

TELEFONOS DE MEXICO S A DE C V  
Form 20-F  
June 30, 2006  
Table of Contents

As filed with the Securities and Exchange Commission on June 30, 2006.

---

# SECURITIES AND EXCHANGE COMMISSION

Washington, DC 20549

---

## FORM 20-F

---

ANNUAL REPORT PURSUANT TO SECTION 13 OF THE SECURITIES EXCHANGE ACT OF 1934

For the fiscal year ended December 31, 2005

Commission File Number: 001-32741

---

## Teléfonos de México, S.A. de C.V.

(Exact name of registrant as specified in its charter)

---

Telephones of Mexico

(Translation of registrant's name into English)

United Mexican States

(Jurisdiction of incorporation or organization)

Parque Vía 190, Colonia Cuauhtémoc, 06599 México, D.F., México

(Address of principal executive offices)

### SECURITIES REGISTERED PURSUANT TO SECTION 12(b) OF THE ACT:

Title of each class	Name of each exchange on which registered
American Depositary Shares, each representing 20 Series L Shares, without par value ( L Share ADSs )	New York Stock Exchange
Series L Shares, without par value ( L Shares )	

New York Stock Exchange  
(for listing purposes only)

8.75% Senior Notes due 2016

New York Stock Exchange

SECURITIES REGISTERED PURSUANT TO SECTION 12(g) OF THE ACT:

American Depositary Shares, each representing 20

Series A Shares, without par value ( A Share ADSs )

Series A Shares, without par value ( A Shares )

SECURITIES FOR WHICH THERE IS A REPORTING OBLIGATION PURSUANT TO SECTION 15(d) OF THE ACT: None

The number of outstanding shares of each class of capital or common stock as of December 31, 2005 was:

8,115 million	AA Shares
479 million	A Shares
13,451 million	L Shares

Indicate by check mark if the registrant is a well-known seasoned issuer, as defined in Rule 405 of the Securities Act. Yes  No

If this report is an annual or transition report, indicate by check mark if the registrant is not required to file reports pursuant to Section 13 or 15(d) of the Securities Exchange Act of 1934. Yes  No

Indicate by check mark whether the registrant: (1) has filed all reports required to be filed by Section 13 or 15(d) of the Securities Exchange Act of 1934 during the preceding 12 months (or for such shorter period that the registrant was required to file such reports) and (2) has been subject to such filing requirements for the past 90 days. Yes  No

Indicate by check mark whether the registrant is a large accelerated filer, an accelerated filer, or a non-accelerated filer. See definition of accelerated filer and large accelerated filer in Rule 12b-2 of the Exchange Act. (Check one):

Large accelerated filer  Accelerated filer  Non-accelerated filer   
Indicate by check mark which financial statement item the registrant has elected to follow. Item 17  Item 18

If this is an annual report, indicate by check mark whether the registrant is a shell company (as defined in Rule 12b-2 of the Exchange Act). Yes  No

---

**Table of Contents****TABLE OF CONTENTS**

	<b>Page</b>
Item 1. <u>Identity of Directors, Senior Management and Advisers</u>	1
Item 2. <u>Offer Statistics and Expected Timetable</u>	1
Item 3. <u>Key Information</u>	1
<u>Selected Financial Data</u>	1
<u>Exchange Rates</u>	4
<u>Risk Factors</u>	5
<u>Forward-Looking Statements</u>	12
Item 4. <u>Information on the Company</u>	13
<u>General</u>	13
<u>Mexican Operations</u>	16
<u>Non-Mexican Operations</u>	32
<u>Capital Expenditures</u>	40
<u>Other Matters</u>	40
Item 4A. <u>Unresolved Staff Comments</u>	41
Item 5. <u>Operating and Financial Review and Prospects</u>	42
Item 6. <u>Directors and Officers of Registrant</u>	59
Item 7. <u>Major Shareholders and Related Party Transactions</u>	73
<u>Major Shareholders</u>	73
<u>Related Party Transactions</u>	75
Item 8. <u>Financial Information</u>	77
<u>Consolidated Financial Statements</u>	77
<u>Legal Proceedings</u>	77
<u>Dividends</u>	79
Item 9. <u>The Offer and Listing</u>	80
<u>Trading Market</u>	80
<u>Trading on the Mexican Stock Exchange</u>	81
Item 10. <u>Additional Information</u>	82
<u>Bylaws and Mexican Law</u>	82
<u>Certain Contracts</u>	89
<u>Exchange Controls</u>	89
<u>Taxation</u>	89
<u>Corporate Governance Practices</u>	94
<u>Documents on Display</u>	97
Item 11. <u>Quantitative and Qualitative Disclosures about Market Risk</u>	98
<u>Exchange Rate and Interest Rate Risks</u>	98
<u>Sensitivity Analysis Disclosures</u>	98
Item 12. <u>Description of Securities Other Than Equity Securities</u>	99
Item 13. <u>Defaults, Dividend Arrearages and Delinquencies</u>	99
Item 14. <u>Material Modifications to the Rights of Securities Holders and Use of Proceeds</u>	99
Item 15. <u>Controls and Procedures</u>	99
Item 16A. <u>Audit Committee Financial Expert</u>	99
Item 16B. <u>Code of Ethics</u>	100
Item 16C. <u>Principal Accountant Fees and Services</u>	100
Item 16D. <u>Exemptions from the Listing Standards for Audit Committees</u>	101
Item 16E. <u>Purchases of Equity Securities by the Issuer and Affiliated Purchasers</u>	101
Item 17. <u>Financial Statements</u>	102
Item 18. <u>Financial Statements</u>	102
Item 19. <u>Exhibits</u>	103

**Table of Contents**

**PART I**

**Item 1. Identity of Directors, Senior Management and Advisers**

Not applicable.

**Item 2. Offer Statistics and Expected Timetable**

Not applicable.

**Item 3. Key Information**

**SELECTED FINANCIAL DATA**

The selected consolidated financial data set forth below have been derived from our audited consolidated financial statements for each of the five years in the period ended December 31, 2005, which have been reported on by Mancera, S.C., a member of Ernst & Young Global, an independent, registered public accounting firm. The selected consolidated financial data should be read in conjunction with, and are qualified in their entirety by reference to, our consolidated financial statements and notes thereto included elsewhere in this Annual Report.

Our consolidated financial statements have been prepared in accordance with generally accepted accounting principles in Mexico, or Mexican GAAP, which differ in certain respects from generally accepted accounting principles in the United States, or U.S. GAAP. Note 19 to our audited consolidated financial statements provides a description of the principal differences between Mexican GAAP and U.S. GAAP, as they relate to us; a reconciliation to U.S. GAAP of operating income, net income and total stockholders' equity; and a condensed statement of cash flows under U.S. GAAP.

Pursuant to Mexican GAAP, in the consolidated financial statements and the selected consolidated financial data set forth below:

nonmonetary assets (excluding plant, property and equipment of non-Mexican origin) and stockholders' equity are restated for inflation based on the Mexican National Consumer Price Index;

plant, property and equipment of non-Mexican origin are restated based on the rate of inflation in the country of origin and converted into Mexican pesos using the prevailing exchange rate at the balance sheet date;

gains and losses in purchasing power from holding monetary assets and liabilities are recognized in income; and

all financial statements are restated in constant pesos as of December 31, 2005.

We have not reversed the effect of inflation accounting under Mexican GAAP in the reconciliation to U.S. GAAP of our net income and stockholders' equity, except with respect to the methodology for restatement of plant, property and equipment of non-Mexican origin. See Note 19 to our audited consolidated financial statements.

**Table of Contents**

	Year ended December 31,				
	2005	2004	2003	2002	2001
(in millions of constant pesos as of December 31, 2005, except per share data)					
<b>Income Statement Data:</b>					
Mexican GAAP:					
Operating revenues	P.162,948	P.144,677	P.128,955	P.128,987	P.134,924
Operating costs and expenses	114,254	99,962	86,040	84,247	84,044
Operating income	48,694	44,715	42,915	44,740	50,880
Net income	28,999	28,762	24,401	22,116	28,066
Net income per share Basic <sup>(1)(2)</sup>	1.231	1.188	0.980	0.851	1.036
Net income per share Diluted <sup>(1)(2)</sup>	1.231	1.185	0.953	0.836	0.972
Dividends paid per share <sup>(1)(3)</sup>	0.370	0.333	0.303	0.273	0.245
Weighted average number of shares outstanding (millions) <sup>(2)</sup>					
Basic	22,893	23,906	24,908	25,972	27,082
Diluted	22,893	24,404	26,202	27,354	28,442
U.S. GAAP:					
Operating revenues	P.162,948	P.144,677	P.128,955	P.128,987	P.134,924
Operating costs and expenses	119,398	105,521	90,708	90,361	92,900
Operating income	43,550	39,156	38,247	38,626	42,024
Net income	27,049	29,175	23,594	20,072	24,162
Net income per share Basic <sup>(1)(2)</sup>	1.182	1.220	0.947	0.773	0.892
Net income per share Diluted <sup>(1)(2)</sup>	1.182	1.216	0.922	0.762	0.835
Dividends paid per share <sup>(1)(3)</sup>	0.370	0.333	0.303	0.273	0.245

*(see footnotes on following page)*

**Table of Contents**

	December 31,				
	2005	2004	2003	2002	2001
	(in millions of constant pesos as of December 31, 2005, except number of shares and ratios of earnings to fixed charges)				
<b>Balance Sheet Data:</b>					
Mexican GAAP:					
Plant, property and equipment, net	P. 150,577	P. 156,385	P. 131,586	P. 138,481	P. 136,535
Total assets	249,989	261,423	201,910	190,767	187,447
Short-term debt and current portion of long-term debt	14,595	13,634	22,024	12,500	20,891
Long-term debt	76,364	79,406	52,625	62,244	62,424
Total stockholders' equity	111,348	111,418	86,573	69,127	60,641
Capital stock	27,536	28,934	30,098	31,295	31,980
Number of outstanding shares (millions) <sup>(2)</sup>					
Series AA	8,115	8,127	8,272	8,272	8,614
Series A	479	504	530	578	626
Series L	13,451	15,034	15,416	16,704	17,090
U.S. GAAP:					
Plant, property and equipment, net	P. 157,265	P. 164,676	P. 137,771	P. 150,701	P. 161,533
Total assets	258,008	270,247	210,159	204,519	214,008
Short-term debt and current portion of long-term debt	14,595	13,634	22,024	12,500	20,891
Long-term debt	76,364	79,406	52,625	62,244	62,424
Total stockholders' equity	96,285	93,526	79,763	65,325	63,197
Capital stock	27,536	28,934	30,098	31,295	31,980
<b>Other Data:</b>					
Mexican GAAP:					
Ratio of earnings to fixed charges <sup>(4)</sup>	6.9	8.2	7.4	6.5	6.7
U.S. GAAP:					
Ratio of earnings to fixed charges <sup>(4)</sup>	6.3	7.6	6.9	5.8	5.8

- (1) We have not presented net income or dividends on a per ADS basis. Each L Share ADS represents twenty L Shares, and each A Share ADS represents twenty A Shares.
- (2) All amounts have been adjusted to reflect a two-for-one stock split effected on May 25, 2005.
- (3) Nominal amounts. For information on dividends paid per share translated into U.S. dollars, see *Item 8. Financial Information Dividends*.
- (4) Earnings for this purpose consist of earnings before provision for income tax but after provision for employee profit sharing, plus fixed charges and depreciation of capitalized interest and minus interest capitalized during the period. Fixed charges for this purpose consist of interest expense plus interest capitalized during the period. Fixed charges do not take into account gain or loss from monetary position or exchange gain or loss attributable to our indebtedness.

**Table of Contents****EXCHANGE RATES**

Mexico has a free market for foreign exchange, and the Mexican government allows the peso to float freely against the U.S. dollar. There can be no assurance that the Mexican government will maintain its current policies with regard to the peso or that the peso will not depreciate or appreciate significantly in the future.

The following table sets forth, for the periods indicated, the high, low, average and period-end noon buying rate in New York City for cable transfers in pesos published by the Federal Reserve Bank of New York, expressed in pesos per U.S. dollar. The rates have not been restated in constant currency units.

<b>Period</b>	<b>High</b>	<b>Low</b>	<b>Average<sup>(1)</sup></b>	<b>Period End</b>
2001	P. 8.95	P. 9.97	P. 9.33	P. 9.16
2002	9.00	10.43	9.66	10.43
2003	10.11	11.41	10.79	11.24
2004	10.81	11.64	11.29	11.15
2005	10.41	11.41	10.87	10.63
2005:				
December	10.41	10.77		10.63
2006:				
January	10.44	10.64		10.44
February	10.43	10.53		10.45
March	10.46	10.95		10.90
April	10.86	11.16		11.09
May	10.84	11.31		11.29
June (through June 23)	11.28	11.46		11.44

(1) Average of month-end rates.

On June 23, 2006, the noon buying rate was P.11.44 to U.S.\$1.00.

We will pay any cash dividends in pesos, and exchange rate fluctuations will affect the U.S. dollar amounts received by holders of American Depositary Shares, or ADSs, on conversion by the depository of cash dividends on the shares represented by such ADSs. Fluctuations in the exchange rate between the peso and the U.S. dollar affect the U.S. dollar equivalent of the peso price of our shares on the Mexican Stock Exchange (*Bolsa Mexicana de Valores, S.A. de C.V.*) and, as a result, can also affect the market price of the ADSs.

**Table of Contents**

**RISK FACTORS**

**Risks Relating to Our Business Generally**

***Increasing competition in Mexico, Brazil and the other countries in which we operate could adversely affect our revenues and profitability***

We face significant competition in Mexico, Brazil and the other countries in which we operate, which could result in decreases in current and potential customers, revenues and profitability. Governmental authorities in many of these countries continue to grant new licenses and concessions to new market entrants, which results in increased competition in those countries. In addition, technological developments are increasing cross-competition in certain markets, such as between wireless providers and fixed-line operators.

In Mexico, competition in local service, principally from wireless service providers, has been developing since 1999. In December 2005, there were approximately 47.5 million cellular lines in service, compared with approximately 19.5 million fixed lines in service (18.4 million of which are part of our network). At present, 20 fixed-line local operators have been granted licenses, primarily in Mexico City, Guadalajara, Monterrey, Puebla and other large and medium-sized cities.

We have also begun to face new competition in Mexico from cable television providers, who have been authorized by the Communications Ministry (*Secretaría de Comunicaciones y Transportes*) to provide voice-transmission services to local fixed-line telecommunications operators and data and broadband Internet services to the Mexican public. In addition, in April 2006, the Mexican Congress amended the Federal Telecommunications Law (*Ley Federal de Telecomunicaciones*) and the Federal Radio and Television Law (*Ley Federal de Radio y Televisión*) to allow radio and television broadcasting companies to apply for authorizations to provide telecommunications services.

The effects of competition on our business are highly uncertain and will depend on a variety of factors, including economic conditions, regulatory developments, the behavior of our customers and competitors and the effectiveness of measures we take.

***Dominant carrier regulations and other regulatory developments could hurt our business by limiting our ability to pursue competitive and profitable strategies***

Our business is subject to extensive regulation, and it can be adversely affected by changes in law, regulation or regulatory policy. The Competition Commission (*Comisión Federal de Competencia*) has determined that we are a dominant provider of certain telecommunications services, and Mexican law provides for the regulatory authorities to impose additional regulations on a dominant provider. In the past several years, the Competition Commission and the Mexican Federal Telecommunications Commission (*Comisión Federal de Telecomunicaciones*, or Cofetel) have adopted resolutions and regulations that apply specifically to us as a dominant carrier. We have successfully challenged these resolutions and regulations in Mexican federal court. We cannot predict whether the Competition Commission or Cofetel will issue new resolutions or regulations that are substantially similar to those that were challenged successfully, and if so, whether our judicial challenges will be successful in the future. We believe that if dominant carrier regulations are eventually implemented, the new rules and the related regulatory procedures will reduce our flexibility to adopt competitive tariff policies.



## **Table of Contents**

### ***World Trade Organization dispute settlement between the United States and Mexico has resulted in changes in regulation that may affect our business***

In August 2000, the United States initiated a World Trade Organization dispute settlement against Mexico regarding alleged illegal barriers to competition in the Mexican telecommunications market. In June 2004, the United States and Mexico reached an agreement under which Mexico has eliminated its uniform settlement rate system, its proportional return system and its requirement that the Mexican carrier with the greatest share of outgoing traffic to a particular country negotiate the settlement rate on behalf of all Mexican carriers for that country. Mexico also agreed to introduce new regulations authorizing the resale of outgoing international long distance service. In August 2005, Mexico adopted regulations authorizing resale of outgoing international long distance service and domestic long distance service. We expect that these new regulations will likely affect our business and competition in the future and will put downward pressure on the prices we charge our customers for those services.

### ***Shifting usage patterns could adversely affect our revenues***

Our fixed-line network services face increasing competition due to shifting usage patterns resulting from the adoption of popular new technologies, including wireless devices for voice and other communications, and the subsequent substitution of these technologies for fixed-line phones. For example, we estimate that an increasing proportion of calls that previously would have been made over our fixed-line network are now being made on wireless telephones and voice over IP services outside our network, for which we receive no revenue. There can be no assurance that this process will not adversely affect our traffic volume and our results of operations.

### ***We have invested in countries in which we have limited experience, and we may be unsuccessful in addressing the new challenges and risks they present***

We have invested in a growing number of telecommunications businesses outside our historical core activity of providing fixed-line telecommunications services in Mexico, and we plan to continue to do so in the rest of Latin America. These investments have been made in some countries in which we have little experience and may involve risks to which we have not previously been exposed. Some of the investments are in countries that may present different or greater risks than Mexico, such as Brazil, Chile, Argentina, Peru and Colombia. We also have agreed to make a substantial investment in Venezuela. We cannot assure you that these investments will be successful.

## **Risks Relating to Our Controlling Shareholder and Capital Structure**

### ***We are controlled by one shareholder***

A majority of the voting shares of our company (71.0% as of May 11, 2006) is owned by Carso Global Telecom, S.A. de C.V., or Carso Global Telecom, which is controlled by Carlos Slim Helú and members of his immediate family who, taken together, own a majority of the common stock. Carso Global Telecom has the effective power to designate a majority of the members of our Board of Directors and to determine the outcome of other actions requiring a vote of the shareholders, except in very limited cases that require a vote of the holders of L Shares.

### ***The protections afforded to minority shareholders in Mexico are different from those in the United States***

Our bylaws provide that any controversy between us and our shareholders will be governed by Mexican law and that our shareholders will submit to the jurisdiction of Mexican courts for any proceedings in respect thereof. Under Mexican law, the protections afforded to minority shareholders are

## **Table of Contents**

different from those in the United States. In particular, the case law concerning fiduciary duties of directors is not well developed, there is no procedure for class actions, there are different procedural requirements for bringing shareholder lawsuits and there are different discovery rules. As a result, in practice it may be more difficult for minority shareholders of Telmex to enforce their rights against us or our directors or controlling shareholder than it would be for shareholders of a U.S. company.

### ***We engage in transactions with related parties that may create the potential for conflicts of interest***

We engage in transactions with certain subsidiaries of Grupo Carso, S.A. de C.V., or Grupo Carso, and Grupo Financiero Inbursa, S.A. de C.V., or Grupo Financiero Inbursa. Transactions with subsidiaries of Grupo Carso include the purchase of network construction services and materials, and transactions with Grupo Financiero Inbursa include banking services and insurance. We also have ongoing operational relationships with América Móvil, S.A. de C.V., or América Móvil, which is controlled by América Telecom, S.A. de C.V., or América Telecom. América Telecom, Carso Global Telecom, Grupo Carso and Grupo Financiero Inbursa are controlled by Carlos Slim Helú and members of his immediate family who, taken together, own a majority of the common stock of each company.

We also make investments jointly with related parties, sell our investments to related parties and buy investments from related parties. On April 3, 2006, we announced that América Móvil and we had together entered into an agreement with Verizon Communications, Inc., or Verizon, to acquire through an equally-owned joint venture Verizon's 28.5% equity interest in Compañía Anónima Nacional Teléfonos de Venezuela for an aggregate purchase price of U.S.\$676.6 million in cash. Another recent investment transaction with a related party includes our investment in the equity securities of MCI, Inc., which we and others who may be deemed to be under common control with us sold to Verizon in May 2005.

Our transactions with related parties may create the potential for conflicts of interest.

### ***Holders of L Shares and L Share ADSs have limited voting rights***

Our bylaws provide that holders of L Shares are not permitted to vote except on such limited matters as the transformation or merger of Telmex or the cancellation of registration of the L Shares with the Mexican National Banking and Securities Commission (*Comisión Nacional Bancaria y de Valores*) or any stock exchange on which they are listed. If you hold L Shares or L Share ADSs, you will not be able to vote on most matters, including the declaration of dividends, that are subject to a shareholder vote in accordance with our bylaws.

### ***Holders of ADSs are not entitled to attend shareholders' meetings, and they may only vote through the depositary***

Under Mexican law, a shareholder is required to deposit its shares with a Mexican custodian in order to attend a shareholders' meeting. As long as a shareholder holds shares in ADS form, the shareholder will not be able to satisfy this requirement. There can be no assurance that holders of ADSs will receive notice of shareholders' meetings from our ADS depositary in sufficient time to enable such holders to return voting instructions to the ADS depositary in a timely manner. In the event that instructions are not received with respect to any shares underlying ADSs, the ADS depositary will, subject to certain limitations, grant a proxy to a person designated by us. In the event that this proxy is not granted, the ADS depositary will vote these shares in the same manner as the majority of the shares of each class for which voting instructions are received.

**Table of Contents**

*You may not be entitled to preemptive rights*

Under current Mexican law, if we issue new shares for cash as part of a capital increase, we generally must grant our shareholders the right to purchase a sufficient number of shares to maintain their existing ownership percentage in Telmex. Rights to purchase shares in these circumstances are known as preemptive rights. We may not legally be permitted to allow holders of ADSs or holders of L Shares or A Shares in the United States to exercise any preemptive rights in any future capital increase unless we file a registration statement with the U.S. Securities and Exchange Commission, or SEC, with respect to that future issuance of shares. At the time of any future capital increase, we will evaluate the costs and potential liabilities associated with filing a registration statement with the SEC and any other factors that we consider important to determine whether we will file such a registration statement.

We cannot assure you that we will file a registration statement with the SEC to allow holders of ADSs or U.S. holders of L Shares or A Shares to participate in a preemptive rights offering. As a result, the equity interest of such holders in Telmex may be diluted proportionately. In addition, under current Mexican law, it is not practicable for the depositary to sell preemptive rights and distribute the proceeds from such sales to ADS holders.

Under the new Mexican Securities Market Law, preemptive rights will not arise upon the sale of newly issued shares in a public offering or the resale of shares of capital stock previously repurchased by