

Management's Discussion and Analysis of Financial Condition and Results of Operations



Shang Bing
President

I. Overview

Faced with the intense market competition within the telecommunications industry, the financial operating results of the Company maintained steady development in 2004. The operating revenue sustained their steady growth. Free cash flow (i.e. net cash inflow from operating activities minus capital expenditures) was further improved, with the balance sheet remaining sound.

Operating revenue in 2004 increased by 17.3% from 2003 to RMB79.33 billion. EBITDA^(Note 1) increased by 8.5% from 2003 to RMB27.02 billion. Operating profit decreased by 6.6% to RMB7.96 billion. Net profit increased by 4.0% from 2003 to RMB4.39 billion. Basic earnings per share were RMB0.349, up by RMB0.013 per share from RMB0.336 in 2003. Capital expenditures were RMB18.39 billion. Free cash flow further improved from RMB2.81 billion in 2003 to RMB5.43 billion.

On 31 December 2003, the Company completed the acquisition of the GSM cellular assets and businesses and the CDMA businesses of Unicom New World in 9 provinces, municipalities and autonomous regions including Shanxi, and the sale of the entire equity interests in Guoxin Paging. For the ease of comparison, the unaudited pro forma information in 2003 ("pro forma") referred to in this report were prepared on the assumption that the acquisition of Unicom New World and the sale of Guoxin Paging had been undertaken before 1 January 2003 (unless otherwise stated, same as below).

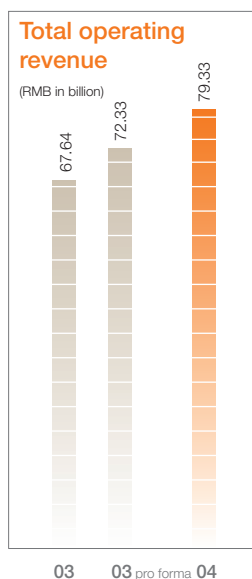
On a pro forma basis, in 2004, operating revenue increased by 9.7%, EBITDA decreased by 0.7%, operating profit decreased by 23.7%, and net profit decreased by 24.0%.

(Note 1) EBITDA represented the net profit before deducting interest income, finance costs, net other income, income tax, depreciation and amortization and minority interests.

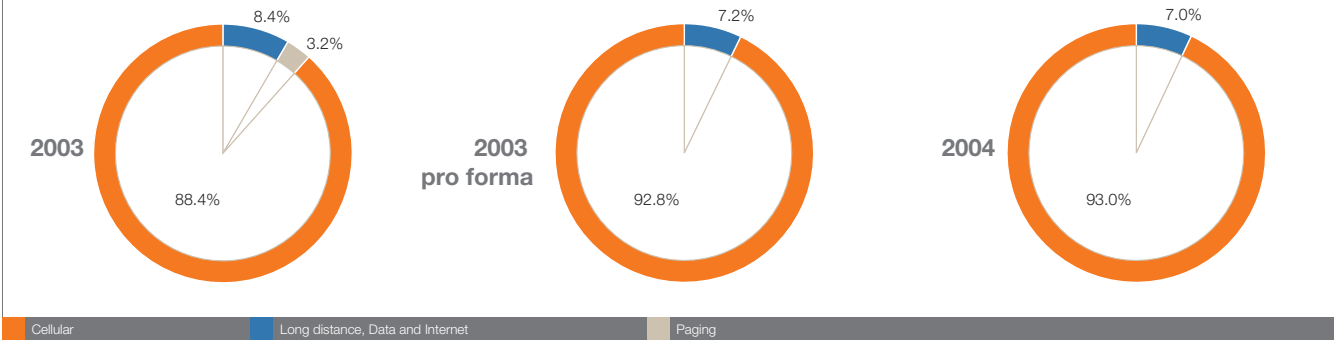
II. Operating revenue

Growth in the operating revenue of the Company continued to remain steady in 2004, and was RMB79.33 billion, up by 17.3% from 2003. On a pro forma basis, the increase was 9.7%.

Our operating revenue is mainly generated by the GSM and CDMA Cellular Businesses, the Long Distance, Data and Internet Business. The table below sets forth the changes in revenue composition and their proportion to total operating revenue for each of our business segments for the years 2003, 2003 pro forma and 2004.



Revenue composition

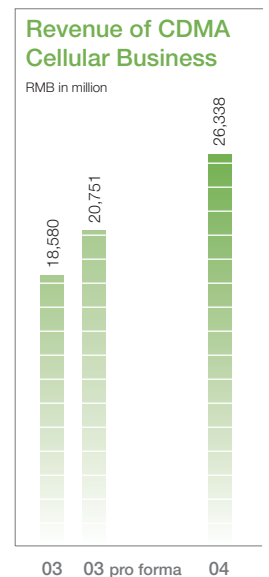


	2003		2003 pro forma		2004	
	RMB in million	As percentage of total	RMB in million	As percentage of total	RMB in million	As percentage of total
Operating revenue:						
Cellular, include:						
GSM	41,166	60.9%	46,369	64.1%	47,466	59.8%
CDMA	18,580	27.5%	20,751	28.7%	26,338	33.2%
Long Distance, Data and Internet	5,733	8.4%	5,207	7.2%	5,528	7.0%
Paging	2,157	3.2%	—	—	—	—
Total operating revenue	67,636	100.0%	72,327	100.0%	79,332	100.0%

1. Sustained and rapid growth in CDMA Cellular Business

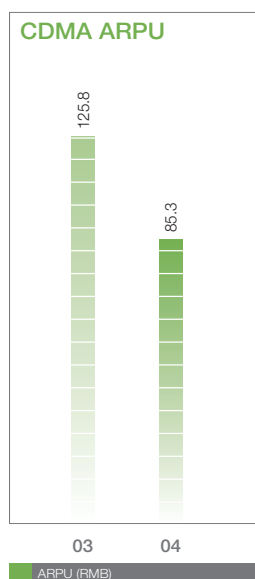
Revenue from the CDMA Cellular Business grew further by the sustainable and fast growth in our CDMA subscribers base. Operating revenue from our CDMA Cellular Business reached RMB26.34 billion in 2004, an increase of 41.8% from 2003. On a pro forma basis, the increase was 26.9%. Average revenue per user (“ARPU”) for our CDMA Cellular Business reached RMB85.3, a decrease of 32.2% from 2003 on a pro forma basis.

The table below sets forth the revenue composition of our CDMA Cellular Business and their respective share of operating revenue from CDMA Cellular Business in 2003, 2003 pro forma and 2004.



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	2003		2003 pro forma		2004	
	RMB in million	As percentage of total	RMB in million	As percentage of total	RMB in million	As percentage of total
Operating revenue:	18,580	100.0%	20,751	100.0%	26,338	100.0%
(1) Service revenue	16,624	89.5%	18,336	88.4%	24,220	92.0%
Include:						
Usage fee	11,672	62.8%	12,993	62.6%	16,165	61.4%
Monthly fee	3,488	18.8%	3,914	18.9%	4,638	17.6%
Interconnection revenue	608	3.3%	465	2.3%	927	3.5%
Others	856	4.6%	964	4.6%	2,490	9.5%
(2) Sales of telecommunication products	1,956	10.5%	2,415	11.6%	2,118	8.0%



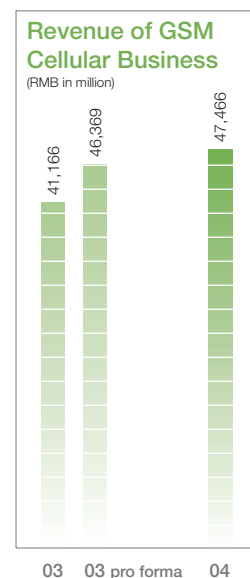
Service revenue from CDMA Cellular Business as a percentage of the total operating revenue increased from 88.4% in 2003 to 92.0% in 2004. CDMA usage fees rose to RMB16.16 billion in 2004, representing 61.4% of its total operating revenue from CDMA Cellular Business, while monthly fee reached RMB4.64 billion in 2004, representing 17.6% of its total operating revenue from CDMA Cellular Business. CDMA interconnection revenue reached RMB0.93 billion, accounting for 3.5% of the total operating revenue from CDMA Cellular Business. Revenue from the sales of telecommunication products as a percentage of the total operating revenue from CDMA Cellular Business reduced from 11.6% in 2003 on a pro forma basis to 8.0% in 2004.

The Company has devoted a lot of efforts to develop its CDMA wireless data business, and will use its best endeavours to convert the technology and business superiority in CDMA to a competitive edge in marketing in order to enhance competitiveness. Revenue from the value-added business of CDMA Cellular Business reached RMB2.38 billion, and accounted for 9.8% of total service revenue from CDMA Cellular Business in 2004, an increase from 4.5% in 2003.

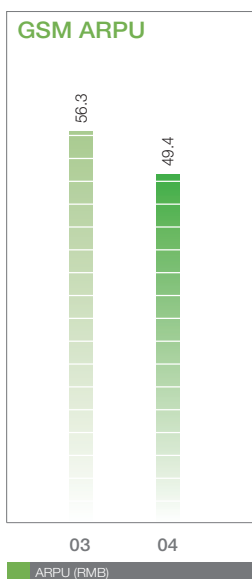
2. Development in GSM Cellular Business remained steady

Revenue from the GSM Cellular Business increased by 15.3% from 2003 and reached RMB47.47 billion in 2004, representing an increase of 2.4% on a pro forma basis. ARPU from GSM Cellular Business decreased from RMB56.3 in 2003 on a pro forma basis to RMB49.4 in 2004, down by 12.3%.

The table below sets forth the revenue composition of our GSM Cellular Business and their respective share of operating revenue from the GSM Cellular Business in the years 2003, 2003 pro forma and 2004.



	2003		2003 pro forma		2004	
	RMB in million	As percentage of total	RMB in million	As percentage of total	RMB in million	As percentage of total
Operating revenue:	41,166	100.0%	46,369	100.0%	47,466	100.0%
(1) Service revenue	40,303	97.9%	45,409	97.9%	46,579	98.1%
Include:						
Usage fee	29,072	70.6%	33,103	71.4%	31,997	67.4%
Monthly fee	7,042	17.1%	8,047	17.4%	6,922	14.6%
Interconnection revenue	1,927	4.7%	1,722	3.7%	2,614	5.5%
Others	2,262	5.5%	2,537	5.4%	5,046	10.6%
(2) Sales of telecommunication products	863	2.1%	960	2.1%	887	1.9%

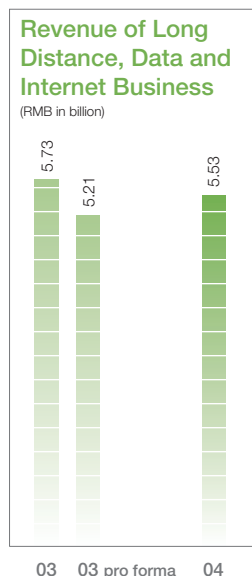


Service revenue from GSM Cellular Business as a percentage of the total operating revenue from GSM Cellular Business increased from 97.9% in 2003 on a pro forma basis to 98.1% in 2004. GSM usage fees reached RMB32.00 billion in 2004, representing 67.4% of the total operating revenue from GSM Cellular Business, while monthly fee reached RMB6.92 billion in 2004, representing 14.6% of the total operating revenue from GSM Cellular Business. GSM interconnection revenue was RMB2.61 billion, accounting for 5.5% of the total operating revenue from GSM Cellular Business.

Revenue from GSM value-added services of the Company reached RMB4.86 billion in 2004, representing a 10.4% share in the service revenue from GSM Cellular Business, an increase from 5.0% in 2003.

3. Steady development in traffic volume of Long Distance, Data and Internet Business

By leveraging on the technological features of our multi-businesses integrated network platform, along with effectively expanding international and domestic call volume for PSTN and IP telephony, we have been proactively promoting distinctive services such as: "Ruyi Mailbox", "Uni-Video" and "Unicom One Net". Revenue from our Long Distance, Data and Internet Business decreased by 3.6% from 2003 and reached RMB5.53 billion in 2004, an increase of 6.2% from 2003 on a pro forma basis.



III. Operating expenses

Operating expenses in 2004 were RMB71.38 billion, representing an increase of 20.7%, which was greater than the 17.3% growth in operating revenue for the same period. On a pro forma basis, the increase would be 15.3%.

The table below illustrates the major expense items from 2003, 2003 pro forma and 2004 and their respective share of total operating revenue.

	2003		2003 pro forma		2004	
	RMB in million	As percentage of total revenue	RMB in million	As percentage of total revenue	RMB in million	As percentage of total revenue
Total operating expenses, include:	59,122	87.4%	61,896	85.6%	71,375	90.0%
Leased lines and network capacities	4,320	6.4%	4,727	6.5%	7,398	9.3%
Interconnection charges	5,921	8.7%	6,119	8.5%	7,517	9.5%
Depreciation and amortization	16,385	24.2%	16,766	23.2%	19,063	24.0%
Personnel	4,575	6.8%	4,355	6.0%	4,526	5.7%
Selling and marketing	15,157	22.4%	17,200	23.8%	18,944	23.9%
General, administrative and other expenses	9,112	13.5%	9,070	12.5%	10,448	13.2%
Cost of telecommunications products sold	3,652	5.4%	3,659	5.1%	3,479	4.4%

1. Leased lines and network capacities

As a result of the increasing in the subscribers of the CDMA Business in 2004, leased CDMA network capacities increased by 9.75 million subscribers, which led to lease expense for CDMA network capacities increased from RMB 3.91 billion in 2003 on a pro forma basis to RMB6.59 billion. In 2004, the aggregate amount of leased line and network capacities of the Company increased to RMB7.40 billion. On a pro forma basis, the increase was 56.5%. Their proportion to total operating revenue rose from 6.5% on a pro forma basis to 9.3% in 2004.

2. Interconnection charges

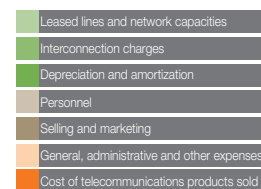
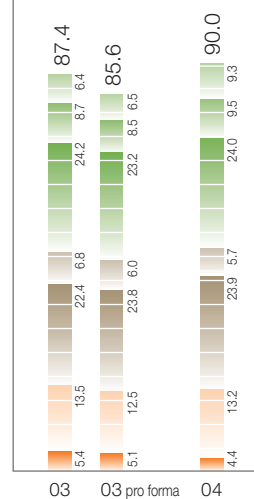
With an increase in interconnection traffic volume, interconnection charges increased to RMB7.52 billion in 2004, an increase of 22.8% on a pro forma basis. Interconnection charges for CDMA and GSM Cellular Business increased by 59.0% and 7.8% respectively from 2003 on a pro forma basis. Interconnection charges for Long Distance, Data and Internet Business increased by 23.6% from 2003 on a pro forma basis. With the developments in our businesses, interconnection charges as a percentage of total operating revenue also increased from 8.5% on a pro forma basis to 9.5%.

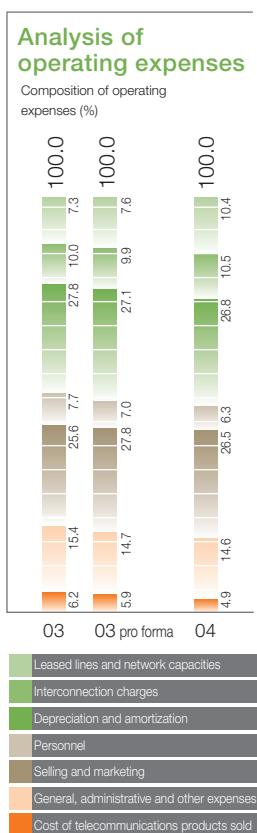
3. Depreciation and amortization

Due to adequate expansion of capacity for the GSM network and the expansion of assets scale, depreciation and amortization expenses increased by 13.7% from 2003 on a pro forma basis to RMB19.06 billion in 2004. Depreciation and amortization expenses as a percentage of total operating revenue changed from 23.2% in 2003 on a pro forma basis to 24.0%.

Analysis of operating expenses

Percentage of expenses to total revenue (%)





4. Personnel

In 2004, the Company continued to control its personnel expenses, so as to improve labor productivity. Our personnel expenses in 2004 were RMB4.53 billion in 2004, an increase of 3.9% from 2003 on a pro forma basis. The proportion of personnel expenses as a percentage of total operating revenue dropped to 5.7%, from 6.0% in 2003 on a pro forma basis. In order to align the interests of our employees with that of our shareholders, we have set up an employee share option scheme and granted options to qualified employees. During 2004, total share option involving 113,322,000 shares in the Company were granted under the share option scheme. For more information regarding our share option scheme, please refer to the Report of the Directors and Note 29 to the Financial Statements.

5. Selling and marketing

Our major selling and marketing expenses included commissions, promotion and advertising expenses and amortization of customer acquisition costs of contractual CDMA subscribers. Selling and marketing expenses totaled RMB18.94 billion in 2004, an increase of 10.1% from 2003 on a pro forma basis. Amortization of CDMA subscribers acquisition costs in 2004 was RMB6.12 billion. The balance of unamortised deferred CDMA subscribers acquisition costs changed from RMB4.45 billion in 2003 to RMB4.75 billion. Due to the continued growth in the subscriber base of our various business segments, the commissions to distributors and sales agents rose to RMB9.91 billion, an increase of 26.1% from 2003 on a pro forma basis. Promotion and advertising expenses were RMB2.37 billion, an increase of 9.2% from 2003 on a pro forma basis. Selling and marketing expenses as a percentage of operating revenue changed from 23.8% in 2003 on a pro forma basis to 23.9%.

6. General, administrative and other expenses

As a result of expansion in scale of operation, as well as the surge in energy prices, such as water and electricity, our general, administrative and other expenses were RMB10.45 billion in 2004, up by 15.2% from that in 2003 on a pro forma basis. General, administrative and other expenses as a percentage of total operating revenue increased from 12.5% in 2003 on a pro forma basis to 13.2% in 2004. In 2004, the provision for doubtful debts was RMB2.19 billion, an increase of 12.1% from 2003 on a pro forma basis. Provision for doubtful debts as a percentage of service revenue increased slightly from 2.8% in 2003 on a pro forma basis to 2.9% in 2004.

7. Cost of telecommunications products sold

The cost of telecommunication products sold increased to RMB3.48 billion in 2004, a decrease of 4.9% from 2003 on a pro forma basis. The share of cost of telecommunications products sold as a percentage of operating revenue decreased from 5.1% in 2003 on a pro forma basis to 4.4%.

IV. Earnings

1. Operating profit

As market competition became intense, and the newly added subscribers were mainly from the low end market, rate of growth in costs was greater than that in operating revenue. In 2004, our operating profit reached RMB7.96 billion, a decrease of 6.6% from 2003. On a pro forma basis, the decrease was 23.7%.

Operating profit from our GSM Cellular Business decreased to RMB8.26 billion, a decrease of 15.8% from 2003 on a pro forma basis. Operating loss from our CDMA Cellular Business was RMB0.59 billion in 2004, which was decreased by 5.0% from the loss of RMB 0.62 billion on a pro forma basis in 2003. Operating profit from our Long Distance, Data and Internet Business increased to RMB0.47 billion in 2004, a decrease of 67.3% from 2003 on a pro forma basis. The decrease in operating profit from our Long Distance, Data and Internet Business was mainly attributable to competition in the market becoming more intense, which resulted in a slow growth in business income. Rate of growth in operating costs exceeded that in revenue by 13.8 percentage points.

2. Finance income and costs

Finance income in 2004 fell to RMB 0.10 billion, a decrease of 36.6% from that in 2003 on a pro forma basis. Finance costs were RMB 1.69 billion, a decline of 27.2% from 2003 on a pro forma basis. Net finance costs fell from RMB 2.16 billion on a pro forma basis in 2003 to RMB 1.59 billion, a decrease of 26.5%, which was mainly attributable to fund raising by way of syndicated loans, which is a low-cost financing method, whilst maintaining turnover on its capital to enhance its efficiency.

3. Other income, net

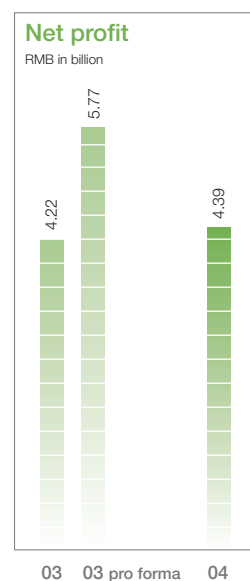
Net other income of the Company in 2004 was RMB 0.10 billion.

4. Income tax

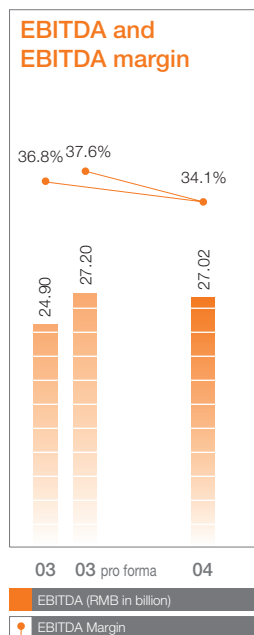
Our income tax increased to RMB2.08 billion in 2004, a decrease of 15.9% from that in 2003 on a pro forma basis. The effective tax rate was 32.2%.

5. Net profit

Our net profit reached RMB4.39 billion in 2004. Basic earnings per share were RMB0.349, an increase of 4.0% from RMB0.336 in 2003.



EBITDA and EBITDA margin



V. EBITDA

EBITDA of the Company increased by 8.5% from 2003 to RMB27.02 billion in 2004. On a pro forma basis, a fall of 0.7% was recorded. EBITDA margin (EBITDA as a percentage of operating revenue) fell from 37.6% on a pro forma basis in 2003 to 34.1%.

EBITDA for the GSM Cellular Business in 2004 was RMB24.43 billion, which was comparable to that on a pro forma basis in 2003. EBITDA margin fell from 52.6% on a pro forma basis to 51.3%. EBITDA for the CDMA Cellular Business changed from -RMB0.33 billion on a pro forma basis in 2003 to -RMB0.15 billion in 2004. EBITDA for the Long Distance, Data and Internet Business was RMB2.8 billion in 2004, a decrease of 11.4% from that in 2003 on a pro forma basis. EBITDA margin for this business fell from 37.5% on a pro forma basis in 2003 to 31.6% in 2004.

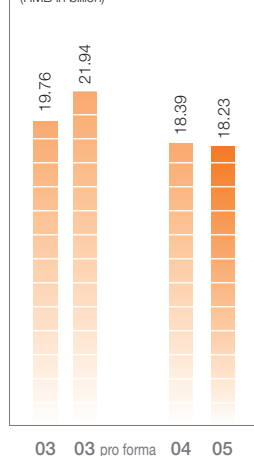
VI. Capital expenditures and free cash flow

The Company implemented strict controls over the capital expenditures. Efficiency in investment was enhanced through exploring potentials for the existing network and optimizing resources allocation. The Company made investments with respect to GSM cellular communication as appropriate in regions with high market demand. Capital expenditures for our various businesses totaled RMB18.39 billion in 2004, accounting for 95.0% of total budget for 2004, i.e. RMB19.35 billion. Capital expenditures attributable to the GSM Cellular Business, the Long Distance, Data and Internet Business, infrastructure network and local transmission and gateway, billing system, customer services and information technology system and buildings were RMB6.40 billion, RMB1.34 billion, RMB3.06 billion and RMB7.59 billion respectively.

Free cash flow in 2004 improved further from RMB2.81 billion in 2003 to RMB5.43 billion.

Capital expenditure and projected capital expenditure

(RMB in billion)



The table below illustrates the capital expenditures of various major segments in 2004 and the planned expenditures in 2005.

	2004 (RMB billion)	2005 (RMB billion)
Total	18.39	18.23
Cellular	6.40	7.59
Long Distance, Data and Internet	1.34	1.22
Infrastructure transmission network	3.06	3.05
Others	7.59	6.37

Capital expenditures planned for the Company in 2005 is RMB18.23 billion, which will be used mostly to improve the GSM network and construction of network infrastructure such as auxiliary system. The Company will rely principally on cash generated by operations for satisfying our capital expenditures needs.

VII. Balance sheet analysis

The Company's balance sheet was further improved in 2004. Total assets changed from RMB149.84 billion as at the end of 2003 to RMB 145.63 billion in 2004. Total liabilities decreased from RMB 80.22 billion as at the end of 2003 to RMB 72.82 billion as at the end of 2004. The liabilities-to-assets ratio fell from 53.5% as at the end of 2003 to 50.0% as at the end of 2004.

As of 31 December 2003, we had net current liabilities (i.e. current assets minus current liabilities) of RMB21.66 billion. The Company's net current liabilities were RMB28.27 billion as of 31 December 2004. The decrease in working capital mainly attributable to the use of short term bank deposits from internal resources to repay long term bank borrowings. Taking into account available financing and continuous net cash inflows from our operating results, we believe that the Company has sufficient working capital for its present requirements.

VIII. Critical accounting policies and significant accounting estimates

The preparation of our financial statements and this annual report requires us to make estimates and assumptions that affect the reported and disclosed amounts of assets and liabilities, including contingent assets and liabilities as at the relevant dates, and revenue and expenses for the relevant periods. We have identified the accounting policies and estimates below as considered critical to our operating activities and to the understanding of our operating results and financial positions. For a discussion of the application of these and other accounting policies, see Notes 2 and 3 to the financial statements included in this annual report. There can be no assurance that actual results will not differ from those estimates and assumptions.

1. Deferral of CDMA Customer Acquisition Costs

We have been operating the CDMA business since the beginning of 2002. In order to accelerate the development of the CDMA business and subscriber growth, we began to offer certain promotional packages in the second half of 2002. As part of the contractual arrangements with certain CDMA contractual subscribers under these special promotional packages, CDMA handsets were provided to the subscribers for their use at no additional charge during the specified contract periods, which range from 6 months to 2 years. In return, the subscribers are required to incur a minimum amount of service fees during the contract period. If the contractual subscribers can fulfill the minimum contract spending amounts by the end of the contract period, they will not be obliged to repay the remaining costs of the CDMA handsets given for their use. In addition, to secure contract performance, these subscribers are required under their contracts to (1) prepay certain non-refundable amounts of service fees or deposits, (2) maintain a bank deposit in one of the designated commercial banks to secure their minimum contract amounts, or (3) provide a guarantor who will compensate us for any loss in the event of the subscriber's non-performance of related contractual obligations.

We consider the costs of the CDMA handsets provided to contractual subscribers under these promotional packages as part of the customer acquisition costs for the development of these new CDMA contractual subscribers. Such customer acquisition costs are deferred, to the extent recoverable, and amortised over the contractual periods to match with the minimum contract revenue.

We determined our accounting policy of deferred customer acquisition costs of contractual CDMA subscribers after a careful evaluation of our specific facts and circumstances, and believe that the capitalisation of such costs appropriately matches with the future contractual revenues due to (1) the historically high ARPU and low churn, default or bad debt rates of these subscribers; (2) our established procedures and the relative low cost of enforcement of contracts in default; and (3) the existence of specified contract periods with minimum contract spending amounts and built-in contractual safeguarding measures such as non-refundable prepayments, bank deposits, and guarantees received, as well as penalty clauses imposed on subscribers.

Therefore, we believe that the deferred customer acquisition costs are recoverable from future revenue to be derived from these promotional packages, and the capitalisation and amortisation of these customer acquisition costs to match future revenue is an appropriate accounting policy. Furthermore, we continuously assess and evaluate the recoverability of these deferred customer acquisition costs, based on the detailed review of historical subscriber churn rates and the estimated default rate. Based on our current assessment and evaluation, we believe that there is no significant problem in recovering the carrying amounts of the deferred customer acquisition costs as at 31 December 2004.

We have made the above recoverability assessments based on the current legal and operating environment relating to the subscribers' contract performance and other information currently available to us. Actual results may differ significantly from the current situation and our current estimates. If the situation changes significantly in the future, we may need to expense off additional non-recoverable deferred customer acquisition costs based on conditions at that time.

2. Lease of CDMA Network Capacity

We have entered into a CDMA network capacity lease agreement with Unicom Group and its wholly-owned subsidiary, Unicom New Horizon. Pursuant to this CDMA lease agreement, Unicom New Horizon has agreed to lease the capacity of the CDMA network to us covering the 9 provinces of Guangdong, Jiangsu, Zhejiang, Fujian, Liaoning, Shandong, Anhui, Hebei, Hubei and the 3 municipalities of Beijing, Shanghai and Tianjin. This lease became effective on 8 January 2002.

In addition, on 31 December 2002 and 2003, we acquired all the equity interests in Unicom New Century and Unicom New World respectively, which together operate GSM and CDMA Cellular Businesses in another 12 provinces, 1 municipality and 5 autonomous regions in the PRC. Unicom New Century and Unicom New World have also respectively entered into a CDMA lease agreement with Unicom Group and Unicom New Horizon on similar terms and conditions. These lease agreements and our existing lease agreement will be referred to as the "CDMA Lease Agreements".

According to the terms of the CDMA Lease Agreements, the initial lease period is for one year, renewable for additional one-year terms at our own option. We have the exclusive right to lease and operate the CDMA network capacity in the above regions. Also, we have the option to add or reduce the capacity leased by giving specified period of advance notice. The lease per unit of capacity is calculated on a basis that if full capacity is leased, it would permit Unicom New Horizon to recover its investment in constructing the CDMA network in 7 years, together with an internal return of 8%. In January 2004, we renewed the CDMA network capacity for an additional one-year term.

We have assessed the appropriate lease classification at the inception of the CDMA Lease Agreements. Factors and related implications we have considered include whether we have taken the risks and rewards of ownership of the CDMA assets. Furthermore, we have considered whether the existence of the purchase option and the annual renewal options, combined with the related economic penalties, risks and benefits, have caused us to take on risks and rewards similar to those that an owner of these assets would bear.

Unicom New Horizon has the legal ownership of the CDMA network, is directly responsible for the planning, financing and construction of the CDMA network, and directly enters into all contracts with suppliers and constructors. We believe we only bear the risks associated with the operation of our CDMA business during the relevant leasing periods and are free from any ownership risks of CDMA network. According to the terms of the CDMA Lease Agreements, our initial lease period is only one year, with renewal for additional one-year terms at our own option. Accordingly, there is no predetermined lease period and minimum network capacity to be leased in future periods. We have the option to determine whether we will renew and continue the leases and how much capacity to lease. We also have the option to decide whether we will exercise the purchase option of CDMA network based on market environment and the future operating performance of the CDMA business subject to approvals obtained from our independent minority shareholders.

Accordingly, if the CDMA business turns out to be unsuccessful, we do not have the obligation to continue this CDMA lease arrangement or to exercise the purchase option. Or, we could continue to lease nominal capacity in order to ensure that no other operators takes possession of the assets to compete with us in our service areas.

In general, the classification of leases is dependent on whether the risks and rewards of ownership of the leased assets rest substantially with the lessor or the lessee. Leases that substantially transfer to the lessee all the risks and rewards of ownership of the leased assets are accounted for as finance leases; and leases where substantially all the risks and rewards of ownership of the leased assets remain with the lessor are accounted for as operating leases. When performing this assessment, we have considered a number of factors above that required significant judgments.

At the inception of the CDMA Lease Agreements, there has been a high degree of uncertainty related to the market condition and existing operating results of CDMA business. It remains highly uncertain whether we will continue to lease the network in the future or to estimate the future network capacity to be leased. We are also unable to determine whether or not we will exercise the purchase option. Given these uncertainties and due to the fact that the risks associated with the ownership of the CDMA assets substantially remain with Unicom Group and Unicom New Horizon, we account for the leasing of the CDMA network as operating leases for the initial lease periods, estimated to be three years, so as to reflect the respective rights and obligations of the relevant parties to the CDMA Lease Agreements. At the end of the effective lease term, we will reassess the appropriate classification based on the relevant factors and circumstances available at that time.

Under the above accounting estimates, only the operating lease expense has been recorded in our income statement since the commencement of the CDMA Lease Agreements, whereas the carrying value of the CDMA assets and the related liabilities are not reflected in our balance sheet. For the year ended 31 December 2004, we recorded lease expense of approximately RMB6.59 billion under the CDMA Lease Agreements.

3. Provision for Doubtful Debts

Accounts receivables are stated at costs, less provision for doubtful debts. We evaluate specific accounts receivable where there are indications that the receivable may be doubtful or is not collectible. We record a provision based on our best estimates to reduce the receivable balance to the amount that is expected to be collected. For the remaining receivable balances as of each period-end, we make a general provision based on the aging pattern of the receivable amounts and by applying reasonable percentages to the outstanding receivables. We make such estimates based on our past experience, historical collection patterns, subscribers' credit worthiness and collection trends. For the general subscribers of Cellular, Long Distance, Data and Internet services, we make a full provision for receivables aged over 3 months, which is consistent with our credit policy with respect to relevant subscribers.

Our estimates described above are based on our historical experience, subscriber creditability and collection trends. If circumstances change (e.g. due to factors including developments in our business and the external market environment), we may need to re-evaluate our policies on doubtful debts, and make additional provisions in the future.

4. Income Tax and Deferred Taxation

Income tax is provided for based on income before tax for statutory financial reporting purposes, adjusted for income and expense item that are not assessable or deductible for tax purposes and taking into consideration any preferential tax treatment to which we are entitled.

Deferred taxation is provided in full, using the liability method, on temporary differences arising between the tax basis of assets and liabilities and their carrying amounts in the financial statements. Deferred 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.

In the preparation of our financial statements, we estimated our income tax provision and deferred taxation in accordance with the prevailing tax rules and regulations, taking into account any special approvals obtained from relevant tax authorities and any preferential tax treatment to which we are entitled in each location or jurisdiction in which we operate. This process involves estimation made by us about our current tax exposure together with an assessment of temporary differences resulting from different treatment of items for tax and accounting purposes in order to determine the amount of tax provisions for the period. We believe that we have recorded adequate tax provisions based on our best estimates and assumptions. For the evaluation of temporary differences, we have assessed the likelihood that our deferred taxes could be deferred and recovered. Major deferred tax components include interests on loans from CCF joint ventures, loss arising from terminations of CCF arrangements, provisions for doubtful debts and write-down of inventory to net realisable value and additional depreciation deductible for tax purpose. Due to the effects of these temporary differences on income tax, we have recorded deferred tax assets amounting to RMB0.54 billion as of 31 December 2004. Deferred tax assets are recognised based on our estimates and assumptions that they will be recovered from taxable income from the continuing operations in the foreseeable future.

We believe we have recorded adequate current and deferred taxes based on prevailing tax rules and regulations and our current best estimates and assumptions. In the event that future tax rules and regulations or related circumstances change, adjustments to current and deferred taxes may be necessary.

IX. Others

In the course of our regular internal audit during 2004, we identified certain improper accounting recordings and errors at our Jiangxi and Xinjiang branches. These two branches were acquired by us in connection with our acquisition of the cellular telecommunications businesses in nine provinces and autonomous regions in the PRC on 31 December 2002. We have identified and communicated these issues to our audit committee. We have concluded that no restatement of our consolidated financial statements as of and for the years ended 31 December 2002 and 2003 is necessary as these issues did not result in a material misstatement of such consolidated financial statements and did not have a material impact on our financial condition and results of operations.

However, our management is of the view that these issues at our Jiangxi and Xinjiang branches reflect a material weakness in internal control over financial reporting. These issues relate to, among others: bad debt provision, mobile handset costs and agency commission as well as revenue recognition. These issues resulted in an overstatement of our net assets of approximately RMB34 million as of 31 December 2002 and an overstatement of profit after taxation of approximately RMB115 million for the year ended 31 December 2003. Our management has made the appropriate corrections in the consolidated income statement for the year ended 31 December 2004.

Upon the identification of these issues at our Jiangxi and Xinjiang branches, our management promptly imposed disciplinary action against the responsible employees at these two branches. We have not identified similar issues at our other branches in the course of our regular internal audit. Under the direction of our audit committee, our management has strengthened control processes and procedures in order to prevent a recurrence of such issues. These steps include, among others: (1) further strengthening the internal audit and monitoring controls over our branches; (2) establishing centralized management information systems to improve internal controls; and (3) implementing more stringent responsibility systems to ensure the accuracy in the reporting of financial data.