Note 21.

3 Finance income and costs

In CZK million	Year ended 31 December 2012	Year ended 31 December 2011
Finance income		
Interest income	82	117
Gain on fair value adjustments of financial instruments (net)	-	185
Foreign exchange gain (net)	12	-
Other finance income	9	11
Total finance income	<u>103</u>	<u>313</u>
Finance costs		
Interest expenses	(160)	(224)
Loss on fair value adjustments of financial instruments (net)	(90)	-
Foreign exchange loss (net)	-	(191)
Other finance costs	(41)	(29)
Total finance costs	<u>(291)</u>	<u>(444)</u>

The Group recognises foreign exchange gains and losses and fair value adjustments on net basis. Comparative figures were adjusted accordingly.

4 Income taxes

In CZK million	Year ended 31 December 2012	Year ended 31 December 2011
Total income tax expense is made up of:		
Current income tax charge	1,857	2,231
Deferred income tax credit (Note 15)	(477)	(907)
Taxes on income	<u>1,380</u>	<u>1,324</u>

The tax on the Group's profit before tax differs from the theoretical amount that would arise using the basic tax rate of the home country of the Group as follows:

Telefónica Czech Republic, a.s.
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In CZK million	Year ended 31 December 2012	Year ended 31 December 2011
Profit before tax	8,156	10,008
Income tax charge calculated at the statutory rate of 19%	1,550	1,902
Not taxable income	(45)	-
Expenses not deductible for tax purposes	91	129
Tax related to prior periods	(100)	59
Tax losses from previous years	-	(57)
Additional tax on profit of Telefónica Slovakia, s.r.o.	12	-
Effect of the first time deferred tax recognition by Telefónica Slovakia, s.r.o.	(11)	(709)
Effect of tax rate change on deferred tax asset by Telefónica Slovakia, s.r.o.	(117)	-
Taxes on income	1,380	1,324
Effective tax rate	17%	13%

As at 31 December 2012 the total amount of provisions for current income taxes is CZK 1,859 million (2011: CZK 2,220 million), advances paid for income taxes amount to CZK 1,955 million (2011: CZK 2,380 million), the net deferred tax liability is CZK 3,206 million (2011: CZK 3,736 million), and the net deferred tax asset is CZK 673 million (2011: CZK 746 million).

5 Earnings per share

Basic earnings per share are calculated by dividing the net profit attributable to shareholders by the weighted average number of ordinary shares in issue during the period. The weighted average number of shares takes into account the weighted average effect of changes in treasury share transactions during the year.

	31 December 2012	31 December 2011
Weighted number of ordinary shares outstanding	319,932,546	322,089,900
Net profit attributable to shareholders (in CZK million)	6,776	8,684
Basic earnings per share (CZK)	21	27

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

The Annual General Meeting on 19 April 2012 approved the ordinary share acquisition programme for the next 5 years, up to a maximum of 10% of the total number of 322,089,890 ordinary shares.

6 Dividends

In CZK million	31 December 2012	31 December 2011
Dividends declared (including withholding tax)	8,696	12,884

Dividends include withholding tax on dividends paid by the Company to its shareholders. There has been no interim dividend paid in respect of 2012. Approval of the 2012 profit and the decision regarding the amount of any dividend payment for the 2012 financial year will take place at the Annual General Shareholder Meeting.

Dividend per share for the years ended 31 December was as follows:

In CZK	Year ended 31 December 2012	Year ended 31 December 2011
Dividend per share (nominal value of CZK 100)	27	40

7 Property, plant and equipment

In CZK million	Land, buildings and construction	Ducts, cables and related plant	Communication technology and related equipment	Other fixed assets	Total
At 31 December 2012					
Opening net book amount	10,976	29,647	9,427	1,475	51,525
Additions	262	858	2,864	382	4,366
Additions from WiFi acquisition	-	-	15	-	15
Disposals	(7)	(3)	(51)	(3)	(64)
Reclassifications and currency differences	6	(14)	24	26	42
Assets classified as held for sale	(11)	-	-	-	(11)
Depreciation charge	(931)	(4,911)	(2,642)	(670)	(9,154)
Impairment charge	-	-	(28)	-	(28)
Closing net book amount	10,295	25,577	9,609	1,210	46,691
At 31 December 2012					
Cost	20,222	103,716	89,752	8,202	221,892
Accumulated depreciation and impairment allowance	(9,927)	(78,139)	(80,143)	(6,992)	(175,201)
Net book amount	10,295	25,577	9,609	1,210	46,691
At 31 December 2011					
Opening net book amount	11,808	33,688	9,314	1,841	56,651
Additions	317	823	2,650	446	4,236
Additions from WiFi acquisition	-	-	30	-	30
Disposals	(27)	(2)	(32)	(4)	(65)
Reclassifications and currency differences	26	(2)	112	2	138
Assets classified as held for sale	(199)	(2)	-	-	(201)
Depreciation charge	(949)	(4,858)	(2,626)	(810)	(9,243)
Impairment charge	-	-	(21)	-	(21)
Closing net book amount	10,976	29,647	9,427	1,475	51,525
At 31 December 2011					
Cost	20,180	102,999	90,460	8,183	221,822
Accumulated depreciation and impairment allowance	(9,204)	(73,352)	(81,033)	(6,708)	(170,297)
Net book amount	10,976	29,647	9,427	1,475	51,525

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

The net book amount at 31 December 2012 includes CZK 2,117 million of assets under construction (2011: CZK 1,805 million). The assets under construction are spread over all disclosed categories of property, plant and equipment following their nature.

As at 31 December 2012, the carrying value of non-depreciated assets amounted to CZK 179 million (2011: CZK 191 million).

No property, plant and equipment were pledged as at 31 December 2012 and 31 December 2011.

No borrowing costs were capitalized during the years 2012 and 2011.

Classes of property, plant and equipment can be broken down into main categories as follows:

Land, buildings and construction	Closing balance	
In CZK million	31 December 2012	31 December 2011
Buildings *	5,343	5,679
* Majority of buildings are buildings for telecommunication technologies.		
Ducts, cables and related plant	Closing balance	
In CZK million	31 December 2012	31 December 2011
Twin cables	18,214	21,539
Terrestrial optic fibre	4,780	5,167
Communication technology and related equipment	Closing balance	
In CZK million	31 December 2012	31 December 2011
Exchanges	1,247	1,235
Transmission equipment	1,472	1,504
IP technology, routers, modems	901	943
Other fixed assets	Closing balance	
In CZK million	31 December 2012	31 December 2011
Information process equipment	846	1,113

The Group did not recognise any assets held for sale as at 31 December 2012 (2011: CZK 1 million in net book value).

In 2012, the Group achieved a total gain from the sale of the above fixed assets amounting to CZK 285 million (2011: CZK 346 million) and total losses of CZK 10 million (2011: CZK 49 million).

Cost of fully depreciated property, plant and equipment was CZK 73,091 million as at 31 December 2012 (2011: CZK 70,470 million).

8 Intangible assets

In CZK million	Goodwill	Licences	Software	Customer portfolio	Total
At 31 December 2012					
Opening net book amount	13,453	3,236	3,767	202	20,658
Additions	-	23	1,460	394	1,877
Additions from WiFi acquisition	44	-	-	64	108
Disposals	-	-	(4)	-	(4)
Reclassifications and currency differences	-	(3)	(38)	15	(26)
Amortisation charge	-	(400)	(1,838)	(45)	(2,283)
Closing net book amount	13,497	2,856	3,347	630	20,330
At 31 December 2012					
Cost	13,497	6,236	27,928	687	48,348
Accumulated amortisation and impairment allowance	-	(3,380)	(24,581)	(57)	(28,018)
Net book amount	13,497	2,856	3,347	630	20,330
At 31 December 2011					
Opening net book amount	13,448	3,628	4,361	-	21,437
Additions	-	-	1,386	-	1,386
Additions from WiFi acquisition	5	-	-	199	204
Disposals	-	(2)	(9)	-	(11)
Reclassifications and currency differences	-	3	33	14	50
Amortisation charge	-	(393)	(2,004)	(11)	(2,408)
Closing net book amount	13,453	3,236	3,767	202	20,658
At 31 December 2011					
Cost	13,453	6,217	26,568	213	46,451
Accumulated amortisation and impairment allowance	-	(2,981)	(22,801)	(11)	(25,793)
Net book amount	13,453	3,236	3,767	202	20,658

Goodwill

Goodwill of CZK 13,320 million resulted from the acquisition of the remaining 49% ownership interest in Eurotel Praha spol. s r.o. (Eurotel). The goodwill initially recognized at CZK 14,087 million resulted from a comparison of the cost of a business combination of CZK 29,215 million, and the fair value of net assets acquired of CZK 15,128 million. Until 31 December 2004, the goodwill had been amortised on a straight line basis over a period of 20 years and assessed for an indication of impairment at each balance sheet date.

Due to a revision of IFRS 3, IAS 36 and IAS 38 the Group ceased amortisation of the previously recognized goodwill from 1 January 2005. Accumulated amortisation as at 31 December 2004 was eliminated with a corresponding decrease in the cost of goodwill (CZK 767 million). Since the year ending 31 December 2005 onwards, goodwill is classified as an asset with an indefinite useful life, which has been tested annually for the impairment, as well as when there are indications of impairment.

The Group performed impairment tests, which did not result in any impairment losses of goodwill, in 2012 and 2011. The impairment test involves a determination of the recoverable amount for the mobile cash-generating unit, which corresponds to the value in use. Value in use is the present value of the future cash flows expected to be derived from the cash-generating unit.

Value in use is determined on the basis of an enterprise valuation model and is assessed from a Group internal perspective. Value in use is derived from the cash flow budgets, which are based on the medium-term business plan for a period of 3 years, have been approved by the management and are valid at the time of the impairment test. The business plan is based on past experience, as well as on future market trends. Further, the business plan is based on general economic data derived from macroeconomic and financial studies. Cash flows beyond the three-year period are extrapolated using appropriate growth rates. Key assumptions, on which the management has based its business plan and growth rates, include the trend of the gross domestic product, interest rates, nominal wages, average revenue per user (ARPU), customer acquisition and retention costs, churn rates, capital expenditure, market share, growth rates and the discount rates.

Any significant future changes in the market and competitive environments could have an adverse effect on the value of the cash-generating units.

The calculations of value in use for all cash-generating units are the most sensitive to the following assumptions:

Estimated growth rate – the forecast of the market and regulatory environment, where the Group conducts its principal business, is the basis for determination of the value assigned to the estimated growth rate.

Discount rate – discount rates reflect the management's estimate of the risk specific to the cash generating unit. Weighted average of cost of capital (WACC) forms the basis for the determination of the discount rate.

There is no other intangible asset with indefinite useful life except for goodwill.

Goodwill on WiFi acquisitions

In accordance with principles of standard IFRS 3, the acquirer measures the identifiable assets acquired and liabilities assumed at their acquisition-date fair values. Identifiable assets and liabilities assumed are recognised separately from goodwill. For this purpose Purchase Price Allocation of all acquired assets and assumed liabilities at their fair values was carried out in all acquired businesses.

By purchasing the network infrastructure, customer base and related assets and liabilities from local providers of WiFi Internet access, a goodwill in the amount of CZK 49 million was recognised. Goodwill is presented separately on the balance sheet and is tested annually for impairment. The goodwill resulted from a comparison of the present value of the purchase price in the amount of CZK 231 million and the fair value of net assets acquired of CZK 182 million.

Licences

Acquired licences represent the rights to operate cellular networks in the Czech Republic, UMTS (Universal Mobile Telecommunication System, the third generation mobile cellular technology for networks), GSM (Global System for Mobile Communication, the second generation technology) and CDMA (Code Division Multiple Access).

To enable its service to go live in 2007, a licence for the GSM and UMTS networks was awarded to Telefónica Slovakia, s.r.o. on 7 September 2006 for SKK 150 million (EUR 4.1 million).

In 2012, the Company acquired the rights for Internet network access using CDMA technology (Code Division Multiple Access) from the Czech Telecommunications Office (CTO) for CZK 23 million. The rights have been granted until 7 February 2018.

In 2012, the Company initiated a pilot project of the fourth generation mobile data technology LTE (Long Term Evolution). The commercial operation of this technology was launched in municipality of Jesenice in July 2012.

In November 2012, the Company has entered the public tender, launched by the CTO, which will allocate the rights to use the radio frequencies in the 800 MHz, 1,800 MHz and 2,600 MHz bands. Originally, these bands were used mainly for the terrestrial television broadcasting. The frequencies are dedicated for the provision of public mobile data services. The application to enter the tender was submitted in September and the auction phase was launched in November. At the year-end of 2012, the tender was still ongoing.

Carrying value of licences:

In CZK million	Valid by	31 December 2012	31 December 2011
GSM 900 licence	2016	258	330
GSM 1800 licence	2016	208	266
CDMA 450 licence	2018	23	13
UMTS licence	2022	2,269	2,519
GSM and UMTS licence – Slovakia	2026	98	108
Total		2,856	3,236

No borrowing costs were capitalized during the years 2012 and 2011.

Cost of fully amortised intangible assets was CZK 19,790 million as at 31 December 2012 (2011 CZK: 18,109 million).

All of the Group's intangible assets with finite lives are amortised and are subject to an annual review of impairment indicators and a review of their useful lives.

9 Impairment of non-current assets

As at 31 December 2012 and as at 31 December 2011, the Group reviewed the indicators of cash-generating units (CGU), i.e. fixed and mobile segment, seeking for any indication of impairment to the CGU's assets. As requested by IAS 36 the Group also performed full impairment testing for CGUs that include goodwill (see Note 8). The assessment and impairment testing carried out as at 31 December 2012 and 2011 confirmed that carrying amounts of non-current assets are supportable.

10 Inventories

In CZK million	31 December 2012	31 December 2011
Telecommunication material	94	134
Goods	393	354
Total	487	488

The inventories stated above are net of an allowance of CZK 60 million (2011: CZK 43 million), reducing the value of the inventories to their net realisable value. The total carrying amount of inventories at net realisable value amounts to CZK 65 million (2011: CZK 47 million). The amount of inventories recognised as an expense is CZK 2,614 million (2011: CZK 2,775 million).

In 2012 and 2011, the Group had no inventories pledged as security for liabilities.

11 Receivables

In CZK million	31 December 2012	31 December 2011
Trade receivables from third parties (net)	6,448	6,912
Group trade receivables	352	350
Prepayments	699	543
Other debtors (net)	233	468
Total	7,732	8,273

Trade receivables and other debtors are stated net of bad debt provision of CZK 3,819 million (2011: CZK 3,718 million).

As at 31 December 2012, other debtors do not contain any restricted cash (2011: CZK 22 million).

Receivables from related parties are disclosed in Note 21.

Trade receivables In CZK million	Carrying amount	Neither Impaired nor overdue	Not impaired but overdue			
			Less than 90 days	90 and 180 days	180 and 360 days	More than 360 days
At 31 December 2012	6,800	3,035	183	23	26	74
At 31 December 2011	7,262	3,594	246	25	38	67

Bad debt provisions In CZK million

At 1 January 2011	3,831
Additions	2,519
Retirements/amount paid	(2,632)
At 31 December 2011	3,718
Additions	2,490
Retirements/amount paid	(2,389)
At 31 December 2012	3,819

The Group's historical experience regarding the collection of accounts receivable is consistent with the recorded allowances. Due to these factors, the management believes that no additional credit risk beyond the amounts provided for is inherent in the Group's trade receivables.

As at 31 December 2012, the Group presented non-current financial assets of CZK 112 million (2011: CZK 149 million) consisting of other long-term credits, advance payments for long-term expenses and other holdings, which are classified as other financial assets. As at 31 December 2012 non-current financial assets contained restricted cash of CZK 20 million (2011: CZK 20 million) resulting to the Company, as small payment services provider, from the legal requirements of the regulator Czech National Bank.

12 Cash and cash equivalents

In CZK million	31 December 2012	31 December 2011	Interest rate
Cash at current bank accounts and other cash equivalents	283	192	Floating
Cash at cash-pooling structures (inter-company)	2,761	6,763	Floating
Total cash and cash equivalents	3,044	6,955	

As at 31 December 2012 and 2011, cash equivalents of the Group comprised interest bearing deposits with the maximum maturity of three months.

Since April 2006, the Group has been taking part in Telefónica Group cash-pooling, which is having a positive effect on Telefónica Group's good financial governance and effective cash flow management.

At 31 December 2012, the Group had available equivalent of CZK 1,408 million (2011: CZK 1,884 million) of undrawn committed facilities.

For the purposes of the statement of cash flows, the year-end cash and cash equivalents comprise only the following component:

In CZK million	31 December 2012	31 December 2011
Cash and cash equivalents	3,044	6,955

As at 31 December 2012 and 2011 no cash and cash equivalents were pledged.

In CZK million	Year ended 31 December 2012	Year ended 31 December 2011
Interest paid	(210)	(221)
Interest received	87	111
Bank commissions	(40)	(28)
Other financial income	13	37
Total net interest and other financial expenses paid	(150)	(101)

13 Trade and other payables

In CZK million	31 December 2012	31 December 2011
Trade creditors	9,896	10,334
Tax and social security liability	669	681
Other deferred revenue	319	396
Prepaid cards	461	560
Employee wages and benefits	519	541
Other creditors	371	370
Total payables	12,235	12,882
Other non-current liabilities	87	108

As at 31 December 2012 and 2011, other non-current liabilities were made up primarily of deposits placed by recharging partners for prepaid cards and liabilities with due date in more than 12 months.

14 Financial liabilities and financial assets

In CZK million	31 December 2012	31 December 2011
Debt in local currency	3,000	-
Debt in foreign currencies	-	2,969
Interest obligation and derivatives	31	92
Total financial debt	3,031	3,061
Repayable:		
Within one year	31	3,061
Between two and five years (total non-current)	3,000	-
Total financial debt	3,031	3,061

Term loan facility

On 27 September 2012, the Company signed the CZK 3-billion credit facility jointly arranged by UniCredit Bank Czech Republic, a.s., Česká spořitelna, a.s., Komerční banka, a.s., Citibank Europe plc and Československá obchodní banka, a.s.

The Company used the 4-year term loan facility for refinancing of the debt due in 2012 and will use it for general corporate purposes as well. The loan facility is priced at PRIBOR plus margin 1.75% p.a.

In July 2012 the Company repaid in due course a loan in the amount of EUR 115 million drew in 1997.

The Group's debt interest rate allocation after taking into account interest rate swaps was as follows:

In CZK million	31 December 2012	31 December 2011
At fixed rate	-	2,969
At floating rate	3,000	-

The fair values of borrowings are based on discounted cash flows using a discount rate based upon the borrowing rate estimated by the management of the Group as reachable at the balance sheet date. The carrying amounts of short-term debts approximate their fair value.

Loans are not secured over any assets of the Group.

The table below summarizes the maturity profile of the Group's financial and trade liabilities at 31 December 2012 based on contractual undiscounted payments.

At 31 December 2012				
In CZK million	Less than 3 months	3 to 12 months	1 to 5 years	> 5 years
Interest bearing loans and borrowings	29	48	3,179	-
Trade and other payables (except for Other deferred revenue and Prepaid cards)	10,288	1,167	-	-
Total	10,317	1,215	3,179	-
Non-current other liabilities	-	-	81	6
At 31 December 2011				
In CZK million	Less than 3 months	3 to 12 months	1 to 5 years	> 5 years
Interest bearing loans and borrowings	2	3,165	-	-
Trade and other payables (except for Other deferred revenue and Prepaid cards)	10,495	1,431	-	-
Total	10,497	4,596	-	-
Non-current other liabilities	-	-	102	6

Fair values

Set out below is a comparison by category of carrying amounts and fair values of all of the Group's financial instruments that are carried in the financial statements.

In CZK million	Carrying amount		Fair value	
	2012	2011	2012	2011
Financial assets				
Cash and cash equivalents	3,044	6,955	3,044	6,955
Short-term loans (incl. accrued interest)	1	5	1	5
Derivatives	2	101	2	101
Other financial assets	112	149	112	149
	Carrying amount		Fair value	
	2012	2011	2012	2011
Financial liabilities				
Interest bearing loans and borrowings (incl. accrued interest)	3,019	3,052	3,019	3,115
Derivatives	12	9	12	9

The fair value of derivatives and borrowings has been calculated by discounting the expected future cash flows at prevailing interest rates.

Fair value hierarchy

The Group uses the following hierarchy for determining and disclosing the fair value of financial instruments by valuation technique:

Level 1: quoted (unadjusted) prices in active markets for identical assets or liabilities.

Level 2: other techniques for which all inputs which have a significant effect on the recorded fair value are observable, either directly or indirectly.

Level 3: techniques which use inputs that have a significant effect on the recorded fair value and that are not based on observable market data.

As at 31 December 2012 and 31 December 2011, the Group held only foreign currency forward and swap contracts classified as Level 2 financial instruments measured at fair value.

During the reporting period ending 31 December 2012 and 31 December 2011, there were no transfers between Level 1 and Level 2 fair value measurements, and no transfers into and out of Level 3 fair value measurements.

Financial risk analysis

The following table demonstrates the sensitivity to a reasonably possible change in foreign exchange rates and interest rates.

In CZK million	Effect on profit before tax	
	2012	2011
FX risk		
Value at Risk*	(145)	(149)
Stress testing*	(42)	(47)
IR risk		
Stress testing*	(29)	(94)

* The Value at Risk (VaR) Model enables the Group estimate the probability of maximum possible loss to the portfolio value in the given time frame which will not be exceeded given the defined reliability level. For conducting a VaR calculation, the Group uses the risk variance and covariance method using the normal distribution (e.g. parametric method). The time frame used is one month with a 95% reliability rate. Considering the importance of net open positions resulting from financial assets and financial liabilities of the Group in individual foreign currencies, the Group models VaR from a position of translation and transaction in EUR and USD.

FX risk used stress scenario represents the immediate loss caused by one-off change in the foreign exchange rate by 1% in an unfavourable direction.

IR risk used stress scenario represents immediate one-off change of interest rates along the whole yield curve by 1% in an unfavourable direction. The calculation of unfavorable impact on Group cash flows (due to an increase in interest expense or drop in interest received relating to financial assets and financial liabilities) is made each month on a floating basis within a 12 month time frame.

Financial derivatives

The following nominal value of foreign exchange contracts was used by the Group to manage the currency risk:

In CZK million	Nominal value		Fair value	
	2012	2011	2012	2011
Foreign exchange contracts	1,387	4,257	(10)	92

15 Deferred income taxes

Deferred income taxes are calculated using currently enacted tax rates expected to apply when the asset is realized or the liability settled.

Short-term and long-term deferred taxes were calculated at 19% for both years 2012 and 2011.

In CZK million	2012	2011
At 1 January	2,990	3,931
Profit or loss tax charge / (credit) (Note 4)	(477)	(907)
Foreign exchange translation reserve	20	(34)
At 31 December	2,533	2,990

In 2012 deferred tax asset in Telefónica Slovakia, s.r.o. amounting to CZK 673 million (2011: CZK 744 million) was recognized resulting mainly from possible utilization of tax losses suffered in prior periods.

The following amounts, determined after offsetting, are shown in the consolidated balance sheet:

In CZK million	31 December 2012	31 December 2011
Deferred tax assets	(959)	(966)
Deferred tax liabilities	3,492	3,956
Total	2,533	2,990

The deferred tax asset includes CZK 668 million (2011: CZK 419 million) recoverable in less than twelve months and CZK 291 million (2011: CZK 547 million) recoverable after more than twelve months. The deferred tax liability includes CZK 650 million (2011: CZK 497 million) to be settled in less than twelve months and CZK 2,842 million (2011: CZK 3,459 million) to be settled in more than twelve months.

The deferred tax is determined by these components:

In CZK million	Consolidated balance sheet		Consolidated profit or loss	
	2012	2011	2012	2011
Temporary differences relating to:				
Tax losses	(384)	(559)	161	(533)
Property, plant and equipment and intangible assets	3,114	3,695	(581)	(458)
Trade receivables, inventories and other differences	(197)	(146)	(57)	84
Total	2,533	2,990	(477)	(907)

As at 31 December 2012 the total amount of unused tax losses from previous years in Telefónica Slovakia, s.r.o. totals to CZK 1,669 million (2011: CZK 3,054 million). At 31 December 2012 all these tax losses are taken into account in the tax asset.

The tax loss in the Slovak Republic generated before 31 December 2009 can be carried forward up to five years, while the tax loss generated after 1 January 2010 can be carried forward up to seven years.

16 Provisions for liabilities and charges

In CZK million	Regulatory and court decisions	Other provisions	Total
At 1 January 2012	24	69	93
Additions during the year	15	370	385
Utilised during the year	(5)	(412)	(417)
At 31 December 2012	34	27	61
Short-term provisions 2012	12	20	32
Long-term provisions 2012	22	7	29
	34	27	61
Short-term provisions 2011	5	62	67
Long-term provisions 2011	19	7	26
	24	69	93

With the exception of the regulatory and court decision provisions and other small provisions for which the expected timing of payments is not certain all other provisions are expected to be utilised within the next twelve months from the balance sheet date. Other provisions consist mainly of provision for employee benefits, share-based compensation and untaken holiday.

Regulatory and court decisions

A provision for regulatory and court decisions is made for legal proceedings involving the Group (see Note 17).

17 Contingencies

The Company is involved in a number of legal disputes arising from the usual course of business. Throughout 2012 the Company successfully litigated against lawsuits filed by the third parties in the past. Despite this fact, several new speculative legal actions were made against the Company. The main litigation cases involving the Company are shown below.

I. Vodafone Czech Republic a.s. - Interconnection agreement dispute

On 30 June 2005, Vodafone Czech Republic a.s. (formerly Český Mobil/Oskar Mobil) filed a legal action with the Municipal Court in Prague against the Company for damages worth CZK 538 million with accessories, and for the return of unjust enrichment of CZK 117 million with accessories. The allegation against the Company is that it did not transit traffic via the mobile operator thus violating the relevant interconnection agreements. The proceeding was legally closed in favour of the Company in February 2011 but Vodafone Czech Republic a.s. filed an extraordinary appeal over the amount of CZK 26 million, claiming that the decision is incorrect in this extent. The Supreme Court has not decided on extraordinary appeal yet.

II. ÚOHS (Office for the Protection of Economic Competition)

i. Administrative proceedings regarding the alleged abuse of dominant position in the fixed broadband market

The Office for the Protection of Economic Competition (ÚOHS) has been conducting the so-called 'preliminary investigation' since November 2008, to determine whether the Company had abused its dominant position in the broadband market. The Company provided the Office with the requested cooperation while repeatedly stating and proving that it had not held a dominant position in the market and, as such, no abuse could have been committed. Although the demands for information and documents from the Office to the Company during more than two years of the investigation have grown immeasurably, during all this time the Company was never allowed to inspect the file to check its content and see how the information was interpreted by the Office. In the light of the above, the Company requested court protection by a legal action filed with the Regional Court in Brno. In December 2010, the Regional Court in Brno preliminarily banned the Office from continuing the preliminary investigation and, in February 2011, issued a verdict stating that the preliminary investigation had to be ceased immediately. The verdict was later confirmed by the Supreme Administrative Court in September 2011. The Office reacted in March 2011 by opening an official administrative procedure regarding the dominant position on the fixed broadband ADSL market. The Company filed its statement with the authority, proving that the Office incorrectly defined the relevant market in which Company allegedly held the dominant position and was alleged to abuse it. The Company's statement citing the fierce competition between technology platforms such as xDSL, cable and WiFi in the Czech Republic was repeatedly corroborated by the Czech Telecommunications Office and the European Commission. The Company also provided the Office with numerous documents proving that all steps taken by the Company had been correct. More records are continuously added to the file. With regard to the extreme length and volume of information, the Company cannot estimate when the procedure against it would be closed. The Office did not promulgate a decision in 2012, despite the fact that the Company has provided the Office with all the necessary evidence and information. It was not possible to make a reliable estimate of the financial impact of this administrative procedure at the closing of the 2011 financial statements or these financial statements.

ii. Proceeding for a penalty of CZK 81.7 million

In December 2009, the Regional Court in Brno cancelled the decision of the Office over a penalty of CZK 81.7 million imposed on the Company in December 2003 by administrative procedure for the alleged abuse of the dominant position in the fixed voice services market. As a consequence of the dismissal, the Company asked the Office to return the penalty plus accessories. Although the principal was returned by the Office, before it was decided on the returning of the accessories, the Supreme Administrative Court had in the meantime cancelled the verdict of the Regional Court in Brno and returned the case (for the third time) back to the Regional Court in Brno. Ultimately, in March 2011 the Regional Court in Brno cancelled the decision regarding the penalty, and returned the case back to the Office for it to provide a legal justification for the penalty in relation to the adjudicated period. Despite the objections of the Company citing insufficient background, the Office issued

a new decision imposing a fine CZK 91.9 million on the Company. The Company regards the decision as an impermissible reprisal on the part of the Office, and will start a legal action including a proposal to stay the penalty for the duration of the proceedings.

III. Disputes with AUGUSTUS spol. s r.o.

The Company clearly turned around in its favour the dispute with AUGUSTUS and presently concentrates on recovering the amount of unjust enrichment from AUGUSTUS. Originally, AUGUSTUS spol. s r.o. had sued the Company for an alleged loss of profit in the period from 1995 to 2001 in the amount of CZK 183 million with accessories. AUGUSTUS spol. s r.o. claimed that the Company had unjustifiably terminated the contract for the issue and distribution of phone cards signed for an indefinite period. Based on the decision of the High Court in Prague from August 2006, the Company paid a sum of CZK 83 million plus relevant accessories (total of CZK 139 million). Subsequently, there was a positive turn in the proceedings in the favour of the Company when the Supreme Court based on the Company's appeal cancelled the previous verdicts in June 2009 and the Municipal Court in Prague ultimately dismissed the lawsuit in April 2010. The High Court finally confirmed the dismissal in August 2011. Consequently, the Company filed a lawsuit against AUGUSTUS spol. s r.o. to claim CZK 139 million back. The Municipal Court in Prague decided favourably for the Company in September 2011. AUGUSTUS spol. s r.o. filed an unsuccessful appeal. In the interim it turned out that an amount of at least CZK 94 million had been transferred to third parties based on agreements with the statutory representative. The Company takes all legal steps to secure the property and to avoid additional losses. Municipal court in Prague declared AUGUSTUS bankrupt in November 2012.

IV. MEDIATEL, spol. s r.o. – a claim for CZK 359 million

MEDIATEL, spol. s r.o., which had been cooperating with the Company in the area of phone directory publishing and distribution to all telephone subscribers (under the commercial brand Zlaté stránky) since 1992, filed a legal action against the Company for the compensation of an alleged damage exceeding CZK 359 million in December 2009. The Municipal court in Prague fully dismissed the legal action in January 2012 and the decision is final and conclusive. The dispute has been closed in favour of the Company

V. CNS a.s. – a claim for CZK 137 million

In 2009, employees of CNS a.s., dealing with the development and updates of IT applications, and employees of Telefónica O2 Business Solutions, spol. s r.o. were in negotiations over potential collaboration relating to the operation of data boxes. Ultimately, no agreement had been signed between the parties and, due to commercial reasons, the project had never gone ahead. In August 2010, CNS a.s. mounted a legal action against the Company for damages and lost profit totalling CZK 137.2 million, citing the failure to sign a contract. The Company regards this claim as fabricated and the amount as patently inflated, which can be demonstrated by the fact that, in accordance with the annual profit and loss statement for the year 2009, CNS a.s. generated a yearly profit of less than CZK 5.5 million. The Municipal court in Prague dismissed the legal action in full in December 2012. CNS company has a right to file an appeal.

VI. VOLNÝ, a.s. – a claim for CZK 4 billion

On 28 March 2011, VOLNÝ, a.s. filed a legal action with the Municipal Court in Prague against the Company for an amount exceeding CZK 4 billion, regarding alleged abuse of the dominant position in the market of broadband Internet access for households via ADSL technology. The amount is meant to represent the lost profit for years 2004 to 2010. VOLNÝ, a.s. claims to have had a 30% share of the dial-up Internet market in 2003 and implies in its legal action that it ought to have automatically the same share of the broadband market, which it does not. Allegedly it is due to a margin squeeze applied by the Company on the fix broadband market. The Company replied to the petition in July 2011 by noting that both the claim and the calculations submitted by the claimant were unsubstantiated and by pointing at discrepancies in the petition claims. The lawsuit has not been heard by the Court yet. The court has already started the proceeding in the matter and further oral hearings could be expected during the year 2013.

VII. BELL TRADE s.r.o. – a claim for CZK 3.2 billion

A legal action for CZK 3.2 billion filed by company BELL TRADE was delivered to the Company in January 2012. The legal action was filed at the District Court in Malacky (Slovakia); it alleges that the Company had signed contracts with a company called RVI, a.s. for the delivery of several IT projects back in 2002. BELL TRADE, based in Bratislava, allegedly acquired the claims as an agreed fee for services, through a chain of intermediaries. The Company filed a statement with the District Court in Malacky, refuting the existence of any contract and any services from the performance of which any fees would have arisen to any party. The Company also challenged the jurisdiction of Slovak courts since the dispute has no relation to the Slovak territory. The lack of jurisdiction has finally led to the termination of the proceedings in June 2012 but BELL TRADE filed an appeal which is still waiting to be heard by the Regional Court in Bratislava.

VIII. ČESKÉ RADIOKOMUNIKACE – a claim for CZK 3.1 billion

A legal action for CZK 3.1 billion filed by ČESKÉ RADIOKOMUNIKACE (ČRa) was served to the Company in October 2012. The claimant states that the Company allegedly caused him damage by abusing of the dominant position on the xDSL market, which had impacted ČRa's ability to reach "equitable position on the retail xDSL market". The claimed sum is calculated as a difference between the hypothetical price of the part of the business and the sale price for which the part of the business was actually sold to T-Mobile Czech Republic, a.s. in 2009. The Company considers the claim as fabricated and and this was also communicated to the court in the statement. Any oral hearing in this case has not been ordered yet.

The Company is involved in other legal disputes. The aggregate value of all ongoing disputes over CZK 5 million with a verdict expected in 2012 represents nearly CZK 24 million. The annual profit and loss statement also reflects some minor disputes with a less material risk.

The Company considers disclosing other information regarding the said litigations as not advisable, since it could jeopardize the Company's litigation strategy.

The Group is convinced that all litigation risk has been faithfully reflected in the financial statements.

18 Commitments

Operating leases - lessee

The aggregate future minimum lease payments under operating leases are as follows:

In CZK million	31 December 2012	31 December 2011
No later than 1 year	1,359	1,386
Later than 1 year and not later than 5 years	4,474	4,617
Later than 5 years	<u>3,228</u>	<u>3,981</u>
Total	9,061	9,984

The total minimum lease payments relating to operating leasing of property, plant and equipment recognised as an expense in 2012 were CZK 1,513 million (2011: CZK 1,456 million). The lease agreements may contain clauses requiring restoration of the leased site at the end of the lease term. At present, such costs do not have a material impact on the Group's consolidated results of operations, financial position, or cash flow and therefore are not accounted for.

Operating leases - lessor

The table below shows aggregate future minimum lease payments under non-cancellable operating leases, where the Group is a lessor and which give rise to future revenues consist of the buildings and other telecommunication equipment rentals:

In CZK million	31 December 2012	31 December 2011
No later than 1 year	118	112
Later than 1 year and not later than 5 years	405	409
Later than 5 years	<u>89</u>	<u>90</u>
Total	612	611

Capital and other commitments

In CZK million	31 December 2012	31 December 2011
Capital and other expenditure contracted but not provided for in the financial statements	1,980	1,881

The majority of contracted amounts relate to the telecommunications network and service contracts.

19 Service concession arrangements

The Company performs communication activities as defined in the Act on Electronic Communications based on a notification and a certificate from the Czech Telecommunications Office no. 516 as amended by later changes nos. 516/1, 516/2, 516/3, 516/4, 516/5 and 516/6.

The communication activities include (territory of the Czech Republic):

- a) public fixed communications network,
- b) public mobile communications network,
- c) public access telephone service,
- d) other voice services - service is defined as of public access,
- e) leased lines - service is defined as of public access,
- f) radio and TV signal broadcasting - service is defined as of public access,
- g) data transmission - service is defined as of public access,
- h) internet access services - service is defined as of public access,
- i) other voice services - service is not defined as of public access,
- j) leased lines - service is not defined as of public access,
- k) radio and TV signal broadcasting - service is not defined as of public access,
- l) data transmission - service is not defined as of public access,
- m) internet access services - service is not defined as of public access.

The Company provides mobile services of electronic communications in the 900 and 1,800 MHz frequency bands under the Global System for Mobile Communication (GSM) standard and LTE standard (Long Term Evolution) on the basis of radio frequency assignment from CTO valid until 7 February 2016, in the 2,100 MHz frequency band under the Universal Mobile Telecommunications System (UMTS) standard on the basis of radio frequency assignment from CTO valid until 1 January 2022 and in the 450 MHz frequency band using technology CDMA2000 (Code Division Multiple Access - CDMA), where is provided broadband mobile access to Internet on the basis of radio frequency assignment from CTO valid until 7 February 2018.

The radio frequency licence can be extended by another licence period based on an application submitted to the CTO in accordance with the Act on Electronic Communications. On the other hand, the current regulatory and business environment in the Czech Republic, the prevailing contractual, legal, regulatory, competitive or other economic factors may limit the period for which the Company can benefit from the use of these radio frequency assignments in the future.

Provision of electronic communications services in Slovakia

In 2006, Telefónica Slovakia, s.r.o. was granted a licence for the provision of electronic communications services by the means of a public mobile electronic communications network in the 900 MHz, 1,800 MHz and 2,100 MHz band on the territory of the Slovak Republic. The licence has been granted for 20 years, i.e. until 2026. The licence can be extended for an additional period based on an application submitted to the Telecommunications Office of the Slovak Republic.

Imposition of obligations related to the provision of the Universal Service

During 2012 and 2011, the Company provided the following selective services under CTO imposed obligations to provide Universal Service:

- a) public pay telephone services,
- b) access for disabled persons to the public telephone service, which must be equal to access enjoyed by other end users; such special access takes namely the form of specially adapted telecommunication equipment,
- c) special price plans, which are different from the price plans used under standard commercial conditions, for low-income persons, persons with special social needs and disabled persons.

Universal Service is reimbursed by the Czech Telecommunications Office that receives funds from the state budget, which are remitted without delay to the Company's account.

20 Share capital and reserves

	31 December 2012	31 December 2011
Nominal value per ordinary registered share (CZK)	87	100
Number of shares	322,089,890	322,089,890
Nominal value per ordinary registered share (CZK)	870	1,000
Number of shares	1	1
Ordinary shares (in CZK million)	28,022	32,209

The reduction of the Company's share capital was registered into the Commercial Register on 14 November 2012. Each share with the nominal value of CZK 100 was decreased by CZK 13 per share and each share with the nominal value of CZK 1,000 was decreased by CZK 130. As at 31 December 2012, the amount of the Company's share capital equaled to CZK 28,021,821,300.

During year 2012 the Company acquired in ordinary share acquisition programme 6,441,798 treasury shares for CZK 2,483 million.

Shareholdings in the Company were as follows:

	31 December 2012	31 December 2011
Telefónica, S.A.	69.41%	69.41%
Telefónica Czech Republic, a.s. (treasury shares)	2.00%	0.00%
Other shareholders	28.59%	30.59%

The funds include a statutory reserve fund of CZK 6,491 million (2011: CZK 6,442 million) that is by law not distributable. The equity-settled share based payments reserve of CZK 31 million (2011: CZK 56 million) is not distributable.

Capital management

The Company is not subject to any externally imposed capital requirements.

The Company's objectives when managing its capital are:

- a) to safeguard the Company's ability to continue as a going concern so that it can provide value for its shareholders, and
- b) to comply with all relevant legal requirements.

The investment strategy in the light of managing the capital of the Company is to focus its investment activities in the pro-growth areas, such as the development and improvement of fixed and mobile broadband internet and data networks, mobile services, ICT solutions for corporations and for the public sector, and further expansion and development of mobile services (including data) in Slovakia. IT systems renewal and upgrade are among other investment activities aiming to simplify and improve processes that will lead to improved operational effectiveness.

At present, the Company's policy is not to retain surplus cash and distribute it to shareholders. In the following periods, the Board of Directors will continue to make in-depth analysis and assessment of the current and anticipated results of the Company, including scheduled and potential investments and cash flow generation, and will optimize the capital structure to serve the purpose of achieving the ultimate plans.

There are no other specific objectives.

In the case that the dividend capacity (capped at the retained earnings from previous years and the profit for the current year) is lower than the amount of surplus cash, the Company will, in line with its intention not to hold the surplus cash, make an annual analysis of the other options allowing the distribution of cash surpluses to its shareholders. These options comprise:

- a) distribution of the share premium
- b) share capital reduction through a decrease of the nominal value of shares
- c) share buyback

Standalone equity structure as at 31 December 2012:

In CZK million	31 December 2012
Share capital	28,022
Treasury shares	(2,483)
Share premium	24,374
Funds and reserves	6,481
Retained earnings from previous years	868
Net income for current year	5,925
Total	63,187

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

21 Related party transactions

The Telefónica Group is organized into four divisions – two geographic and two global ones.

Two geographic divisions are Telefónica Europe and Telefónica Latin America while the Group belongs to the former.

Two global cross-business divisions are Telefónica Digital and Telefónica Global Resources. Telefónica Digital seeks to strengthen the role of Telefónica in the digital world and exploit all growth opportunities while strengthening the portfolio of products and services. Telefónica Global Resources was created to increase the profitability by using all benefits of global exposure.

The Group operates in roaming, interconnection and telecommunications services in regional divisions. In the area of support services it uses cooperation within global divisions.

The Group cooperates with Telefónica Global Services GmbH in the area of centralized demand aggregation, negotiation activities related to the purchases of selected product categories and services and carrying out centralized commercial supplier management.

The Group cooperates with Telefónica Global Roaming GmbH in the area of wholesale roaming business, negotiaton and execution of roaming discounts agreements with roaming partners, which enables the Group to be granted discounts by the roaming partners and to grant discounts to the roaming partners.

Sales and purchase transactions with related parties are based on contractual agreements negotiated on normal commercial terms and conditions and at market prices. Outstanding balances of assets and liabilities are unsecured, interest-free (excl. financial assets and liabilities used for financing) and the settlement occurs either in cash or by offsetting. The financial assets balances are tested for the impairment at the balance sheet date, and neither allowance nor write-off were incurred.

The following transactions were carried out with related parties:

I. Parent company:

Balance sheet In CZK million	31 December 2012	31 December 2011
a) Receivables	-	6
b) Payables	751	800
Comprehensive income In CZK million	Year ended 31 December 2012	Year ended 31 December 2011
a) Purchases of services and goods	47	40
b) Royalty fees	726	768

The total amount of dividend paid as at 31 December 2012 to Telefónica, S.A. was CZK 6,036 million (2011: CZK 8,943 million). The amount paid due to the share capital reduction as at 31 December 2012 amounted to CZK 2,906 million (2011: CZK 0 million).

II. Other related parties – Telefónica Group:

Balance sheet	31 December 2012	31 December 2011
In CZK million		
a) Receivables	352	344
b) Payables	2,115	2,202
c) Short-term receivables - interest (Note 14)	1	5
d) Cash equivalents (Note 12)	2,761	6,763
Comprehensive income	Year ended	Year ended
In CZK million	31 December 2012	31 December 2011
a) Sales of services and goods	821	865
b) Purchases of services and goods	1,261	711
c) Management fees	412	398
d) Interest income	65	76

For the period ended 31 December 2012, capital expenditures amounted CZK 4 million (2011: CZK 1 million).

The list of the Telefónica companies with which the Group had any transaction in 2012 and 2011 includes the following entities: Telefónica S.A., Telefónica de España, S.A.U., Telefónica Germany GmbH & CO.OHG, Telefónica UK Ltd., Telefónica Ireland Ltd., Telefónica Móviles España, S.A.U., Telefónica Móviles Argentina, S.A., O2 Holdings Ltd., Telefónica Germany Customer Services GmbH, Telefónica Insurance S.A., Telefónica Móviles Guatemala, S.A., Telefónica Móviles El Salvador, S.A. de C.V., Telefónica Móviles Panamá, S.A., Telefónica Móviles Chile, S.A., Otecel, S.A., Telefónica Móviles Nicaragua, S.A., Telefónica Móviles Columbia, S.A., Telefónica Investigación y Desarrollo, S.A., Telecom Italia S.p.A., Telfisa Global BV, Telfisa, Telefónica International Wholesale Services, Telefónica International Wholesale Services II, S.L., S.A., Atento Chequia, Portugal Telecom, Telefónica Compras Electrónica, S.L., Telefónica Móviles Mexico, S.A., Telefónica Móviles del Uruguay, S.A., Telefónica Móviles Peru, S.A., Telefónica Venezuela, S.A., China Unicom (Hong Kong) Limited, Telefónica Global Roaming GmbH, Vivo, S.A., Telefónica Europe People Services Limited, Jajah Ltd., Telefónica USA, Telefonica Global Technology Chequia, Telefonica Global Technology, Telefonica Global Services GmbH, MOPET CZ a.s., Telefónica Factoring, E.F.C., S.A., Telefónica Costa Rica S.A., Telefónica Soluciones de Informatica y Comunicaciones de España S.A., Telefónica Digital España SL.

III. Other related parties

a) Key management compensation

Members of the Board of Directors and of the Supervisory Board of the Company were provided with benefits as follows:

In CZK million	31 December 2012	31 December 2011
Salaries and other short-term benefits	100	109
Personal indemnification insurance	<u>3</u>	<u>4</u>
Total	103	113

b) Loans to related parties

There were no loans provided to members of Board of Directors and Supervisory Board in 2012 and 2011.

No other loan was provided to related parties by the Group.

22 Principal subsidiary undertakings and associates

As at 31 December 2012

Subsidiaries	Group's interest	Cost of investment in CZK million	Country of incorporation	Activity	Method of consolidation
1. CZECH TELECOM Germany GmbH	100%	10	Germany	Data transmission services	Full consolidation
2. CZECH TELECOM Austria GmbH	100%	6	Austria	Data transmission services	Full consolidation
3. Telefónica Slovakia, s.r.o.	100%	6,116	Slovakia	Mobile telephony, internet and data transmission services	Full consolidation
4. Internethome, s.r.o.	100%	72	Czech Republic	Provision of WiFi internet access	Full consolidation
5. Bonerix s.r.o.	100%	200	Czech Republic	Mobile telephony, internet and data transmission services	Full consolidation
Associates					
6. První certifikační autorita, a.s.	23%	9	Czech Republic	Certification services	Not consolidated
7. AUGUSTUS, spol. s r.o.	40%	-	Czech Republic	Auction sales and advisory services	Not consolidated
8. MOPET CZ a.s.	14%	20	Czech Republic	Real time mobile payments	Not consolidated

As at 31 December 2011

Subsidiaries	Group's interest	Cost of investment in CZK million	Country of incorporation	Activity	Method of consolidation
1. Telefónica Q2 Business Solutions, spol. s r.o.	100%	237	Czech Republic	Network and consultancy services in telecommunications, IT/ICT services	Full consolidation
2. CZECH TELECOM Germany GmbH	100%	10	Germany	Data transmission services	Full consolidation
3. CZECH TELECOM Austria GmbH	100%	6	Austria	Data transmission services	Full consolidation
4. Telefónica Slovakia, s.r.o.	100%	6,116	Slovakia	Mobile telephony, internet and data transmission services	Full consolidation
5. Internethome, s.r.o.	100%	55	Czech Republic	Provision of WiFi internet access	Full consolidation
Associates					
6. První certifikační autorita, a.s.	23%	9	Czech Republic	Certification services	Not consolidated
7. AUGUSTUS, spol. s r.o.	40%	-	Czech Republic	Auction sales and advisory services	Not consolidated
8. MOPET CZ a.s.	14%	13	Czech Republic	Real time mobile payments	Not consolidated

In 2012, the Company became the sole shareholder of the new subsidiary Bonerix s.r.o. with the registered capital of CZK 200 thousand. In August 2012, Bonerix s.r.o. acquired five parts of the business of Global Care Group.

In August 2012, the Board of Directors approved an increase of the other equity funds of Bonerix s.r.o. by CZK 200 million in the form of a cash contribution.

In 2012, the investment in MOPET CZ a.s. was increased by CZK 7 million.

23 Post balance sheet events

During 2013, the Company plans to continue implementing additional operational efficiencies and improvements that would lead to further savings in various areas, personnel costs inclusive. This efficiency enhancement programme is the way for the Company to retain the leading position on the market and face the macroeconomic situation in the Czech Republic. The overall 2013 restructuring plan is not yet finalized and available as at date of the issue of the Financial Statements, however, the costs of such programme are expected between CZK 330 million and CZK 390 million.

There were no other events, which have occurred subsequent to the year end, which would have a material impact on the financial statements at 31 December 2012.

