

The following is the text of a report, prepared for the purpose of incorporation in this prospectus, received from the independent reporting accountants, KPMG, Certified Public Accountants, Hong Kong. As described in the section headed "Documents Available for Inspection" in Appendix IX, a copy of the accountants' report is available for inspection.



8th Floor
Prince's Building
10 Chater Road
Hong Kong

October 25, 2002

The Directors
China Telecom Corporation Limited

China International Capital Corporation Limited
China International Capital Corporation (Hong Kong) Limited
Merrill Lynch Far East Limited
Morgan Stanley Dean Witter Asia Limited

Dear Sirs

Introduction

We set out below our report on the combined financial information relating to China Telecom Corporation Limited (the "Company") and its subsidiaries (hereinafter collectively referred to as the "Group"), in Sections I to VII below (the "Financial Information"), including the combined balance sheets of the Group as at December 31, 1999, 2000 and 2001 and June 30, 2002, the combined statements of income, the combined statements of owner's equity and the combined statements of cash flows of the Group for each of the three years ended December 31, 2001 and the six-month period ended June 30, 2002 (the "relevant period"), and the combined statement of income and the combined statement of cash flows for the six-month period ended June 30, 2001, and the notes thereto, for inclusion in the prospectus of the Company dated October 25, 2002 (the "prospectus").

The Company was incorporated in the People's Republic of China (the "PRC", "China" or the "State") on September 10, 2002 as part of the reorganisation (the "Restructuring") of China Telecommunications Corporation, a state-owned enterprise which is under the supervision and regulation of the Ministry of Information Industry as described in Section V Note 1. Pursuant to the Restructuring, China Telecommunications Corporation transferred to the Company the wireline telecommunication business and related operations in Shanghai Municipality, Guangdong Province, Jiangsu Province and Zhejiang Province together with the related assets and liabilities (the "Predecessor Operations").

As a state-owned enterprise, China Telecommunications Corporation prepares financial statements in accordance with the relevant accounting rules and regulations applicable to state-owned enterprises in the PRC. The financial statements of the Predecessor Operations were not required to be audited by independent auditors during the relevant period. No financial statements have been prepared by the Company since the date of its incorporation.

Basis of preparation

The Financial Information has been prepared by the directors of the Company based on the management accounts of the Predecessor Operations, on the bases set out in Section V Notes 1 and 2 below to conform with International Financial Reporting Standards ("IFRS") promulgated by the International Accounting Standards Board. IFRS includes International Accounting Standards and interpretations.

Responsibility

The directors are responsible for the preparation of the Financial Information which gives a true and fair view. In preparing the Financial Information which gives a true and fair view it is fundamental that appropriate accounting policies are selected and applied consistently, that judgements and estimates are made which are prudent and reasonable and that the reasons for any significant departure from applicable accounting standards are stated.

It is our responsibility to form an independent opinion, based on our audit, on the Financial Information.

Basis of opinion

For the purpose of this report, we have audited the financial statements of the Predecessor Operations for the relevant period and carried out such procedures as we considered necessary in accordance with the Auditing Guideline "Prospectuses and the Reporting Accountant" issued by the Hong Kong Society of Accountants ("HKSA"), for the inclusion of financial information relating to the Group in this report. We have not audited any financial statements of the Predecessor Operations in respect of any period subsequent to June 30, 2002.

We conducted our audit in accordance with Statements of Auditing Standards issued by HKSA. An audit includes examination, on a test basis, of evidence relevant to the amounts and disclosures in the Financial Information. It also includes an assessment of the significant estimates and judgements made by the directors in the preparation of the Financial Information, and of whether the accounting policies are appropriate to the Group's circumstances, consistently applied and adequately disclosed.

We planned and performed our audit so as to obtain all the information and explanations which we considered necessary in order to provide us with sufficient evidence to give reasonable assurance as to whether the Financial Information is free from material misstatement. In forming our opinion we also evaluated the overall adequacy of the presentation of the Financial Information. We believe that our audit provides a reasonable basis for our opinion.

Opinion

In our opinion, the Financial Information referred to above, for the purpose of this report, and on the basis of presentation and basis of preparation set out in Section V Notes 1 and 2 below, gives a true and fair view of the Group's state of affairs as at December 31, 1999, 2000 and 2001 and June 30, 2002 and of the Group's combined results and combined cash flows for each of the three years ended December 31, 2001 and the six-month periods ended June 30, 2001 and 2002 and has been properly prepared in accordance with IFRS.

(I) COMBINED BALANCE SHEETS

	Note	December 31,			June 30,
		1999	2000	2001	2002
		RMB million	RMB million	RMB million	RMB million
ASSETS					
Non-current assets					
Property, plant and equipment, net	3	116,461	127,528	138,623	136,343
Construction in progress	4	26,313	28,656	23,274	23,345
Lease prepayments		2,019	2,250	2,638	2,630
Interests in associates	5	1,023	1,157	417	426
Investments	6	2,841	4,015	446	482
Deferred tax assets	7	1,793	2,310	4,059	4,641
Other assets	16	3,482	4,784	5,749	6,110
Total non-current assets		<u>153,932</u>	<u>170,700</u>	<u>175,206</u>	<u>173,977</u>
Current assets					
Inventories	8	992	1,314	1,413	1,050
Accounts receivable, net	9	6,810	7,130	5,608	6,922
Prepayments and other current assets	10	4,993	4,057	2,752	2,168
Time deposits with maturity over three months		189	339	473	364
Cash and cash equivalents	11	15,451	13,861	3,882	2,640
Total current assets		<u>28,435</u>	<u>26,701</u>	<u>14,128</u>	<u>13,144</u>
Total assets		<u>182,367</u>	<u>197,401</u>	<u>189,334</u>	<u>187,121</u>
LIABILITIES AND OWNER'S EQUITY					
Current liabilities					
Short-term debt	12	9,811	12,194	18,827	14,316
Current portion of long-term debt	12	3,009	3,174	3,621	2,779
Accounts payable	13	6,952	10,214	14,919	11,353
Accrued expenses and other payables	14	9,024	10,050	11,884	13,225
Current portion of finance lease obligations	15	469	272	38	27
Current portion of deferred revenue	16	7,178	7,895	8,155	7,417
Total current liabilities		<u>36,443</u>	<u>43,799</u>	<u>57,444</u>	<u>49,117</u>
Net current liabilities		<u>(8,008)</u>	<u>(17,098)</u>	<u>(43,316)</u>	<u>(35,973)</u>
Total assets less current liabilities		<u>145,924</u>	<u>153,602</u>	<u>131,890</u>	<u>138,004</u>
Non-current liabilities					
Long-term debt	12	12,108	10,068	7,101	6,567
Finance lease obligations	15	287	76	11	—
Deferred revenue	16	32,604	30,304	26,353	24,112
Deferred tax liabilities	7	9,509	10,585	—	378
Total non-current liabilities		<u>54,508</u>	<u>51,033</u>	<u>33,465</u>	<u>31,057</u>
Total liabilities		<u>90,951</u>	<u>94,832</u>	<u>90,909</u>	<u>80,174</u>
Minority interests		866	950	940	979
Owner's equity		<u>90,550</u>	<u>101,619</u>	<u>97,485</u>	<u>105,968</u>
Total liabilities and owner's equity		<u>182,367</u>	<u>197,401</u>	<u>189,334</u>	<u>187,121</u>

(II) COMBINED STATEMENTS OF INCOME

	Note	Years ended December 31,			Six-month periods ended June 30,	
		1999	2000	2001	2001	2002
		RMB million	RMB million	RMB million	RMB million	RMB million
Operating revenues	17	65,291	71,021	68,546	33,877	36,868
Operating expenses						
Depreciation and amortisation		(14,903)	(17,386)	(19,451)	(9,365)	(10,030)
Network operations and support		(15,584)	(19,004)	(20,269)	(9,653)	(10,019)
Selling, general and administrative		(7,553)	(9,743)	(9,401)	(4,471)	(4,517)
Other operating expenses	18	(889)	(1,264)	(1,327)	(741)	(1,404)
Total operating expenses	19	(38,929)	(47,397)	(50,448)	(24,230)	(25,970)
Operating profit		26,362	23,624	18,098	9,647	10,898
Deficit on revaluation of property, plant and equipment	3	—	—	(11,930)	—	—
Net finance (costs)/income	20	(516)	298	293	187	(421)
Investment income		95	177	310	117	1
Share of profit from associates		20	45	22	12	9
Profit before taxation and minority interests ...		25,961	24,144	6,793	9,963	10,487
Taxation	21	(5,459)	(4,857)	69	(1,775)	(1,965)
Profit before minority interests		20,502	19,287	6,862	8,188	8,522
Minority interests		(93)	(68)	21	(51)	(39)
Net profit		<u>20,409</u>	<u>19,219</u>	<u>6,883</u>	<u>8,137</u>	<u>8,483</u>
Basic earnings per share (in RMB)	22	<u>0.30</u>	<u>0.28</u>	<u>0.10</u>	<u>0.12</u>	<u>0.12</u>
Weighted average number of shares (in millions)	22	<u>68,317</u>	<u>68,317</u>	<u>68,317</u>	<u>68,317</u>	<u>68,317</u>

(III) COMBINED STATEMENTS OF OWNER'S EQUITY

	Note	Share capital	Capital reserve	Revaluation reserve	Other reserve	Retained earnings / owner's capital	Total owner's equity
		RMB million	RMB million	RMB million	RMB million	RMB million	RMB million
Balance as at January 1, 1999		—	—	—	—	78,052	78,052
Net profit		—	—	—	—	20,409	20,409
Contributions from owner		—	—	—	—	3,115	3,115
Distributions to owner		—	—	—	—	(11,026)	(11,026)
Balance as at December 31, 1999		—	—	—	—	90,550	90,550
Net profit		—	—	—	—	19,219	19,219
Contributions from owner		—	—	—	—	3,746	3,746
Distributions to owner		—	—	—	—	(11,896)	(11,896)
Balance as at December 31, 2000		—	—	—	—	101,619	101,619
Net profit		—	—	—	—	6,883	6,883
Contributions from owner		—	—	—	—	3,003	3,003
Distributions to owner		—	—	—	—	(15,835)	(15,835)
Assets distributed to owner in connection with the Restructuring	1	—	—	—	—	(11,285)	(11,285)
Revaluation surplus	3	—	—	4,154	—	—	4,154
Recognition of deferred tax assets	7	—	—	—	4,059	—	4,059
Elimination of net deferred tax liabilities	7	—	—	—	—	4,887	4,887
Balance as at December 31, 2001		—	—	4,154	4,059	89,272	97,485
Net profit		—	—	—	—	8,483	8,483
Balance as at June 30, 2002		—	—	4,154	4,059	97,755	105,968

(Note 22)

(IV) COMBINED STATEMENTS OF CASH FLOWS

	Note	Years ended December 31,			Six-month periods ended June 30,	
		1999	2000	2001	2001	2002
		RMB million	RMB million	RMB million	RMB million	RMB million
Cash flows from operating activities	(a)	37,379	38,255	32,761	17,863	17,449
Cash flows from investing activities						
Capital expenditure		(25,773)	(30,618)	(34,610)	(16,195)	(11,101)
Purchase of investments		(220)	(838)	(290)	(293)	(36)
Lease prepayments		(163)	(274)	(437)	(301)	(26)
Proceeds from disposal of property, plant and equipment		735	144	72	61	59
Increase in time deposits with maturity over three months		(189)	(339)	(473)	(328)	(364)
Maturity of time deposits with maturity over three months		376	189	339	237	473
Net cash used in investing activities		(25,234)	(31,736)	(35,399)	(16,819)	(10,995)
Cash flows from financing activities						
Capital element of finance lease payments		(487)	(485)	(305)	(207)	(22)
Proceeds from bank debt		13,796	15,935	21,423	10,054	10,112
Repayments of bank debt		(14,262)	(15,060)	(16,979)	(8,824)	(16,192)
Cash (distributions to)/ contributions from minority interests		(30)	16	—	—	—
Cash contributions from owner		3,115	3,746	3,003	662	—
Cash distributions to owner		(11,308)	(12,261)	(14,483)	(4,130)	(1,594)
Net cash used in financing activities		(9,176)	(8,109)	(7,341)	(2,445)	(7,696)
Net increase/(decrease) in cash and cash equivalents		2,969	(1,590)	(9,979)	(1,401)	(1,242)
Cash and cash equivalents at beginning of year/period		12,482	15,451	13,861	13,861	3,882
Cash and cash equivalents at end of year/period		15,451	13,861	3,882	12,460	2,640

(IV) COMBINED STATEMENTS OF CASH FLOWS—(CONTINUED)

(a) Reconciliation of profit before taxation and minority interests to cash flows from operating activities

	Years ended December 31,			Six-month periods ended June 30,	
	1999	2000	2001	2001	2002
	RMB million	RMB million	RMB million	RMB million	RMB million
Profit before taxation and minority interests	25,961	24,144	6,793	9,963	10,487
Adjustments for:					
Depreciation and amortisation	14,903	17,386	19,451	9,365	10,030
Deficit on revaluation of property, plant and equipment	—	—	11,930	—	—
Provision for doubtful accounts	279	223	186	118	171
Investment income	(95)	(177)	(310)	(117)	(1)
Share of profit from associates	(20)	(45)	(22)	(12)	(9)
Interest income	(301)	(253)	(246)	(109)	(67)
Interest expense	1,420	1,342	1,415	690	656
Unrealised foreign exchange losses/(gains)	385	(358)	(325)	(208)	193
Loss on retirement and disposal of property, plant and equipment	2,646	2,787	1,720	825	434
Decrease/(increase) in accounts receivable	449	(543)	1,336	(458)	(1,485)
Decrease/(increase) in inventories	129	(322)	(99)	(134)	363
Decrease/(increase) in prepayments and other current assets	1,842	824	(550)	90	578
Increase in other non-current assets	(854)	(1,259)	(1,139)	(481)	(327)
(Decrease)/increase in accounts payable	(722)	817	1,231	192	(386)
(Decrease)/increase in accrued expenses and other payables	(2,281)	277	(373)	1,398	774
Decrease in deferred revenue	(660)	(1,583)	(3,691)	(1,345)	(2,979)
Cash generated from operations	43,081	43,260	37,307	19,777	18,432
Interest received	301	253	246	109	67
Interest paid	(1,436)	(1,357)	(1,408)	(663)	(662)
Investment income received	46	157	255	80	—
Income tax paid	(4,613)	(4,058)	(3,639)	(1,440)	(388)
Cash flows from operating activities	<u>37,379</u>	<u>38,255</u>	<u>32,761</u>	<u>17,863</u>	<u>17,449</u>

(V) NOTES TO THE FINANCIAL INFORMATION**1. PRINCIPAL ACTIVITIES, ORGANISATION AND BASIS OF PRESENTATION*****Principal activities***

China Telecom Corporation Limited (the “Company”) and its subsidiaries (hereinafter, collectively referred to as the “Group”) are engaged in the provision of wireline telecommunication and related services in Shanghai Municipality, Guangdong Province, Jiangsu Province and Zhejiang Province of the People’s Republic of China (the “PRC”). The Group offers a comprehensive range of wireline telecommunication services to residential and business customers, including local, domestic long distance and international long distance telephone services, Internet and managed data, leased line, and other related services.

The operations of the Group are subject to the supervision and regulation by the PRC government. The Ministry of Information Industry (“MII”), pursuant to the authority delegated to it by the PRC’s State Council, is responsible for formulating the telecommunication industry policies and regulations, including the regulation and setting of tariff levels for basic telecommunication services, such as local and long distance telephone services, Internet and managed data services, leased line and interconnection arrangements.

Organisation

The Company was incorporated in the PRC on September 10, 2002 as part of the reorganisation (the “Restructuring”) of China Telecommunications Corporation (China Telecommunications Corporation and together with its subsidiaries other than the Company are referred to as “China Telecom Group”), a state-owned enterprise which is under the supervision and regulation of the MII.

Pursuant to the Restructuring, China Telecommunications Corporation transferred to the Company the wireline telecommunication business and related operations in Shanghai Municipality, Guangdong Province, Jiangsu Province and Zhejiang Province together with the related assets and liabilities (the “Predecessor Operations”) in consideration for 68,317 million ordinary domestic shares of the Company. The shares issued to China Telecommunications Corporation have a par value of RMB1.00 each and represented the entire authorised and issued share capital of the Company. As discussed below, certain assets historically associated with the Predecessor Operations were not transferred to the Company but were retained by China Telecommunications Corporation in connection with the Restructuring.

China Telecommunications Corporation was initially established in May 2000 to operate the PRC’s nationwide wireline telecommunication network as part of the restructuring of the PRC’s telecommunications industry. In November 2001, pursuant to a further industry restructuring plan approved by the State Council, China Telecommunications Corporation’s wireline telecommunication networks and related operations in 10 northern provinces, municipalities and autonomous regions of the PRC were transferred to China Netcom Group. China Telecommunications Corporation retained the wireline telecommunication networks and related operations of 21 provinces, municipalities and autonomous regions of the PRC,

(V) NOTES TO THE FINANCIAL INFORMATION—(CONTINUED)

including the Predecessor Operations. In accordance with this industry restructuring plan, China Telecommunications Corporation and China Netcom Group own 70% and 30%, respectively, of the nationwide inter-provincial optic fibres.

Basis of presentation

Because China Telecommunications Corporation controlled the Predecessor Operations transferred to the Company before the Restructuring and continues to control the Company after the Restructuring, the Financial Information has been prepared as a reorganisation of businesses under common control in a manner similar to a pooling-of-interests. Accordingly, the assets and liabilities transferred to the Company have been recognised at historical amounts. The Financial Information for each of the years in the three-year period ended December 31, 2001 and for the six-month periods ended June 30, 2001 and 2002 presents the results of the Company and subsidiaries as if the Group had been in existence throughout the period from January 1, 1999 to June 30, 2002 and as if the Predecessor Operations were transferred to the Company from China Telecommunications Corporation as at the earliest date presented. In addition, the Financial Information includes the results related to certain assets historically associated with the Predecessor Operations that were not transferred to the Company and were retained by China Telecommunications Corporation in connection with the Restructuring. The assets retained by China Telecommunications Corporation primarily related to investments in non-telecommunication industries, inter-provincial transmission optic fibres and properties and, as at December 31, 2001, consisted of the following:

	RMB million
Current assets, primarily prepayments	1,128
Property, plant and equipment, net	4,457
Construction in progress	686
Interests in associates and long-term investments	5,014
	<u>11,285</u>

In preparing the Financial Information, the assets and liabilities, revenues and expenses of the Predecessor Operations are reflected in the Financial Information. In addition, for periods up to December 31, 2001, the Financial Information has been prepared to include certain assets historically associated with the Predecessor Operations that were retained by China Telecommunications Corporation. As a result of the segregation and separate management of these assets by China Telecommunications Corporation beginning December 31, 2001, the assets retained by China Telecommunications Corporation have been reflected as a distribution to owner in the combined statements of owner's equity as at December 31, 2001.

Management believes that all historical costs of operations have been reflected in the Financial Information. Expenses that were specifically identified to the Predecessor Operations, including the costs of ancillary, social and supporting services provided to the Predecessor Operations by China Telecommunications Corporation and its affiliates, are

(V) NOTES TO THE FINANCIAL INFORMATION—(CONTINUED)

reflected in the Financial Information. Expenses associated with corporate services provided by China Telecommunications Corporation (consisting primarily of corporate headquarter administrative expenses) were allocated based on revenues to companies within China Telecommunications Corporation, including the Predecessor Operations. The amount of corporate administrative expenses allocated to the Group for the years ended December 31, 1999, 2000 and 2001 and for the six-month period ended June 30, 2001 was RMB59 million, RMB78 million, RMB118 million and RMB46 million, respectively. Management believes that the method of allocation of corporate administrative expenses presents a reasonable basis of estimating what the Group's expenses would have been on a stand-alone basis for the periods presented.

2. SIGNIFICANT ACCOUNTING POLICIES**(a) Basis of preparation**

The Financial Information has been prepared in accordance with International Financial Reporting Standards ("IFRS") promulgated by the International Accounting Standards Board ("IASB"). IFRS includes International Accounting Standards ("IAS") and interpretations.

The Financial Information is prepared on the historical cost basis as modified by the revaluation of certain property, plant and equipment (Note 3). The accounting policies described below have been consistently applied by the Group.

The preparation of the Financial Information in accordance with IFRS requires management to make estimates and assumptions that affect the reported amounts of assets and liabilities and disclosure of contingent assets and liabilities at the date of the Financial Information and the reported amounts of revenues and expenses during the reporting period. Actual results could differ from those estimates.

(b) Basis of consolidation

A subsidiary is an enterprise controlled by the Company. Control exists when the Company has the power, directly or indirectly, to govern the financial and operating policies of an enterprise so as to obtain benefits from its activities.

The financial results of subsidiaries are included in the Financial Information from the date that control commences until the date that control ceases, and the share attributable to minority interests is deducted from or added to the profit before minority interests. All significant intercompany balances and transactions and any unrealised gains/losses arising from intercompany transactions are eliminated in consolidation.

An associate is a company, not being a subsidiary, in which the Group exercises significant influence over its management. Significant influence is the power to participate in the financial and operating policy decisions of the investee but is not control over those policies.

(V) NOTES TO THE FINANCIAL INFORMATION—(CONTINUED)

The combined statements of income include the Group's share of the results of its associates for the period. In the combined balance sheets, interests in associates are stated at the Group's attributable share of net assets.

(c) Translation of foreign currencies

The functional and reporting currency of the Group is Renminbi ("RMB"). Foreign currency transactions during the period are translated into RMB at the applicable rates of exchange quoted by the People's Bank of China ("PBOC rates") prevailing on the transaction dates. Foreign currency monetary assets and liabilities are translated into RMB at the applicable PBOC rates at the balance sheet date.

Exchange differences, other than those capitalised as construction in progress, are recognised as income or expense in the combined statements of income. For the periods presented, no exchange differences were capitalised.

(d) Cash and cash equivalents

Cash and cash equivalents comprise cash at bank and on hand and time deposits with original maturities of three months or less when purchased. Cash equivalents are stated at cost, which approximates fair value. None of the Group's cash and cash equivalents is restricted as to withdrawal.

(e) Accounts receivable

Accounts receivable are stated at cost less allowance for doubtful accounts. An allowance for doubtful accounts is provided based upon the evaluation of the recoverability of these accounts at the balance sheet date.

(f) Inventories

Inventories consist of materials and supplies used in maintaining the wireline telecommunication network and goods for resale. Materials and supplies are valued at cost less a provision for obsolescence.

Inventories that are held for resale are stated at the lower of cost and net realisable value. Net realisable value is the estimated selling price in the ordinary course of business less the estimated costs of completion and the estimated costs necessary to make the sale.

(g) Property, plant and equipment

Property, plant and equipment are initially recorded at cost less accumulated depreciation and impairment losses (Note 2(k)). The cost of an asset comprises its purchase price, any directly attributable costs of bringing the asset to working condition and location for its intended use and the cost of borrowed funds used during construction. Expenditure incurred after the asset has been put into operation is capitalised only when it increases the future economic benefits embodied in the item of property, plant and equipment. All other expenditure, including the cost of repairs and maintenance, is expensed as it is incurred.

(V) NOTES TO THE FINANCIAL INFORMATION—(CONTINUED)

Subsequent to the revaluation carried out as at December 31, 2001, which was based on depreciated replacement costs (Note 3), property, plant and equipment are carried at revalued amount, being the fair value at the date of the revaluation, less subsequent accumulated depreciation and impairment losses. When an item of property, plant and equipment is revalued, any accumulated depreciation at the date of the revaluation is restated proportionately with the change in the gross carrying amount of the asset so that the carrying amount of the asset after revaluation equals its revalued amount. The separate classes into which the Company groups assets for revaluation are buildings and improvements; telecommunication network plant and transmission and switching equipment; and furniture, fixture, motor vehicles and other equipment. When an item of property, plant and equipment is revalued, the entire class of property, plant and equipment to which that asset belongs is revalued simultaneously. When an asset's carrying amount is increased as a result of a revaluation, the increase is credited directly to equity under the component of revaluation reserve. However, a revaluation increase is recognised as income to the extent that it reverses a revaluation decrease of the same asset previously recognised as an expense. When an asset's carrying amount is decreased as a result of a revaluation, the decrease is recognised as an expense in the combined statements of income. However, a revaluation decrease is charged directly against any related revaluation surplus to the extent that the decrease does not exceed the amount held in the revaluation reserve in respect of that same asset. Revaluations will be performed with sufficient regularity such that the carrying amount does not differ materially from that which would be determined using fair value at the balance sheet date. Revaluations will be performed annually on items which experience significant and volatile movements in fair value while items which experience insignificant movements in fair value will be revalued every three years.

Assets acquired under leasing agreements which effectively transfer substantially all the risks and benefits incidental to ownership from the lessor to the lessee are classified as finance leases. Finance leases are recorded at amounts equivalent to the present value of the minimum lease payments (computed using the rate of interest implicit in the lease) which approximate the fair value at the inception of the lease. The net present value of the future minimum lease payments is recorded correspondingly as a finance lease obligation. Assets under finance leases are amortised over their estimated useful lives. The carrying amount of assets under finance leases as at December 31, 1999, 2000 and 2001 and as at June 30, 2002 was RMB710 million, RMB391 million, RMB48 million and RMB28 million, respectively.

Gains or losses arising from the retirement or disposal of property, plant and equipment, are determined as the difference between the net disposal proceeds and the carrying amount of the asset and are recognised as income or expense in the combined statements of income on the date of disposal.

Depreciation is provided to write off the cost/revalued amount of each asset over its estimated useful life on a straight-line basis, after taking into account its estimated residual value, as follows:

	Depreciable life
Buildings and improvements	8 to 30 years
Telecommunication network plant, transmission and switching equipment	6 to 10 years
Furniture, fixture, motor vehicles and other equipment	4 to 10 years

(V) NOTES TO THE FINANCIAL INFORMATION—(CONTINUED)**(h) Lease prepayments**

Lease prepayments represent land use rights paid to the PRC's land bureau. Land use rights are carried at cost and are amortised on a straight-line basis over the respective periods of the rights which range from 20 years to 70 years.

(i) Construction in progress

Construction in progress represents buildings, telecommunication network plant, transmission and switching equipment under construction and pending installation, and is stated at cost less impairment losses (Note 2(k)). Cost comprises direct costs of construction as well as interest charges, and foreign exchange differences on related borrowed funds to the extent that they are regarded as an adjustment to interest charges, during the periods of construction. Capitalisation of these costs ceases and the construction in progress is transferred to property, plant and equipment when the asset is substantially ready for its intended use.

No depreciation is provided in respect of construction in progress.

(j) Investments

Investments in non-marketable equity securities are stated at cost less provision for impairment losses. A provision is made where, in the opinion of management, the carrying amount of the investment exceeds its recoverable amount.

(k) Impairment

The carrying amounts of the Group's long-lived assets, including property, plant and equipment, are reviewed periodically in order to assess whether the recoverable amounts have declined below the carrying amounts. These assets are tested for impairment whenever events or changes in circumstances indicate that their recorded carrying amounts may not be recoverable. When such a decline has occurred, the carrying amount is reduced to the recoverable amount. The recoverable amount is the greater of the net selling price and the value in use. The amount of the reduction is recognised as an expense in the combined statements of income. In determining the value in use, expected future cash flows generated by the assets are discounted to their present value. For the periods presented, no impairment losses were recognised in the combined statements of income.

(l) Revenue recognition

The Group's revenues are principally derived from the provision of local, domestic long distance ("DLD") and international long distance ("ILD") telephone services which consist of (i) charges for telephone service, which vary depending on the day, the time of day, distance and duration of the call, (ii) a monthly telephone service fee, (iii) service activation and installation fees, and (iv) value-added telecommunication services, such as call waiting, call diverting and caller number display. The Group records wireline service revenues over the periods they are earned as follows:

- (i) Revenues derived from local, DLD and ILD telephone usage are recognised as the services are provided.

(V) NOTES TO THE FINANCIAL INFORMATION—(CONTINUED)

- (ii) Upfront fees received for activation of wireline services and wireline installation charges are deferred and recognised over the expected customer relationship period. The related direct incremental customer acquisition costs are deferred to the extent of the upfront fees and are amortised over the same expected customer relationship period.
- (iii) Monthly telephone service fees are recognised in the month during which the telephone services are provided to customers.
- (iv) Revenues from sale of prepaid calling cards are recognised as the cards are used by customers.
- (v) Revenues derived from value-added telecommunication services are recognised when the services are provided to customers.

Other related wireline telecommunication service revenues are recognised as follows:

- (i) Revenues from the provision of Internet and managed data services are recognised when the services are provided to customers.
- (ii) Interconnection fees from domestic and foreign telecommunication operators are recognised when the services are rendered as measured by the minutes of traffic processed.
- (iii) Lease income from operating leases is recognised over the term of the lease.
- (iv) Sale of customer-end equipment is recognised on delivery of the equipment to customers and when the significant risks and rewards of ownership and title have been transferred to the customers.

(m) Advertising and promotion expense

The costs for advertising and promoting the Group's wireline telecommunication services are expensed as incurred. Advertising and promotion expense, which is included in selling, general and administrative expenses, was RMB622 million, RMB862 million and RMB1,097 million for the years ended December 31, 1999, 2000 and 2001, and RMB501 million and RMB427 million for the six-month periods ended June 30, 2001 and 2002, respectively.

(n) Net financing costs

Net financing costs comprise interest income on time deposits, interest expense on borrowings, and foreign exchange gains and losses. Interest income from time deposits in bank is recognised on a time proportion basis that takes into account the effective yield on the asset.

Interest costs incurred in connection with borrowings are expensed as incurred, except to the extent that they are capitalised as being directly attributable to the construction of an asset which necessarily take a substantial period of time to get ready for its intended use.

(V) NOTES TO THE FINANCIAL INFORMATION—(CONTINUED)**(o) Research and development expense**

Research and development costs are expensed as incurred. For the years ended December 31, 1999, 2000 and 2001 and for the six-month periods ended June 30, 2001 and 2002, research and development expense was RMB176 million, RMB220 million, RMB123 million, RMB39 million and RMB24 million, respectively.

(p) Employee benefits

The Group's contribution to the defined contribution retirement plan administered by the PRC's government is recognised as an expense in the combined statements of income. Further information is set out in Note 28.

(q) Provisions

A provision is recognised in the combined balance sheet when the Group has a legal or constructive obligation as a result of a past event, and it is probable that an outflow of economic benefits will be required to settle the obligation.

(r) Taxation

Taxation comprises current and deferred tax. Current tax is calculated on the taxable income for the period by applying the applicable tax rates. Deferred tax is provided using the balance sheet liability method, providing for all temporary differences between the carrying amounts of assets and liabilities for financial reporting purposes and the amounts used for taxation purposes. The amount of deferred tax is calculated on the basis of the enacted tax rates that are expected to apply in the period when the asset is realised or the liability is settled. The effect on deferred tax of any changes in tax rates is charged or credited to the combined statements of income. A deferred tax asset is recognised only to the extent that it is probable that future taxable profits will be available against which the asset can be utilised. Deferred tax assets are reduced to the extent that it is no longer probable that the related tax benefit will be realised.

(s) Dividends

Dividends are recognised as a liability in the period in which they are declared.

(t) Segmental reporting

A business segment is a distinguishable component of the Group that is engaged in providing products or services and is subject to risks and rewards that are different from those of other segments. For the periods presented, the Group has one operating segment which is the provision of wireline telecommunication services. All the Group's operating activities are carried out in the PRC.

(V) NOTES TO THE FINANCIAL INFORMATION—(CONTINUED)

3. PROPERTY, PLANT AND EQUIPMENT, NET

	Buildings and improvements	Telecommunications network and equipment	Furniture, fixture, motor vehicles and other equipment	Total
	RMB million	RMB million	RMB million	RMB million
Cost:				
Balance at January 1, 1999	16,704	121,978	7,673	146,355
Additions	1,244	5,584	442	7,270
Transferred from construction in progress	4,588	16,632	1,165	22,385
Disposals	(2,598)	(2,438)	(359)	(5,395)
Balance at December 31, 1999	19,938	141,756	8,921	170,615
Accumulated depreciation:				
Balance at January 1, 1999	(2,591)	(36,516)	(2,099)	(41,206)
Depreciation charge for the year	(651)	(13,092)	(1,160)	(14,903)
Written back on disposals	227	1,453	275	1,955
Balance at December 31, 1999	(3,015)	(48,155)	(2,984)	(54,154)
Net book value at December 31, 1999	16,923	93,601	5,937	116,461
Cost:				
Balance at January 1, 2000	19,938	141,756	8,921	170,615
Additions	692	7,578	967	9,237
Transferred from construction in progress	4,635	17,296	799	22,730
Disposals	(2,321)	(2,180)	(768)	(5,269)
Balance at December 31, 2000	22,944	164,450	9,919	197,313
Accumulated depreciation:				
Balance at January 1, 2000	(3,015)	(48,155)	(2,984)	(54,154)
Depreciation charge for the year	(767)	(15,327)	(1,292)	(17,386)
Written back on disposals	276	870	609	1,755
Balance at December 31, 2000	(3,506)	(62,612)	(3,667)	(69,785)
Net book value at December 31, 2000	19,438	101,838	6,252	127,528
Cost / valuation:				
Balance at January 1, 2001	22,944	164,450	9,919	197,313
Additions	1,187	5,763	877	7,827
Transferred from construction in progress	4,481	30,915	1,501	36,897
Disposals	(265)	(3,794)	(780)	(4,839)
Revaluation	641	(28,016)	(2,328)	(29,703)
Distribution to China Telecommunications Corporation in connection with the Restructuring	(2,865)	(2,057)	(1,130)	(6,052)
Balance at December 31, 2001	26,123	167,261	8,059	201,443
Accumulated depreciation:				
Balance at January 1, 2001	(3,506)	(62,612)	(3,667)	(69,785)
Depreciation charge for the year	(918)	(17,116)	(1,417)	(19,451)
Written back on disposals	126	2,288	480	2,894
Revaluation	1,482	18,719	1,726	21,927
Distribution to China Telecommunications Corporation in connection with the Restructuring	480	742	373	1,595
Balance at December 31, 2001	(2,336)	(57,979)	(2,505)	(62,820)
Net book value at December 31, 2001	23,787	109,282	5,554	138,623
Cost / valuation:				
Balance at January 1, 2002	26,123	167,261	8,059	201,443
Additions	40	388	105	533
Transferred from construction in progress	1,107	6,387	216	7,710
Disposals	(34)	(1,129)	(166)	(1,329)
Balance at June 30, 2002	27,236	172,907	8,214	208,357
Accumulated depreciation:				
Balance at January 1, 2002	(2,336)	(57,979)	(2,505)	(62,820)
Depreciation charge for the period	(520)	(8,874)	(636)	(10,030)
Written back on disposals	18	734	84	836
Balance at June 30, 2002	(2,838)	(66,119)	(3,057)	(72,014)
Net book value at June 30, 2002	24,398	106,788	5,157	136,343

(V) NOTES TO THE FINANCIAL INFORMATION—(CONTINUED)

As required by the relevant PRC rules and regulations with respect to the Restructuring, the property, plant and equipment of the Group as at December 31, 2001 were valued for each asset class by Beijing China Enterprise Appraisal Co., Ltd. (the "PRC valuers"), independent valuers registered in the PRC, on a depreciated replacement cost basis. The value of property, plant and equipment has been determined at RMB138,623 million. Such amount will serve as the tax base for such assets for future years (see Note 7). The surplus on revaluation of certain property, plant and equipment totalling RMB4,154 million has been credited to the revaluation reserve while the deficit arising from the revaluation of certain property, plant and equipment totalling RMB11,930 million has been recognised as an expense for the year ended December 31, 2001. The reduction in the carrying amount was primarily the result of a current market decline in the replacement cost of certain network switching equipment. The net deficit on the revaluation of property, plant and equipment of RMB7,776 million has been reflected in the combined balance sheet of the Group as at December 31, 2001.

The Group's properties were also valued separately by Chesterton Petty Limited, independent qualified valuers in Hong Kong, as at December 31, 2001. The value arrived at by these valuers was approximately the same as that arrived at by the PRC valuers.

The historical carrying amount of the Group's property, plant and equipment as at December 31, 2001 and the revalued basis of these assets is as follows:

	Historical carrying amount	Revaluation surplus	Revaluation deficit	Revalued amount
	RMB million	RMB million	RMB million	RMB million
Buildings and improvements	21,664	2,361	(238)	23,787
Telecommunications network and equipment	118,579	1,653	(10,950)	109,282
Furniture, fixture, motor vehicles and other equipment ..	6,156	140	(742)	5,554
	<u>146,399</u>	<u>4,154</u>	<u>(11,930)</u>	<u>138,623</u>

4. CONSTRUCTION IN PROGRESS

	December 31,			June 30,
	1999	2000	2001	2002
	RMB million	RMB million	RMB million	RMB million
Balance at beginning of year/period	30,414	26,313	28,656	23,274
Additions	18,284	25,073	32,201	7,781
Transferred to fixed assets	(22,385)	(22,730)	(36,897)	(7,710)
Distribution to China Telecommunications Corporation in connection with the Restructuring	—	—	(686)	—
Balance at end of year/period	<u>26,313</u>	<u>28,656</u>	<u>23,274</u>	<u>23,345</u>

5. INTERESTS IN ASSOCIATES

	December 31,			June 30,
	1999	2000	2001	2002
	RMB million	RMB million	RMB million	RMB million
Share of net assets	973	1,157	417	426
Loans to associates	50	—	—	—
	<u>1,023</u>	<u>1,157</u>	<u>417</u>	<u>426</u>

(V) NOTES TO THE FINANCIAL INFORMATION—(CONTINUED)

The Group's interests in associates are individually and in aggregate not material to the Group's financial conditions or results of operation for all periods presented. Details of the Group's principal associates are as follows:

<u>Name of company</u>	<u>Attributable equity interest</u>	<u>Principal activities</u>
Shenzhen Shekou Telecommunications Company Limited	50.00%	Provision of telecommunication services
Shanghai Information Investment Incorporation	24.00%	Provision of information technology consultancy services

The above associates are established in the PRC and are not traded on any stock exchange. In connection with the Restructuring, interests in associates of RMB719 million were distributed to China Telecommunications Corporation as at December 31, 2001.

6. INVESTMENTS

	<u>December 31,</u>			<u>June 30,</u>
	<u>1999</u>	<u>2000</u>	<u>2001</u>	<u>2002</u>
	<u>RMB million</u>	<u>RMB million</u>	<u>RMB million</u>	<u>RMB million</u>
Unlisted equity investments	<u>2,841</u>	<u>4,015</u>	<u>446</u>	<u>482</u>

Unlisted equity investments mainly represent the Group's various interests in PRC private enterprises which are mainly engaged in the construction, equipment manufacturing and import/export trading industries. These investments are accounted for at cost, less provision for any impairment. The Group has no investments in marketable securities. In connection with the Restructuring, investments of RMB4,295 million were distributed to China Telecommunications Corporation as at December 31, 2001.

7. DEFERRED TAX ASSETS AND LIABILITIES

Deferred tax assets and deferred tax liabilities are attributable to the items set out below:

	<u>Assets</u>				<u>Liabilities</u>				<u>Net balance</u>			
	<u>December 31,</u>				<u>December 31,</u>				<u>December 31,</u>			
	<u>1999</u>	<u>2000</u>	<u>2001</u>	<u>June 30, 2002</u>	<u>1999</u>	<u>2000</u>	<u>2001</u>	<u>June 30, 2002</u>	<u>1999</u>	<u>2000</u>	<u>2001</u>	<u>June 30, 2002</u>
	<u>RMB million</u>	<u>RMB million</u>	<u>RMB million</u>	<u>RMB million</u>	<u>RMB million</u>	<u>RMB million</u>	<u>RMB million</u>	<u>RMB million</u>	<u>RMB million</u>	<u>RMB million</u>	<u>RMB million</u>	<u>RMB million</u>
<i>Current</i>												
Provisions, primarily for accounts receivable	199	308	—	59	—	—	—	—	199	308	—	59
<i>Non-Current</i>												
Property, plant and equipment	—	—	—	—	(8,398)	(9,194)	—	(127)	(8,398)	(9,194)	—	(127)
Deferred revenues and installation costs	1,594	2,002	—	564	(1,111)	(1,391)	—	(251)	483	611	—	313
Land use rights	—	—	4,059	4,018	—	—	—	—	—	—	4,059	4,018
Deferred tax assets/(liabilities)	<u>1,793</u>	<u>2,310</u>	<u>4,059</u>	<u>4,641</u>	<u>(9,509)</u>	<u>(10,585)</u>	<u>—</u>	<u>(378)</u>	<u>(7,716)</u>	<u>(8,275)</u>	<u>4,059</u>	<u>4,263</u>

A valuation allowance on deferred tax assets is recorded if it is more likely than not that some portion or all of the deferred tax assets will not be realised through the recovery of taxes previously paid and/or future taxable income. The allowance is subject to ongoing adjustments based on changes in circumstances that affect the Group's assessment of the realisability of the deferred tax assets. The Group has reviewed its deferred tax assets as at

(V) NOTES TO THE FINANCIAL INFORMATION—(CONTINUED)

December 31, 1999, 2000 and 2001 and June 30, 2001 and 2002. Based on the level of historical taxable income and projections of future taxable income over the periods which the deferred tax assets are deductible, management believes that it is more likely than not the Group will realise the benefits of these temporary differences. Therefore, no valuation allowances were provided for the years ended December 31, 1999, 2000 and 2001 and the six-month periods ended June 30, 2001 and 2002 in respect of deferred tax assets arising from temporary differences.

Movements in temporary differences for the three years ended December 31, 2001 and for the six-month period ended June 30, 2002 are as follows:

		Balance at January 1, 1999	Recognised in statement of income	Recognised in owner's equity	Balance at December 31, 1999
		RMB million	RMB million	RMB million	RMB million
<i>Current</i>					
Provisions, primarily for accounts receivable		204	(5)	—	199
<i>Non-current</i>					
Property, plant and equipment		(7,461)	(937)	—	(8,398)
Deferred revenues and installation costs		316	167	—	483
Net deferred tax liabilities		<u>(6,941)</u>	<u>(775)</u>	<u>—</u>	<u>(7,716)</u>
			(Note 21)		
		Balance at January 1, 2000	Recognised in statement of income	Recognised in owner's equity	Balance at December 31, 2000
		RMB million	RMB million	RMB million	RMB million
<i>Current</i>					
Provisions, primarily for accounts receivable		199	109	—	308
<i>Non-current</i>					
Property, plant and equipment		(8,398)	(796)	—	(9,194)
Deferred revenues and installation costs		483	128	—	611
Net deferred tax liabilities		<u>(7,716)</u>	<u>(559)</u>	<u>—</u>	<u>(8,275)</u>
			(Note 21)		
		Balance at January 1, 2001	Recognised in statement of income	Recognised in owner's equity	Balance at December 31, 2001
		RMB million	RMB million	RMB million	RMB million
<i>Current</i>					
Provisions, primarily for accounts receivable	(i)	308	(88)	(220)	—
<i>Non-current</i>					
Property, plant and equipment	(i)	(9,194)	3,271	5,923	—
Deferred revenues and installation costs . . .	(i)	611	205	(816)	—
Land use rights	(ii)	—	—	4,059	4,059
Net deferred tax (liabilities) / assets		<u>(8,275)</u>	<u>3,388</u>	<u>8,946</u>	<u>4,059</u>
			(Note 21)		

(V) NOTES TO THE FINANCIAL INFORMATION—(CONTINUED)

	Balance at January 1, 2002	Recognised in statement of income	Recognised in owner's equity	Balance at June 30, 2002
	RMB million	RMB million	RMB million	RMB million
<i>Current</i>				
Provisions, primarily for accounts receivable	—	59	—	59
<i>Non-current</i>				
Property, plant and equipment	—	(127)	—	(127)
Deferred revenues and installation costs	—	313	—	313
Land use rights	4,059	(41)	—	4,018
Net deferred tax assets	4,059	204	—	4,263
		(Note 21)		

Note:

- (i) As described in Note 3, in connection with the Restructuring, the Group's property, plant and equipment were revalued as at December 31, 2001. Such revalued amount will serve as the tax base for these assets for future years. In addition, in connection with the Restructuring, the tax bases of the Group's assets and liabilities that gave rise to the temporary differences above have been adjusted to conform to the related financial carrying amounts. As a result, the timing differences that gave rise to the net deferred tax liabilities relating to the items above were eliminated. The reduction in net deferred tax liabilities of RMB 4,887 million as at December 31, 2001 was reflected as a credit to owner's equity.
- (ii) In connection with the Restructuring, the Group's land use rights, which as at December 31, 2001 had a carrying amount of RMB2,638 million, were revalued as required by the relevant PRC rules and regulations. The revalued amount of the land use rights has been determined at RMB14,939 million. Such amount will serve as the tax base for future years. The land use rights were not revalued for financial reporting purposes and accordingly, a deferred tax asset of RMB4,059 million is created with a corresponding increase in owner's equity. Based upon the level of historical taxable income and projections of future taxable income, management believes it is more likely than not the Group will realise the benefits of the deferred tax asset.

8. INVENTORIES

Inventories represent:

	December 31,			June 30,
	1999	2000	2001	2002
	RMB million	RMB million	RMB million	RMB million
Materials and supplies	773	1,185	1,166	868
Goods for resale	219	129	247	182
	992	1,314	1,413	1,050

(V) NOTES TO THE FINANCIAL INFORMATION—(CONTINUED)

9. ACCOUNTS RECEIVABLE, NET

Accounts receivable, net, is analysed as follows:

	December 31,			June 30,
	1999	2000	2001	2002
	RMB million	RMB million	RMB million	RMB million
Accounts receivable	7,365	7,791	6,121	7,606
Less: Allowance for doubtful accounts	(555)	(661)	(513)	(684)
	<u>6,810</u>	<u>7,130</u>	<u>5,608</u>	<u>6,922</u>

Amounts due from the provision of wireline telecommunication services to residential and business customers are due within 30 days from the date of billing. Customers who have accounts overdue by more than 90 days will have their services disconnected. Accounts receivable from other telecommunication operators and customers are due between 30 to 60 days from the billing date.

The following table summarises the changes in the allowance for doubtful accounts for each of the years in the three-year period ended December 31, 2001 and for the six-month period ended June 30, 2002:

	Year ended December 31,			Six-month period ended June 30, 2002
	1999	2000	2001	
	RMB million	RMB million	RMB million	RMB million
At beginning of year/period	490	555	661	513
Provision for doubtful accounts	279	223	186	171
Accounts receivable written off	(214)	(117)	(334)	—
At end of year/period	<u>555</u>	<u>661</u>	<u>513</u>	<u>684</u>

Ageing analysis of accounts receivable from telephone subscribers is as follows:

	December 31,			June 30,
	1999	2000	2001	2002
	RMB million	RMB million	RMB million	RMB million
Current, within 1 month	4,317	4,916	4,436	5,187
1 to 3 months	744	852	709	927
4 to 12 months	270	288	233	327
More than 12 months	267	346	255	321
	5,598	6,402	5,633	6,762
Less: Allowance for doubtful accounts	(537)	(634)	(488)	(648)
	<u>5,061</u>	<u>5,768</u>	<u>5,145</u>	<u>6,114</u>

(V) NOTES TO THE FINANCIAL INFORMATION—(CONTINUED)

Ageing analysis of accounts receivable from other telecommunication operators and customers is as follows:

	December 31,			June 30,
	1999	2000	2001	2002
	RMB million	RMB million	RMB million	RMB million
Current, within 1 month	462	274	189	303
1 to 3 months	438	419	137	334
4 to 12 months	282	191	77	160
More than 12 months	585	505	85	47
	1,767	1,389	488	844
Less: Allowance for doubtful accounts	(18)	(27)	(25)	(36)
	<u>1,749</u>	<u>1,362</u>	<u>463</u>	<u>808</u>

10. PREPAYMENTS AND OTHER CURRENT ASSETS

Prepayments and other current assets represent:

	December 31,			June 30,
	1999	2000	2001	2002
	RMB million	RMB million	RMB million	RMB million
Amounts due from China Telecom Group	1,401	876	970	791
Prepayments in connection with construction work and equipment purchases	1,408	1,296	383	377
Prepaid expenses and deposits	214	419	247	264
Other receivables	1,970	1,466	1,152	736
	<u>4,993</u>	<u>4,057</u>	<u>2,752</u>	<u>2,168</u>

11. CASH AND CASH EQUIVALENTS

	December 31,			June 30,
	1999	2000	2001	2002
	RMB million	RMB million	RMB million	RMB million
Cash at bank and on hand	14,890	13,607	3,604	2,394
Time deposits with maturity within three months	561	254	278	246
	<u>15,451</u>	<u>13,861</u>	<u>3,882</u>	<u>2,640</u>

12. SHORT-TERM AND LONG-TERM DEBT

The Group's short-term debt comprises:

	December 31,			June 30,
	1999	2000	2001	2002
	RMB million	RMB million	RMB million	RMB million
Bank loans	9,811	12,194	18,827	14,316

The Group's weighted average interest rate on short-term debt was 5.9%, 5.9%, 5.5% and 5.1% as at December 31, 1999, 2000 and 2001 and June 30, 2002, respectively.

(V) NOTES TO THE FINANCIAL INFORMATION—(CONTINUED)

The Group's long-term debt comprises:

<u>Interest rate and final maturity</u>		<u>December 31,</u>			<u>June 30,</u>
		<u>1999</u>	<u>2000</u>	<u>2001</u>	<u>2002</u>
		<u>RMB</u>	<u>RMB</u>	<u>RMB</u>	<u>RMB</u>
		<u>million</u>	<u>million</u>	<u>million</u>	<u>million</u>
Bank loans					
Renminbi denominated	Interest rates ranging from 4.8% to 8.0% per annum with maturities through 2007	7,640	7,415	6,005	4,792
US Dollar denominated	Interest rates ranging from 2.0% to 8.3% per annum with maturities through 2021	3,616	2,675	2,137	1,866
Japanese Yen denominated	Interest rates ranging from 2.5% to 3.5% per annum with maturities through 2022	3,445	3,070	2,544	2,688
		14,701	13,160	10,686	9,346
Other loans					
Renminbi denominated	Interest rates at 2.4% per annum	416	82	36	—
Total long-term debt		15,117	13,242	10,722	9,346
Less: current portion		(3,009)	(3,174)	(3,621)	(2,779)
Non-current portion		12,108	10,068	7,101	6,567

Bank loans of RMB234 million as at December 31, 1999, RMB233 million as at December 31, 2000, RMB14 million as at December 31, 2001 and RMB6 million as at June 30, 2002 were secured by certain of the Group's property, plant and equipment. The net book value of property, plant and equipment pledged as security amounted to RMB226 million as at December 31, 1999, RMB206 million as at December 31, 2000, RMB4 million as at December 31, 2001 and RMB14 million as at June 30, 2002.

The aggregate maturities of the Group's long-term debt subsequent to December 31, 2001 are as follows:

	<u>RMB</u>
	<u>million</u>
2002	3,621
2003	2,795
2004	1,306
2005	325
2006	263
Thereafter	2,412
	<u>10,722</u>

(V) NOTES TO THE FINANCIAL INFORMATION—(CONTINUED)

The aggregate maturities of the Group's long-term debt subsequent to June 30, 2002 are as follows:

	RMB million
2002—subsequent to June 30, 2002	2,252
2003	2,393
2004	1,366
2005	464
2006	256
2007	252
Thereafter	<u>2,363</u>
	<u>9,346</u>

The Group's short and long-term debts do not contain any financial covenants. As at December 31, 2001 and June 30, 2002, the Group had no undrawn credit facilities.

13. ACCOUNTS PAYABLE

Accounts payable are analysed as follows:

	December 31,			June 30,
	1999	2000	2001	2002
	RMB million	RMB million	RMB million	RMB million
Third parties	6,284	9,030	12,498	8,873
China Telecom Group	668	1,184	2,421	2,480
	<u>6,952</u>	<u>10,214</u>	<u>14,919</u>	<u>11,353</u>

Amounts due to China Telecom Group are repayable in accordance with normal commercial terms.

Ageing analysis of accounts payable is as follows:

	December 31,			June 30,
	1999	2000	2001	2002
	RMB million	RMB million	RMB million	RMB million
Due within 1 month or on demand	1,107	1,617	2,166	2,091
Due after 1 month but within 3 months	1,012	1,280	2,010	1,158
Due after 3 months but within 6 months	1,081	1,540	2,150	1,468
Due after 6 months	3,752	5,777	8,593	6,636
	<u>6,952</u>	<u>10,214</u>	<u>14,919</u>	<u>11,353</u>

(V) NOTES TO THE FINANCIAL INFORMATION—(CONTINUED)

14. ACCRUED EXPENSES AND OTHER PAYABLES

Accrued expenses and other payables represent:

	December 31,			June 30,
	1999	2000	2001	2002
	RMB million	RMB million	RMB million	RMB million
Distribution payable to China Telecommunications Corporation . . .	1,548	1,183	2,535	941
Amounts due to China Telecom Group	170	436	1,673	2,481
Accrued expenses	6,223	7,730	7,095	9,345
Customer deposits and receipts in advance	1,083	701	581	458
	<u>9,024</u>	<u>10,050</u>	<u>11,884</u>	<u>13,225</u>

15. FINANCE LEASE OBLIGATIONS

The Group's obligations under finance leases are analysed as follows:

	December 31,			June 30,
	1999	2000	2001	2002
	RMB million	RMB million	RMB million	RMB million
Within 1 year	504	291	40	28
After 1 year but within 2 years	320	77	7	—
After 2 years but within 3 years	11	7	4	—
After 3 years but within 4 years	—	4	—	—
Total minimum lease payments	835	379	51	28
Less: finance charges related to future periods	(79)	(31)	(2)	(1)
Present value of net minimum lease payments	756	348	49	27
Less: current portion	(469)	(272)	(38)	(27)
Non-current portion	<u>287</u>	<u>76</u>	<u>11</u>	<u>—</u>

(V) NOTES TO THE FINANCIAL INFORMATION—(CONTINUED)

16. DEFERRED REVENUE

Deferred revenue represents the unearned portion of upfront connection fees and installation fees received from customers and the unused portion of calling cards. Connection fees and installation fees are amortised over the expected customer relationship period of 10 years. Beginning July 1, 2001, connection fees were no longer collected from new customers.

	December 31,			June 30,
	1999	2000	2001	2002
	RMB million	RMB million	RMB million	RMB million
Balance at beginning of year / period	40,442	39,782	38,199	34,508
Additions for the year / period				
—connection fees	4,169	3,504	1,168	—
—installation fees	1,308	1,434	2,019	1,097
—calling cards	3,146	4,415	5,580	2,349
	<u>8,623</u>	<u>9,353</u>	<u>8,767</u>	<u>3,446</u>
Reduction for the year / period				
—amortisation of connection fees	(5,923)	(6,322)	(6,290)	(3,058)
—amortisation of installation fees	(442)	(583)	(780)	(467)
—usage of calling cards	(2,918)	(4,031)	(5,388)	(2,900)
Balance at end of year / period	<u>39,782</u>	<u>38,199</u>	<u>34,508</u>	<u>31,529</u>
Representing:				
—Current portion	7,178	7,895	8,155	7,417
—Non-current portion	<u>32,604</u>	<u>30,304</u>	<u>26,353</u>	<u>24,112</u>
	<u>39,782</u>	<u>38,199</u>	<u>34,508</u>	<u>31,529</u>

Included in other non-current assets are capitalised direct incremental costs associated with the installation of wireline services. As at December 31, 1999, 2000 and 2001 and June 30, 2002, the unamortised portion of these costs was RMB3,366 million, RMB4,215 million, RMB5,126 million and RMB5,530 million, respectively.

(V) NOTES TO THE FINANCIAL INFORMATION—(CONTINUED)

17. OPERATING REVENUES

Operating revenues represent revenues from the provision of wireline telecommunications services, net of PRC business tax and government levies, where applicable, in all periods presented. The components of the Group's operating revenues are as follows:

	Note	Years ended December 31,			Six-month periods ended June 30,	
		1999	2000	2001	2001	2002
		RMB million	RMB million	RMB million	RMB million	RMB million
Upfront connection fees	(i)	5,923	6,322	6,290	3,205	3,058
Upfront installation fees	(ii)	442	583	780	365	467
Monthly fees	(iii)	6,829	7,763	10,186	4,713	6,083
Local usage fees	(iv)	18,371	20,503	21,004	10,400	10,967
DLD	(iv)	15,220	17,190	14,676	7,611	7,148
ILD	(iv)	6,043	5,177	3,392	1,766	1,601
Internet	(v)	435	1,144	2,150	907	1,665
Managed data	(vi)	1,429	1,750	1,477	709	846
Interconnections	(vii)	4,779	4,869	3,814	2,009	2,272
Leased line	(viii)	4,549	4,268	2,862	1,391	1,555
Others	(ix)	1,271	1,452	1,915	801	1,206
		<u>65,291</u>	<u>71,021</u>	<u>68,546</u>	<u>33,877</u>	<u>36,868</u>

Note:

- (i) Represent the amortised amount of the upfront fees received for the initial activation of wireline services.
- (ii) Represent the amortised amount of the upfront fees received for installation of wireline services.
- (iii) Represent amounts charged to customers each month for their use of the Group's telephone services.
- (iv) Represent usage fees charged to customers for the provision of telephone services.
- (v) Represent amounts charged to customers for the provision of Internet access services.
- (vi) Represent amounts charged to customers for the provision of managed data transmission services.
- (vii) Represent amounts charged to domestic and foreign telecommunication operators for delivery of calls connecting to the Group's wireline telecommunication networks.
- (viii) Represent lease income from other domestic telecommunication operators and business customers for the usage of the Group's wireline telecommunication networks and is measured by the number of lines leased and the agreed upon rate per line leased. The lease arrangements are primarily on a year to year basis.
- (ix) Represent primarily revenues from provision of value-added telecommunication services to customers, sale and repairs and maintenance of customer-end equipment.

18. OTHER OPERATING EXPENSES

Other operating expenses consist of:

	Note	Years ended December 31,			Six-month periods ended June 30,	
		1999	2000	2001	2001	2002
		RMB million	RMB million	RMB million	RMB million	RMB million
Interconnection charges	(i)	754	1,172	1,290	724	1,391
Donations		102	27	26	10	8
Others		33	65	11	7	5
		<u>889</u>	<u>1,264</u>	<u>1,327</u>	<u>741</u>	<u>1,404</u>

Note:

- (i) Interconnection charges represent amounts incurred for the use of other telecommunication operators' networks for facilitating the completion of calls that originate from the Group's wireline telecommunication networks.

(V) NOTES TO THE FINANCIAL INFORMATION—(CONTINUED)

19. TOTAL OPERATING EXPENSES

Total operating expenses include personnel expenses of RMB6,294 million, RMB7,794 million and RMB6,207 million for the years ended December 31, 1999, 2000 and 2001 and RMB2,986 million and RMB3,393 million for the six-month periods ended June 30, 2001 and 2002, respectively.

20. NET FINANCE COSTS / (INCOME)

Net finance costs/(income) comprise:

	Years ended December 31,			Six-month periods ended June 30,	
	1999	2000	2001	2001	2002
	RMB million	RMB million	RMB million	RMB million	RMB million
Interest expense incurred	1,420	1,342	1,415	690	656
Less: Interest expense capitalised*	(1,018)	(1,067)	(1,032)	(547)	(386)
Net interest expense	402	275	383	143	270
Interest income	(301)	(253)	(246)	(109)	(67)
Foreign exchange losses	421	16	3	1	218
Foreign exchange gains	(6)	(336)	(433)	(222)	—
	<u>516</u>	<u>(298)</u>	<u>(293)</u>	<u>(187)</u>	<u>421</u>
* Interest expense was capitalised in construction in progress at the following rates per annum	4.5% to <u>7.2%</u>	5.0% to <u>7.1%</u>	5.1% to <u>5.8%</u>	5.1% to <u>5.8%</u>	4.4% to <u>5.6%</u>

21. TAXATION

Taxation in the combined statements of income comprises:

	Years ended December 31,			Six-month periods ended June 30,	
	1999	2000	2001	2001	2002
	RMB million	RMB million	RMB million	RMB million	RMB million
Provision for PRC income tax	4,684	4,298	3,319	1,480	2,169
Deferred taxation	775	559	(3,388)	295	(204)
	<u>5,459</u>	<u>4,857</u>	<u>(69)</u>	<u>1,775</u>	<u>1,965</u>

(V) NOTES TO THE FINANCIAL INFORMATION—(CONTINUED)

A reconciliation of the expected tax with the actual tax expense/(benefit) is as follows:

	Note	Years ended December 31,			Six-month periods ended June 30,	
		1999	2000	2001	2001	2002
		RMB million	RMB million	RMB million	RMB million	RMB million
Profit before taxation and minority interests		25,961	24,144	6,793	9,963	10,487
Expected PRC income tax expense at statutory tax rate of 33%	(i)	8,567	7,968	2,242	3,288	3,461
Differential tax rate on subsidiaries' income	(i)	(416)	(587)	(506)	(391)	(312)
Non-deductible expenses		721	827	234	39	168
Non-taxable income	(ii)	(3,565)	(3,545)	(2,241)	(1,268)	(1,352)
Others		152	194	202	107	—
Income tax		5,459	4,857	(69)	1,775	1,965

Note:

- (i) The provision for PRC current income tax is based on a statutory rate of 33% of the assessable income of the Group as determined in accordance with the relevant income tax rules and regulations of the PRC for all periods presented, except for certain subsidiaries of the Company which are taxed at a preferential rate of 15%.
- (ii) Amounts represent connection fees and certain usage fees on phone calls received from customers which are not subject to income tax.

22. BASIC EARNINGS PER SHARE

Basic earnings per share for the years ended December 31, 1999, 2000 and 2001 and for the six-month periods ended June 30, 2001 and 2002 has been computed by dividing net profit by the number of shares issued and outstanding upon the legal formation of the Company on September 10, 2002 as if such shares have been outstanding for all periods presented. The Company had no diluted potential shares outstanding for all periods presented.

On September 10, 2002, the Company was incorporated with a registered share capital of RMB68,317 million divided into 68,317 million shares of RMB1.00 each. As described in Note 1, such shares were issued to China Telecommunications Corporation in consideration for the assets and liabilities of the Predecessor Operations transferred to the Company in connection with the Restructuring. Accordingly, the share capital of the Company reflecting the incorporation is as follows:

Registered: 68,317,270,803 shares of RMB1.00 each

Issued and fully paid: 68,317,270,803 shares of RMB1.00 each

23. DIRECTORS' AND SUPERVISORS' REMUNERATION

Prior to the establishment of China Telecommunications Corporation in May 2000, the Predecessor Operations were under the management of the Directorate General of Telecommunications. Accordingly, the following table sets out the remuneration paid by China

(V) NOTES TO THE FINANCIAL INFORMATION—(CONTINUED)

Telecommunications Corporation after its establishment to the Company's directors and supervisors during the relevant period:

	Years ended December 31,			Six-month periods ended June 30,	
	1999	2000	2001	2001	2002
	RMB thousand	RMB thousand	RMB thousand	RMB thousand	RMB thousand
Salaries, allowances and benefits in kind	—	629	1,602	801	1,220
Retirement benefits	—	95	145	72	86
	<u>—</u>	<u>724</u>	<u>1,747</u>	<u>873</u>	<u>1,306</u>

The number of directors and supervisors whose remuneration falls within the following band is set out below:

	Years ended December 31,			Six-month periods ended June 30,	
	1999	2000	2001	2001	2002
	Number	Number	Number	Number	Number
RMB Nil – RMB1,000,000	<u>—</u>	<u>11</u>	<u>12</u>	<u>12</u>	<u>12</u>

None of the directors and supervisors received any fees, bonuses, inducements, or compensation for loss of office, or waived any emoluments during the relevant period.

24. INDIVIDUALS WITH HIGHEST EMOLUMENTS

Of the five highest paid individuals of the Group during the relevant period, one is director of the Company and his remuneration has been included in Note 23 above. The following table sets out the emoluments of the Group's remaining four highest paid employees who were not directors or supervisors of the Company during the relevant period:

	Years ended December 31,			Six-month periods ended June 30,	
	1999	2000	2001	2001	2002
	RMB thousand	RMB thousand	RMB thousand	RMB thousand	RMB thousand
Salaries, allowances and benefits in kind	669	778	991	496	596
Retirement benefits	73	85	108	54	65
	<u>742</u>	<u>863</u>	<u>1,099</u>	<u>550</u>	<u>661</u>

The number of these employees whose emoluments fall within the following band is set out below:

	Years ended December 31,			Six-month periods ended June 30,	
	1999	2000	2001	2001	2002
	Number	Number	Number	Number	Number
RMB Nil to RMB 1,000,000	<u>4</u>	<u>4</u>	<u>4</u>	<u>4</u>	<u>4</u>

None of these employees received any inducements or compensation for loss of office, or waived any emoluments during the relevant period.

(V) NOTES TO THE FINANCIAL INFORMATION—(CONTINUED)

25. COMMITMENTS AND CONTINGENCIES

Operating lease commitments

The Group leases business premises through non-cancellable operating leases. These operating leases do not contain provisions for contingent lease rentals. None of the rental agreements contain escalation provisions that may require higher future rental payments nor impose restrictions on dividends, additional debt and/or further leasing. As at December 31, 1999, 2000 and 2001, future minimum lease payments under non-cancellable operating leases having initial or remaining lease terms of more than one year are payable in periods as follows:

	December 31,		
	1999	2000	2001
	RMB million	RMB million	RMB million
Within 1 year	185	204	334
Within 2 years	110	132	154
Within 3 years	103	100	111
Within 4 years	84	76	73
Within 5 years	62	50	52
Thereafter	298	272	316
Total minimum lease payments	<u>842</u>	<u>834</u>	<u>1,040</u>

As at June 30, 2002, future minimum lease payments under non-cancellable operating leases having initial or remaining lease terms of more than one year, which include the new lease agreements with China Telecom Group (Note 27), are payable in periods as follows:

	RMB million
2002—subsequent to June 30, 2002	314
2003	382
2004	326
2005	103
2006	68
2007	68
Thereafter	329
Total minimum lease payments	<u>1,590</u>

Total rental expense in respect of operating leases charged to the combined statements of income for the years ended December 31, 1999, 2000 and 2001 was RMB237 million, RMB312 million and RMB523 million and for the six-month periods ended June 30, 2001 and 2002 was RMB230 million and RMB433 million, respectively.

(V) NOTES TO THE FINANCIAL INFORMATION—(CONTINUED)***Capital commitments***

As at December 31, 1999, 2000 and 2001 and June 30, 2002, the Group had capital commitments as follows:

	December 31,			June 30,
	1999	2000	2001	2002
	RMB	RMB	RMB	RMB
	million	million	million	million
Authorised and contracted for				
Properties	1,107	1,158	755	811
Telecommunications plant and equipment	4,578	6,013	2,742	2,730
	<u>5,685</u>	<u>7,171</u>	<u>3,497</u>	<u>3,541</u>
Authorised but not contracted for				
Properties	1,439	1,918	1,398	1,431
Telecommunications plant and equipment	4,816	5,226	5,831	5,631
	<u>6,255</u>	<u>7,144</u>	<u>7,229</u>	<u>7,062</u>

Contingent liabilities

(a) The Company has been advised by its PRC lawyers that, except for liabilities constituting or arising out of or relating to the business transferred to the Company in the Restructuring, no other liabilities were assumed by the Company, and the Company is not jointly and severally liable for other debts and obligations incurred by China Telecom Group prior to the Restructuring.

(b) As at December 31, 1999, 2000 and 2001 and June 30, 2002, guarantees given to banks in respect of banking facilities granted to China Telecom Group and the Group's investees were RMB88 million, RMB287 million, RMB150 million and RMB263 million, respectively.

Legal contingencies

The Group is a defendant in certain lawsuits as well as the named party in other proceedings arising in the ordinary course of business. While the outcomes of such contingencies, lawsuits or other proceedings cannot be determined at present, management believes that any resulting liabilities will not have a material adverse effect on the financial position or operating results of the Group.

26. CONCENTRATION OF RISKS***Credit and concentration risks***

The carrying amounts of cash and cash equivalents, time deposits, accounts receivable and other receivables represent the Group's maximum exposure to credit risk in relation to financial assets. The majority of the Group's accounts receivable relate to provision of telecommunications services to residential and corporate customers operating in various industries. The Group performs ongoing credit evaluations of its customers' financial condition and generally does not require collateral on accounts receivable. The Group maintains an allowance for doubtful accounts and actual losses have been within management's expectations.

(V) NOTES TO THE FINANCIAL INFORMATION—(CONTINUED)

The Group has a diversified base of customers. Except for China Mobile Communications Corporation which contributed 13%, 11%, 8%, 8% and 6% of the Group's operating revenues for the years ended December 31, 1999, 2000 and 2001 and for the six-month periods ended June 30, 2001 and 2002, respectively, no single customer comprised more than 10% of revenues for the periods presented.

The Group does not have concentrations of available sources of labour, services, franchises, licences or other rights that could, if suddenly eliminated, severely impact its operations. The Group invests its cash with several large state-owned financial institutions in the PRC.

Business and economic risks

The Group conducts its principal operations in the PRC and accordingly is subject to special considerations and significant risks not typically associated with investments in equity securities of United States and Western European companies. These include risks associated with, among others, the political, economic and legal environment, social uncertainties in the PRC, influence of the MII over certain aspects of the Group's operations and competition in the telecommunications industry. In addition, the ability to negotiate and implement specific business development projects in a timely and favourable manner may be impacted by political considerations unrelated to or beyond the control of the Group. Although the PRC government has been pursuing economic reform policies for the past two decades, no assurance can be given that the PRC government will continue to pursue such policies or that such policies may not be significantly altered. There is also no guarantee that the PRC government's pursuit of economic reforms will be consistent or effective and as a result, changes in the rate or method of taxation, reduction in tariff protection and other import restrictions, and changes in State policies and regulations affecting the telecommunication industry may have a negative impact on its operating results and financial conditions.

Currency risk

Substantially all of the revenue-generating operations of the Group are transacted in RMB, which is not fully convertible into foreign currencies. On January 1, 1994, the PRC government abolished the dual rate system and introduced a single rate of exchange as quoted by the People's Bank of China. However, the unification of the exchange rate does not imply convertibility of RMB into United States dollars or other foreign currencies. All foreign exchange transactions must take place either through the People's Bank of China or other institutions authorised to buy and sell foreign exchange or at a swap centre. Approval of foreign currency payments by the People's Bank of China or other institutions requires submitting a payment application form together with suppliers' invoices, shipping documents and signed contracts.

Interest rate risk

The interest rates and terms of repayment of the Group's debts are disclosed in Note 12.

(V) NOTES TO THE FINANCIAL INFORMATION—(CONTINUED)**27. RELATED PARTY TRANSACTIONS**

Companies are considered to be related if one company has the ability, directly or indirectly, to control the other company or exercise significant influence over the other company in making financial and operating decisions. Companies are also considered to be related if they are subject to common control or common significant influence.

The Group conducts business with enterprises directly or indirectly owned or controlled by the PRC government ("state-owned enterprises"). Furthermore, the PRC government itself represents a significant customer of the Group both directly through its numerous authorities and indirectly through its numerous affiliates and other organisations. The Group considers that provision of these services to the PRC government authorities and affiliates and other state-owned enterprises are activities in the ordinary course of business and has not disclosed such services as related party transactions.

The Group is part of a larger group of companies under China Telecommunications Corporation and has significant transactions and relationships with members of China Telecommunications Corporation. Because of these relationships, it is possible that the terms of these transactions are not the same as those that would result from transactions among wholly unrelated parties. Under IFRS, state-owned enterprises, other than China Telecommunications Corporation and its affiliates, are not disclosed as related parties. Related parties refer to enterprises over which China Telecommunications Corporation is able to exercise significant influence.

The principal related party transactions with China Telecom Group, which were carried out in the ordinary course of business, are as follows:

	Note	Years ended December 31,			Six-month periods ended June 30,	
		1999	2000	2001	2001	2002
		RMB million	RMB million	RMB million	RMB million	RMB million
Purchases of telecommunication equipment and materials	(i)	2,246	2,827	2,331	1,044	87
Constructions, engineering and information technology services	(ii)	1,929	2,105	2,884	1,399	1,112
Provision of community services	(iii)	612	684	742	392	622
Provision of ancillary services	(iv)	383	544	613	267	419
Operating lease expenses	(v)	92	116	94	38	184
Centralised services expense	(vi)	—	—	—	—	339
Interconnection revenue	(vii)	—	—	—	—	151
Interconnection expense	(vii)	—	—	—	—	392

Note:

- (i) Represent purchases of telecommunication equipment and materials from China Telecom Group.
- (ii) Represent provision of network construction, engineering and information technology services to the Group by China Telecom Group.
- (iii) Represent amounts paid and payable by the Group to China Telecom Group in respect of cultural, educational, hygiene and other community services.

(V) NOTES TO THE FINANCIAL INFORMATION—(CONTINUED)

- (iv) Represent amounts paid and payable by the Group to China Telecom Group in respect of ancillary services such as repairs and maintenance of telecommunication equipment and facilities and certain customer services.
- (v) Represent amounts paid and payable to China Telecom Group for operating leases in respect of business premises and inter-provincial transmission optic fibres.
- (vi) Represent expenses associated with common corporate services and international telecommunications facilities charged by China Telecommunications Corporation to the Group.
- (vii) Represent amounts charged from/to China Telecommunications Corporation for interconnection of domestic long distance telephone calls.

The directors of the Company are of the opinion that the above transactions with related parties were conducted in the ordinary course of business and have confirmed that the above transactions will continue in the future after the global offering of the shares of the Company.

In connection with the Restructuring, the Group and China Telecom Group entered into a number of agreements effective January 1, 2002 with an initial term expiring on December 31, 2004. These agreements will impact the results of operations of the Group beginning January 1, 2002. The terms of the principal agreements are summarised as follows:

- (1) The Company has entered into an agreement with China Telecommunications Corporation pursuant to which expenses associated with common corporate services and international telecommunications facilities, will be allocated between the Group and China Telecommunications Corporation based on revenues or volume of traffic as appropriate.
- (2) The Company has entered into an agreement with China Telecommunications Corporation for interconnection of domestic long distance telephone calls. Pursuant to the interconnection agreement, the telephony operator terminating a telephone call made to its local network shall be entitled to receive a fee prescribed by the MII from the operator from which the telephone call is originated.
- (3) The Company has entered into an optic fibres leasing agreement with China Telecommunications Corporation pursuant to which the Company will lease the inter-provincial transmission optic fibres in Shanghai Municipality, Guangdong Province, Jiangsu Province and Zhejiang Province from China Telecommunications Corporation. The lease payment will be based on the depreciation charge of the optic fibres.
- (4) The Group has entered into agreements with China Telecom Group pursuant to which China Telecom Group will provide the Group with construction, design, equipment installation, testing and engineering project management services. In addition, the Group has entered into information technology service agreements with China Telecom Group pursuant to which China Telecom Group will provide the Group with certain information technology services including office automation and software modification. The amounts to be charged for these services will be determined by reference to market rates as reflected in prices obtained through a tender.

(V) NOTES TO THE FINANCIAL INFORMATION—(CONTINUED)

- (5) The Group has entered into property leasing agreements with China Telecom Group pursuant to which the Group will lease certain business premises and storage facilities from China Telecom Group. The rental charges will be based on market rates, with reference to amounts stipulated by local price bureaux.
- (6) The Group has entered into agreements with China Telecom Group pursuant to which China Telecom Group will provide the Group with the procurement of equipment and materials. The amount to be charged for this service will be based on a percentage not exceeding 1.8% of the contract value of the equipment and materials purchased.
- (7) The Group has entered into community services agreements for cultural, educational, hygiene and other community services with China Telecom Group. In addition, the Group has entered into ancillary services agreements with China Telecom Group. The ancillary services to be provided by China Telecom Group will include repairs and maintenance of telecommunication equipment and facilities and certain customer services. Pursuant to these agreements, China Telecom Group will charge the Group for these services in accordance with the following terms:
- government prescribed price;
 - where there is no government prescribed price but where there is a government guided price, the government guided price will apply;
 - where there is neither a government prescribed price nor a government guided price, the market price will apply;
 - where none of the above is available, the price is to be agreed between the relevant parties, which shall be based on the cost incurred in providing the services plus a reasonable profit margin.

Pursuant to the Restructuring, China Telecommunications Corporation has agreed to hold and maintain, for the Group's benefit, all licences received from the MII in connection with the Predecessor Operations transferred to the Group. The licences maintained by China Telecommunications Corporation were granted by the MII at nil or nominal costs. To the extent that China Telecommunications Corporation incurs a cost to maintain or obtain licences in the future, the Company will reimburse China Telecommunications Corporation for the expenses it incurs.

28. EMPLOYEE BENEFITS PLAN

As stipulated by the regulations of the PRC, the Group participates in various defined contribution retirement plans organised by municipal and provincial governments for its staff. The Group is required to make contributions to the retirement plans at rates ranging from 16.5% to 20% of the salaries, bonuses and certain allowances of its staff. A member of the plan is entitled to a pension equal to a fixed proportion of the salary prevailing at his retirement date. The Group has no other material obligation for the payment of pension benefits associated with these plans beyond the annual contributions described above. The Group's contributions for the years ended December 31, 1999, 2000 and 2001 were RMB619 million, RMB648 million and RMB849 million, and for the six-month periods ended June 30, 2001 and 2002 were RMB398 million and RMB482 million, respectively.

(V) NOTES TO THE FINANCIAL INFORMATION—(CONTINUED)**29. PRINCIPAL SUBSIDIARIES**

Details of the Group's principal subsidiaries are as follows:

<u>Name of Company</u>	<u>Date of incorporation</u>	<u>Registered capital</u> (RMB million)	<u>Direct attributable equity interest</u>	<u>Principal activities</u>
Guangdong Telecom Company Limited	October 10, 2002	47,513	100%	Provision of telecommunication services
Zhejiang Telecom Company Limited	October 10, 2002	22,400	100%	Provision of telecommunication services
Jiangsu Telecom Company Limited	October 19, 2002	19,208	100%	Provision of telecommunication services
Shanghai Telecom Company Limited	October 11, 2002	15,984	100%	Provision of telecommunication services

The above subsidiaries are established in the PRC.

30. FAIR VALUES OF FINANCIAL INSTRUMENTS

Financial assets of the Group include cash and cash equivalents, time deposits, investments, accounts receivable, amounts due from China Telecom Group, loans to associates, advances and other receivables. Financial liabilities of the Group include debts, accounts payable, amounts due to China Telecom Group, accrued expenses and other payable. The Group does not hold nor issue financial instruments for trading purposes. The Group had no positions in derivative contracts as at December 31, 1999, 2000 and 2001 and June 30, 2002.

The following disclosure of the estimated fair value of financial instruments is made in accordance with the requirements of IAS 32. Fair value estimates, methods and assumptions, set forth below for the Group's financial instruments, are made solely to comply with the requirements of IAS 32 and should be read in conjunction with the Financial Information. The estimated fair value amounts have been determined by the Group using market information and valuation methodologies considered appropriate. However, considerable judgement is required to interpret market data to develop the estimates of fair values. Accordingly, the estimates presented herein are not necessarily indicative of the amounts the Group could realise in a current market exchange. The use of different market assumptions and/or estimation methodologies may have a material effect on the estimated fair value amounts.

The following summarise the major methods and assumptions used in estimating the fair values of the Group's financial instruments.

Long-term debt: The fair values of long-term indebtedness are estimated by discounting future cash flows using current market interest rates offered to the Group for debt with substantially the same characteristics and maturities. As at December 31, 1999, 2000 and 2001

(V) NOTES TO THE FINANCIAL INFORMATION—(CONTINUED)

and June 30, 2002, the carrying amounts and fair values of the Group's long-term debt are as follows:

	December 31, 1999		December 31, 2000		December 31, 2001		June 30, 2002	
	Carrying amount	Fair value	Carrying amount	Fair value	Carrying amount	Fair value	Carrying amount	Fair value
	RMB million	RMB million	RMB million	RMB million	RMB million	RMB million	RMB million	RMB million
Long-term debt . . .	<u>15,117</u>	<u>15,751</u>	<u>13,242</u>	<u>13,658</u>	<u>10,722</u>	<u>11,160</u>	<u>9,346</u>	<u>9,628</u>

Long-term investments are unlisted equity interests and there are no quoted market prices for such interests in the PRC. Accordingly, a reasonable estimate of fair value could not be made without incurring excessive costs.

The fair values of all other financial instruments approximate their carrying amounts due to the nature or short-term maturity of these instruments.

31. DISTRIBUTABLE RESERVE

Upon legal incorporation of the Company, in accordance with the applicable requirements of the PRC Company Law, the Company may only declare dividends after the Company has made allowance for:

- recovery of losses, if any;
- allocation to the statutory common reserve funds; and
- allocation to a discretionary common reserve fund if approved by our shareholders and after allocation is made to the statutory common reserve funds.

The minimum and maximum aggregate allocations to the statutory funds are 15% and 20%, respectively, of the Company's net profit determined in accordance with the PRC accounting rules and regulations ("PRC GAAP"). Under PRC law, the Company's distributable earnings will be equal to our net profit, as determined in accordance with PRC GAAP or IFRS, whichever yields a lower figure, less allocations to the statutory and discretionary reserve funds.

Since the Company had not been legally incorporated as at June 30, 2002, there were no distributable reserves attributable to the equity owners. No dividend has been declared by the Company from the date of its incorporation to the date of this report. The payment of any future dividends will be determined by the Board of Directors.

(VI) ULTIMATE HOLDING COMPANY

The directors consider the ultimate holding company of the Company to be China Telecommunications Corporation, a state-owned enterprise established in the PRC.

(V) NOTES TO THE FINANCIAL INFORMATION—(CONTINUED)**(VII) SUBSEQUENT FINANCIAL STATEMENTS**

No audited financial statements have been prepared by the Company or any of the companies now comprising the Group in respect of any period subsequent to June 30, 2002.

Yours faithfully

KPMG
Certified Public Accountants
Hong Kong, China