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 telecommunications 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 telecommunications 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, pursuant to the authority delegated to it by the PRC's State Council, is responsible for formulating the telecommunications industry policies and regulations, including the regulation and setting of tariff levels for basic telecommunications services, such as local and long distance telephone services, managed data services, leased line and interconnection arrangements.

Organisation

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

Pursuant to the Restructuring, China Telecom transferred to the Company the wireline telecommunications 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 Telecom have a par value of RMB1.00 each and represented the entire registered and issued share capital of the Company at that date. As discussed below, certain assets historically associated with the Predecessor Operations were not transferred to the Company but were retained by China Telecom in connection with the Restructuring.

China Telecom was initially established in May 2000 to operate the PRC's nationwide wireline telecommunications 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 Telecom's wireline telecommunications networks and related operations in 10 northern provinces, municipalities and autonomous regions of the PRC were transferred to China Netcom Group. China Telecom retained the wireline telecommunications networks and related operations of 21 provinces, municipalities and autonomous regions of the PRC, including the Predecessor Operations. In accordance with this industry restructuring plan, China Telecom and China Netcom Group own 70% and 30%, respectively, of the nationwide inter-provincial optic fibres.

NOTES TO THE FINANCIAL STATEMENTS

for the year ended 31 December 2002

1. PRINCIPAL ACTIVITIES, ORGANISATION AND BASIS OF PRESENTATION (Continued)

Basis of presentation

Since China Telecom controlled the Predecessor Operations transferred to the Company before the Restructuring and continues to control the Company after the Restructuring, the accompanying financial statements have 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. For periods prior to the legal formation of the Company and its subsidiaries, the assets, liabilities, revenue and expenses of the entities comprising the Predecessor Operations were combined in preparing the financial statements.

The accompanying consolidated financial statements present the results of the Company and its subsidiaries as if the Group had been in existence throughout the years presented and as if the Predecessor Operations were transferred to the Company from China Telecom as at 1 January 2001. In addition, the consolidated financial statements for the year ended 31 December 2001 include the results related to certain assets historically associated with the Predecessor Operations that were not transferred to the Company and were retained by China Telecom in connection with the Restructuring. The assets retained by China Telecom primarily related to investments in non-telecommunications industries, inter-provincial transmission optic fibres and properties and, as at 31 December 2001, consisted of the following:

	RMB millions
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
	11,285

In preparing the consolidated financial statements, the assets and liabilities, revenues and expenses of the Predecessor Operations are reflected in the accompanying consolidated financial statements. In addition, for the year ended 31 December 2001, the consolidated financial statements have been prepared to include certain assets historically associated with the Predecessor Operations that were retained by China Telecom. As a result of the segregation and separate management of these assets by China Telecom beginning 31 December 2001, the assets retained by China Telecom have been reflected as a distribution to China Telecom in the consolidated statement of shareholders' equity as at 31 December 2001.

1. PRINCIPAL ACTIVITIES, ORGANISATION AND BASIS OF PRESENTATION (Continued)

Basis of presentation (Continued)

Management believes that all historical costs of operations have been reflected in the consolidated financial statements for the year ended 31 December 2001. 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 Telecom and its affiliates, are reflected in the consolidated financial statements. Expenses associated with corporate services provided by China Telecom (consisting primarily of corporate headquarter administrative expenses) were allocated based on revenues to companies within China Telecom, including the Predecessor Operations. The amount of corporate administrative expenses allocated to the Group for the year ended 31 December 2001 was RMB118 million. 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 year ended 31 December 2001.

2. SIGNIFICANT ACCOUNTING POLICIES

(a) Basis of preparation

The accompanying financial statements have 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. These financial statements also comply with the disclosure requirements of the Hong Kong Companies Ordinance and the applicable disclosure provisions of the Rules Governing the Listing of Securities on the Stock Exchange of Hong Kong Limited.

These financial statements are prepared on the historical cost basis as modified by the revaluation of certain property, plant and equipment (Note 3).

The preparation of the financial statements 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 statements and the reported amounts of revenues and expenses during the reporting period. Actual results could differ from those estimates. The accounting policies described below have been consistently applied by the Group.

(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.

NOTES TO THE FINANCIAL STATEMENTS

for the year ended 31 December 2002

2. SIGNIFICANT ACCOUNTING POLICIES (Continued)

(b) Basis of consolidation (Continued)

The financial results of subsidiaries are included in the consolidated financial statements 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 profit before minority interests. All significant intercompany balances and transactions and any unrealised gains/losses arising from intercompany transactions are eliminated on 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.

The consolidated statement of income includes the Group's share of the results of its associates for the period. In the consolidated balance sheet, 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 year 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 consolidated statement 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 in 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.

2. SIGNIFICANT ACCOUNTING POLICIES (Continued)

(f) Inventories

Inventories consist of materials and supplies used in maintaining the Group's wireline telecommunications 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(l)). 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 the periods of 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.

Subsequent to the revaluation carried out as at 31 December 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 the revaluation are buildings and improvements; telecommunications 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 shareholders' 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 consolidated statement 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 are 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 are performed annually on items which experience significant and volatile movements in fair value while items which experience insignificant movements in fair value are revalued every three years.

NOTES TO THE FINANCIAL STATEMENTS

for the year ended 31 December 2002

2. SIGNIFICANT ACCOUNTING POLICIES (Continued)

(g) Property, plant and equipment (Continued)

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 assets under finance leases. Assets under finance leases are initially 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. As at 31 December 2002, none of the Group's assets were held under finance leases (2001: RMB48 million).

Gains or losses arising from 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 consolidated statement of income on the date of disposal. On disposal of a revalued asset, the related revaluation surplus is transferred from the revaluation reserve to retained earnings.

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
Telecommunications network plant, transmission and switching equipment	6 to 10 years
Furniture, fixture, motor vehicles and other equipment	4 to 10 years

(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, telecommunications network plant, transmission and switching equipment and other equipment under construction and pending installation, and is stated at cost less impairment losses (Note 2(l)). 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.

2. SIGNIFICANT ACCOUNTING POLICIES (Continued)

(i) Construction in progress (Continued)

No depreciation is provided in respect of construction in progress.

(j) Investments in subsidiaries

In the Company's stand-alone balance sheet, investments in subsidiaries are accounted for using the equity method.

(k) Investments

Investments in non-marketable equity securities are stated at cost less provision for impairment losses (Note 2(l)). A provision is made where, in the opinion of management, the carrying amount of the investments exceeds its recoverable amount.

(l) 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 consolidated statement 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 consolidated statement of income.

(m) 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) usage charges for telephone services, which vary depending on the day, the time of day, distance and duration of the telephone call, (ii) a monthly telephone service fee, (iii) service activation and installation fees, and (iv) charges for value-added telecommunications 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.

(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.

2. SIGNIFICANT ACCOUNTING POLICIES (Continued)

(m) Revenue recognition (Continued)

(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 telecommunications services are recognised when the services are provided to customers.

Other related wireline telecommunications 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 telecommunications 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.

(n) Advertising and promotion expense

The costs for advertising and promoting the Group's wireline telecommunications services are expensed as incurred. Advertising and promotion expense, which is included in selling, general and administrative expenses, was RMB1,300 million for the year ended 31 December 2002 (2001: RMB1,097 million).

(o) Net financing costs

Net financing costs comprise interest income on bank deposits, interest expense on borrowings, and foreign exchange gains and losses. Interest income from bank deposits 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 takes a substantial period of time to get ready for its intended use.

2. SIGNIFICANT ACCOUNTING POLICIES (Continued)

(p) Research and development expense

Research and development expenditure is expensed as incurred. For the year ended 31 December 2002, research and development expense was RMB172 million (2001: RMB123 million).

(q) Employee benefits

The Group's contributions to defined contribution retirement plans administered by the PRC government are recognised as an expense in the consolidated statement of income. Further information is set out in Note 33.

(r) Provisions

A provision is recognised in the consolidated 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.

(s) Income tax

Income tax comprises current and deferred tax. Current tax is calculated on the taxable income for the year 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 consolidated statement of income. A deferred tax asset is recognised only to the extent that it is probable that future taxable income 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.

(t) Dividends

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

(u) 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 telecommunications services. All the Group's operating activities are carried out in the PRC.

NOTES TO THE FINANCIAL STATEMENTS

for the year ended 31 December 2002

3. PROPERTY, PLANT AND EQUIPMENT, NET

The Group:

	Buildings and improvements RMB millions	Telecommunications network plant and equipment RMB millions	Furniture, fixture, motor vehicles and other equipment RMB millions	Total RMB millions
Cost/valuation:				
Balance at 1 January 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)
Distributions to China Telecom in connection with the Restructuring	(2,865)	(2,057)	(1,130)	(6,052)
Balance at 31 December 2001	26,123	167,261	8,059	201,443
Accumulated depreciation:				
Balance at 1 January 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
Distributions to China Telecom in connection with the Restructuring	480	742	373	1,595
Balance at 31 December 2001	(2,336)	(57,979)	(2,505)	(62,820)
Net book value at 31 December 2001	23,787	109,282	5,554	138,623
Cost/valuation:				
Balance at 1 January 2002	26,123	167,261	8,059	201,443
Additions	438	1,133	356	1,927
Transferred from construction in progress	4,888	23,530	1,529	29,947
Disposals	(81)	(1,136)	(250)	(1,467)
Balance at 31 December 2002	31,368	190,788	9,694	231,850
Accumulated depreciation:				
Balance at 1 January 2002	(2,336)	(57,979)	(2,505)	(62,820)
Depreciation charge for the year	(1,188)	(18,281)	(1,413)	(20,882)
Written back on disposals	25	796	196	1,017
Balance at 31 December 2002	(3,499)	(75,464)	(3,722)	(82,685)
Net book value at 31 December 2002	27,869	115,324	5,972	149,165

3. PROPERTY, PLANT AND EQUIPMENT, NET (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 31 December 2001 were revalued 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 the property, plant and equipment was determined at RMB138,623 million. The tax base of such assets has been adjusted to the revalued amount (Note 8). The surplus on revaluation of certain property, plant and equipment totalling RMB4,154 million was credited to the revaluation reserve while the deficit arising from the revaluation of certain property, plant and equipment totalling RMB11,930 million was recognised as an expense for the year ended 31 December 2001. The reduction in the carrying amount was primarily the result of the-then market decline in the replacement cost of certain network switching equipment. The net deficit on the revaluation of the property, plant and equipment of RMB7,776 million was reflected in the consolidated balance sheet of the Group as at 31 December 2001.

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

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

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

In connection with the initial public offering of the Company's H shares, the properties of the Group as at 30 June 2002 were valued by Chesterton Petty Limited, independent qualified valuers in Hong Kong, as required by the Rules Governing the Listing of Securities on the Stock Exchange of Hong Kong Limited. The value of the properties other than land use rights was not materially different from the book carrying value as at 30 June 2002 and therefore the consolidated financial statements have not been adjusted.

NOTES TO THE FINANCIAL STATEMENTS

for the year ended 31 December 2002

4. CONSTRUCTION IN PROGRESS

	The Group	
	2002	2001
	RMB millions	RMB millions
Balance at beginning of year	**23,274**	28,656
Additions	**26,992**	32,201
Transferred to property, plant and equipment	**(29,947)**	(36,897)
Distributions to China Telecom in connection with the Restructuring	**—**	(686)
Balance at end of year	**20,319**	23,274

5. INTERESTS IN SUBSIDIARIES

	The Company
	2002
	RMB millions
Share of net assets	**114,866**

Details of the Company's subsidiaries at 31 December 2002 which principally affected the results of operations and the financial position of the Group are as follows:

Name of Company	Type of legal entity	Date of incorporation	Registered capital (RMB millions)	Direct attributable equity interest	Principal activities
Guangdong Telecom Company Limited	Limited company	10 October 2002	47,513	100%	Provision of telecommunications services
Zhejiang Telecom Company Limited	Limited company	10 October 2002	22,400	100%	Provision of telecommunications services
Jiangsu Telecom Company Limited	Limited company	19 October 2002	19,208	100%	Provision of telecommunications services
Shanghai Telecom Company Limited	Limited company	11 October 2002	15,984	100%	Provision of telecommunications services

The above subsidiaries are incorporated in the PRC.

6. INTERESTS IN ASSOCIATES

	The Group	
	2002	2001
	RMB millions	RMB millions
Share of net assets	**429**	417

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

Name of company	**Attributable equity interest**	**Principal activities**
Shenzhen Shekou Telecommunications Company Limited	50.00%	Provision of telecommunications 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.

7. INVESTMENTS

	The Group	
	2002	2001
	RMB millions	RMB millions
Unlisted equity investments	**270**	446

Unlisted equity investments mainly represent the Group's various interests in PRC private enterprises which are mainly engaged in the provision of information technology services and Internet contents. These investments are accounted for at cost, less provision for any impairment. The Group has no investments in marketable securities.

NOTES TO THE FINANCIAL STATEMENTS

for the year ended 31 December 2002

8. DEFERRED TAX ASSETS AND LIABILITIES

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

The Group:

	Assets		Liabilities		Net balance	
	2002	2001	**2002**	2001	**2002**	2001
	RMB millions	RMB millions	**RMB millions**	RMB millions	**RMB millions**	RMB millions
Current						
Provisions, primarily for accounts receivable	**99**	—	**—**	—	**99**	—
Non-current						
Property, plant and equipment	**—**	—	**(193)**	—	**(193)**	—
Deferred revenues and installation costs	**1,035**	—	**(425)**	—	**610**	—
Land use rights	**3,984**	4,059	**—**	—	**3,984**	4,059
Deferred tax assets	**5,118**	4,059	**(618)**	—	**4,500**	4,059

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 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 31 December 2001 and 2002. Based on the level of historical taxable income and projections for 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 31 December 2001 and 2002 in respect of deferred tax assets arising from temporary differences.

8. DEFERRED TAX ASSETS AND LIABILITIES (Continued)

Movements in temporary differences are as follows:

	Note	Balance at 1 January 2001 RMB millions	Recognised in statement of income RMB millions	Recognised in shareholders' equity RMB millions	Balance at 31 December 2001 RMB millions
Current					
Provisions, primarily for accounts receivable	(i)	308	(88)	(220)	—
Non-current					
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		(8,275)	3,388	8,946	4,059
			(Note 24)		

	Balance at 1 January 2002 RMB millions	Recognised in statement of income RMB millions	Balance at 31 December 2002 RMB millions
Current			
Provisions, primarily for accounts receivable	—	99	99
Non-current			
Property, plant and equipment	—	(193)	(193)
Deferred revenues and installation costs	—	610	610
Land use rights	4,059	(75)	3,984
Net deferred tax assets	4,059	441	4,500
		(Note 24)	

Note:

(i) As described in Note 3, in connection with the Restructuring, the Group's property, plant and equipment were revalued as at 31 December 2001. The tax base of these assets has been adjusted to conform to the respective revalued amount. 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 RMB4,887 million as at 31 December 2001 was reflected as a credit to shareholders' equity.

(ii) In connection with the Restructuring, the Group's land use rights, which as at 31 December 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 was determined at RMB14,939 million. The tax base of the land use rights has been adjusted to conform to such revalued amount. The land use rights were not revalued for financial reporting purposes and accordingly, a deferred tax asset of RMB4,059 million was created with a corresponding increase in shareholders' equity. Based upon the level of historical taxable income and projections of future taxable income, management believes that it is more likely than not the Group will realise the benefits of the deferred tax asset.

9. INVENTORIES

Inventories represent:

	The Group	
	2002	2001
	RMB millions	RMB millions
Materials and supplies	**911**	1,166
Goods for resale	**155**	247
	1,066	1,413

10. ACCOUNTS RECEIVABLE, NET

Accounts receivable, net, is analysed as follows:

	The Group	
	2002	2001
	RMB millions	RMB millions
Accounts receivable	**6,440**	6,121
Less: Allowance for doubtful accounts	**(479)**	(513)
	5,961	5,608

Amounts due from the provision of wireline telecommunications 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.

The following table summarises the changes in the allowance for doubtful accounts:

	The Group	
	2002	2001
	RMB millions	RMB millions
At beginning of year	**513**	661
Provision for doubtful accounts	**345**	186
Accounts receivable written off	**(379)**	(334)
At end of year	**479**	513

10. ACCOUNTS RECEIVABLE, NET (Continued)

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

	The Group	
	2002	2001
	RMB millions	RMB millions
Current, within 1 month	**5,036**	4,436
1 to 3 months	**352**	709
4 to 12 months	**309**	233
More than 12 months	**130**	255
	5,827	5,633
Less: Allowance for doubtful accounts	**(439)**	(488)
	5,388	5,145

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

	The Group	
	2002	2001
	RMB millions	RMB millions
Current, within 1 month	**363**	189
1 to 3 months	**109**	137
4 to 12 months	**85**	77
More than 12 months	**56**	85
	613	488
Less: Allowance for doubtful accounts	**(40)**	(25)
	573	463

11. PREPAYMENTS AND OTHER CURRENT ASSETS

Prepayments and other current assets represent:

	The Group		The Company
	2002	2001	**2002**
	RMB millions	RMB millions	**RMB millions**
Amounts due from China Telecom Group	**342**	970	**34**
Amounts due from subsidiaries	**—**	—	**1,493**
Prepayments in connection with construction work and equipment purchases	**376**	383	**—**
Prepaid expenses and deposits	**269**	247	**—**
Other receivables	**749**	1,152	**—**
	1,736	2,752	**1,527**

12. CASH AND CASH EQUIVALENTS

	The Group		The Company
	2002	2001	**2002**
	RMB millions	RMB millions	**RMB millions**
Cash at bank and in hand	**11,574**	3,604	**4,815**
Time deposits with maturity within three months	**4,849**	278	**4,755**
	16,423	3,882	**9,570**

13. SHORT-TERM AND LONG-TERM DEBT

Short-term debt comprises:

	The Group	
	2002	2001
	RMB millions	RMB millions
Bank loans	**19,175**	18,827

Weighted average interest rate of the Group's short-term debt as at 31 December 2002 was 4.7% (2001: 5.5%).

13. SHORT-TERM AND LONG-TERM DEBT (Continued)

Long-term debt comprises:

		The Group	
		2002	2001
	Interest rates and final maturity	**RMB millions**	RMB millions
Bank loans			
Renminbi denominated	Interest rates ranging from 4.5% to 8.0% per annum with maturities through 2006	**2,867**	6,005
US Dollars denominated	Interest rates ranging from 2.0% to 8.3% per annum with maturities through 2021	**1,582**	2,137
Japanese Yen denominated	Interest rates ranging from 2.5% to 3.5% per annum with maturities through 2022	**2,623**	2,544
		7,072	10,686
Other loans			
Renminbi denominated	Interest rate at 2.4% per annum	**—**	36
Total long-term debt		**7,072**	10,722
Less: current portion		**(2,219)**	(3,621)
Non-current portion		**4,853**	7,101

As at 31 December 2002, no bank loans were secured. As at 31 December 2001, bank loans of RMB14 million were secured by certain of the Group's property, plant and equipment. The net book value of the property, plant and equipment pledged as security amounted to RMB4 million as at 31 December 2001.

13. SHORT-TERM AND LONG-TERM DEBT (Continued)

The aggregate maturities of the Group's long-term debt subsequent to 31 December 2002 are as follows:

	The Group	
	2002	2001
	RMB millions	RMB millions
Within 1 year	**2,219**	3,621
Between 1 to 2 years	**1,196**	2,795
Between 2 to 3 years	**825**	1,306
Between 3 to 4 years	**268**	325
Between 4 to 5 years	**219**	263
Thereafter	**2,345**	2,412
	7,072	10,722

The Group's short-term and long-term debts do not contain any financial covenants. As at 31 December 2002, the Group had available credit facilities of RMB2,634 million (2001: RMB Nil) which it can draw upon.

14. ACCOUNTS PAYABLE

Accounts payable are analysed as follows:

	The Group	
	2002	2001
	RMB millions	RMB millions
Third parties	**11,505**	12,498
China Telecom Group	**2,894**	2,421
	14,399	14,919

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

14. ACCOUNTS PAYABLE (Continued)

Ageing analysis of accounts payable is as follows:

	The Group	
	2002	2001
	RMB millions	RMB millions
Due within 1 month or on demand	**1,715**	2,166
Due after 1 month but within 3 months	**2,701**	2,010
Due after 3 months but within 6 months	**3,329**	2,150
Due after 6 months	**6,654**	8,593
	14,399	14,919

15. ACCRUED EXPENSES AND OTHER PAYABLES

Accrued expenses and other payables represent:

	The Group		The Company
	2002	2001	**2002**
	RMB millions	RMB millions	**RMB millions**
Distributions payable to China Telecom	**—**	2,535	**—**
Amounts due to China Telecom Group	**1,790**	1,673	**—**
Accrued expenses	**7,884**	6,883	**570**
Customer deposits and receipts in advance	**592**	581	**—**
	10,266	11,672	**570**

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16. FINANCE LEASE OBLIGATIONS

Obligations under finance leases are analysed as follows:

	The Group	
	2002	2001
	RMB millions	RMB millions
Within 1 year	**—**	40
Between 1 to 2 years	**—**	7
Between 2 to 3 years	**—**	4
Less: finance charges related to future periods	**—**	(2)
Present value of minimum lease payments	**—**	49
Less: current portion	**—**	(38)
Non-current portion	**—**	11

17. DEFERRED REVENUES

Deferred revenues represent 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 1 July 2001, connection fees were no longer collected from new customers.

	The Group	
	2002	2001
	RMB millions	RMB millions
Balance at beginning of year	**34,508**	38,199
Additions for the year		
— connection fees	**—**	1,168
— installation fees	**1,987**	2,019
— calling cards	**5,235**	5,580
	7,222	8,767
Reduction for the year		
— amortisation of connection fees	**(6,018)**	(6,290)
— amortisation of installation fees	**(995)**	(780)
— usage of calling cards	**(5,379)**	(5,388)
Balance at end of year	**29,338**	34,508
Representing:		
— Current portion	**7,726**	8,155
— Non-current portion	**21,612**	26,353
	29,338	34,508

17. DEFERRED REVENUES (Continued)

Included in other non-current assets are capitalised direct incremental costs associated with the installation of wireline services. As at 31 December 2002, the unamortised portion of these costs was RMB5,687 million (2001: RMB5,126 million).

18. SHARE CAPITAL

	The Group and the Company	
	2002	2001
	RMB millions	RMB millions
Registered, issued and fully paid		
67,586,776,503 ordinary domestic shares of RMB 1.00 each	**67,587**	—
8,027,410,000 overseas listed H shares of RMB 1.00 each	**8,027**	—
	75,614	—

The Company was incorporated on 10 September 2002 with a registered capital of 68,317,270,803 ordinary domestic shares with a par value of RMB1.00 each. Such shares were issued to China Telecom in consideration for the assets and liabilities related to the Predecessor Operations transferred to the Company (Note 1). As part of a reform plan approved by the State Council on the administration of rural telecommunication services, China Telecom transferred a portion of its shareholdings in the Company to certain state-owned enterprises ("Other Domestic Shareholders") owned and controlled by the provincial governments in each of Guangdong Province, Jiangsu Province and Zhejiang Province.

Pursuant to the resolutions passed at an extraordinary general meeting held on 4 November 2002 and approvals from relevant government authorities, the Company was authorised to increase its share capital to a maximum of 76,216 million shares with a par value of RMB1.00 each and offer not more than 7,899 million of such shares to investors outside the PRC. China Telecom and the Other Domestic Shareholders were authorised to offer not more than 791 million shares in aggregate of their shareholdings in the Company to investors outside the PRC. The shares sold by China Telecom and the Other Domestic Shareholders to investors outside the PRC would be converted into H shares.

In November 2002, the Company issued 6,868,767,600 H shares with a par value of RMB1.00 each, representing 377,820,000 H shares and 64,909,476 American Depositary Shares ("ADSs", each representing 100 H shares), at prices of HK$1.47 per H share and US$18.98 per ADS, respectively, by way of a global initial public offering to Hong Kong and overseas investors. As part of the global initial public offering, 687,632,400 ordinary domestic shares of RMB1.00 each owned by China Telecom and the Other Domestic Shareholders were converted into H shares and sold to Hong Kong and overseas investors.

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18. SHARE CAPITAL (Continued)

In December 2002, the Company issued 428,148,100 H shares with a par value of RMB1.00 each, representing 4,281,481 ADSs at US$18.98 per ADS to overseas investors upon exercise of an over-allotment option granted to the underwriters in connection with the global initial public offering. In addition, 42,861,900 ordinary domestic shares of RMB1.00 each owned by China Telecom and the Other Domestic Shareholders were converted into H shares and sold to overseas investors.

All ordinary domestic shares and H shares rank pari passu in all material respects.

19. RESERVES

The Group	Capital reserve RMB millions	Share premium RMB millions	Revaluation reserve RMB millions	Surplus reserves RMB millions	Statutory common welfare fund RMB millions	Other reserves RMB millions	Retained earnings RMB millions	Total RMB millions
Balance as at 1 January 2001	—	—	—	—	—	—	101,619	101,619
Net profit	—	—	—	—	—	—	6,883	6,883
Contributions from China Telecom	—	—	—	—	—	—	3,003	3,003
Distributions to China Telecom	—	—	—	—	—	—	(15,835)	(15,835)
Assets distributed to China Telecom in connection with the Restructuring (Note 1)	—	—	—	—	—	—	(11,285)	(11,285)
Revaluation surplus (Note 3)	—	—	4,154	—	—	—	—	4,154
Recognition of deferred tax assets (Note 8)	—	—	—	—	—	4,059	—	4,059
Elimination of net deferred tax liabilities (Note 8)	—	—	—	—	—	—	4,887	4,887
Balance as at 31 December 2001	—	—	4,154	—	—	4,059	89,272	97,485
Capitalisation as share capital upon incorporation of the Company (Note (i))	20,955	—	—	—	—	—	(89,272)	(68,317)
Issue of shares, net of issuing expenses of RMB796 million	—	3,362	—	—	—	—	—	3,362
Net profit	—	—	—	—	—	—	16,864	16,864
Appropriations (Notes (ii) and (iii))	—	—	—	8,121	1,624	—	(9,745)	—
Revaluation surplus realised	—	—	(10)	—	—	—	10	—
Deferred tax on amortisation of land use rights realised	—	—	—	—	—	(75)	75	—
Balance as at 31 December 2002	20,955	3,362	4,144	8,121	1,624	3,984	7,204	49,394

19. RESERVES (Continued)

The Company	Capital reserve RMB millions	Share premium RMB millions	Revaluation reserve RMB millions	Surplus reserves RMB millions	Statutory common welfare fund RMB millions	Other reserves RMB millions	Retained earnings RMB millions	Total RMB millions
Capitalisation as share capital upon incorporation of the Company (Note (i))	20,955	—	4,154	—	—	4,059	—	29,168
Issue of shares, net of issuing expenses of RMB796 million	—	3,362	—	—	—	—	—	3,362
Net profit	—	—	—	—	—	—	16,864	16,864
Appropriations (Notes (ii) and (iii))	—	—	—	8,121	1,624	—	(9,745)	—
Revaluation surplus realised	—	—	(10)	—	—	—	10	—
Deferred tax on amortisation of land use rights realised	—	—	—	—	—	(75)	75	—
Balance as at 31 December 2002	20,955	3,362	4,144	8,121	1,624	3,984	7,204	49,394

Note:

(i) The amount of RMB68,317 million represents the par value of shares issued to China Telecom upon incorporation of the Company.

(ii) According to the Company's Articles of Association, the Company is required to transfer 10% of its net profit, as determined in accordance with the PRC accounting rules and regulations, to a statutory surplus reserve until such reserve balance reaches 50% of the registered capital. The transfer to this reserve must be made before distribution of any dividend to shareholders. For the year ended 31 December 2002, the Company transferred RMB1,624 million, being 10% of the year's net profit determined in accordance with PRC accounting rules and regulations, to this reserve.

According to the Company's Articles of Association, the Directors authorised, subject to shareholders' approval, the transfer of RMB6,497 million, being 40% of the year's net profit determined in accordance with PRC accounting rules and regulations, to a discretionary surplus reserve.

The surplus reserves are non-distributable other than liquidation and can be used to make good of previous years' losses, if any, and may be utilised for business expansion or converted into share capital by issuing new shares to existing shareholders in proportion to their shareholdings or by increasing the par value of the shares currently held by them, provided that the remaining reserve balance after such issue is not less than 25% of the registered capital.

(iii) According to the Company's Articles of Association, the Company is required to transfer 5% to 10% of its net profit, as determined in accordance with the PRC accounting rules and regulations, to a statutory common welfare fund. This fund can only be utilised on capital items for the collective benefits of the Company's employees such as construction of dormitories, canteen and other staff welfare facilities. This fund is non-distributable other than on liquidation. The transfer to this fund must be made before distribution of any dividend to shareholders. For the year ended 31 December 2002, the Directors authorised, subject to shareholders' approval, the transfer of RMB1,624 million, being 10% of the year's net profit determined in accordance with the PRC accounting rules and regulations, to this fund.

NOTES TO THE FINANCIAL STATEMENTS

for the year ended 31 December 2002

19. RESERVES (Continued)

(iv) According to the Company's Articles of Association, the amount of retained earnings available for distribution to shareholders of the Company is the lower of the amount determined in accordance with the PRC accounting rules and regulations and the amount determined in accordance with IFRS. At 31 December 2002, the amount of retained earnings available for distribution was RMB6,497 million, being the amount determined in accordance with the PRC accounting rules and regulations. Final dividend of RMB672 million in respect of the financial year 2002 proposed after the balance sheet date has not been recognised as a liability at the balance sheet date (Note 28).

20. 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:

		The Group	
		2002	2001
	Note	**RMB millions**	RMB millions
Upfront connection fees	(i)	**6,018**	6,290
Upfront installation fees	(ii)	**995**	780
Monthly fees	(iii)	**12,460**	10,186
Local usage fees	(iv)	**22,392**	21,004
DLD	(iv)	**14,365**	14,676
ILD	(iv)	**3,285**	3,392
Internet	(v)	**3,775**	2,150
Managed data	(vi)	**1,789**	1,477
Interconnections	(vii)	**4,363**	3,814
Leased line	(viii)	**3,095**	2,862
Others	(ix)	**2,959**	1,915
		75,496	68,546

Note:

(i) Represent the amortised amount of the upfront fees received for 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.

20. OPERATING REVENUES (Continued)

(vii) Represent amounts charged to domestic and foreign telecommunications operators for delivery of calls connecting to the Group's wireline telecommunications networks.

(viii) Represent lease income from other domestic telecommunications operators and business customers for the usage of the Group's wireline telecommunications 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 telecommunications services to customers, sale and repairs and maintenance of customer-end equipment.

21. OTHER OPERATING EXPENSES

Other operating expenses consist of:

		The Group	
		2002	2001
	Note	**RMB millions**	RMB millions
Interconnection charges	(i)	**2,608**	1,290
Donations		**23**	26
Others		**6**	11
		2,637	1,327

Note:

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

22. TOTAL OPERATING EXPENSES

Total operating expenses for the year ended 31 December 2002 include personnel expenses of RMB8,915 million (2001: RMB6,207 million) and auditors' remuneration of RMB19 million (2001: RMB Nil).

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for the year ended 31 December 2002

23. NET FINANCE COSTS/(INCOME)

Net finance costs/(income) comprise:

	The Group	
	2002	2001
	RMB millions	RMB millions
Interest expense incurred	**1,321**	1,415
Less: Interest expense capitalised*	**(770)**	(1,032)
Net interest expense	**551**	383
Interest income	**(140)**	(246)
Foreign exchange losses	**228**	3
Foreign exchange gains	**(7)**	(433)
	632	(293)
* Interest expense was capitalised in construction in progress at the following rates per annum	**4.4% to 5.6%**	5.1% to 5.8%

24. TAXATION

Taxation in the consolidated statement of income comprises:

	The Group	
	2002	2001
	RMB millions	RMB millions
Provision for PRC income tax	**4,296**	3,319
Deferred taxation (Note 8)	**(441)**	(3,388)
	3,855	(69)

24. TAXATION (Continued)

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

		The Group	
		2002	2001
	Note	**RMB millions**	RMB millions
Profit before taxation and minority interests		**20,785**	6,793
Expected PRC income tax expense at statutory tax rate of 33%	(i)	**6,859**	2,242
Differential tax rate on subsidiaries' income	(i)	**(708)**	(506)
Non-deductible expenses		**542**	436
Non-taxable income	(ii)	**(2,838)**	(2,241)
Income tax		**3,855**	(69)

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, except for certain subsidiaries of the Company which are taxed at a preferential rate of 15%.

(ii) Amounts primarily represent connection fees and certain usage fees on phone calls received from customers which are not subject to income tax.

25. DIRECTORS' AND SUPERVISORS' REMUNERATION

The following table sets out the remuneration received or receivable by the Company's directors and supervisors during the periods presented:

	2002	2001
	RMB thousand	RMB thousand
Fees	**127**	—
Salaries, allowances and benefits in kind	**3,148**	1,602
Retirement benefits	**211**	145
	3,486	1,747

NOTES TO THE FINANCIAL STATEMENTS

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25. DIRECTORS' AND SUPERVISORS' REMUNERATION (Continued)

Included in the directors' and supervisors' remuneration were fees of RMB127,000 (2001: RMB Nil) paid or payable to the independent non-executive directors and independent supervisors for the year ended 31 December 2002.

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

	2002 Number	2001 Number
HK$ equivalent		
Nil–1,000,000	**16**	12

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

26. INDIVIDUALS WITH HIGHEST EMOLUMENTS

Of the five highest paid individuals of the Group during the periods presented, one is a director of the Company and his remuneration has been included in Note 25 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 periods presented:

	2002 RMB thousand	2001 RMB thousand
Salaries, allowances and benefits in kind	**1,614**	991
Retirement benefits	**110**	108
	1,724	1,099

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

	2002 Number	2001 Number
HK$ equivalent		
Nil–1,000,000	**4**	4

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

27. PROFIT ATTRIBUTABLE TO SHAREHOLDERS

The profit attributable to shareholders includes a profit of RMB16,864 million which has been dealt with in the stand-alone financial statements of the Company.

28. DIVIDENDS

Pursuant to a resolution passed at the Directors' meeting on 24 April 2003, a final dividend of RMB0.00888 per share totalling RMB672 million was proposed for shareholders' approval at the Annual General Meeting. The dividend has not been provided for in the financial statements for the year ended 31 December 2002.

29. BASIC EARNINGS PER SHARE

The calculation of basic earnings per share is based on the net profit of RMB16,864 million (2001: RMB6,883 million) and the weighted average number of shares in issue during the year of 69,241,674,942 (2001: 68,317,270,803), as if the 68,317,270,803 shares issued and outstanding upon the legal formation of the Company on 10 September 2002 had been outstanding for all periods presented. The weighted average number of shares for the year ended 31 December 2002 also reflects the issuance of 7,296,915,700 shares in 2002 in connection with the Company's global initial public offering (Note 18).

The amount of diluted earnings per share is not presented as there were no dilutive potential ordinary shares in existence for both years.

30. 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.

30. COMMITMENTS AND CONTINGENCIES (Continued)

Operating lease commitments (Continued)

As at 31 December 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 32), were as follows:

	The Group	
	2002	2001
	RMB millions	RMB millions
Within 1 year	**457**	334
Between 1 to 2 years	**355**	154
Between 2 to 3 years	**114**	111
Between 3 to 4 years	**75**	73
Between 4 to 5 years	**70**	52
Thereafter	**367**	316
Total minimum lease payments	**1,438**	1,040

Total rental expense in respect of operating leases charged to the consolidated statement of income for the year ended 31 December 2002 was RMB807 million (2001: RMB523 million).

Capital commitments

As at 31 December 2002, the Group had capital commitments as follows:

	The Group	
	2002	2001
	RMB millions	RMB millions
Authorised and contracted for		
Properties	**800**	755
Telecommunications network plant and equipment	**3,439**	2,742
	4,239	3,497
Authorised but not contracted for		
Properties	**1,359**	1,398
Telecommunications network plant and equipment	**3,640**	5,831
	4,999	7,229

30. COMMITMENTS AND CONTINGENCIES (Continued)

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 31 December 2002, the undiscounted maximum amount of potential future payments under guarantees given to banks in respect of banking facilities granted to the parties below were as follows:

	The Group		**The Company**
	2002	2001	**2002**
	RMB millions	RMB millions	**RMB millions**
China Telecom Group and the Group's investees	**6**	150	**—**
Subsidiaries	**—**	—	**2,869**
	6	150	**2,869**

The Group monitors the conditions that are subject to the guarantees to identify whether it is probable that a loss has occurred, and recognise any such losses under guarantees when those losses can be estimated. At 31 December 2001 and 2002, it was not probable that the Group would be required to make payments under these guarantees. Thus no liability was accrued for losses related to the Group's obligations under these guarantee arrangements.

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.

31. 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.

The Group has a diversified base of customers. No single customer contributed more than 10% of revenues for the periods presented.

The Group does not have concentrations of available sources of labour, services, franchises, licenses 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 and international financial institutions.

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, legal environment and social uncertainties in the PRC, influence of the Ministry of Information Industry 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 telecommunications industry may have a negative impact on the Group's operating results and financial condition.

31. CONCENTRATION OF RISKS (Continued)

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 1 January 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 center. 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 13.

32. 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 the provision of wireline telecommunications services to the PRC government authorities and affiliates and other state-owned enterprises are activities in the ordinary course of business in the PRC and has not disclosed such services as related party transactions.

The Group is part of a larger group of companies under China Telecom and has significant transactions and relationships with members of China Telecom. 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 Telecom and its affiliates, are not disclosed as related parties. Related parties refer to enterprises over which China Telecom is able to exercise control or significant influence.

32. RELATED PARTY TRANSACTIONS (Continued)

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

	Note	**2002** **RMB millions**	2001 RMB millions
Purchases of telecommunications equipment and materials	(i)	**78**	2,331
Construction, engineering and information technology services	(ii)	**3,394**	2,884
Provision of community services	(iii)	**1,291**	742
Provision of ancillary services	(iv)	**1,219**	613
Operating lease expenses	(v)	**368**	94
Centralised service expenses	(vi)	**483**	—
Interconnection revenues	(vii)	**302**	—
Interconnection charges	(vii)	**687**	—

Note:

(i) Represent purchases of telecommunications 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.

(iv) Represent amounts paid and payable by the Group to China Telecom Group in respect of ancillary services such as repairs and maintenance of telecommunications 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 net amount charged by China Telecom to the Group for costs associated with common corporate services and international telecommunications facilities.

(vii) Represent amounts charged from/to China Telecom 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 on normal commercial terms or in accordance with the agreements governing such transactions, and this has been confirmed by the independent non-executive directors.

32. RELATED PARTY TRANSACTIONS (Continued)

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

(1) The Company has entered into an agreement with China Telecom pursuant to which expenses associated with common corporate services and international telecommunications facilities will be allocated between the Group and China Telecom based on revenues or volume of traffic as appropriate.

(2) The Company has entered into an agreement with China Telecom 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 Ministry of Information Industry from the operator from which the telephone call is originated.

(3) The Company has entered into an optic fibre leasing agreement with China Telecom 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 Telecom. 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.

(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 bureaus.

(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.

32. RELATED PARTY TRANSACTIONS (Continued)

(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 telecommunications 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 Telecom has agreed to hold and maintain, for the Group's benefit, all licenses received from the Ministry of Information Industry in connection with the Predecessor Operations transferred to the Group. The licenses maintained by China Telecom were granted by the Ministry of Information Industry at zero or nominal cost. To the extent that China Telecom incurs a cost to maintain or obtain licenses in the future, the Company will reimburse China Telecom for the expenses it incurs.

33. 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 employees. The Group is required to make contributions to the retirement plans at rates ranging from 18% to 20% of the salaries, bonuses and certain allowances of the employees. A member of the plan is entitled to a pension equal to a fixed proportion of the salary prevailing at the member's 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 year ended 31 December 2002 were RMB999 million (2001: RMB849 million).

34. 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, advances and other receivables. Financial liabilities of the Group include debts, accounts payable, amounts due to China Telecom Group, accrued expenses and other payables. The Group does not hold nor issue financial instruments for trading purposes.

The following disclosure of the estimated fair value of financial instruments is made in accordance with the requirements of IAS 32 and IAS 39. Fair value estimates, methods and assumptions, set forth below for the Group's financial instruments, are made to comply with the requirements of IAS 32 and IAS 39, and should be read in conjunction with the Group's consolidated financial statements and related notes. 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 summarises 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 31 December 2002 and 2001, the carrying amounts and fair values of the Group's long-term debt were as follows:

	2002		2001	
	Carrying amount RMB millions	**Fair value RMB millions**	Carrying amount RMB millions	Fair value RMB millions
Long-term debt	**7,072**	**7,368**	10,722	11,160

The Group's 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 their fair values could not be made without incurring excessive costs.

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

35. ULTIMATE HOLDING COMPANY

The directors consider the ultimate holding company of the Group at 31 December 2002 to be China Telecommunications Corporation, a state-owned enterprise established in the PRC.