

Telefónica O2 Czech Republic, a.s.

**CONSOLIDATED FINANCIAL STATEMENTS
FOR THE YEAR ENDED 31 DECEMBER 2006**

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

Content	Pages
GENERAL INFORMATION	1
INDEPENDENT AUDITORS' REPORT	3
CONSOLIDATED INCOME STATEMENT	5
CONSOLIDATED BALANCE SHEET	6
CONSOLIDATED STATEMENT OF CHANGES IN SHAREHOLDERS' EQUITY	7
CONSOLIDATED CASH FLOW STATEMENT	8
ACCOUNTING POLICIES	9
NOTES TO THE CONSOLIDATED FINANCIAL STATEMENTS	34

GENERAL INFORMATION

Telefónica O2 Czech Republic, a.s. Group (the "Group") consists of Telefónica O2 Czech Republic, a.s. (the "Company") and its subsidiaries: Telefónica O2 Services, spol. s r.o., CenTrade, a.s, SPT TELECOM (Czech Republic) Finance B.V., CZECH TELECOM Germany GmbH, CZECH TELECOM Austria GmbH and Telefónica O2 Slovakia s r.o. As of June 2005, the Group became a member of the Telefónica Group of companies (the "Telefónica Group") with a parent company, Telefónica, S.A. (the "Telefónica").

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

The number of employees employed with the Group amounted in average to 9,951 in 2006 (2005: 10,506).

Telefónica O2 Czech Republic, a.s. has a form of a joint stock company and is incorporated and domiciled in the Czech Republic. The address of its registered office is Olšanská 5/55, Prague 3, 130 34, Czech Republic.

The Company's shares are traded on the Prague Stock Exchange and London Stock Exchange (GDRs).

These consolidated financial statements were approved for issue by the Company's Board of Directors on 22 February 2007.

Transfer of assets and liabilities (Up-stream merger) and restructuring of the Group in 2006

On 27 April 2006, the General Shareholders Meeting approved a transfer of assets and liabilities of the former 100% subsidiary Eurotel Praha, spol. s r.o. (the "former Eurotel") to ČESKÝ TELECOM, a.s. and approved an Agreement on transfer of assets and liabilities between ČESKÝ TELECOM, a.s. and former Eurotel. The General Shareholders Meeting further approved a change in the Articles of Association related to a transfer of the National Property Fund's stake in 2005.

In addition, the Company changed its registered name from ČESKÝ TELECOM, a.s. to Telefónica O2 Czech Republic, a.s. within the transfer of assets and liabilities process as a result of the Company's integration with the Telefónica Group.

As a result of the Decision of the General Shareholders Meeting of 27 April 2006, the following changes have been incorporated in the Company's Register with effective date 1 July 2006 and decisive date 1 January 2006:

- Dissolution of former Eurotel without liquidation and transfer of its assets and liabilities to its sole shareholder ČESKÝ TELECOM, a.s.
- Change of the registered name of ČESKÝ TELECOM, a.s. to Telefónica O2 Czech Republic, a.s.

Relationship with the Czech state, privatisation and acquisition process finalised in 2005

The Czech state, through the National Property Fund of the Czech Republic (the "NPF"), had been the majority shareholder of the Company until the take-over of Telefónica, S.A. and completion of the privatisation process in June 2005. As a majority shareholder, the NPF had the power to control certain decisions taken at the General Shareholders' Meetings, including the election of the members of the Supervisory Board and the approval of dividend payments.

The acquisition process was completed on 16 June 2005, once Telefónica, S.A. paid the remaining 90% of the purchase price, and the NPF transferred its 51.1% stake in the Company to Telefónica, S.A. Telefónica, S.A. then increased its stake in the Company from 51.1% to 69.4% of the common stock.

Telefónica, S.A. applied effectively its control at the General Shareholders Meeting which took place on 23 June 2005. The Group was included in the Telefónica Group since finalisation of the take-over. Mutual transactions, representing generally supplies of telecommunication services take place amongst Telefónica companies. All these transactions are being made under common commercial terms and conditions that are not more preferable than those offered to other customers and suppliers.

The Group supplies telecommunication services to and acquires services from various state-owned entities, agencies and companies in which the Czech state holds the majority shareholding. All such transactions are made under normal commercial terms and conditions that are not more preferable than those available to other customers and suppliers. In aggregate, the state-owned entities, agencies and companies comprise one of the Group's largest customers. In providing services to these entities, agencies and companies, Telefónica O2 Czech Republic, a.s. conducts business with them as separate customers. Services provided to any individual governmental entity, agency or state-owned company do not represent a significant component of the Group's revenues.

**INDEPENDENT AUDITORS' REPORT TO THE SHAREHOLDERS
OF TELEFÓNICA O2 CZECH REPUBLIC, a.s.**

We have audited the accompanying financial statements of Telefónica O2 Czech Republic, a.s. and its subsidiaries ("the Group"), which comprise the consolidated balance sheet as at 31 December 2006 and the consolidated income statement, consolidated statement of changes in equity and consolidated cash flow statement for the year then ended, and a summary of significant accounting policies and other explanatory notes.

Management's Responsibility for the Financial Statements

Management is responsible for the preparation and fair presentation of these financial statements in accordance with International Financial Reporting Standards. This responsibility includes: designing, implementing and maintaining internal control relevant to the preparation and fair presentation of financial statements that are free from material misstatement, whether due to fraud or error; selecting and applying appropriate accounting policies; and making accounting estimates that are reasonable in the circumstances.

Auditor's Responsibility

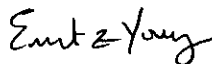
Our responsibility is to express an opinion on these financial statements based on our audit. We conducted our audit in accordance with International Standards on Auditing. Those standards require that we comply with ethical requirements and plan and perform the audit to obtain reasonable assurance whether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

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

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

Opinion

In our opinion, the consolidated financial statements give a true and fair view of the financial position of the Group as at 31 December 2006, and of its financial performance and its cash flows for the year then ended in accordance with International Financial Reporting Standards as adopted by the EU.



Ernst & Young Audit & Advisory, s.r.o., člen koncernu
Licence No. 401
Represented by



Brian Welsh
Partner



Magdalena Souček
Auditor, Licence No. 1291

22 February 2007
Prague, Czech Republic

CONSOLIDATED INCOME STATEMENT

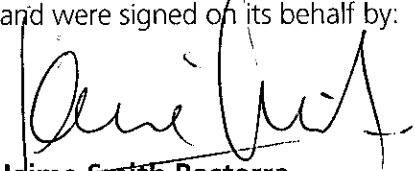
	<u>Notes</u>	Year ended	
		<u>31 December 2006</u>	<u>31 December 2005</u>
Revenue	2	61,311	61,040
Gains from sale of non-current assets		98	116
Internal expenses capitalized in fixed assets	2	911	594
Operating expenses	3	(34,161)	(33,249)
Impairment loss	8,9,10	(253)	(1,261)
Depreciation and amortisation	8,9	<u>(16,746)</u>	<u>(17,808)</u>
Operating profit		11,160	9,432
Interest income	4	149	46
Interest expense	4	(430)	(748)
Other finance income (net)	4	<u>61</u>	<u>18</u>
Profit before income tax		10,940	8,748
Taxes on income	5	<u>(2,920)</u>	<u>(2,500)</u>
Profit for the year		<u>8,020</u>	<u>6,248</u>
Attributable to:			
Equity holders of the Company	6	8,020	6,249
Minority interest	29	-	(1)
Earnings per share (CZK) – basic*	6	25	19

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

CONSOLIDATED BALANCE SHEET

	<u>Notes</u>	<u>31 December 2006</u>	<u>31 December 2005</u>
ASSETS			
Property, plant and equipment	8	78,755	88,003
Intangible assets	9	21,628	22,846
Available-for-sale investments	13	-	58
Held-to-maturity investments	13	27	29
Investment in associate	28	11	11
Deferred tax receivable	17	26	-
Other financial assets	12	<u>377</u>	<u>412</u>
Non-current assets		100,824	111,359
Inventories	11	987	716
Receivables and prepayments	12	8,346	8,013
Income tax receivable		-	124
Available-for-sale investments	13	56	-
Cash and cash equivalents	14	<u>7,461</u>	<u>3,639</u>
Current assets		16,850	12,492
Non-current assets classified as held for sale	8	<u>203</u>	<u>360</u>
Total assets		<u>117,877</u>	<u>124,211</u>
EQUITY AND LIABILITIES			
Ordinary shares	24	32,209	32,209
Share premium		30,816	30,816
Retained earnings, funds and reserves		<u>25,456</u>	<u>31,950</u>
		88,481	94,975
Minority interest	29	<u>-</u>	<u>-</u>
Total equity		<u>88,481</u>	<u>94,975</u>
Long-term financial debts	16	9,156	9,324
Deferred taxes	17	4,495	5,721
Non-current provisions for liabilities and charges	19	2,037	2,111
Non-current other liabilities	15	<u>807</u>	<u>1,265</u>
Non-current liabilities		16,495	18,421
Short-term financial debts	16	207	307
Trade and other payables	15	11,129	9,634
Income tax liability		730	251
Provisions for liabilities and charges	19	<u>835</u>	<u>623</u>
Current liabilities		<u>12,901</u>	<u>10,815</u>
Total liabilities		<u>29,396</u>	<u>29,236</u>
Total equity and liabilities		<u>117,877</u>	<u>124,211</u>

These consolidated financial statements were approved by the Board of Directors on 22 February 2007 and were signed on its behalf by:


Jaime Smith Basterra
 Chairman of the Board of Directors
 and Chief Executive Officer


Ramon Ros
 Member of the Board of Directors
 and Chief Financial Officer

CONSOLIDATED STATEMENT OF CHANGES IN SHAREHOLDERS' EQUITY

	Notes	Share capital	Share premium	Hedging reserve	Foreign exchange translation reserve	Funds*	Retained earnings	Minority interest	Total
Balance at 1 January 2005		32,209	30,816	(47)	13	5,628	20,080	6	88,705
Fair value losses (net of tax)									
- cash flow hedges	26	-	-	36	-	-	-	-	36
Currency translation differences									
- amount arising in year		-	-	-	(13)	-	-	-	(13)
Changes in statutory reserves and other movements		-	-	-	-	405	(401)	(5)	(1)
Net income/(expense) recognised directly in equity		-	-	36	(13)	405	(401)	(5)	22
Net profit		-	-	-	-	-	6,249	-	6,249
Minority interest		-	-	-	-	-	-	(1)	(1)
Balance at 31 December 2005		<u>32,209</u>	<u>30,816</u>	<u>(11)</u>	<u>-</u>	<u>6,033</u>	<u>25,928</u>	<u>-</u>	<u>94,975</u>
Merger impact – funds		-	-	-	-	(121)	121	-	-
Balance at 1 January 2006 as restated		<u>32,209</u>	<u>30,816</u>	<u>(11)</u>	<u>-</u>	<u>5,912</u>	<u>26,049</u>	<u>-</u>	<u>94,975</u>
Fair value gains (net of tax)									
- cash flow hedges	26	-	-	(8)	-	-	-	-	(8)
Currency translation differences									
- amount arising in year		-	-	-	(9)	-	-	-	(9)
Changes in statutory reserves and other movements		-	-	1	(3)	358	(359)	-	(3)
Net income/(expense) recognised directly in equity		-	-	(7)	(12)	358	(359)	-	(20)
Dividends declared in 2006	7	-	-	-	-	-	(14,494)	-	(14,494)
Net profit		-	-	-	-	-	8,020	-	8,020
Balance at 31 December 2006		<u>32,209</u>	<u>30,816</u>	<u>(18)</u>	<u>(12)</u>	<u>6,270</u>	<u>19,216</u>	<u>-</u>	<u>88,481</u>

* Refer Note 24 regarding amounts not available for distribution.

CONSOLIDATED CASH FLOW STATEMENT

		Year ended	
	Notes	<u>31 December 2006</u>	<u>31 December 2005</u>
Cash flows from operating activities			
Cash generated from operations	26	28,263	27,760
Interest paid		(429)	(889)
Interest received		186	47
Income tax paid		<u>(3,564)</u>	<u>(3,262)</u>
Net cash from operating activities		24,456	23,656
Cash flows from investing activities			
Purchase of property, plant and equipment		(4,770)	(4,044)
Purchase of intangible assets		(1,444)	(1,156)
Proceeds from sales of property, plant and equipment		214	235
Proceeds from marketable securities		-	184
Grant of loan		(3,294)	-
Repayment of loan		<u>3,253</u>	<u>-</u>
Net cash used in investing activities		(6,041)	(4,781)
Cash flows from financing activities			
Proceeds from borrowings		-	11,580
Repayment of borrowings		-	(27,393)
Dividends – paid		<u>(14,494)</u>	<u>-</u>
Net cash used in financing activities		<u>(14,494)</u>	<u>(15,813)</u>
Net increase/(decrease) in cash and cash equivalents			
		3,921	3,062
Cash and cash equivalents at beginning of year		3,538	480
Effects of exchange rate changes		<u>2</u>	<u>(4)</u>
Cash and cash equivalents at the year end	14	<u><u>7,461</u></u>	<u><u>3,538</u></u>

ACCOUNTING POLICIES

	Pages
Index to accounting policies	
A Basis of preparation	10
B Group accounting	13
C Property, plant and equipment	14
D Intangible assets	15
E Non-current assets classified as held for sale	16
F Impairment of assets	17
G Investments and other financial assets	17
H Leases	19
I Inventories	20
J Trade receivables	20
K Cash and cash equivalents	20
L Financial debt	20
M Current and deferred income taxes	21
N Employee benefits	21
O Share-based compensation	22
P Provisions	23
Q Revenue recognition	23
R Dividend distribution	26
S Financial instruments	26
T Critical accounting estimates and judgments	29
U Change in accounting policy	31
V Mobile license in Slovakia	32
W Integration process	32
X Operating profit	33

A Basis of preparation

The principal accounting policies applied in the preparation of these consolidated financial statements are set out below. These 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 International Financial Reporting Interpretations Committee ("IFRIC").

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 this particular time, due to the endorsement process of the EU and the activities of the Group, there is no difference in the policies applied by the Group between IFRS 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, financial derivatives, available for sale investment securities, share based payment liability and certain assets and liabilities acquired during business combinations, as disclosed in the accounting policies below.

The preparation of financial statements in conformity with IFRS required the Group to use certain critical accounting estimates. It also required management to exercise its judgement 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 T.

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

Adoption of IFRS standards and interpretations

In 2006, the Group applied the below stated IFRS, which are relevant to its operations:

IAS 1 (revised 2005)	Presentation of Financial Statements
IAS 2 (revised 2003)	Inventories
IAS 7 (revised 2005)	Cash flow statement
IAS 8 (revised 2003)	Accounting Policies, Changes in Accounting Estimates and Errors
IAS 10 (revised 2003)	Events after Balance Sheet Date
IAS 11	Construction contracts
IAS 12	Income Taxes
IAS 14	Segment Reporting
IAS 16 (revised 2003)	Property, Plant and Equipment
IAS 17 (revised 2003)	Leases

IAS 18	Revenue
IAS 19	Employee Benefits
IAS 20	Accounting for Government Grants and Disclosure of Government Assistance
IAS 21 (revised 2005)	The effects of Changes in Foreign Exchange Rates
IAS 23	Borrowing Costs
IAS 24 (revised 2003)	Related Party Disclosures
IAS 27 (revised 2003)	Consolidated and Separate Financial Statements
IAS 28 (revised 2003)	Investments in Associates
IAS 32 (revised 2004)	Financial Instruments: Disclosure and Presentation
IAS 33 (revised 2003)	Earnings per Share
IAS 36 (revised 2004)	Impairment of Assets
IAS 37	Provisions, Contingent Liabilities and Contingent Assets
IAS 38 (revised 2004)	Intangible Assets
IAS 39 (revised 2005)	Financial Instruments: Recognition and Measurement
IAS 40	Investment Property
IFRS 2 (issued 2004)	Share-based Payments
IFRS 3 (issued 2004)	Business Combinations
IFRS 5 (issued 2004)	Non-current Assets Held for Sale and Discontinued Operations

IFRS 3 requires simultaneous adoption with IAS 36 and IAS 38.

IAS 39 requires simultaneous adoption with IAS 32.

IFRIC 1 (issued 2001)	Changes in Existing Decommissioning, Restoration and Similar Liabilities
IFRIC 4 (effective date 1 January 2006)	Determining whether an Arrangement contains a Lease

Out of the above mentioned standards and interpretations, in 2006 the Group newly adopted the following:

IAS 21 (revised 2005)

The Group adopted the amendments to IAS 21. As a result, all exchange differences arising from a monetary item that forms part of the Group's net investment in a foreign operation are recognised in a separate component of equity in the consolidated financial statements regardless of the currency in which the monetary item is denominated. This change had no impact on the consolidated financial statements of the Group.

IFRIC 4 (effective date 1 January 2006)

The adoption of this interpretation did not have any material effect relating to the Group's activities.

Standards and interpretations issued but not early adopted by the Group

IFRS 7, IAS 30 and IAS 32 (issued in 2005, effective date 1 January 2007) Financial Instruments: Disclosures - the Group does not expect any material effect on the Balance Sheet and the Income Statement relating to the adoption of this standard from the effective date 1 January 2007. This adoption will affect certain disclosures in the notes to the consolidated financial statements.

Amendments to IAS 1 (issued 2005, effective date 1 January 2007) Presentation of financial statements, Capital disclosures – the Group does not expect any material effect on the Balance Sheet and the Income Statement relating to the adoption of this amendment from the effective date 1 January 2007. This adoption will affect certain disclosures in the notes to the consolidated financial statements.

IFRS 8 Operating Segments (effective date 1 January 2009) - the Group does not expect any material effect on the Balance Sheet and the Income Statement relating to the adoption of this standard from the effective date 1 January 2009. This adoption will affect certain disclosures in the notes to the consolidated financial statements.

IFRIC 7 Applying the Restatement Approach under IAS 29 Financial Reporting in Hyperinflationary Economies (effective date 1 March 2006) – the interpretation does not apply to the Group's activities.

IFRIC 9 Reassessment of Embedded Derivatives (effective date 1 June 2006) – the Group does not expect any material effect relating to the adoption of this interpretation since the effective date 1 June 2006.

IFRIC 10 Interim Financial Reporting and Impairment (effective date 1 November 2006) – the Group does not expect any material effect relating to the adoption of this interpretation since the effective date 1 November 2006.

IFRIC 12 Service Concession Arrangements (effective date 1 January 2008) - the Group does not expect any material effect relating to the adoption of this interpretation from the effective date 1 January 2008.

IFRIC 8 Scope of IFRS 2 (effective date 1 May 2006)

IFRIC 11 IFRS 2 Group and Treasury Share Transactions (effective date 1 March 2007)

This adoption will affect certain disclosures in the notes to the consolidated financial statements.

The Group does not intend to early adopt any of those standards and interpretations before their effective date.

B Group accounting

(1) 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 and are no longer consolidated from the date when the Group ceases to have control.

A business combination is accounted for using the purchase method of accounting. An acquisition is accounted for at its cost, being the amount of cash and cash equivalents paid in exchange for control over the net assets of an acquired company, plus any costs directly attributable to the acquisition. The excess of the cost of acquisition over the fair value of the net assets of the subsidiary acquired is recorded as goodwill. For detail refer to Note D Intangible assets and also Note 9.

Intercompany transactions and balances between 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.

The ultimate parent company of the Telefónica Group is Telefónica, S.A.

(2) Foreign currencies

(i) Functional and presentation currency

Items included in the financial statements of each entity included 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 Company's functional and 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 the income statement, except when deferred in equity 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*

The income and cash flow statements 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 shareholders' equity. When a foreign entity is sold, such exchange differences are recognised in the income statement as part of the gain or loss on sale.

C 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 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 depreciation and 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 all expenditure up to the customers' premises, including the cost of contractors, materials, direct labour costs and interest cost incurred during the course of construction.

Repairs and maintenance 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 de-recognised or 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 these consolidated financial statements are as follows:

	Years
Freehold buildings	up to 40
Cable and other related plant	5 to 25
Exchanges and related equipment	up to 10
Other fixed assets	2 to 10

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 F Impairment of assets).

D Intangible assets

Intangible assets include computer software, purchased goodwill, licenses, trade names, customer base and roaming contracts. 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 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 amortisation and impairment charges and 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 (only the post-paid customer base is recognised as a separate intangible asset).

Acquired licenses are recorded at cost and amortised on a straight-line method basis over the remaining life of the license (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 indefinite useful life are not amortised. They are subject to the regular impairment reviews (see Note 9 and Note 10).

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 the 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 it is not expected any future economic benefits or that are disposed of for any other reason are de-recognised from the balance sheet together with corresponding accumulated depreciation (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 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.

E 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 the impairment loss with impact in the income statement of the relevant period.

From the moment the asset is classified as held for sale and eventually revaluated, it ceases to be depreciated/amortised and an impairment is only being determined.

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 the income statement.

F 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).

G 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 2005 and 2006, 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.

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 the income statement 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 equity 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 equity is recognised in the income statement.

An associated undertaking is an enterprise where the Group has significant influence, which has the power to participate in the financial and operating policy decisions, but not exercise control. Investments in associates are accounted for using the equity method (initially recognised at cost and the carrying amount is increased or decreased to recognise the investor's share of the profit or loss of the investee after the date of acquisition).

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 the income statement.

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 an 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 the income statement and only to the extent that the carrying amount of the financial asset does not exceed its amortised cost at the reversal date.

(2) Available-for-sale financial assets

If this asset is impaired, the cumulative loss that had been previously recognised (due to fair value revaluation) directly in equity shall be removed from equity 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 equity 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 the income statement.

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.

H Leases

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 the income statement 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 on the finance balance outstanding. 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 the income statement 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.

I 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.

J 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 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 the income statement.

K Cash and cash equivalents

Cash and cash equivalents are carried in the balance sheet at cost. For the purposes of the cash flow statement, 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 on the balance sheet.

L Financial debt

Borrowings are recognised initially at 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 the income statement over the period of the borrowings.

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

Interest costs on borrowings 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.

M 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.

Current income tax relating to items recognised directly in equity is recognised in equity and not in the income statement.

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 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 the income statement, any related tax effects are also recognised in the income statement. For transactions and other events recognised directly in equity, any related tax effects are also recognised directly in equity. 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.

N 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 the income statement 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 the income statement 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 redundancy and termination benefits when it is demonstrably committed to terminating 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 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 contractually obliged or where there is a past practice that has created a constructive obligation.

O Share-based compensation

During 2006, the Group introduced performance compensation systems linked to the market value of shares of the parent company, Telefónica, S.A. Certain compensation plans are settled in cash, while the 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 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 shares granted are expensed over the period during which terms 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 the income statement for the period, if appropriate. For 2006, the financial impact on the Group is, however, immaterial.

For the equity-settled share option plan, fair value at the grant date is measured using the binomial 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. For 2006, the financial impact on the Group is, however, immaterial.

P Provisions

Provisions are recognised when the Group has a present legal or constructive obligation as a result of past events, it is probable that an outflow of resources will be required to settle the obligation, and 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.

Q 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 selected price based on chosen customer plan. Free unused minutes at the end of the month might be rolled over to the following month. The Company 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 is 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:

- The Group is the primary obligor in the arrangement,
- The Group has general inventory risk,
- The Group has price latitude,
- The Group changes the product or performs part of the service,
- The Group has discretion in supplier selection,
- The Group is involved in the determination of product or service specifications,
- The Group has credit risk,
- The Group has the ability to set the terms of the transaction,
- The Group has the managerial control over the transaction.

The relative strength of each indicator is considered when concluding which accounting treatment to use for principal/agency arrangement.

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, e.g. premium rate lines.

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

The Group offers products, which may include deliverables such as a handset, activation and airtime. These are then defined as arrangements with multiple deliverables. The arrangement consideration is allocated to each deliverable, based on its fair value. Revenue allocated to the identified deliverables in each revenue arrangement is recognized based on the same recognition criteria of the individual deliverables at the time the product or service is delivered.

(1) Fixed line telephony revenues

Revenue is recognized as follows:

Domestic and international call revenues

Domestic and international call revenues are recognised in the income statement at the time the call is made.

Subscription revenues

Revenue from subscriptions is recognised in the income statement 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 Company's network, are deferred and recognised in the income statement over the estimated average customer relationship period on the basis of degressive accounting method.

Equipment sales and other sale of goods

Revenue from the sale of telephone equipment and accessories and other sale of 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 the income statement and recognised in the period in which the service is rendered. Regular monthly fee is recognised on the straight line basis in the period when the service is consumed. Revenue from the preparation of the space (collocation) for an alternative operator is recognized upfront in the income statement when it occurs.

(2) Mobile telephony revenues

The Group earns mobile services revenue from customers usage of the Group's network, interconnection and roaming – collectively, "Mobile service revenue". 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 accrued as their airtime and other services are used. Prepaid customers recharge a credit, which entitles them to a certain value of airtime and other services. Revenue from prepaid customers is deferred and recognized as the airtime and other services are used. Upon termination of the customer contract or expiration of voucher (up to 24 months), all deferred revenue for unused airtime is recognized in income.

Both, post-paid and prepaid products may include deliverables such as a handset, activation and airtime and that are defined as arrangements with multiple deliverables. The arrangement consideration is allocated to each deliverable, based on its fair value. Revenue allocated to the identified deliverables in each revenue arrangement is recognized based on the same recognition criteria of the individual deliverables at the time the product or service is delivered.

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

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.

Costs

Commissions and 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. Other commission payments to dealers for activations, various marketing promotions and other activities are included in the costs of sales for the period.

(3) Interconnect revenues

Interconnect revenues are derived from calls and other traffic that originate in other domestic and foreign operators' network but use the Group's network. These revenues are recognised in the income statement 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 other domestic and foreign operators' for calls and other traffic that originate in the Group's network but 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 and data services

The Group earns revenue from providing Internet services. Revenue from such services is 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

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

R 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.

S Financial instruments

Financial instruments carried on the balance sheet include cash and bank balances, investments, receivables, payables, borrowings and derivatives.

Financial risk management

The Group's activities expose it to a variety of financial risks, including the effects of changes in debt market prices, foreign currency exchange rates and interest rates. The Group's overall risk management program focuses on the unpredictability of financial markets and seeks to minimize potential adverse effects on the financial performance of the Group. The Group uses derivative financial instruments such as forward foreign exchange contracts, currency swaps, interest rate swaps, forward rate agreements and currency options 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 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, use of derivative financial instruments and investing excess liquidity.

(i) Foreign exchange risk

The Group is exposed to foreign exchange risk arising from various currency exposures, primarily with respect to the Euro and US Dollar. The treasury department is responsible for hedging the net position in each currency by using currency borrowings, external forward foreign exchange contracts, currency swaps and currency options.

The Group primarily hedges the foreign currency exposure of its contract commitments to purchase network technology and other operating expenses from European Union countries. The forward contracts used in its program mature in 6 months or less, consistent with the related purchase commitments.

Additionally, the Group hedges the foreign currency exposure of its borrowings in foreign currencies. 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 exchange rate derivatives (including forward foreign exchange contracts, currency swaps and currency options) are designed to match anticipated foreign currency transactions (interest rate payments or principal payments).

(ii) Interest rate risk

The Group's income and operating cash flows are substantially independent of changes in market interest rates. The Group sometimes borrows at variable rates and uses interest rate swaps and forward rate agreements as cash flow hedges of future interest payments, which have the economic effect of converting borrowings from floating rates to fixed rates. The interest rate swaps and forward rate agreements allow the Group to raise long-term borrowings at floating rates and swap them into fixed rates. Under the interest rate swaps, the Group agrees with other parties to exchange, at specified intervals, the difference between fixed contract rates and floating rate interest amounts calculated by reference to the agreed notional principal amounts.

(iii) Credit risk

Concentrations of credit risk, with respect to trade accounts receivable, are 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 higher credit risk associated with these receivables, repayment is significantly impacted by the financial stability of the national economy.

Derivative counterparties and cash transactions are limited to high credit quality financial institutions. The Group has policies that limit the amount of credit exposure to any one financial institution.

(iv) Liquidity risk

Prudent liquidity risk management implies maintaining sufficient cash and marketable securities, the availability of funding through an adequate amount of money market (committed and uncommitted) credit facilities and the ability to close out market positions. The treasury department aims to maintain flexibility in funding by keeping money market credit lines available.

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

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

Changes in the fair value of derivatives that are designated and qualify as fair value hedges and that are highly effective are recorded in the income statement, 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 qualify as cash flow hedges and that are highly effective are recognised in equity. 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 equity are transferred from equity and included in the initial measurement of the cost of the asset or liability. Otherwise, amounts deferred in equity are transferred to the income statement and classified as revenue or expense in the same periods during which the hedged firm commitment or forecasted transaction affects the income statement.

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 the income statement.

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 equity at that time remains in equity and is recognised when the committed or forecasted transaction ultimately is recognised in the income statement. However, if a committed or forecasted transaction is no longer expected to occur, the cumulative gain or loss that was reported in equity is immediately transferred to the income statement.

The Group documents at the inception of the transaction the relationship between hedging instruments and hedged items, as well as its risk management objective and strategy for undertaking various hedge transactions. This 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.

The fair values of various derivative instruments used for hedging purposes are disclosed in Note 20. Movements on the hedging reserve in shareholder's equity are shown in Note 25.

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.

T Critical accounting estimates and judgments

The Group makes estimates and assumptions concerning the future. 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 year are discussed below:

(1) Income taxes and deferred taxes

The Group created 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-deductible expenses 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. The total amount of provision for current income taxes is CZK 3,689 million, advances paid for income taxes amount to CZK 2,959 million and the net deferred tax liability is CZK 4,469 million.

(2) Goodwill

The Group tests at each reporting date goodwill for an impairment. 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. From 1 January 2005 the Group implemented IFRS 3 and accordingly ceased to amortize the goodwill. 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. The carrying amount of goodwill is CZK 13,320 million.

(3) Provisions and contingent liabilities

As set out in Note 21 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 will be required to settle the obligation and a reliable estimate can be made of the amount of the obligation. 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) Interconnect

The Group provides and enters into the contracts for interconnect services and the revenue is recognised on the basis of the reasonable estimation of expected amount. Such estimation is regularly reviewed, however the final agreement and invoicing can be with some operators stated on up to a yearly basis.

(5) Impairment of the fixed line business assets

The Group makes an assessment at each balance sheet date whether there is any indication that an impairment loss recognised for the fixed line business assets in prior years may no longer exist, may have decreased or may have increased. If any such indication exists, may have decreased or may have increased, 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 not longer exists, the Group considers both external and internal indicators (declination of asset's market value, changes expected in the market, including technological changes etc.). Where an estimate of recoverable amount is performed, this involves the use for a number of management assumptions about future business performance, which may, ultimately, differ from reality.

Based on the assessment performed by the Company, no increase or decrease of the previously recognised impairment of fixed line business assets was recognised in 2006.

U Change in accounting policy

Connection fees and related costs – 2005 change

During 2005, the Company changed its accounting policy for revenue recognition of the connection fees relating to the activation of the fixed line for all periods starting from 1 January 1996. Retrospective application of the new accounting policy for the periods before 1996 was impracticable because appropriately detailed information for these periods is not available. In previous periods, the Company had recognised such revenue in full in the income statement upon connection of the customers to the network. Since 2005, the Company has decided to defer these revenues over the estimated average customer relationship period and the management also judges that the new policy is preferable, gives more relevant information about the effects on transactions and will be consistent with the telecommunication industry practice. Such policy is also in accordance with the Telefónica Group policy.

Connection fees are deferred and recognised in the income statement over the estimated average customer relationship period on the basis of the degressive accounting method. For the periods starting 2006, the Group estimates the customer relationship period being 12 years (13 years as at 1 January 2005).

Together with the above-mentioned retrospective change in accounting policy for connection fees the Group identified associated connection costs that met the definition of subsequent costs increasing the carrying value of property, plant and equipment but were originally expensed by the Company. In 2005 the Company decided to retrospectively capitalise these costs as property, plant and equipment. The retrospective capitalization resulted in the increase in carrying amount of fixed assets and associated depreciation with the effect on opening 2004 and subsequent balances.

No substantial changes in accounting policies have been applied in 2006.

V Mobile license in Slovakia

On 2 August 2006, Telefónica O2 Slovakia s.r.o., a wholly owned subsidiary of the Company, was announced as a winner of the tender for the 3rd mobile license in Slovakia. Based on this decision, the Telecommunication office of the Slovak Republic awarded Telefónica O2 Slovakia s.r.o. the 20 year license for GSM and UMTS networks on 25 August 2006. The license award became effective on 7 September 2006. Telefónica O2 Slovakia s.r.o. paid SKK 150 million (EUR 4.1 million) for the license. The license conditions require GSM/UMTS network operation launch in 6/12 months from license award. Additionally, Telefónica O2 Slovakia s.r.o. is required to achieve 12%/45% own network population coverage in 12/24 months and to build 400/800 own base stations in these periods.

The new operation is considered as an organic expansion of the Telefónica Group business in the region and will take advantage of synergies with the Company operations. The leverage on the Czech operation is expected in areas of network (development, monitoring, support), IT, procurement and back office (finance, HR, legal). Telefónica O2 Slovakia s.r.o. will use the O2 brand. The commercial launch is expected in 1Q 2007.

During the initial phase, Telefónica O2 Slovakia s.r.o. will provide services on the basis of national roaming. Thus, Telefónica O2 Slovakia s.r.o. entered into agreements with T-Mobile Slovensko, a.s, on provision of services of its network to customers of Telefónica O2 Slovakia s.r.o. in the areas not covered by its own network. From the long-term perspective, the strategy will focus on the building of the Telefónica O2 Slovakia s.r.o. own network.

W Integration process

The integration process continues internally and as well externally through the implementation of ongoing integration projects. These include mainly sales channels and customer care integration, regional network operations integration, alignment of controlling, budget and reporting processes and cultural alignment.

At the same time the Group takes advantage of the global experience and close interaction with Telefónica, S.A., Telefónica O2 Europe plc and other Telefónica Group operating companies. The main activities continue to focus on the introduction and marketing of new services and products in both fixed and mobile segments, new convergent products, further operational efficiencies facilitated by a new organizational structure and synergies leading to revenue growth and OpEx and CapEx savings. The Company will monitor the development of the business in order to find out whether the currently used segments (fixed lines and mobile segment) are still relevant.

(1) Gamma building

In 2006, the Group entered an agreement to lease the Gamma Building to become the Company's headquarter from 2Q 2007. Moving the Company's headquarters will allow for the full physical integration of employees in one area during the ongoing integration process.

(2) Re-branding

The Company presents its services under the O2 brand. This replaced two original brands, ČESKÝ TELECOM and former Eurotel, on 1 September 2006. The Company uses the O2 brand for all products in the fixed as well as the mobile networks.

The change of the corporate identity to O2 involved several areas, from re-branding of thousands of payphones, vehicles, the exteriors and interiors of buildings, and employee uniforms and identification cards to, for instance, logos on the displays of mobile telephones.

The new O2 brand is being presented to the public by means of a classic marketing mix, including print and internet advertisements, billboards, and television spots including also non-traditional forms of communication, e.g. offering a download of a song from Leftfield that the Company is using in its TV campaign introducing the O2 brand.

In order to further improve customer care, an effort to simplify and clarify customers' communication with the firm is being made. Unified O2 shops, one telephone contact to the firm, one internet address were introduced to achieve this.

Together with the brand, the Company also launched new services. As a first new product, television through fixed lines O2TV with its rich functionalities was introduced. Next offer, brand new mobile tariff programs, proved the company's plan to be as transparent as possible. The company's intention to provide convergent products started with combining services in the fixed and mobile networks in a way that allows for savings.

X 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 include primarily bank charges), fair value losses and gains on financial instruments and realized and unrealized exchange rate differences.

NOTES TO THE CONSOLIDATED FINANCIAL STATEMENTS

Index	Pages
1 Segment information	35
2 Revenue and Internal expenses capitalized in fixed assets	37
3 Operating expenses	38
4 Interest and other finance costs (net)	39
5 Tax	39
6 Earnings per share	40
7 Dividends	40
8 Property, plant and equipment	40
9 Intangible assets	43
10 Impairment of fixed assets	45
11 Inventories	46
12 Receivables and prepayments	46
13 Available-for-sale and held-to-maturity investments	47
14 Cash and cash equivalents	48
15 Trade and other payables	48
16 Financial debts	49
17 Deferred income taxes	52
18 Government social security and pension schemes	53
19 Provisions for liabilities and charges	54
20 Financial instruments	55
21 Contingencies	56
22 Commitments	57
23 Service concession arrangements	58
24 Share capital and reserves	61
25 Hedging reserve	61
26 Cash generated from operating activities	62
27 Related party transactions	62
28 Principal subsidiary undertakings	65
29 Minority interest	66
30 Post balance sheet events	66

1 Segment information

The Group comprises two main business segments, as follows:

- Fixed Network communications services using a fixed network provided by former ČESKÝ TELECOM, a.s. and other consolidated subsidiaries
- Mobile Mobile communications services provided by former Eurotel and by Telefónica O2 Slovakia s.r.o.

Revenue of the Group is predominantly derived from domestic trading activities and as a result, segment reporting is only shown on the basis of business segments. With respect to the transfer of assets and liabilities (as detailed in General Information paragraph) and the deep integration process, the Group will analyse criteria for segment identification, which might lead to a change in the reported segments in the future years.

Year ended 31 December 2006	Fixed	Mobile	Group
Revenues	30,895	31,733	62,628
Inter-segment sales	<u>(521)</u>	<u>(796)</u>	<u>(1,317)</u>
Total consolidated revenues	30,374	30,937	61,311
Gains from sale of non-current assets	96	2	98
Work performed by the Group and capitalized	726	185	911
Costs	(17,926)	(17,552)	(35,478)
Inter-segment purchases	<u>796</u>	<u>521</u>	<u>1,317</u>
Total consolidated costs	(17,130)	(17,031)	(34,161)
Impairment charge	(253)	-	(253)
Depreciation	(9,813)	(4,225)	(14,038)
Amortisation	<u>(990)</u>	<u>(1,718)</u>	<u>(2,708)</u>
Total consolidated depreciation and amortization	(10,803)	(5,943)	(16,746)
Operating profit	3,010	8,150	11,160
Interest and other financial income (net)			<u>(220)</u>
Profit before tax			10,940
Tax			<u>(2,920)</u>
Profit after tax			8,020
Minority interest			<u>-</u>
Net profit			<u>8,020</u>
Assets (excluding Goodwill and non-current assets held for sale)	65,497	38,857	104,354
Goodwill on purchase of additional ownership interest in former Eurotel	-	13,320	13,320
Non-current assets held for sale	<u>203</u>	<u>-</u>	<u>203</u>
Total assets	<u>65,700</u>	<u>52,177</u>	<u>117,877</u>
Trade and other payables	(5,568)	(5,561)	(11,129)
Other liabilities	<u>(15,719)</u>	<u>(2,548)</u>	<u>(18,267)</u>
Total liabilities	<u>(21,287)</u>	<u>(8,109)</u>	<u>(29,396)</u>
Capital expenditure	3,209	3,291	6,500

Year ended 31 December 2005	Fixed	Mobile	Group
Revenues	32,278	30,029	62,307
Inter-segment sales	<u>(415)</u>	<u>(852)</u>	<u>(1,267)</u>
Total consolidated revenues	31,863	29,177	61,040
Gains from sale of non-current assets	116	-	116
Work performed by the Group and capitalized	366	228	594
Costs	(17,874)	(16,642)	(34,516)
Inter-segment purchases	<u>852</u>	<u>415</u>	<u>1,267</u>
Total consolidated costs	(17,022)	(16,227)	(33,249)
Impairment charge	(465)	(796)	(1,261)
Depreciation	(10,705)	(4,325)	(15,030)
Amortisation	<u>(1,837)</u>	<u>(941)</u>	<u>(2,778)</u>
Total consolidated depreciation and amortization	(12,542)	(5,266)	(17,808)
Operating profit	2,316	7,116	9,432
Interest and other financial income (net)			<u>(684)</u>
Profit before tax			8,748
Tax			<u>(2,500)</u>
Profit after tax			6,248
Minority interest			<u>1</u>
Net profit			<u>6,249</u>
Assets (excluding Goodwill and non-current assets held for sale)	79,150	31,381	110,531
Goodwill on purchase of additional ownership interest in former Eurotel	-	13,320	13,320
Non-current assets held for sale	<u>360</u>	<u>-</u>	<u>360</u>
Total assets	<u>79,510</u>	<u>44,701</u>	<u>124,211</u>
Trade and other payables	(4,921)	(4,713)	(9,634)
Other liabilities	<u>(16,872)</u>	<u>(2,730)</u>	<u>(19,602)</u>
Total liabilities	<u>(21,793)</u>	<u>(7,443)</u>	<u>(29,236)</u>
Capital expenditure	2,258	3,814	6,072

Inter-segment sales and purchases represent sales and purchases to the Group companies belonging to another segment.

Inter-segment pricing between the mobile and the fixed segment is based on rates agreed upon between former ČESKÝ TELECOM, a.s. and former Eurotel or based on a decision of the Czech Telecommunication Office (Český telekomunikační úřad). The rates applied in 2006 and 2005 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. With respect to the transfer of assets and liabilities, the 2001 price amendment to an agreement governing interconnect arrangements with former Eurotel became irrelevant in 2006. After the transfer of assets and liabilities as of 1 July 2006, all inter-company transactions between fixed (ČESKÝ TELECOM, a.s.) and mobile (former Eurotel) segments became intra-company (inter-segments).

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

2 Revenue and Internal expenses capitalized in fixed assets

Revenue	Year ended	
	<u>31 December 2006</u>	<u>31 December 2005</u>
Voice	23,462	23,839
Interconnection	9,444	9,154
Subscription charges	9,841	10,542
Connection charges	669	702
SMS & MMS & Value Added Services	4,813	4,537
Leased lines	2,330	2,615
Data services	1,839	1,732
Internet	5,051	4,422
IT and business solutions	751	345
Equipment and Activation Fee	2,172	2,357
Other Telco Revenues	500	478
Other revenues	<u>439</u>	<u>317</u>
Total revenues	<u>61,311</u>	<u>61,040</u>

Revenues from related parties are disclosed in Note 27.

The aggregate future minimum lease payments under non-cancellable operating leases relating to the buildings and other telecommunication equipment are as follows:

	<u>31 December 2006</u>
No later than 1 year	229
Later than 1 year and not later than 5 years	835
Later than 5 years	<u>203</u>
Total	<u>1,267</u>

Internal expenses capitalized in fixed assets

	Year ended	
	<u>31 December 2006</u>	<u>31 December 2005</u>
Material	593	343
Labour	<u>318</u>	<u>251</u>
Total	<u>911</u>	<u>594</u>

3 Operating expenses

The following items have been included to arrive at operating profit:

	Year ended	
	<u>31 December 2006</u>	<u>31 December 2005</u>
Wages and salaries*	4,912	5,427
Redundancy payments	247	270
Social security contributions (Note 18)	1,650	1,830
Staff welfare costs	<u>284</u>	<u>301</u>
Total staff costs	7,093	7,828
Interconnection and roaming	10,010	9,701
Cost of goods sold	3,067	3,510
Other cost of sales	1,198	941
Other purchases	1,148	944
Marketing and sales	3,139	2,611
Call centres	95	-
Network & IT repairs and maintenance	2,594	2,413
Rentals, buildings and vehicles	1,652	1,609
Utilities supplies	746	604
Consultancy and professional fees	483	435
Other external services	1,796	1,669
Impairment charge for bad and doubtful debts and inventories	681	414
Taxes (other than income tax)	398	507
Other operating expenses	<u>61</u>	<u>63</u>
Total operating expenses	<u>34,161</u>	<u>33,249</u>

* Certain Group employees (including the Board of Directors) with specialised know how, or who have access to business secrets, or who are considered important to the development of the business, are bound by non-competition restrictions, for a maximum period of 12 months from the date of termination of their employment with the Group. The Group paid CZK 6 million in relation to such non-competition clauses in 2006 (2005: CZK 40 million).

Purchases from related parties are disclosed in Note 27.

4 Interest and other finance income (net)

	Year ended	
	<u>31 December 2006</u>	<u>31 December 2005</u>
Interest expense		
Interest incurred on loans and bonds	430	748
Interest income	(149)	(46)
Interest expense (net)	281	702
Other finance charges/(gains)	(40)	218
Fair value losses/(gains) on financial instruments:		
Derivative financial instruments	29	(119)
Net foreign exchange transaction gains	(50)	(117)
Other finance income (net)	(61)	(18)
Net finance costs	<u>220</u>	<u>684</u>

5 Tax

	Year ended	
	<u>31 December 2006</u>	<u>31 December 2005</u>
Total income tax expense is made up of:		
Current income tax charge	4,171	2,818
Deferred income tax credit (Note 17)	(1,251)	(318)
Taxes on income	<u>2,920</u>	<u>2,500</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:

	Year ended	
	<u>31 December 2006</u>	<u>31 December 2005</u>
Profit before tax	10,940	8,748
Income tax charge calculated at the statutory rate of 24% (2005: 26%)	2,626	2,275
Income not subjected to tax	1	(65)
Expenses not deductible for tax purposes	385	410
Other	(92)	(112)
Investments allowances	<u>-</u>	<u>(8)</u>
Taxes on income	<u>2,920</u>	<u>2,500</u>
Effective tax rate	27%	29%

6 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 year.

	Year ended	
	<u>31 December 2006</u>	<u>31 December 2005</u>
Weighted number of ordinary shares in issue	322,089,900	322,089,900
Net profit attributable to shareholders (in CZK million)	8,020	6,249
Basic earnings per share (CZK)	25	19

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

7 Dividends

	<u>2006</u>	<u>2005</u>
Dividends (including withholding tax)	14,494	-

Dividends include withholding tax on dividends paid by the Company to its shareholders. There has been no interim dividend paid in respect of 2006. Approval of the 2006 profit and the decision regarding the amount of any dividend payment for the 2006 financial year will take place at the Annual General Shareholders Meeting scheduled for 26 April 2007.

8 Property, plant and equipment

	<u>Land and buildings</u>	<u>Ducts, cables and related plant</u>	<u>Communication exchanges and related equipment</u>	<u>Other fixed assets</u>	<u>Capital work in progress</u>	<u>Total</u>
Year ended 31 December 2006						
Opening net book amount	14,494	47,141	22,355	2,001	2,012	88,003
Additions	615	464	2,983	847	4,942	9,851
Disposals and other movements	(4)	(4)	38	(14)	(4,885)	(4,869)
Assets classified as held for sale	54	-	-	1	-	55
Depreciation charge	(739)	(4,201)	(8,079)	(1,019)	-	(14,038)
Impairment charge	(201)	(5)	(5)	(2)	(34)	(247)
Closing net book amount	<u>14,219</u>	<u>43,395</u>	<u>17,292</u>	<u>1,814</u>	<u>2,035</u>	<u>78,755</u>
At 31 December 2006						
Cost	22,486	99,329	92,328	10,709	2,084	226,936
Accumulated depreciation and impairment allowance	<u>(8,267)</u>	<u>(55,934)</u>	<u>(75,036)</u>	<u>(8,895)</u>	<u>(49)</u>	<u>(148,181)</u>
Net book amount	<u>14,219</u>	<u>43,395</u>	<u>17,292</u>	<u>1,814</u>	<u>2,035</u>	<u>78,755</u>

	Land and buildings	Ducts, cables and related plant	Communication exchanges and related equipment	Other fixed assets	Capital work in progress	Total
Year ended 31 December 2005						
Opening net book amount	15,665	50,745	28,610	2,731	1,594	99,345
Additions	361	633	2,761	579	4,736	9,070
Disposals and other movements	(117)	2	(129)	(15)	(4,301)	(4,560)
Assets classified as held for sale	(358)	-	(1)	(1)	-	(360)
Depreciation charge	(750)	(4,203)	(8,785)	(1,292)	-	(15,030)
Impairment charge	(307)	(36)	(101)	(1)	(17)	(462)
Closing net book amount	<u>14,494</u>	<u>47,141</u>	<u>22,355</u>	<u>2,001</u>	<u>2,012</u>	<u>88,003</u>
At 31 December 2005						
Cost	22,204	99,201	90,879	10,757	2,022	225,063
Accumulated depreciation and impairment allowance	<u>(7,710)</u>	<u>(52,060)</u>	<u>(68,524)</u>	<u>(8,756)</u>	<u>(10)</u>	<u>(137,060)</u>
Net book amount	<u>14,494</u>	<u>47,141</u>	<u>22,355</u>	<u>2,001</u>	<u>2,012</u>	<u>88,003</u>

As at 31 December 2006, the carrying value of non-depreciated assets amounted to CZK 460 million.

Land and buildings, plant and equipment with a carrying value of CZK 21 million (2005: CZK 1,220 million) were pledged as collateral for CZK 5,300 million of provided borrowings. The borrowings were fully paid off in 2005, but the cancellation of the pledge is still in process (see Note 16).

No borrowing costs were capitalized during the years 2006 and 2005.

The Group reports and classifies the following assets held for sale at the balance sheet date:

	<u>Land and buildings</u>	<u>Communication exchanges and related equipment</u>	<u>Other fixed assets</u>	<u>Total</u>
Year ended 31 December 2006				
Opening net book amount	358	1	1	360
Disposals and other movements	(96)	-	-	(96)
Impairment charge	(6)	-	-	(6)
Assets re-classified as held for sale	<u>(54)</u>	<u>-</u>	<u>(1)</u>	<u>(55)</u>
Closing net book amount	<u>202</u>	<u>1</u>	<u>-</u>	<u>203</u>
At 31 December 2006				
Cost	904	190	7	1,101
Accumulated depreciation and impairment allowance	<u>(702)</u>	<u>(189)</u>	<u>(7)</u>	<u>(898)</u>
Net book amount	<u>202</u>	<u>1</u>	<u>-</u>	<u>203</u>
Year ended 31 December 2005				
Opening net book amount	-	-	-	-
Assets re-classified as held for sale	<u>358</u>	<u>1</u>	<u>1</u>	<u>360</u>
Closing net book amount	<u>358</u>	<u>1</u>	<u>1</u>	<u>360</u>
At 31 December 2005				
Cost	769	5	7	781
Accumulated depreciation and impairment allowance	<u>(411)</u>	<u>(4)</u>	<u>(6)</u>	<u>(421)</u>
Net book amount	<u>358</u>	<u>1</u>	<u>1</u>	<u>360</u>

Assets intended for sale in most cases represent administration buildings with land, that became vacant due to the optimization of the Group's processes and which the Group will not use in the future and it is expected their sale will take place within one year.

The non-current assets classified as held for sale are presented in the fixed segment.

As at 31 December 2006, the total recognised loss from the impairment / decrease in value of assets classified as held for sale was CZK 41 million. With regard to assets for which a loss from decrease in value was recognised, no cancellation/reverse of the previously recognised impairment occurred.

Cost of fully depreciated property, plant and equipment was CZK 47,061 million as at 31 December 2006.

Notes to the consolidated financial statements for the year ended 31 December 2006
(all tabular amounts in CZK million)

In 2006, the Group achieved a total gain from the sale of the above assets amounting to CZK 98 million and total losses in amount CZK 61 million. The total net sales were CZK 205 million and the carrying amount was CZK 168 million.

The impairment charge recorded in 2006 represents mainly correction of value of special constructions, which were idle.

9 Intangible assets

	<u>Goodwill</u>	<u>Licences</u>	<u>Software</u>	<u>Other</u>	<u>Total</u>
Year ended 31 December 2006					
Opening net book amount	13,320	5,494	3,405	627	22,846
Additions	-	120	1,384	-	1,504
Disposals and other movements	-	-	(14)	-	(14)
Amortisation charge	-	(404)	(1,677)	(627)	(2,708)
Impairment charge	-	-	-	-	-
Closing net book amount	<u>13,320</u>	<u>5,210</u>	<u>3,098</u>	<u>-</u>	<u>21,628</u>
At 31 December 2006					
Cost	13,320	6,193	22,258	2,829	44,600
Accumulated amortisation and impairment allowance	-	(983)	(19,160)	(2,829)	(22,972)
Net book amount	<u>13,320</u>	<u>5,210</u>	<u>3,098</u>	<u>-</u>	<u>21,628</u>
Year ended 31 December 2005					
Opening net book amount	13,320	5,668	4,318	1,702	25,008
Additions	-	-	1,416	-	1,416
Disposals and other movements	-	-	(1)	-	(1)
Amortisation charge	-	(174)	(2,315)	(289)	(2,778)
Impairment charge	-	-	(13)	(786)	(799)
Closing net book amount	<u>13,320</u>	<u>5,494</u>	<u>3,405</u>	<u>627</u>	<u>22,846</u>
At 31 December 2005					
Cost	13,320	6,073	21,225	2,829	43,447
Accumulated amortisation and impairment allowance	-	(579)	(17,820)	(2,202)	(20,601)
Net book amount	<u>13,320</u>	<u>5,494</u>	<u>3,405</u>	<u>627</u>	<u>22,846</u>

Details regarding the impairment loss that was recorded in 2005 are described in Note 10.

Acquired licences are represented by rights to operate the UMTS, GSM and NMT cellular networks in the Czech Republic. The original 450 MHz and GSM operating licenses were granted for a period of twenty years from the signing of the agreement for the original 450 MHz license in 1991 and from the granting of the GSM license in 1996 for use of the 900 spectrum. In 1999, former Eurotel acquired an additional GSM 1800 spectrum under its existing GSM license. In 2002, the GSM license to both spectrums was renewed and is currently valid for the remaining period of ten years. Carrying value of GSM 900 license is as at 31 December 2006 CZK 695 million (2005: CZK 770 million) and carrying value of GSM 1800 license is CZK 559 million (2005: CZK 620 million). In 2002, former Eurotel renewed its 450 MHz license; the current license enables the mobile segment to offer any internationally recognized public mobile telecommunication services on frequency of 450 MHz. Mobile segment currently provides on this frequency voice services under NMT standard and broadband Internet access services using CDMA technology. The license is currently valid for the remaining period of five years. Carrying value of NMT 450 license is CZK 65 million (2005: CZK 81 million). In December 2001, former Eurotel acquired the UMTS license, which has been granted for a period of twenty years. Under the license, former Eurotel was provided with deferred payment terms by the Czech Telecommunication Office ("CTU") to finance the license acquisition. In December 2003, former Eurotel signed an amendment to its original UMTS license agreement, by which the original launch of the service was extended by one year. According to the terms of this new amendment, former Eurotel agreed to pay the UMTS obligation in full during 2004 in exchange for a forgiveness of 2003 and 2004 interest on the deferred payments provided as part of the UMTS license agreement. Carrying value of UMTS license is CZK 3,771 million (2005: CZK 4,023 million). UMTS license was put into commercial use on 1 December 2005 when it also started to be amortized.

With respect to the operation launch in 2007, the license for GSM and UMTS networks awarded to Telefónica O2 Slovakia s.r.o on 7 September 2006 for SKK 150 million (EUR 4.1 million) has not been amortized as of 31 December 2006.

No borrowing costs were capitalized during the years 2006 and 2005.

Cost of fully amortised intangible assets was CZK 13,874 million as at 31 December 2006.

The caption "Other" includes brand names acquired through business combination in 2003 by the purchase of the remaining share in former Eurotel. These intangible assets were originally determined as having an indefinite useful life after adoption of revised IAS 38 from 1 January 2005, because there was no foreseeable limit to the period over which the asset was expected to generate net cash flows. After the acquisition by Telefónica, S.A. the Group reassessed its intangible assets previously acquired through business combination and reviewed the relating useful lives. The Group decided, as a result of this assessment, to change the useful lives of brand names with indefinite useful lives from indefinite to finite. This change was accounted for as a change in an accounting estimate and the revised useful lives were determined to be 30 months. From 1 July 2005, the date of change in indefinite useful life, the Group amortizes these brand names using the straight-line method. Upon the transfer of assets and liabilities and with respect

to the re-branding process, the Group re-considered an estimate of useful life of former Eurotel related brand names and accelerated their amortization with final effect of their full amortization as at 31 December 2006.

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

10 Impairment of fixed assets

Intangible assets

Brand names acquired through business combination in 2003 with former Eurotel

During the process of allocation of the cost of a business combination arising from the acquisition by Telefónica, S.A., the Group tested the recoverable amounts of previously acquired brand names. Considering that result the Group recognised immediately an impairment loss in the income statement in the amount of CZK 786 million in 2005 (see Note 9).

As at 30 June 2005 the carrying amount of brand names before the impairment charge was CZK 1,567 million (CZK 1,567 million as at 31 December 2004). Upon the transfer of assets and liabilities and with respect to the re-branding process, the Group re-considered an estimate of useful life of former Eurotel related brand names and accelerated their amortization with final effect of their full amortization as at 31 December 2006.

Fixed assets of the fixed line business

During 2003, external factors relating to the telecommunication market and regulatory environment namely uncertainty regarding tariff rebalancing, termination charges for internet dial-up interconnection charges and other regulatory decisions in the Czech Republic led the management to assess the recoverable amount of the fixed line segment assets. The fixed line segment assets constitute one cash-generating unit (the "CGU").

As at 31 December 2006, the management of the Company reviewed the indicators which would indicate that the impairment allowance of fixed line business assets made in 2003 is no longer relevant and should be reversed. Upon the review, a recoverable amount of the fixed line business assets (impairment test model) was estimated. Based on this assessment performed, the management believes that the value of the existing fixed network assets is fairly stated and does not differ substantially from the assets' recoverable amount as at 31 December 2006.

11 Inventories

	<u>31 December 2006</u>	<u>31 December 2005</u>
Construction material	81	35
Cables	28	159
Other inventory including goods for resale	642	522
Finished products and work in progress	<u>236</u>	<u>—</u>
	<u>987</u>	<u>716</u>

The inventories noted above are stated net of an allowance of CZK 179 million (2005: CZK 187 million), reducing the value of the inventories to their net realisable value. The total carrying amount of inventories carried at net realisable value amounts to CZK 9 million (2005: CZK 47 million). The amount of inventories recognised as an expense is CZK 4,212 million (2005: CZK 4,637 million).

12 Receivables and prepayments

	<u>31 December 2006</u>	<u>31 December 2005</u>
Domestic trade receivables (net)	6,065	6,238
Foreign currency trade receivables (net)	710	620
Other debtors (net)	880	449
Prepayments	681	706
Other financial assets - short-term	<u>10</u>	<u>—</u>
	<u>8,346</u>	<u>8,013</u>

Trade receivables are stated net of an allowance for impaired receivables of CZK 3,572 million (2005: CZK 3,218 million). In order to preserve the tax-deductible status of the bad debt expense, the Group's trade receivables are not written off and removed from the primary books and records until certain statutory collection requirements have been satisfied.

Receivables from related parties are disclosed in Note 27.

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.

Notes to the consolidated financial statements for the year ended 31 December 2006
(all tabular amounts in CZK million)

As at 31 December 2006 and 2005 the Group has the following non-current balances, which are classified as other financial assets:

	<u>31 December 2006</u>	<u>31 December 2005</u>
Long-term credits	156	185
Advance payments for long-term expenses	<u>221</u>	<u>227</u>
Total	<u>377</u>	<u>412</u>

Long-term trade credits include interest bearing credit (interest 5.9%) amounting to CZK 78 million (2005: CZK 83 million).

13 Available-for-sale and held-to-maturity investments

Available-for-sale investments	<u>2006</u>	<u>2005</u>
At beginning of year	58	176
Revaluation deficit	(2)	(1)
Additions	3	4
Disposals	<u>(3)</u>	<u>(121)</u>
At end of year	<u>56</u>	<u>58</u>
Non-current	-	58
Current	<u>56</u>	<u>-</u>
Total	<u>56</u>	<u>58</u>
Held-to-maturity investments	<u>2006</u>	<u>2005</u>
At beginning of year	29	109
Exchange differences	(1)	(2)
Revaluation deficit	-	-
Additions	1	1
Matured	<u>(2)</u>	<u>(79)</u>
At end of year	<u>27</u>	<u>29</u>
Non-current	27	29
Current	<u>-</u>	<u>-</u>
Total	<u>27</u>	<u>29</u>

Available-for-sale investments, principally comprising marketable securities, are fair valued monthly and at the balance sheet date. For investments traded in active markets, the fair value is determined by reference to quoted bid prices. For other investments, the fair value is estimated by reference to the current market value of similar instruments or by reference to the discounted cash flows of the underlying net assets.

Held to maturity investments category comprise a debt instrument – a bond held in EUR with maturity date July 2008, which is carried at amortised cost.

14 Cash and cash equivalents

	<u>31 December 2006</u>	<u>31 December 2005</u>
Cash balances	334	322
Intra-group cash pooling	3,605	-
Short-term bank deposits and cash equivalents	<u>3,522</u>	<u>3,317</u>
Cash and cash equivalents	<u>7,461</u>	<u>3,639</u>

As at 31 December 2006 and 2005, the Group's cash equivalents partially consisted of short-term bank promissory notes that were economically equivalent to bank term deposits and interest bearing deposits maturing in three months or less.

During 2006 (since April 2006) the Group entered into mutual Telefónica Group cash-pooling, which enables the Telefónica Group good financial governance and effective operating free cash flow. The short-term deposits are based on the arm's length principle and classified as a cash equivalent.

For the purposes of the cash flow statement, the year-end cash and cash equivalents comprise the following components:

	<u>31 December 2006</u>	<u>31 December 2005</u>
Cash and cash equivalents	7,461	3,639
Bank overdrafts and other short-term borrowings (Note 16)	<u>-</u>	<u>(101)</u>
Balance at the end of period	<u>7,461</u>	<u>3,538</u>

15 Trade and other payables

	<u>31 December 2006</u>	<u>31 December 2005</u>
Trade creditors in local currency (net)	4,504	4,524
Trade creditors in foreign currencies (net)	855	766
Other taxes and social security	196	205
Deferred revenue	2,026	1,585
Employee wages and benefits	559	397
VAT payable	445	308
Other creditors	72	60
Accruals	<u>2,472</u>	<u>1,789</u>
	<u>11,129</u>	<u>9,634</u>
Other non-current liabilities	<u>807</u>	<u>1,265</u>

Payables to related parties are disclosed in Note 27.

Other non-current liabilities include primarily deferred revenues from connection fees, which are expected to be taken to income in more than 12 months from the balance sheet date.

16 Financial debts

	<u>31 December 2006</u>	<u>31 December 2005</u>
Bank loans and overdrafts in local currency (a)	-	101
International financial institution loans in foreign currencies (b)	-	-
Bank loans and overdrafts in foreign currencies (a)	3,163	3,337
Bonds in local currency (c)	<u>5,993</u>	<u>5,987</u>
Total borrowings	<u>9,156</u>	<u>9,425</u>
Accrued interest	189	193
Derivatives	<u>18</u>	<u>13</u>
Other financial debt	<u>207</u>	<u>206</u>
Total financial debt	<u>9,363</u>	<u>9,631</u>
Repayable:		
Within one year	<u>207</u>	<u>307</u>
Between one and two years	5,993	-
Between two and five years	-	5,987
After five years	<u>3,163</u>	<u>3,337</u>
Total non-current	<u>9,156</u>	<u>9,324</u>
Total financial debt	<u>9,363</u>	<u>9,631</u>

- (a) Bank loans and overdrafts include overdrafts of CZK 0 million denominated in the local currency (2005: CZK 101 million) and CZK 0 million in foreign currencies (2005: CZK 0 million).

Short-term borrowings as at 31 December 2005 consisted of loans drawn under bilateral short-term facilities.

In November 2003, the Company raised a syndicated credit facility in the total amount of EUR 850 million equivalent, with a final maturity day on 21 November 2008. The purpose of the loan was to finance the acquisition of the remaining 49% ownership interest in former Eurotel and general corporate purposes of the Group. The loan was fully paid off during 2005. Therefore, as at 31 December 2006 the outstanding amount of the loans under the credit facility was EUR 0 million (2005: EUR 0 million) and CZK 0 million (2005: CZK 0 million). The terms and conditions of the credit facility agreement, inter alia, require the Group to maintain certain gearing and interest cover ratios of earnings before interest, tax, depreciation and amortisation to net borrowings and interest payable.

In July 1997, the Company raised a private placement in the total amount of EUR 127.8 million with a maturity day on 30 July 2012. In October 2005, the bank loan in foreign currency was partially repaid prior to its maturity date. The fees associated with this earlier repayment in the amount of CZK 70.6 million were immediately recognised in the income statement. As at 31 December 2006, the outstanding amount of the foreign currency loan amounts to EUR 115 million.

- (b) In 2005, the International financial institution loans have been fully repaid prior to their maturity dates. The fees associated with this earlier repayment in the total amount of CZK 51.2 million were immediately recognised in the income statement.
- (c) In 2003, the Company issued CZK 1,000 million of bonds (as additional issue to CZK 3,000 million of bonds from 2002) with an interest rate of 4.55% p.a. The bonds in the total amount of CZK 4,000 million were fully repaid on the maturity date in July 2005.

In 2003, the Company issued CZK 6,000 million of bonds with an interest rate 3.50% p.a. and a maturity date of 9 July 2008.

At 31 December 2006, the Group had approximately CZK 8,404 million of available undrawn credit facilities (2005: CZK 10,224 million).

Loans with a maturity within one year and denominated in a foreign currency have a total value of EUR 0 million (2005: EUR 0 million).

For all borrowings, interest has been charged at commercial rates.

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

	<u>31 December 2006</u>	<u>31 December 2005</u>
At fixed rate	9,156	9,324
At floating rate	—	101
Total	<u>9,156</u>	<u>9,425</u>

The carrying amounts and fair values of bonds and bank loans are as follows:

31 December 2006	<u>Carrying amounts</u>	<u>Fair values</u>
Bank loans	3,163	3,557
Bonds	<u>5,993</u>	<u>6,135</u>
Total	<u>9,156</u>	<u>9,692</u>

The fair values of borrowings are based on discounted cash flows using a discount rate based upon the borrowing rate that the Board of Directors expect would be available to the Group at the balance sheet date, except for the fair value of the issued bonds, which are based on actual bond market pricing. The carrying amounts of short-term borrowings approximate their fair value.

Effective interest rates	<u>31 December 2006</u>	<u>31 December 2005</u>
Bank loans and overdrafts in local currency	n/a	2.51%
International financial institution loans in foreign currencies	n/a	n/a
Bank loans and overdrafts in foreign currencies	6.64%	6.64%
Bonds in local currency	3.50%	3.50%

The Group meets the criteria for debt covenants (stipulated level of consolidated total net borrowings, EBITDA and tangible net worth) required by the creditors.

International financial institution loans in foreign currencies (now repaid) have been secured by the Czech Republic (represented by the Ministry of Finance of the Czech Republic) and as a result, certain movables and real estates have been pledged for the benefit of the Czech Republic (see Note 8).

The carrying value of assets pledged is as follows:

	<u>31 December 2006</u>	<u>31 December 2005</u>
Land and buildings	-	7
Plant and equipment	<u>21</u>	<u>1,213</u>
Total	<u>21</u>	<u>1,220</u>

The borrowings were fully paid off in 2005, but the cancellation of the pledge is still in a process.

Other loans are not secured.

17 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.

Both, short-term and long-term deferred taxes were calculated at 24% (24% in 2005).

	<u>2006</u>	<u>2005</u>
At 1 January	5,721	6,041
Income statement tax credit (Note 5)	(1,251)	(318)
Tax on fair value gains	(1)	(2)
At 31 December	<u>4,469</u>	<u>5,721</u>

Deferred income tax assets and liabilities are offset when there is a legally enforceable right to set off current tax assets against current tax liabilities and when the deferred income taxes relate to the same fiscal authority.

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

	<u>31 December 2006</u>	<u>31 December 2005</u>
Deferred tax assets	(1,509)	(1,493)
Deferred tax liabilities	<u>5,978</u>	<u>7,214</u>
Total	<u>4,469</u>	<u>5,721</u>

The deferred tax asset includes CZK 444 million (2005: CZK 462 million) recoverable in less than twelve months and CZK 1,065 million (2005: CZK 1,031 million) recoverable after more than twelve months. The deferred tax liability includes CZK 724 million (2005: CZK 915 million) payable in less than twelve months and CZK 5,254 million (2005: CZK 6,299 million) payable in more than twelve months.

The deferred tax is determined by these components:

	<u>Consolidated balance sheet</u>		<u>Consolidated income statement</u>	
	2006	2005	2006	2005
Amount relating to the origination and reversal of temporary differences from:				
- property, plant and equipment and intangible assets	5,978	7,004	(1,026)	(599)
- trade receivables, inventories and other differences	(1,479)	(1,280)	(199)	281
Revaluations of cash flow hedges	(4)	(3)	-	-
Amount relating to unrecognised tax loss	<u>(26)</u>	-	<u>(26)</u>	-
Total	<u>4,469</u>	<u>5,721</u>	<u>(1,251)</u>	<u>(318)</u>

Deferred income tax related to items charged or credited directly to equity are as follows:

	<u>2006</u>	<u>2005</u>
Revaluation of cash flow hedges	<u>(1)</u>	<u>(2)</u>
Total	<u>(1)</u>	<u>(2)</u>

18 Government social security and pension schemes

The Group is legally required to make contributions to government health, retirement benefit and unemployment schemes. During 2006 and 2005, the Group paid contributions at a rate of 35% of gross salaries and is not required to make any contributions in excess of this statutory rate. The total amount charged to operating expenses in respect of this scheme was CZK 1,649 million in 2006 (2005: CZK 1,830 million). Employees contribute 12.5% (2005: 12.5%) of their gross salaries.

The Group has a voluntary pension plan for employees under which the Group makes contributions on behalf of the Group's employees to approved pension plan providers, under defined contribution schemes. The Group's contribution depends upon the number of employees joining the scheme and their age profile. During the year the Group made contributions of CZK 53 million (2005: CZK 65 million). These contributions were charged as an operating expense.

In accordance with an annually renegotiated collective labour agreement, the Company is required to pay CZK 25,000 or CZK 90,000 on retirement depending on the length of the employee's service, who have completed not less than five years continuous service. These benefits are restricted to those employees who retire during the period for which the labour agreement is in place. The Company is not under any legal or constructive obligation to continue providing such benefits beyond the period of such agreement and therefore, no provisions beyond the period of the agreement are recognised in the financial statements. Payments made during the year 2006 relating to employee retirement amounted to CZK 0.1 million (2005: CZK 0.1 million) and were charged as an operating expense.

All amounts discussed in the above note are included in staff costs (see Note 3).

19 Provisions for liabilities and charges

Short-term Provisions

	<u>Regulatory and court decisions</u>	<u>Employee redundancy costs</u>	<u>Employee- Related costs</u>	<u>Share-based compensation</u>	<u>Benefit loyalty provision</u>	<u>Other</u>	<u>Total</u>
At 1 January 2005	-	-	186	60	489	131	866
Additions during the year	20	10	331	190	441	203	1,195
Reclassification	-	-	-	-	-	7	7
Utilised during the year	<u>-</u>	<u>-</u>	<u>(398)</u>	<u>(250)</u>	<u>(474)</u>	<u>(323)</u>	<u>(1,445)</u>
At 31 December 2005	<u>20</u>	<u>10</u>	<u>119</u>	<u>-</u>	<u>456</u>	<u>18</u>	<u>623</u>
Additions during the year	-	107	181	-	481	38	807
Reclassification	-	-	-	-	-	7	7
Utilised during the year	<u>(6)</u>	<u>(98)</u>	<u>(117)</u>	<u>-</u>	<u>(373)</u>	<u>(8)</u>	<u>(602)</u>
At 31 December 2006	<u>14</u>	<u>19</u>	<u>183</u>	<u>-</u>	<u>564</u>	<u>55</u>	<u>835</u>

Long-term Provisions

	<u>Regulatory and court decisions</u>	<u>Employee related costs</u>	<u>Other</u>	<u>Total</u>
At 1 January 2005	1,566	-	-	1,566
Additions during the year	576	-	4	580
Reclassification	-	-	12	12
Utilised during the year	<u>(44)</u>	<u>-</u>	<u>(3)</u>	<u>(47)</u>
At 31 December 2005	<u>2,098</u>	<u>-</u>	<u>13</u>	<u>2,111</u>
Additions during the year	295	72	-	367
Reclassification	-	-	(7)	(7)
Utilised during the year	<u>(434)</u>	<u>-</u>	<u>-</u>	<u>(434)</u>
At 31 December 2006	<u>1,959</u>	<u>72</u>	<u>6</u>	<u>2,037</u>

With the exception of the regulatory and court decisions and other small items for which the expected timing of payments is not certain all other provisions are expected to be utilised within next 12 months from the balance sheet date.

Benefit loyalty provision

Benefit loyalty provision covers the cost of equipment, accessories, gifts and services provided to participants in the mobile segment's loyalty program in exchange for credits awarded primarily for airtime minutes spent. The provision has been recognized based on past experience of the usage of these credits by loyalty program participants. Expected outflow of provided benefits is CZK 290 million (2005: CZK 242 million) within one year and CZK 274 million (2005: CZK 214 million) from one year up to three years.

The amount of a provision is the present value of the expenditures expected to be required to settle the obligation (CZK 580 million).

Employee-related costs

Provisions for employee-related costs include expected costs associated with performance bonuses and provision for termination payments.

Regulatory and court decisions

Provision for regulatory and court decisions is made for legal proceedings involving the Group companies (see Note 21).

20 Financial instruments

Net fair values of derivative financial instruments

At the balance sheet date, the total net fair values of derivative financial instruments were as follows:

Contracts with positive fair value	31 December 2006	31 December 2005
Total	<u>—</u>	<u>—</u>
Contracts with negative fair value	31 December 2006	31 December 2005
Instruments not qualifying as hedges		
- Interest rate swaps	-	2
Cash flow hedges		
- Forward foreign exchange contracts	<u>18</u>	<u>11</u>
Total (Note 16)	<u>18</u>	<u>13</u>

21 Contingencies

The Group is involved in a variety of legal proceedings that arise from time to time in the ordinary course of business. The following is a discussion of the significant legal matters involving the Group:

Interconnect arrangements

The Company has not yet agreed a 2001 price amendment to an agreement with T-Mobile Czech Republic a.s. governing interconnect arrangements. Whilst in December 2003 the Czech Telecommunication Office (CTO) effectively ruled in favour of the amounts claimed (i.e. CZK 899 million for T-Mobile Czech Republic a.s., the outstanding amount is bearing interest of 0.05% per day), the management believes that the amounts are not substantiated and are without merit. The Company subsequently obtained adjournment of the decision execution and lodged an appeal. Based on the legal environment in the Czech Republic, management estimated maximum probable outflow related to the dispute with T-Mobile Czech Republic a.s. and such outflow is fully provided in the financial statements. The management is confident that all risks, which may arise as a result of the litigation, are adequately provided for in the financial statements. No further disclosure is deemed appropriate as it could prejudice the Company's position in the dispute.

On 30 June 2005, Vodafone Czech Republic, a.s. (former Český Mobil/Oskar Mobil) filed a petition at the Municipal Court in Prague against the Company for damages in the amount of CZK 538 million with appurtenances and for returning the unjustified enrichment of CZK 117 million with appurtenances. The Company is alleged to have failed to transmit the traffic to networks operated by other mobile operators according to respective interconnection agreements. The petition was only unofficially delivered from Vodafone Czech Republic, a.s. and was not served by the court. There was no further development in this respect in 2006. Furthermore, the Company is a defendant in a case filed by Vodafone Czech Republic, a.s. in May 2004 asserting causes for alleged breach of the antitrust law by former Eurotel (damages amounting to CZK 1,043 million). Both parties filed their expert opinions to the court, no hearing has been ordered until now. The management believes that all risks, which may arise as a result of Vodafone litigations, are adequately provided for in the financial statements. No further disclosure is deemed appropriate as it could prejudice the Company's position in the dispute.

Office for the Protection of Economic Competition proceedings

The Company is subject to administrative proceeding by the Office for the Protection of Economic Competition (UOHS) relating to the alleged creation of unfair barriers against development on the market through the application of certain specific price plans for residential customers. UOHS rendered resolution dated 20 April 2005 imposing a fine to the Company in the total amount of CZK 210 million, which was consequently, after the Company completed and filed a protest, reduced to CZK 205 million. The Company lodged an appeal in January 2006 and requested adjournment of the decision execution.

The Court rejected the Company's proposal and the Company lodged a complaint against this decision to the Supreme Administrative Court on 19 October 2006. The matter is fully provided in the financial statements.

Other legal matters

The Company is a defendant in a case filed by TELE2 s.r.o. on 3 February 2005 asserting causes for alleged breach of anti competition law by the Company in connection with offering pricing plans since January 2002. The amount of the claim is CZK 2,142 million with appurtenances. No hearing has been ordered in the matter yet. The Company provided to the court extensive defence along with proposed items of evidence proving the legal imperfectness of the sued court's conduct. The management is satisfied that the matter is adequately reflected in the financial statements and does not believe the resolution of this legal proceeding will have a material adverse effect on net income exceeding the amount of provision already made in the financial statements. No further disclosure is deemed appropriate as it could prejudice the Company's position in the dispute.

The Company is prosecuted by AUGUSTUS spol. s r.o. for an alleged loss of profit in the principal amount of approximately CZK 183 million with appurtenances (totalling approximately additional CZK 257 million as of the end of 2006) relating to the years 1995 – 2001. Augustus claims that the Company illegitimately cancelled a contract for issue of phone cards, which was signed for unlimited period of time. Based on court decision, the Company paid an amount of the principal of CZK 83 million and the corresponding interest in August 2006. Both parties filed subsequently appeal against the court judgement. The management believes that all risks, which may arise as a result of this litigation, are adequately provided for in the financial statements. No further disclosure is deemed appropriate as it could prejudice the Company's position in the dispute.

The Company is a defendant in several other legal cases out of which those that individually exceed CZK 5 million total to CZK 138 million with appurtenances. The management believes that the risk of losing these cases is less than probable and no provision was made in the financial statements.

22 Commitments

Operating leases

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

	<u>31 December 2006</u>	<u>31 December 2005</u>
No later than 1 year	1,052	991
Later than 1 year and not later than 5 years	3,136	1,827
Later than 5 years	<u>2,518</u>	<u>1,383</u>
Total	<u>6,706</u>	<u>4,201</u>

The total lease payments relating to operating leasing of property, plant and equipment recognised as an expense in 2006 were CZK 1,102 million (2005: CZK 1,123 million). These 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.

In 2004 the Group entered into a sale and lease back transaction and now leases the majority of its car fleet under operating leases. There are no contingent rent obligations. The lease arrangements include an option to renew the lease after the initial period. Lease payments are fixed and determinable, however they may be increased to reflect inflation and other market conditions such as interest rates changes (e.g. an increase in PRIBOR by more than 2% over a half year). There are no significant restrictions imposed by these lease arrangements, such as those concerning dividends, additional debt and further leasing. Total future lease payments relating to this contract in 2006 were CZK 368 million (2005: CZK 229 million).

Capital commitments

	<u>31 December 2006</u>	<u>31 December 2005</u>
Capital expenditure contracted but not provided for in the financial statements	673	1,541

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

23 Service concession arrangements

The Company performs communication activities under the Act on electronic communications based on a notification to and a certificate from the Czech Telecommunication Office. In accordance with Section 13 of the Act on electronic communications, on 12 August 2005, the Company delivered a notification to the Czech Telecommunication Office (further CTO) on the performance of a communication activity, which is under Section 8 of this Act a business activity in electronic communications. Relating documentation required by the Act on electronic communications was provided on 29 September 2005. Subsequently, on 11 October 2005, the CTO issued a certificate confirming that a notification on the performance of a communication activity was received. A notification of the changes has been filed before the transfer of assets and liabilities.

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

- a) Public fixed and mobile network of electronic communications
- b) Public network for the transfer of radio and TV signal
- c) Public fixed and mobile telephone network
- d) Publicly accessible telephone services

- e) Other voice services
- f) Rent of circuits
- g) Transmission of radio and TV signal
- h) Transfers of data
- i) Internet access services.

In accordance with the Act on electronic communications, the CTO determined the scope and new detail conditions for the provision of each particular service within the universal service including the selection of providers. The CTO issued, based on the results of tenders, decisions according to which the Company was determined as the provider of the following particular services:

- Periodic issuance of telephone directories with numbers of participants of the publicly accessible telephone service and access of end users to these directories in accordance with Section 38, Para 2, letter c) of the Act on electronic communications (on 21 December 2005);
- Information service on the numbers of participants of the publicly accessible telephone service in accordance with Section 38, Para 2, letter d) of the Act on electronic communications (on 21 December 2005);
- Public pay telephones in accordance with Section 38, Para 2, letter e) of the Act on electronic communications (on 13 March 2006);
- Access for disabled to the public telephone service in accordance with Section 38, Para 2, letter f) of the Act on electronic communications (on 12 July 2006);
- Supplementary services in accordance with Section 38, Para 2, letter g) of the Act on electronic communications (on 28 July 2006);
- Special price plans in accordance with Section 38, Para 3 of the Act on electronic communications (on 1 September 2006); the Company is not the only provider.

CTO also published on 1 September 2006 its decision not to impose the duty to provide the USO service of connection at a fixed location to the public telephone network and the service of access to publicly available telephone services at a fixed location, mainly due to the high level of deployment of these services and high level of substitutability of mobile services.

Mobile segment:

The Company provides mobile services of electronic communications in the 900 and 1800 MHz frequency bands under the Global System for Mobile Communication ("GSM") and in the 450 MHz frequency band under the Nordic Mobile Telephone ("NMT") standard (collectively, "mobile services"). In June 2005 all subscribers of a voice service in the NMT 450 Network were transferred to the GSM Network. The NMT 450 Network is used for broadband mobile access to Internet using CDMA2000 1*EV-DO (Code-Division Multiple Access Evolution Data Optimized "CDMA") technology in the 450 MHz frequency band. Mobile segment operates services based on Universal Mobile Telecommunications System ("UMTS") standard since 1 December 2005. Mobile license 450 MHz, mobile license GSM and UMTS have remaining life 5, 10 and 15 years, respectively. Relative to the current

regulatory and business environment in the Czech Republic, contractual, legal, regulatory, competitive or other economic factors may limit the period during which the Company can benefit from the use of these licenses in the future.

The original 450 MHz and GSM operating licenses were granted for a period of twenty years from the signing of the agreement for the original 450 MHz license in 1991 and from the granting of the GSM license in 1996 for use of the 900 spectrum. In 1999, former Eurotel acquired an additional GSM 1800 spectrum under its existing GSM license. In 2002, the GSM license to both spectrums was renewed and is currently valid for the remaining period of ten years. In 2002, former Eurotel renewed its 450 MHz license; the current license enables the Company to offer any internationally recognized public mobile telecommunication services on a frequency of 450 MHz. Mobile segment currently provides on this frequency broadband Internet access services using CDMA technology. The license is currently valid for the remaining period of five years.

In December 2001, former Eurotel acquired the UMTS license, which has been granted for a period of twenty years. Under the license, former Eurotel was provided with deferred payment terms by the CTO to finance the license acquisition. In December 2003, former Eurotel signed an amendment to its original UMTS license agreement, by which the original launch of the service was extended by one year. According to the terms of this new amendment, former Eurotel agreed to pay the UMTS obligation in full during 2004 in exchange for a forgiveness of 2003 and 2004 interest on the deferred payments provided as part of the UMTS license agreement.

No additional expenses connected with renewal of the individual licences, nor any limitations connected with the renewal of licences, are expected in accordance with the existing interpretation of regulatory provisions.

On 7 September 2006, Telefónica O2 Slovakia s.r.o. was granted a licence to provide public mobile telephone service as well as public data and multimedia services by the means of the public mobile telephone network and to operate the public electronic communication network - GSM and UMTS mobile telephone network within the area of the Slovak Republic. The licence has been granted for 20 years, i.e. till September 2026.

The following obligations were part of the licence:

- Putting into operation the own GSM network within 6 months (i.e. until 7 March 2007);
- Putting into operation the UMTS network within 12 months (i.e. until 7 September 2007);
- Putting into operation 400 GSM base stations and to cover 12% of population by the own network within 12 months;
- Putting into operation 800 GSM base stations and to cover 45% of population by the own network within 24 months.

24 Share capital and reserves

	<u>31 December 2006</u>	<u>31 December 2005</u>
Nominal value per ordinary share (CZK)	100	100
Number of shares	322,089,890	322,089,890
Nominal value per share with special rights (CZK)*	1,000	1,000
Number of shares*	1	1
Ordinary shares (in CZK million)	32,209	32,209

* One share owned by the National Property Fund of the Czech Republic bore special decision-making rights in accordance with the statutes of the Company. These special rights included namely decisions regarding the liquidation of the Company, changes in its activities, sale or lease of the Company or of its assets. This share was assigned to Telefónica, S.A. within the transferred 51.1% stake in the Company (see General information). From this date, the share has not borne special decision-making rights.

At 31 December 2005, shareholdings in the Company were as follows:

Telefónica, S.A.	69.4%
Other shareholders	30.6%

At 31 December 2006, shareholdings in the Company were as follows:

Telefónica, S.A.	69.4%
Other shareholders	30.6%

Funds include a statutory reserve fund of CZK 6,262 million (2005: CZK 5,904 million) that is not distributable under ruling legislation.

25 Hedging reserve

Balance at 1 January 2005	(47)
Fair value losses in period	(36)
Fair value losses transfer to net profit	72
Deferred tax on fair value losses	—
Balance at 31 December 2005	<u>(11)</u>
Fair value losses in period	(34)
Fair value losses transfer to net profit	26
Deferred tax on fair value losses	—
Balance at 31 December 2006	<u>(18)</u>

26 Cash generated from operating activities

	Year ended	
	<u>31 December 2006</u>	<u>31 December 2005</u>
Net profit	8,020	6,248
Adjustments for:		
Tax (Note 5)	2,920	2,500
Depreciation (Note 8)	14,038	15,030
Amortisation (Note 9)	2,708	2,778
Impairment loss (Note 8, 9, 10)	253	1,261
Disposals of obsolete assets	49	76
Profit on sale of property, plant and equipment	(96)	(111)
Net interest and other charges	243	702
Foreign exchange (gains)/losses (net)	(203)	(347)
Fair value changes	29	(119)
Increase in provisions	<u>(11)</u>	<u>73</u>
Operating cash flow before working capital changes	27,950	28,091
Decrease/(increase) in trade and other receivables	(10)	(555)
Decrease/(increase) in inventories	(753)	(211)
(Decrease)/increase in trade and other payables	<u>1,076</u>	<u>435</u>
Cash generated from operations	<u>28,263</u>	<u>27,760</u>

27 Related party transactions

The acquisition process and the transfer of majority ownership of NPF was completed on 16 June 2005 by paying-off the balance of 90% purchase price by Telefónica, S.A, and NPF divested 51.1% shares in the Company. Telefónica effectively used its rights at the General Shareholders Meeting, which took place on 23 June 2005.

The intercompany transactions between the Group and the Telefónica Group companies are disclosed from the date Telefónica, S.A. gained effective control, i.e. 23 June 2005 to 31 December 2006. With respect to the majority ownership of NPF holding to 16 June 2005, all transactions between the Group and the NPF companies are disclosed only to that date.

The Group provides services to all related parties on normal commercial terms. 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 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 no allowance or write off incurred.

The following transactions were carried out with related parties:

I. Parent company:

a) Dividend

	<u>31 December 2006</u>	<u>31 December 2005</u>
Telefónica S.A.	<u>10,061</u>	<u>-</u>

II. Other related parties – Telefónica Group:

a) Sales of services and goods

	Year ended	
	<u>31 December 2006</u>	<u>31 December 2005</u>
Telefónica companies	<u>520</u>	<u>61</u>

b) Purchases of services and goods

	Year ended	
	<u>31 December 2006</u>	<u>31 December 2005</u>
Telefónica companies	<u>351</u>	<u>32</u>

c) Capital purchases

	Year ended	
	<u>31 December 2006</u>	<u>31 December 2005</u>
Telefónica companies	<u>18</u>	<u>-</u>

d) Receivables

	<u>31 December 2006</u>	<u>31 December 2005</u>
Telefónica companies	<u>131</u>	<u>39</u>

e) Payables

	<u>31 December 2006</u>	<u>31 December 2005</u>
Telefónica companies	<u>74</u>	<u>8</u>

f) Short-term receivables (interest)

	<u>31 December 2006</u>	<u>31 December 2005</u>
Telefónica companies	<u>8</u>	<u>-</u>

g) Interest income

	Year ended	
	<u>31 December 2006</u>	<u>31 December 2005</u>
Telefónica companies	<u>15</u>	<u>-</u>

h) Cash equivalents

	<u>31 December 2006</u>	<u>31 December 2005</u>
Telefónica companies	<u>3,605</u>	<u>-</u>

The list of the Telefónica companies with which the Group had any transaction in 2006 includes the following entities: Telefónica de España, S.A.U., O2 Germany GmbH& CO.OHG, Telefónica Deutschland GMBH, O2 (UK) Ltd., O2 Communications (Ireland) Ltd., Telefónica Servicios Integrales de Distribución, S.A.U, Atento Servicios Técnicos y Consultoría, S.L., Telefónica Móviles España, S.A.U., Telefónica Móviles Argentina, S.A., Pléyade Peninsular,

Correduría de Seguros y Reaseguros del Grupo Telefónica, S.A., Telefónica de Contenidos, S.A.U., Portugal Telecom, S.G.P.S., S.A., Telefónica Europe, B.V., Telefónica International Wholesale Services, S.L. and Telefónica Gestión de Servicios Compartidos, S.A.

III. Other related parties – State entities controlled by NPF*

a)	Sales of services and goods	Year ended	
		<u>31 December 2006</u>	<u>31 December 2005</u>
	State controlled entities	<u>=</u>	<u>56</u>
b)	Purchases of services and goods	Year ended	
		<u>31 December 2006</u>	<u>31 December 2005</u>
	State controlled entities	<u>=</u>	<u>116</u>
c)	Receivables	Year ended	
		<u>31 December 2006</u>	<u>31 December 2005</u>
	State controlled entities	<u>=</u>	<u>2</u>
d)	Payables	Year ended	
		<u>31 December 2006</u>	<u>31 December 2005</u>
	State controlled entities	<u>=</u>	<u>75</u>

* NPF did not hold any shares in the Company after 16 June 2005, and accordingly the respective related party sales and purchases have been prepared for period from 1 January 2005 to 16 June 2005. The state controlled entities include all companies that are owned by the State through NPF Czech Republic. Entities controlled by NPF consist of number of commercial (joint stock or limited liability) companies operating across different industries, and they do not include the government or governmental bodies. Accordingly, transactions with ministries and other state agencies are not treated as related party transactions.

IV. Other related parties

a) Key management compensation

Members of the Board of Directors and of the Supervisory Board of the Telefónica O2 Czech Republic, a.s., were provided with benefits as follows:

	Year ended	
	<u>31 December 2006</u>	<u>31 December 2005</u>
Salaries and other short-term benefits	86	254
Board share on profit	-	-
Stock appreciation rights	-	190
Non-competition clause	-	6
Termination benefits	-	58
Capital life insurance	-	16
Personal indemnification insurance	<u>12</u>	<u>16</u>
Total	<u>98</u>	<u>540</u>

b) Loans to related parties

There were no loans provided to members of Board of Directors and Supervisory Board in 2005 and 2006.

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

28 Principal subsidiary undertakings

<u>Name</u>	<u>Group's interest</u>	<u>Country of incorporation</u>	<u>Activity</u>
1. Telefónica O2 Services, spol. s r.o.	100%	Czech Republic	Network and consultancy services in telecommunications
2. SPT TELECOM (Czech Republic) Finance B.V.	100%	Netherlands	Financing other entities in the Group
3. CZECH TELECOM Germany GmbH	100%	Germany	Data transmission services
4. CZECH TELECOM Austria GmbH	100%	Austria	Data transmission services
5. Telefónica O2 Slovakia s.r.o.	100%	Slovakia	Mobile telephony, internet and data transmission services
6. CenTrade, a.s.	100%	Czech Republic	E-business company providing market place services

On 20 December 2001 former Eurotel acquired a 100% ownership interest in a Hungarian registered limited liability company, Trigo Global Services Ltd. ("Trigo") for CZK 1 million. The subsidiary was engaged in the contracting of labour services to former Eurotel for periods prior to January 2004. In September 2004, Trigo commenced the process of voluntary liquidation. On 8 April 2005 the process of liquidation was finished and assets were transferred to former Eurotel (amounts of assets transferred are not material to the Group's consolidated results). Currency translation adjustment upon complete liquidation of the investment in Trigo, the amount attributable to that entity and accumulated in the translation adjustment component of equity (CZK 13 million) was removed from the separate component of equity and was reported as part of the gain on liquidation of the investment. At the date of liquidation goodwill was fully written off.

As of 1 January 2007, CenTrade, a.s. commenced the process of voluntary liquidation. The process is still in progress, the Company increased its investment and paid in capital which would aim to the smooth liquidation process.

29 Minority interest

	<u>2006</u>	<u>2005</u>
At 1 January	-	6
Elimination impact*	-	(5)
Share of net loss of subsidiaries	-	(1)
At 31 December	-	-

* Impact of the elimination of liquidated companies from consolidation.

30 Post balance sheet events

On 2 February 2007, Telefónica O2 Slovakia s.r.o started, in accordance with the license granted, its commercial operation for prepaid mobile services "O2 Jednotky".

The Group is in process of implementing measures to increase efficiency which include also real estates usage optimisation. Real estates' optimisation focus amongst other actions on reduction of employees' territorial diversification as well as move into a new headquarter in 2007. There might be a potential to divest certain real estates as a consequence of the mentioned optimisation plan. The Group has engaged external advisors to assist with the analysis and process of the potential disposal. As a part of the process being carried out the advisors have introduced the selected properties available into the real estates market.

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 2006.