Hillenbrand, Inc.
Form 10-Q
February 02, 2011

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UNITED STATES
SECURITIES AND EXCHANGE COMMISSION
Washington, D.C. 20549
FORM 10-Q

Quarterly Report Pursuant to Section 13 or 15(d) of
the Securities Exchange Act of 1934
For the quarterly period ended December 31, 2010
Commission File No. 001-33794
HILLENBRAND, INC.
(Exact name of registrant as specified in its charter)

Indiana	**26-1342272**
(State or other jurisdiction of incorporation or organization)	(I.R.S. Employer Identification No)
One Batesville Boulevard **Batesville, IN**	**47006**
(Address of principal executive offices)	(Zip Code)

(812) 934-7500
(Registrant s telephone number, including area code)
Not Applicable
(Former name, former address and former fiscal year if changed since last report)

Indicate by check mark whether the registrant (1) has filed all reports required to be filed by Section 13 or 15(d) of the Securities Exchange Act of 1934 during the preceding 12 months (or for such shorter period that the registrant was required to file such reports), and (2) has been subject to such filing requirements for the past 90 days.

Yes þ No o

Indicate by check mark whether the registrant has submitted electronically and posted on its corporate Web site, if any, every Interactive Data File required to be submitted and posted pursuant to Rule 405 of Regulation S-T during the preceding 12 months (or for such shorter period that the registrant was required to submit and post such files).

Yes þ No o

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

Large accelerated filer þ	Accelerated filer o	Non-accelerated filer o	Smaller reporting company o

Indicate by check mark whether the registrant is a shell Company (as defined in Rule 12b-2 of the Exchange Act).

Yes o No þ

Indicate the number of shares outstanding of each of the issuer s classes of common stock, as of the latest practicable date.

Common Stock, without par value 62,646,910 shares as of January 28, 2011.

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PART I FINANCIAL INFORMATION

Item 1. FINANCIAL STATEMENTS

Hillenbrand, Inc.

Consolidated Statements of Income (Unaudited)

(in millions, except per share data)

	Three Months Ended December 31, 2010	Three Months Ended December 31, 2009
Net revenues	$ 211.0	$ 161.5
Cost of goods sold	119.8	89.5
Gross profit	91.2	72.0
Operating expenses (including business acquisition costs)	49.1	30.9
Operating profit	42.1	41.1
Interest expense	(2.8)	(0.2)
Investment income and other	3.0	3.7
Income before income taxes	42.3	44.6
Income tax expense	15.2	15.1
Net income	$ 27.1	$ 29.5
Income per common share basic and diluted	$ 0.44	$ 0.48
Weighted average common shares outstanding basic and diluted	62.0	61.8
Cash dividends per common share	$ 0.1900	$ 0.1875

See Notes to Consolidated Financial Statements

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Hillenbrand, Inc.
Consolidated Balance Sheets (Unaudited)
(in millions)

	December 31, 2010	September 30, 2010
ASSETS		
Current Assets		
Cash and cash equivalents	$ 136.0	$ 98.4
Trade receivables, net	114.5	109.0
Inventories, net	68.3	64.9
Interest receivable from Forethought	10.0	10.0
Deferred income taxes	25.0	25.1
Other current assets	7.4	15.4
Total current assets	361.2	322.8
Property, net	108.7	109.6
Intangible assets, net	425.2	423.0
Auction rate securities	12.3	11.9
Note and long-term interest receivable from Forethought	137.6	134.8
Investments	17.3	18.2
Other assets	32.1	31.8
Total Assets	$ 1,094.4	$ 1,052.1
LIABILITIES		
Current Liabilities		
Trade accounts payable	$ 22.4	$ 26.9
Accrued compensation	20.1	35.7
Accrued customer rebates and advances	29.0	27.1
Other current liabilities	40.1	28.3
Total current liabilities	111.6	118.0
Long-term debt	423.4	403.4
Accrued pension and long-term postretirement healthcare	89.2	88.7
Deferred income taxes	35.2	35.7
Other long-term liabilities	34.5	34.4
Total Liabilities	693.9	680.2
Commitments and contingencies		
SHAREHOLDERS EQUITY		
Common stock, no par value, 63.4 and 63.1 shares issued, 62.6 and 62.3 shares outstanding, of which 0.9 and 0.6 are restricted at December 31, 2010 and September 30, 2010		

Additional paid-in-capital		307.3		304.9
Retained earnings		139.9		124.8
Treasury stock, at cost; 0.8 shares at December 31, 2010 and September 30, 2010		(14.5)		(14.8)
Accumulated other comprehensive loss		(32.2)		(43.0)
Total Shareholders Equity		400.5		371.9
Total Liabilities and Shareholders Equity	$	1,094.4	$	1,052.1

See Notes to Consolidated Financial Statements

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Hillenbrand, Inc.
Consolidated Statements of Cash Flows (Unaudited)
(in millions)

	Three Months Ended December 31, 2010	2009
Operating Activities		
Net income	$ 27.1	$ 29.5
Adjustments to reconcile net income to cash provided by operating activities:		
Depreciation and amortization	8.7	4.5
Deferred income taxes	(1.5)	(3.0)
Net gain on auction rate securities, related put right, and investments		(0.2)
Interest income on Forethought note	(2.8)	(3.3)
Equity in net income from affiliates	(0.6)	(0.1)
Stock-based compensation	2.5	2.1
Trade accounts receivable	(4.6)	(3.0)
Inventories	(2.9)	
Other current assets	2.6	(4.4)
Trade accounts payable	(4.9)	3.9
Accrued expenses and other current liabilities	(11.9)	(3.6)
Income taxes prepaid or payable	14.9	12.1
Defined benefit plan funding	(0.6)	(0.4)
Defined benefit plan expense	2.2	2.2
Other, net	(0.4)	0.1
Net cash provided by operating activities	27.8	36.4
Investing Activities		
Capital expenditures	(3.5)	(3.0)
Proceeds from redemption and sales of auction rate securities and investments	0.2	6.2
Capital contributions to affiliates	(0.2)	(0.2)
Return of investment capital from affiliates	1.7	0.9
Net cash (used in) provided by investing activities	(1.8)	3.9
Financing Activities		
Proceeds from revolving credit facilities	20.0	25.0
Repayments on revolving credit facilities		(85.0)
Payment of dividends on common stock	(11.7)	(11.5)
Proceeds from issuance of common stock		0.2
Financing costs and other		(0.2)
Net cash provided by (used in) financing activities	8.3	(71.5)
Effect of exchange rates on cash and cash equivalents	3.3	0.1

Net cash flows		37.6		(31.1)
Cash and cash equivalents				
At beginning of period		98.4		35.2
At end of period	$	136.0	$	4.1

See Notes to Consolidated Financial Statements

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Hillenbrand, Inc.
Notes to Consolidated Financial Statements (Unaudited)
(in millions, except share and per share data)

1. Background and Basis of Presentation

Hillenbrand, Inc. (Hillenbrand or the Company) is the parent holding company of its wholly owned subsidiaries, Batesville Services, Inc. (Batesville) and K-Tron International, Inc. (K-Tron).

Through Batesville, we are the leader in the North American death care products industry where we manufacture, distribute, and sell funeral service products to licensed funeral directors who operate licensed funeral homes. Our Batesville-branded products consist primarily of burial caskets but also include cremation caskets, containers and urns, selection room display fixturing for funeral homes, and other personalization and memorialization products and services, including web based applications and the creation and hosting of websites for licensed funeral homes.

Through K-Tron, we design, produce, market, and service bulk solids material handling equipment and systems for a wide variety of industrial markets, particularly in the plastics, food, chemical, pharmaceutical, power generation, coal mining, pulp and paper, wood and forest products, and biomass energy generation industries.

The accompanying unaudited consolidated financial statements include the accounts of Hillenbrand, Inc. and its wholly owned subsidiaries. These unaudited financial statements have been prepared pursuant to the rules and regulations of the Securities and Exchange Commission (SEC) for interim financial statements and therefore do not include all information required in accordance with accounting principles generally accepted in the U.S. (U.S. GAAP). The unaudited consolidated financial statements have been prepared on the same basis as the consolidated financial statements as of and for the fiscal year ended September 30, 2010. Certain prior period balances have been reclassified to conform to our current presentation. In the opinion of management, these financial statements reflect all normal and recurring adjustments considered necessary to present fairly the Company s consolidated financial position and the consolidated results of our operations and our cash flows as of the dates and for the periods presented.

The preparation of financial statements in conformity with U.S. GAAP requires us to make estimates and assumptions that affect the reported amounts of certain assets and liabilities and disclosures of contingent assets and liabilities as of the dates presented. Actual results could differ from those estimates. Examples of such estimates include, but are not limited to, the collectability of our note receivable from Forethought Financial Group, Inc. (Forethought); the establishment of reserves related to our customer rebates, allowance for doubtful accounts, warranties, early pay discounts, inventories, income taxes, accrued litigation, and self-insurance reserves; the estimation of progress towards performance criteria under our incentive compensation programs; and the estimation of fair value associated with our auction rate securities (ARS).

2. Summary of Significant Accounting Policies

The accounting policies used in preparing these financial statements are consistent with the accounting policies as described in our Annual Report on Form 10-K for the fiscal year ended September 30, 2010. The following represent additions and changes to our significant accounting policies as described in our previously filed Form 10-K.

Recently Adopted Accounting Standards

On December 31, 2010, we adopted the Financial Accounting Standards Board s (FASB s) accounting standard update 2010-20, *Disclosures about the Credit Quality of Financing Receivables and the Allowance for Credit*

Losses. The standard requires companies to provide additional disclosures about the credit quality of their financing receivables and the credit reserves held against them. The disclosure requirements of this standard are included in Note 5.

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3. Business Acquisitions

K-Tron Acquisition

The unaudited financial information in the table below summarizes the combined results of operations for the Company, including K-Tron, for the three months ended December 31, 2009, on a pro forma basis, as though the companies were combined as of the beginning of the period presented. The pro forma financial information is presented for informational purposes only and may not be indicative of the results of operations if the acquisition had actually taken place at the beginning of the period presented and should not be considered representative of our future consolidated results of operations. The pro forma financial information for the three months ended December 31, 2009, includes adjustments for additional interest expense (assuming we would have been able to borrow $375.0 at October 1, 2009) and additional depreciation and amortization expense (associated with fair value adjustments to property and intangible assets), and excludes $2.8 of business acquisition costs and the non-recurring effects of fair value adjustments to inventory and backlog, all net of estimated income tax effects. See Note 17 for further information regarding K-Tron s financial contribution to our consolidated financial results.

		Three Months Ended December 31, 2009
Pro forma net revenues	$	205.2
Pro forma net income		33.3
Pro forma diluted earnings per share		0.54

4. Supplemental Balance Sheet Information

		December 31, 2010		September 30, 2010
Trade accounts receivable reserves	$	20.3	$	20.1
Inventories:				
Raw materials and components	$	28.5	$	26.6
Work in process		7.2		6.7
Finished products		35.8		34.8
Reserves for excess or obsolescence		(3.2)		(3.2)
Total inventories	$	68.3	$	64.9
Accumulated depreciation on property	$	244.2	$	239.7
Accumulated amortization of intangible assets	$	38.3	$	36.0

5. Financing Receivables and Allowances for Credit Losses

In accordance with accounting standard update 2010-20, *Disclosures about the Credit Quality of Financing Receivables and the Allowance for Credit Losses*, Hillenbrand has two types of financing instruments that require quarterly disclosure: our Forethought note and our notes receivable from customers. We have no significant changes to report to the disclosures regarding the Forethought note contained in our previously filed Form 10-K for the year ended September 30, 2010.

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As of December 31, 2010, we had $7.8 of notes receivable from customers representing long-term payment plans that were negotiated to settle unpaid balances. These notes generally carry repayment terms up to five years at a weighted average interest rate of 6.5%. The current portion of these notes, $4.3, is included in trade receivables and the long-term portion, $3.5, is included in other assets in the consolidated balance sheets. We evaluate the recoverability of notes receivable and record allowances thereon based upon historical experience and individual customer collection experience. Of our $7.8 notes receivable, $7.1 was current and $0.7 was over 31 days past due as of December 31, 2010. Accordingly, we established $0.4 of reserves to address potential collectability as of December 31, 2010. Each quarter we perform a detailed review of all notes upon which a reserve was established to determine whether any amounts should be charged off.

6. Auction Rate Securities

	A	B	C
Balance at September 30, 2010	$ 11.9	$	$
Change in fair value	0.5	(0.5)	
Purchases			
Sales and redemptions	(0.1)		
Balance at December 31, 2010	$ 12.3	$ (0.5)	$

A Auction rate securities available for sale, at fair value

B Amount included in accumulated other comprehensive loss (pre-tax)

C (Gain) loss included in investment income (loss) and other (pre-tax)

See Note 16 for information related to the determination of fair value. See Note 18 for information regarding a subsequent event.

7. Financing Agreements

Borrowings under our financing agreements included:

	December 31, 2010	September 30, 2010
$400 revolving credit facility	$ 275.0	$ 255.0
$150 senior unsecured notes, due July 15, 2020, net of discount	148.4	148.4
Total long-term debt	$ 423.4	$ 403.4

$400 Revolving Credit Facility

As of December 31, 2010, we (i) had $6.9 outstanding undrawn letters of credit under the facility, (ii) were in compliance with all covenants set forth in the credit agreement, and (iii) had $118.1 of remaining borrowing capacity available under the facility. Under our Distribution Agreement with Hill-Rom, our ability to borrow against the facility for certain strategic transactions such as acquisitions may be limited. The term of the revolving credit facility expires in March 2013. During the three-month periods ended December 31, 2010 and 2009, the applicable weighted average interest rates were 0.7%.

Our Swiss location maintains $19.2 local credit facilities secured by cash or real property. As of December 31, 2010, there were no borrowings under these facilities and availability was reduced by $4.1 for outstanding bank guarantees. We had additional outstanding letters of credit and bank guarantees with other financial institutions totaling $3.6 and $0.3 of restricted cash at December 31, 2010.

$150 Senior Unsecured Notes

On July 9, 2010, we issued and sold $150.0 fixed-rate senior unsecured notes due July 15, 2020 (the Notes). The Notes bear interest at a fixed rate of 5.5%, payable semi-annually in arrears commencing on January 15, 2011. The Notes were issued at an original issue discount of $1.6, which is being amortized into interest expense over the term of the Notes using the effective interest rate method, resulting in an annual interest rate of 5.65%. Deferred financing costs associated with the Notes of $2.1 are being amortized to interest expense on a straight-line basis over the term of the Notes.

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8. Retirement and Postemployment Benefits

Defined Benefit Plans

Components of net pension costs were:

	Three Months Ended December 31, 2010	Three Months Ended December 31, 2009
Service costs	$ 1.3	$ 1.1
Interest costs	3.2	3.1
Expected return on plan assets	(3.8)	(3.3)
Amortization of unrecognized prior service costs, net	0.2	0.2
Amortization of net loss	1.0	0.8
Net pension costs	$ 1.9	$ 1.9

The net postretirement healthcare costs recorded during the three months ended December 31, 2010 and 2009 were $0.3 and $0.3.

Defined Contribution Plans

For the three months ended December 31, 2010 and 2009, expenses related to our defined contribution plans were $1.6 and $1.2.

9. Income Taxes

The effective tax rates for the three months ended December 31, 2010 and 2009 were 35.9% and 33.9%. The increase in the December 31, 2010 effective tax rate was primarily attributable to a favorable adjustment of $0.6 recorded in the prior year as a result of periodic reconciliation of our income tax accounts to filed income tax returns.

The activity within our reserve for unrecognized tax benefits was:

Balance at September 30, 2010	$ 7.2
Additions for current-year tax positions	0.1
Balance at December 31, 2010	$ 7.3
Other amounts accrued at December 31, 2010 for interest and penalties	$ 1.5

10. Income per Common Share

At December 31, 2010 and 2009, potential dilutive effects of our time-based restricted stock units and stock option awards, representing approximately 2.2 million and 1.7 million common shares, were excluded from income per common share as their effects were anti-dilutive. The dilutive effects of our performance-based stock awards will be included in diluted net income per share when the related performance criteria are met. At December 31, 2010 and 2009, potential dilutive effects, representing approximately 1.6 million and 1.1 million common shares, were excluded from the computation of income per common share as the related performance criteria was not met, although we expect to meet various levels of criteria in the future. There was no significant difference in basic and diluted net income per share and average common shares outstanding as a result of dilutive equity awards for the three-month periods ended December 31, 2010 and 2009.

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11. Shareholders Equity

During the three months ended December 31, 2010, we paid $11.7 of cash dividends and issued 0.3 million shares of our common stock pursuant to our stock incentive plans.

12. Stock-Based Compensation

	Three Months Ended December 31,	
	2010	2009
Stock-based compensation costs	$ 2.4	$ 2.1
Income tax benefit	0.9	0.8
Stock-based compensation costs, net of tax	$ 1.5	$ 1.3

During the three months ended December 31, 2010, we made the following grants:

	Number of Units
Stock options	481,776
Restricted stock units (RSUs)	2,883
Performance-based stock units (PBUs)	541,947

Stock options granted had a weighted average exercise price of $19.49, and our RSUs and PBUs had a weighted average grant date fair value of $21.51 and $19.50 for the three month period ended December 31, 2010.

13. Comprehensive Income and Accumulated Other Comprehensive Loss

The components of comprehensive income, each net of tax (corresponding to income tax rates between 35.4% and 37.3%, excluding foreign currency translation adjustment), were:

	Three Months Ended December 31,	
	2010	2009
Net income	$ 27.1	$ 29.5
Foreign currency translation adjustment	9.8	0.2
Change in items not recognized as a component of net pension and postretirement healthcare costs	0.8	0.6
Changes in net unrealized gains (losses) on derivative instruments	(0.1)	0.1
Changes in net unrealized gains (losses) on available for sale securities	0.3	(0.2)
Comprehensive income	$ 37.9	$ 30.2

The components of accumulated other comprehensive loss, each net of tax (corresponding to income tax rates between 35.4% and 37.3%, excluding cumulative foreign currency translation adjustment), were:

	December 31, 2010	September 30, 2010
Cumulative foreign currency translation adjustment	$ 18.9	$ 9.1
Items not recognized as a component of net pension and postretirement benefit costs	(51.2)	(52.0)
Net unrealized (loss) on derivative instruments	(0.2)	(0.1)
Net unrealized gain on available for sale securities	0.3	

Accumulated other comprehensive loss	$	(32.2)	$	(43.0)

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14. Investment Income and Other

The components of investment income and other were:

	Three Months Ended December 31,	
	2010	2009
Interest income on note receivable from Forethought	$ 2.8	$ 3.3
Interest income on ARS		0.1
Equity in net income of affiliates	0.6	0.1
Realized gain on sale of investments		0.5
Net realized (loss) on sale or impairment of ARS		(0.3)
Foreign currency exchange (loss), net	(0.3)	
Other, net	(0.1)	
Investment income and other	$ 3.0	$ 3.7

15. Commitments and Contingencies

Antitrust Litigation

In 2005 the Funeral Consumers Alliance, Inc. (FCA) and a number of individual consumer casket purchasers filed a purported class action antitrust lawsuit on behalf of certain consumer purchasers of Batesville® caskets against the Company and our former parent company, Hillenbrand Industries, Inc., now Hill-Rom Holdings, Inc. (Hill-Rom), and three national funeral home businesses (the FCA Action). A similar purported antitrust class action lawsuit was later filed by Pioneer Valley Casket Co. and several so-called independent casket distributors on behalf of casket sellers who were unaffiliated with any licensed funeral home (the Pioneer Valley Action). Class certification hearings in the FCA Action and the Pioneer Valley Action were held before a Magistrate Judge in early December 2006. On November 24, 2008, the Magistrate Judge recommended that the plaintiffs motions for class certification in both cases be denied. On March 26, 2009, the District Judge adopted the memoranda and recommendations of the Magistrate Judge and denied class certification in both cases. On April 9, 2009, the plaintiffs in the FCA case filed a petition with the United States Court of Appeals for the Fifth Circuit for leave to file an appeal of the Court s order denying class certification. On June 19, 2009, a three-judge panel of the Fifth Circuit denied the FCA plaintiffs petition. On July 9, 2009, the FCA plaintiffs filed a request for reconsideration of the denial of their petition. On July 29, 2009, a three-judge panel of the Fifth Circuit denied the FCA plaintiffs motion for reconsideration and their alternative motion for leave to file a petition for rehearing en banc (by all the judges sitting on the Fifth Circuit Court of Appeals).

The Pioneer Valley plaintiffs did not appeal the District Court s order denying class certification and, on April 29, 2009, pursuant to a stipulation among the parties, the District Court dismissed the Pioneer Valley Action with prejudice (i.e., Pioneer Valley cannot appeal or otherwise reinstitute the case). Neither the Company nor Hill-Rom provided any payment or consideration for the plaintiffs to dismiss this case, other than agreeing to bear their own costs rather than pursuing plaintiffs for costs.

Plaintiffs in the FCA Action have generally sought monetary damages on behalf of a class, trebling of any such damages that may be awarded, recovery of attorneys fees and costs, and injunctive relief. The plaintiffs in the FCA Action filed a report indicating that they were seeking damages ranging from approximately $947.0 million to approximately $1.46 billion before trebling on behalf of the purported class of consumers they seek to represent, based on approximately one million casket purchases by the purported class members.

Because Batesville continues to adhere to its long-standing policy of selling Batesville caskets only to licensed funeral directors operating licensed funeral homes, a policy that it continues to believe is appropriate and lawful, if the case goes to trial, the plaintiffs are likely to claim additional alleged damages for periods between their reports and the time of trial. At this point, it is not possible to estimate the amount of any additional alleged damage claims they may make. The defendants are vigorously contesting both liability and the plaintiffs damages theories.

Despite the ruling denying class certification, the FCA plaintiffs continued to pursue their individual injunctive and damages claims. Their individual damages claims are limited to the alleged overcharges on the plaintiffs individual casket purchases (the complaint currently alleges a total of eight casket purchases by the individual plaintiffs), which would be trebled, plus reasonable attorneys fees and costs.
In June 2010, co-defendant Stewart Enterprises, Inc. announced a settlement with the plaintiffs. On July 16, 2010, the District Court granted the remaining defendants motion for leave to file a motion to dismiss for lack of subject matter jurisdiction. On August 2, 2010, the District Court heard argument on the motion and ordered full dismissal of the lawsuit on September 24, 2010, concluding that plaintiffs shall take nothing by their suit. In light of this decision, defendants filed a motion requesting that the Court order plaintiffs to pay costs incurred by Batesville and SCI in the approximate amount of $0.7 million. The Court denied this motion on October 22, 2010.

Plaintiffs had 30 days to declare their intent to appeal the dismissal of their lawsuit, and they did so by way of a Notice of Appeal filed on October 19, 2010. Plaintiffs Notice indicates that they intend to appeal both the Court s final judgment of dismissal entered on September 24, 2010 and the Court s order denying class certification entered on March 26, 2009. The appeal is to the United States Court of Appeals for the Fifth Circuit.

Plaintiffs recently requested an enlargement of time to file their brief appealing the denial of the two District Court orders. The request was granted by the Court of Appeals on January 3, 2011; therefore, plaintiffs brief must now be filed by February 23, 2011. Defendants brief will be due 30 days after receiving plaintiffs brief, unless an enlargement of time is requested and granted. Plaintiffs will then have an opportunity to file a reply brief. Once all briefs are submitted, the Court of Appeals may hear oral argument by the parties attorneys and will then issue its ruling as to whether or not the District Court s decisions should be reversed or affirmed. It should be noted, however, that the above appellate schedule is only approximate and is subject to change dependent upon a number of factors, including the granting of any extensions of time and the relative congestion of the docket of the Court of Appeals.

If plaintiffs succeed in overturning the judgment, reversing the District Court order denying class certification, and a class is subsequently certified in the FCA Action filed against Hill-Rom and Batesville, and if the plaintiffs prevail at a trial of the class action, the damages awarded to the plaintiffs, which would be trebled as a matter of law, could have a significant material adverse effect on our results of operations, financial condition, and/or liquidity. In antitrust actions such as the FCA Action, the plaintiffs may elect to enforce any judgment against any or all of the co-defendants, who have no statutory contribution rights against each other. We and Hill-Rom have entered into a judgment sharing agreement that apportions the costs and any potential liabilities associated with this litigation between us and Hill-Rom. See Note 6 to our Annual Report on Form 10-K for the fiscal year ended September 30, 2010.

As of December 2010, we had incurred approximately $27.8 million in cumulative legal and related costs associated with the FCA matter since its inception.

General

We are involved on an ongoing basis in claims and lawsuits relating to our operations, including environmental, antitrust, patent infringement, business practices, commercial transactions, and other matters. The ultimate outcome of these lawsuits cannot be predicted with certainty. An estimated loss from these contingencies is recognized when we believe it is probable that a loss has been incurred and the amount of the loss can be reasonably estimated. However, it is difficult to measure the actual loss that might be incurred related to litigation. The ultimate outcome of these lawsuits could have a material adverse effect on our financial condition, results of operations, and cash flow.

Legal fees associated with claims and lawsuits are generally expensed as incurred. Upon recognition of an estimated loss resulting from a settlement, an estimate of legal fees to complete the settlement is also included in the amount of the loss recognized.

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We are also involved in other possible claims, including product and general liability, workers compensation, auto liability, and employment-related matters. Claims other than employment and related matters have deductibles and self-insured retentions ranging from $0.5 million to $1.0 million per occurrence or per claim, depending upon the type of coverage and policy period. Outside insurance companies and third-party claims administrators establish individual claim reserves, and an independent outside actuary provides estimates of ultimate projected losses, including incurred but not reported claims, which are used to establish reserves for losses. Claim reserves for employment-related matters are established based upon advice from internal and external counsel and historical settlement information for claims and related fees, when such amounts are considered probable of payment.

The recorded amounts represent our best estimate of the costs we will incur in relation to such exposures, but it is virtually certain that actual costs will differ from those estimates.

16. Fair Value Measurements

Our fair value measurements for our financial assets and liabilities were classified into one of three categories as defined in Note 14 to our Annual Report on Form 10-K for the fiscal year ended September 30, 2010.

			Fair Value Measurements at December 31, 2010 using:		
Description	**Carrying Value at December 31, 2010**	**Fair Value at December 31, 2010**	**Quoted Prices in Active Markets (Level 1)**	**Significant Other Observable Inputs (Level 2)**	**Significant Unobservable Inputs (Level 3)**
Assets:					
Cash and cash equivalents	$ 136.0	$ 136.0	$ 136.0	$	$
ARS	12.3	12.3		12.3	
Forethought note	147.6	125.7			125.7
Equity investments	3.0	3.0			3.0
Investments in rabbi trust	5.9	5.9	5.9		
Liabilities:					
Revolving credit facility	275.0	264.5		264.5	
$150 senior unsecured notes	148.4	151.7	151.7		
Derivative instruments, net	0.2	0.2		0.2	

The following table reconciles the change in our Level 3 financial assets:

	Measurements Using Significant Unobservable Inputs	
	Forethought Note	**Equity Investments**
Balance at September 30, 2010	$ 127.0	$ 3.0
Total gains (losses) (realized and unrealized):		
Included in earnings, net		
Included in other comprehensive income		
Change in fair value	(1.3)	

Purchases, issuances, and settlements				
Transfers in (out) of Level 3				
Balance at December 31, 2010	$	125.7	$	3.0

The methods and assumptions used to estimate the fair value of each class of financial instrument for which it is practicable to estimate that value are described in our Annual Report on Form 10-K for the fiscal year ended September 30, 2010. The decrease in the fair value of the Forethought Note at December 31, 2010 was attributable to a 1.6% increase in the required yield to maturity (discount rate) observed in the marketplace on comparable debt instruments. Assets excluded from the tables above are described in our Annual Report on Form 10-K for the fiscal year ended September 30, 2010.

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17. Segment and Geographical Information

Our operations consist of two reporting segments, Batesville and K-Tron. The following tables provide summary financial information regarding these segments and our corporate operations:

	Three Months Ended December 31,			
	2010		2009	
Net revenues:				
Batesville	$	159.9	$	161.5
K-Tron		51.1		
Total consolidated net revenues	$	211.0	$	161.5
Gross profit:				
Batesville	$	68.4	$	72.0
K-Tron		22.8		
Total consolidated gross profit	$	91.2	$	72.0
Operating profit (loss):				
Batesville[1]	$	42.6	$	50.2
K-Tron[2]		6.9		
Corporate [3]		(7.4)		(9.1)
Total consolidated operating profit	$	42.1	$	41.1
EBITDA:				
Batesville	$	46.5	$	54.2
K-Tron		10.5		
Corporate		(6.5)		(8.5)
Total EBITDA	$	50.5	$	45.7
Net revenues: [4]				
United States	$	178.7	$	150.2
Canada		11.3		9.6
Switzerland		18.3		
All other foreign business units		2.7		1.7
Total consolidated net revenues	$	211.0	$	161.5

1 Batesville operating profit includes sales tax recoveries of $0.6 and $4.1 offset in part by antitrust litigation expense of $0.3 and $0.2 for the three months ended December 31, 2010 and 2009.

2 K-Tron operating profit includes $2.7 of incremental amortization expense related to the intangible assets that were acquired and $0.1 for business acquisition costs during the three months ended December 31, 2010.

3 Corporate operating loss includes $0.2 and $2.8 for business acquisition costs for the three months ended December 31, 2010 and 2009.

4 Revenue is attributed to a geography based upon the location of the business unit that consummated the external sale.

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	December 31, 2010	September 30, 2010
Total assets assigned:		
Batesville	$ 250.0	$ 249.0
K-Tron	571.7	561.3
Corporate	272.7	241.8
Total consolidated assets	$ 1,094.4	$ 1,052.1
Total goodwill assigned:		
Batesville	$ 5.7	$ 5.7
K-Tron	194.5	190.7
Total consolidated goodwill	$ 200.2	$ 196.4
Property, net, by physical location		
United States	$ 94.7	$ 96.2
Switzerland	10.9	10.6
All other foreign business units	3.1	2.8
Total property, net	$ 108.7	$ 109.6

18. Subsequent Events

In January 2011, we sold our remaining ARS for proceeds of $12.3, resulting in a gain of $0.5. We have now fully liquidated the original $56.9 portfolio of ARS transferred to us on March 31, 2008, in connection with our separation from Hill-Rom. We recovered approximately 95.5% of the historical cost of these securities.

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Item 2. MANAGEMENT S DISCUSSION AND ANALYSIS OF FINANCIAL CONDITION AND RESULTS OF OPERATIONS

Forward-Looking Statements and Factors That May Affect Future Results

Throughout this Form 10-Q, we made a number of forward-looking statements within the meaning of the Private Securities Litigation Reform Act of 1995. As the words imply, forward-looking statements are statements about our future plans, objectives, beliefs, and expectations that might or might not happen in the future, as contrasted with historical information. Our forward-looking statements are based on assumptions that we believe are reasonable, but by their very nature they are subject to a wide range of risks.

Accordingly, in this Form 10-Q, we may say something like,

We anticipate that the burial rate will be flat to slightly declining in future years.

That is a forward-looking statement, as indicated by the word anticipate and by the clear meaning of the sentence. Other words that could indicate we are making forward-looking statements include:

intend	believe	plan	expect	may	goal
become	pursue	estimate	will	forecast	continue
targeted	encourage	promise	improve	progress	potential

This is not an exhaustive list, but is intended to give you an idea of how we try to identify forward-looking statements. The absence of any of these words, however, does not mean that the statement is not forward-looking.

Here is the key point: Forward-looking statements are not guarantees of future performance, and our actual results could differ materially from those set forth in any forward-looking statements. Any number of factors many of which are beyond our control could cause our performance to differ significantly from those described in the forward-looking statements.

For a discussion of factors that could cause actual results to differ from those contained in forward-looking statements, see the discussions under the heading Risk Factors in Item 1A of our Form 10-K filed with the SEC on November 23, 2010 and Part II, Item 1A, of this Form 10-Q. We assume no obligation to update or revise any forward-looking statements.

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Executive Overview

In this executive overview, we provide information so that you may review the Company s performance and assess its financial condition as management does.

(in millions throughout Management s Discussion and Analysis)

	Three Months Ended December 31, 2010	
Hillenbrand	**2010**	**2009**
Net revenues	$ 211.0	$ 161.5
Gross profit	91.2	72.0
Operating expenses (including business acquisition costs)	49.1	30.9
Operating profit	42.1	41.1
Interest expense	(2.8)	(0.2)
Investment income and other	3.0	3.7
Income taxes	15.2	15.1
Net income	27.1	29.5

The question that arises when reviewing our consolidated results is most likely, How did net revenues for the three months ended December 31, 2010, increase by 31% compared to the same period in the prior year while net income declined by 8%? The information below provides detail on the key drivers of our results.

Our net revenues were positively impacted by the K-Tron acquisition in April 2010, providing $51.1 of additional net revenue in the three months ended December 31, 2010, compared to the same period in the prior year.

Batesville s revenues were relatively flat, decreasing $1.6 or 1% in the three months ended December 31, 2010, compared to the same period in the prior year.

Gross profit margin for the three months ended December 31, 2010, declined by 140 basis points compared to the same period in the prior year, largely driven by rising commodity costs at Batesville, principally steel and fuel.

Batesville s gross profit margin was 42.8% and 44.6% for the three months ended December 31, 2010 and 2009.

K-Tron s gross profit margin was 44.6% for the three months ended December 31, 2010.

Operating expenses increased $18.2 in the three months ended December 31, 2010, compared to the same period in the prior year.

The addition of K-Tron into our results added $15.9 of operating expenses, including $2.7 relating to incremental amortization of the acquired intangible assets.

An increase of $3.5 in operating expenses was due to sales tax recoveries for Batesville. These recoveries relate to overpayments in previous years and are not a normal part of ongoing operations. Additional recoveries are not expected to be significant. We recognized a benefit of $0.6 in the three months ended December 31, 2010, compared to $4.1 in the same period in the prior year.

We incurred $0.3 of business acquisitions costs in the three months ended December 31, 2010, compared to $2.8 in the same period of the prior year.

Absent sales tax recoveries, operating expenses remained relatively flat for Batesville for the three months ended December 31, 2010, compared to the same period in the prior year. Excluding incremental amortization expense, operating expenses for K-Tron were relatively flat compared to the same period a year ago, yielding an improved operating expense to sales ratio given the revenue growth. Due to the technical nature of its products and related customer support requirements, K-Tron s business model has a higher ratio of operating expenses to sales compared to Batesville. This results in a higher consolidated operating expense to sales ratio for Hillenbrand post-acquisition.

Interest expense increased $2.6 for the three months ended December 31, 2010, compared to the same period in the prior year, due to the borrowings to fund the K-Tron acquisition.

Investment income and other decreased $0.7 for the three months ended December 31, 2010, compared to the same period in the prior year. See Note 14 for more detailed information.

Our income tax rate was 35.9% for the three months ended December 31, 2010, an increase of 2.0% over the same period in the prior year. The increase was primarily due to a favorable adjustment of $0.6 recorded in the prior year as a result of periodic reconciliation of our income tax accounts to filed income tax returns.

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While we report financial results in accordance with U.S. GAAP, we would also like to discuss a non-GAAP measure, Earnings Before Interest, Income Tax, Depreciation and Amortization (EBITDA). We have previously discussed our strategy to prudently acquire selected manufacturing businesses that have a record of success, but which could benefit from our core competencies to spur faster and more profitable growth. Given that strategy, it is a natural consequence to incur related expenses such as amortization from intangible assets acquired and additional interest expense from debt-funded acquisitions. Accordingly, we use EBITDA, among other measures, to monitor our business performance. While EBITDA is not in accordance with, nor is it a substitute for, a U.S. GAAP measure, we believe it provides information to investors so they can see the financial results through the eyes of management . We also believe that it better enables investors to understand the ongoing operating performance of the Company. Investors should consider non-GAAP measures in addition to, not as a substitute for, or as superior to, measures of financial performance prepared in accordance with U.S. GAAP.

EBITDA for the three months ended December 31, 2010, was $50.5 million compared to $45.7 million for the three months ended December 31, 2009. The reconciliation to U.S. GAAP net income is provided below:

	Three Months Ended December 31, 2010	
EBITDA	**2010**	**2009**
Net income	$ 27.1	$ 29.5
Interest income	(3.3)	(3.6)
Interest expense	2.8	0.2
Income tax expense	15.2	15.1
Depreciation and amortization	8.7	4.5
EBITDA[1]	$ 50.5	$ 45.7

1 For the three months ended December 31, 2010 and 2009, EBITDA includes $0.3 and $0.2 of antitrust litigation expense, $0.3 and $2.8 of business acquisition costs, and $0.6 and $4.1 of sales tax recoveries.

Results of Operations

The consolidated operating results of our Company are included in the consolidated financial statements in Part I, Item 1, of this Form 10-Q. We disaggregated the relevant operating information into our two reporting segments, Batesville and K-Tron, along with our corporate operations. See Note 17 for a reconciliation of the financial information below to our consolidated financial results.

The sections that follow present operating results for Batesville, K-Tron, and our corporate operations. We also discuss changes in non-operating expenses and income, along with our income tax provision, in further detail below.

	Three Months Ended December 31,			
	2010		**2009**	
Batesville	**Amount**	**% of Revenue**	**Amount**	**% of Revenue**
Revenue	$ 159.9	100.0	$ 161.5	100.0
Gross profit	68.4	42.8	72.0	44.6
Operating expenses[1]	25.8	16.1	21.8	13.5
Operating profit[1]	42.6	26.6	50.2	31.1

1 Operating expenses and operating profit include sales tax recoveries of $0.6 and $4.1 offset in part by antitrust litigation expense of $0.3 and $0.2 for the three months ended December 31, 2010 and 2009.

Revenue Batesville s net revenues for the three months ended December 31, 2010 decreased from the same period last year by $1.6 or 1.0%. Burial unit volume decreased 1.8% or $2.2 and was the primary contributor to the reduction in net revenue. We believe the volume decrease was largely attributable to year-over-year increases in cremation rates, which reduce the number of burials. Although cremations continue to increase, we have observed a more typical year-over-year growth rate of about 110 to 120 basis points in 2010, following significant increases in 2009. Offsetting this impact was a modest increase in the average selling price that contributed $0.2 to revenue. We believe that Batesville s merchandising initiatives and new product launches helped improve average selling prices and slow the downward trend in product mix, especially in customer locations that used the Batesville merchandising system. The strengthening Canadian dollar increased revenue by $0.4 in the three months ended December 31, 2010, compared to the same period in the prior year.

Gross profit Batesville s gross profit for the three months ended December 31, 2010, decreased $3.6 million or 5.0% compared to the same period in the prior year. Despite the lower revenue noted above, cost of goods sold increased $2.0 million, driven primarily by rising commodity costs of $2.9 million, particularly steel and fuel. These commodity increases were partially offset by lower operating costs as we continue to optimize our cost structure using lean business principles.

Operating expenses Batesville operating expenses increased $4.0 or 18.3% for the three months ended December 31, 2010, compared to the same period in the prior year. This was driven by the prior year impact of recording a $4.1 sales tax receivable for tax overpayments, reducing prior year operating expenses. We recovered an additional $0.6 in sales tax overpayments in the current quarter, which was largely offset by $0.5 of strategic initiative spending. During the three months ended December 31, 2010 and 2009, we incurred legal fees of $0.3 and $0.2 related to our FCA antitrust litigation discussed in Note 15.

	Three Months Ended December 31, 2010		
K-Tron	**Amount**		**% of Revenue**
Revenue	$	51.1	100.0
Gross profit		22.8	44.6
Operating expenses[1]		15.9	31.1
Operating profit[1]		6.9	13.5

1 Operating expenses and operating profit includes $2.7 of incremental amortization expense associated with the acquisition of K-Tron and $0.1 of business acquisition costs.

Comparative results are not presented as K-Tron was acquired on April 1, 2010.

Future revenue associated with K-Tron s business lines is influenced by order backlog. This is due to the lead time involved in manufacturing specialized equipment and parts for customers. Backlog can be an indicator of future revenue; however, it may not include many projects and parts orders that are booked and shipped within the same quarter (i.e. backlog primarily represents new equipment orders). The timing of order placement, size, and customer delivery dates can create unusual fluctuations in backlog. Backlog is also affected by foreign exchange fluctuations because a portion of the orders are denominated in currencies other than U.S. dollars.

Based upon new orders accepted, less orders completed and shipped during the three months ended December 31, 2010, K-Tron s backlog increased $10.8 to $67.9.

	Three Months Ended December 31,			
Corporate	**2010**		**2009**	
Operating expenses, excluding business acquisition costs	$	7.2	$	6.3
Business acquisition costs		0.2		2.8

Operating expenses, excluding business acquisition costs We excluded business acquisition costs because we believe this provides a clearer picture for analyzing our operating cost structure due to their significant and infrequent nature.

Operating expenses excluding business acquisition costs increased $0.9 or 14.3% for the three months ended December 31, 2010, compared to the same period in the prior year. The increases were primarily related to compensation and benefits.

Business acquisition costs We incurred $0.3 of acquisition related expenditures during the three months ended December 31, 2010, of which $0.2 were incurred by our corporate operations. Business acquisition costs were $2.8 for the three months ended December 31, 2009. The decline is attributable to the reduction in business acquisition activity following our acquisition of K-Tron on April 1, 2010.

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Liquidity and Capital Resources

We believe the ability to generate cash is critical to the value of our Company. In this section, we tell you about our ability to generate and access cash to meet our business needs.

First, we will describe our actual results in generating and utilizing cash by comparing the first three months to the same period last year. We will also talk about any significant trends we are seeing to help you understand how this could impact us going forward.

Second, we will tell you about how we see operating, investing, and financing cash flows being affected for the next 12 months. While it is not a certainty, we will tell you where we think the cash will come from and how we intend to use it. We will also talk about significant risks or possible changes to our thinking that could change our expectation.

Third, we will tell you about other significant matters that could affect our liquidity on an ongoing basis.

	Three Months Ended December 31,			
	2010		2009	
Cash flows provided by (used in):				
Operating activities	$	27.8	$	36.4
Investing activities		(1.8)		3.9
Financing activities		8.3		(71.5)
Effect of exchange rate changes on cash and cash equivalents		3.3		0.1
Increase (decrease) in cash and cash equivalents	$	37.6	$	(31.1)

Operating activities

Historically, net cash flows from operating activities have represented our primary source of funds for the growth of our business, including capital expenditures. The degree of correlation between operating cash flow and net income is impacted by the non-cash expenditures we incur (such as non-cash stock-based compensation), non-cash earnings (such as interest income on our note receivable from Forethought), and the timing of income tax payments. Interim periods can also be more volatile individually as they are affected to a greater degree by the seasonality of our revenues.

Net cash flows from operating activities were $8.6 lower during the three months ended December 31, 2010, compared to the same period in the prior year. This decline was primarily driven by the timing of payments to our vendors. Additionally, annual incentive compensation earned in fiscal year 2010 and paid in the first quarter of fiscal 2011 was higher compared to the prior year period. These cash flow declines were partially offset by K-Tron s pre-tax operating cash flows, as well as lower income tax payments.

Investing activities

Net cash receipts from investing activities for the three months ended December 31, 2010, decreased compared to the same period last year by $5.7, primarily due to lower redemptions on auction rate securities and investments.

Financing activities

Net cash receipts from financing activities for the three months ended December 31, 2010, increased $79.8 compared to the same period in the prior year, primarily because no repayments were made on our revolving credit facility.

During the quarter ended December 31, 2010, we announced an increase in our quarterly dividend to $0.19 per common share, which we paid on December 31, 2010. We plan to pay a cash dividend that will require about $11.7 each quarter based on our outstanding common stock at December 31, 2010.

12-Month Outlook

In January 2011, we sold our remaining ARS for proceeds of $12.3 resulting in a gain of $0.5. We believe that our cash on hand, cash generated from operations, and cash available under our credit facility will be sufficient to fund operations, working capital needs, capital expenditure requirements, and financing obligations.

We have no other significant changes to report to the discussion included in our previously filed Form 10-K for the year ended September 30, 2010.

Other Liquidity Matters

As of December 31, 2010, we: (i) had $6.9 in outstanding undrawn letters of credit under our revolving credit facility, (ii) were in compliance with all covenants set forth in the credit agreement, and (iii) had complete access to the remaining $118.1 of borrowing capacity available under the facility. In addition, we have approximately $15.1 of available credit under our Swiss facilities. We have no other significant changes to report to the discussion included in our previously filed Form 10-K for the year ended September 30, 2010.

Off-Balance Sheet Arrangements

We have no significant off-balance sheet arrangements.

Contractual Obligations or Contingent Liabilities and Commitments

There have been no significant changes to our contractual obligations or contingent liabilities and commitments during the three months ended December 31, 2010.

Critical Accounting Estimates

There have been no significant changes to this information during the three months ended December 31, 2010, as outlined in our Annual Report on Form 10-K for the year ended September 30, 2010.

Recently Adopted Accounting Standards

On December 31, 2010, we adopted the Financial Accounting Standards Board s (FASB s) accounting standard update 2010-20, *Disclosures about the Credit Quality of Financing Receivables and the Allowance for Credit Losses*. The standard requires companies to provide additional disclosures about the credit quality of their financing receivables and the credit reserves held against them. The disclosure requirements of this standard are included in Note 5.

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Item 3. QUANTITATIVE AND QUALITATIVE DISCLOSURES ABOUT MARKET RISKS

There have been no significant changes to this information during the three months ended December 31, 2010, as outlined in our Annual Report on Form 10-K for the year ended September 30, 2010.

Item 4. CONTROLS AND PROCEDURES

Our management, with the participation of our President and Chief Executive Officer and our Senior Vice President and Chief Financial Officer (the Certifying Officers), has evaluated the effectiveness of the design and operation of our disclosure controls and procedures (as defined in Rules 13a-15(e) and 15d-15(e) under the Securities Exchange Act of 1934, as amended (the Exchange Act), as of the end of the period covered by this report. Based upon that evaluation, the Certifying Officers concluded that our disclosure controls and procedures were effective as of the end of the period covered by this report for the information required to be disclosed in the reports we file or submit under the Exchange Act to be recorded, processed, summarized, and reported within the time periods specified in the Securities and Exchange Commission s rules and forms and such information is accumulated and communicated to management as appropriate to allow timely decisions regarding required disclosure. There were no changes in our internal control over financial reporting during the quarter ended December 31, 2010 that have materially affected, or are reasonably likely to materially affect, our internal control over financial reporting.

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PART II OTHER INFORMATION

Item 1. LEGAL PROCEEDINGS

Our material legal proceedings are described in detail in Note 15 to our consolidated financial statements in Part I, Item 1, of this report. You should read that note carefully to understand the background and current status of those matters.

Item 1A. RISK FACTORS

For information regarding the risks we face, see the discussion under Item 1A. Risk Factors in our Annual Report on Form 10-K for the year ended September 30, 2010. There have been no material changes to the risk factors described in that report.

Item 2. UNREGISTERED SALES OF EQUITY SECURITIES AND USE OF PROCEEDS

There were no unregistered sales of equity securities in the three months ended December 31, 2010.

Item 6. EXHIBITS

The exhibits filed with this report are listed on the Exhibit Index, which is incorporated herein by reference. In reviewing any agreements included as exhibits to this report, please remember that they are included to provide you with information regarding their terms and are not intended to provide any other factual or disclosure information about us or the other parties to the agreements. The agreements may contain representations and warranties by the parties to the agreements, including us. These representations and warranties have been made solely for the benefit of the other parties to the applicable agreement and:

- should not in all instances be treated as categorical statements of fact, but rather as a way of allocating the risk to one of the parties if those statements prove to be inaccurate;

- may have been qualified by disclosures that were made to the other party in connection with the negotiation of the applicable agreement, which disclosures are not necessarily reflected in the agreement;

- may apply standards of materiality in a way that is different from what may be viewed as material to you or other investors; and

- were made only as of the date of the applicable agreement or such other date or dates as may be specified in the agreement and are subject to more recent developments.

Accordingly, these representations and warranties may not describe the actual state of affairs as of the date they were made or at any other time.

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SIGNATURES

Pursuant to the requirements of the Securities Exchange Act of 1934, the registrant has duly caused this report to be signed on its behalf by the undersigned thereunto duly authorized.

HILLENBRAND, INC.

DATE: February 2, 2011 BY: /s/ Cynthia L. Lucchese

Cynthia L. Lucchese

	2015 RMB	
Profit before taxation	**15,469**	14,544
Adjustments for:		
Depreciation and amortisation	**33,447**	33,585
Impairment losses for doubtful debts	**1,313**	1,471
Write down of inventories	**61**	37
Investment income	**(9)**	(6)
Share of (profits)/losses of associates	**(80)**	456
Interest income	**(170)**	(164)
Interest expense	**1,899**	2,362
Net foreign exchange gain	**(1)**	(38)
Net loss on retirement and disposal of long-lived assets	**991**	1,865
Operating profit before changes in working capital	**52,920**	54,112
Increase in accounts receivable	**(9,235)**	(7,567)
Decrease in inventories	**1,058**	625
Increase in prepayments and other current assets	**(2,066)**	(2,076)
Decrease/(increase) in other assets	**122**	(151)
Increase in accounts payable	**3,070**	6,523
Increase in accrued expenses and other payables	**5,614**	8,259
Decrease in deferred revenues	**(245)**	(226)
Cash generated from operations	**51,238**	59,499
Interest received	**182**	176
Interest paid	**(1,934)**	(2,385)
Investment income received	**1**	
Income tax paid	**(3,139)**	(2,878)
Net cash from operating activities	**46,348**	54,412

(b)

The Company sold certain telecommunications towers and related assets (Tower Assets) to China Tower Corporation Limited (China Tower) (hereinafter referred to as Tower Assets Disposal) and injected cash amounting to RMB2,966 million (Cash Consideration) to China Tower, in return for new shares issued by China Tower. The Tower Assets Disposal was completed on 31 October 2015, and the Cash Consideration was paid in February 2016.

The notes on pages 15 to 33 form part of these interim financial statements.

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Notes to the Unaudited Interim Financial Statements

for the six-month period ended 30 June 2016

1. Principal Activities

China Telecom Corporation Limited (the Company) and its subsidiaries (hereinafter, collectively referred to as the Group) offers a comprehensive range of wireline and mobile telecommunications services including wireline voice, mobile voice, Internet, telecommunications network resource services and lease of network equipment, value-added services, integrated information application services and other related services. The Group provides wireline telecommunications services and related services in Beijing Municipality, Shanghai Municipality, Guangdong Province, Jiangsu Province, Zhejiang Province, Anhui Province, Fujian Province, Jiangxi Province, Guangxi Zhuang Autonomous Region, Chongqing Municipality, Sichuan Province, Hubei Province, Hunan Province, Hainan Province, Guizhou Province, Yunnan Province, Shaanxi Province, Gansu Province, Qinghai Province, Ningxia Hui Autonomous Region and Xinjiang Uygur Autonomous Region of the People s Republic of China (the PRC). Following the acquisition of Code Division Multiple Access (CDMA) mobile telecommunications business in October 2008, the Group also provides mobile telecommunications and related services in the mainland China and Macau Special Administrative Region (Macau) of the PRC. The Group also provides international telecommunications services, including lease of network equipment, International Internet access and transit, and Internet data centre service in certain countries of the Asia Pacific, Europe, Africa, South America and North America regions. The operations of the Group in the mainland China are subject to the supervision and regulation by the PRC government.

2. Basis of Preparation

These interim financial statements have been prepared in accordance with International Accounting Standard 34, (IAS 34) *Interim Financial Reporting* issued by the International Accounting Standards Board and the applicable disclosure requirements of Appendix 16 to the Rules Governing the Listing of Securities on The Stock Exchange of Hong Kong Limited. These interim financial statements, which were authorised for issuance by the Board of Directors on 23 August 2016, reflect the unaudited financial position of the Group as at 30 June 2016 and the unaudited results of operations and cash flows of the Group for the six-month period then ended, which are not necessarily indicative of the results of operations and cash flows expected for the year ending 31 December 2016.

These interim financial statements are prepared on the historical cost basis as modified by the revaluation of certain available-for-sale equity securities at fair value.

Except as described below, these interim financial statements have been prepared in accordance with the same accounting policies adopted in the 2015 annual financial statements of the Group.

Notes to the Unaudited Interim Financial Statements

for the six-month period ended 30 June 2016

2. Basis of Preparation (continued)

In the current interim period, the Group has applied, for the first time, the following amendments to International Financial Reporting Standards (IFRSs) issued by the International Accounting Standards Board that are mandatorily effective for the current period:

Amendments to IFRS 11, Accounting for Acquisitions of Interests in Joint Operations

Amendments to IAS 1, Disclosure Initiative

Amendments to IAS 16 and IAS 38, Clarification of Acceptable Methods of Depreciation and Amortisation

Amendments to IFRSs, Annual Improvements to IFRSs 2012 2014 Cycle

Amendments to IAS 16 and IAS 41, Agriculture: Bearer Plants

Amendments to IFRS 10, IFRS 12 and IAS 28, Investment Entities: Applying the Consolidation Exception

The application of the above amendments to IFRSs has had no material effect on the Group s interim financial statements.

The preparation of interim financial statements in conformity with IAS 34, *Interim Financial Reporting* requires management to make judgments, estimates and assumptions that affect the application of policies and reported amounts of assets and liabilities, income and expenses on a year to date basis. Actual results may differ from these estimates.

These interim financial statements contain consolidated financial statements and selected explanatory notes. The notes include an explanation of events and transactions that are significant to an understanding of the changes in financial position and performance of the Group since the 2015 annual financial statements. The interim financial statements and notes thereon do not include all of the information required for a full set of financial statements prepared in accordance with IFRSs.

These interim financial statements are unaudited, but have been reviewed by the Audit Committee of the Company. These interim financial statements have also been reviewed by the Company s international independent auditor in accordance with Hong Kong Standard on Review Engagements 2410, Review of Interim Financial Information Performed by the Independent Auditor of the Entity , issued by the Hong Kong Institute of Certified Public Accountants.

The financial information relating to the financial year ended 31 December 2015 that is included in these interim financial statements as being previously reported does not constitute the Group s statutory financial statements for that financial year but is derived from those financial statements. The statutory financial statements for the year ended 31

December 2015 are available from the Company s registered office. The Company s international independent auditor has expressed an unqualified opinion on those financial statements in the report dated 23 March 2016.

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Notes to the Unaudited Interim Financial Statements

for the six-month period ended 30 June 2016

3. Segmental Reporting

An operating segment is a component of an entity that engages in business activities from which revenues are earned and expenses are incurred, and is identified on the basis of the internal financial reports that are regularly reviewed by the chief operating decision maker in order to allocate resources and assess performance of the segment. For the periods presented, management has determined that the Group has one operating segment as the Group is only engaged in the integrated telecommunications business. The Group s assets located outside mainland China and operating revenues derived from activities outside mainland China are less than 10% of the Group s assets and operating revenues, respectively. No geographical area information has been presented as such amount is immaterial. No single external customer accounts for 10 percent or more of the Group s operating revenues.

4. Accounts Receivable, Net

Accounts receivable, net, are analysed as follows:

	Note	**30 June 2016 RMB millions**	31 December 2015 RMB millions
Third parties		**31,161**	22,766
China Telecom Group	*(i)*	**905**	492
China Tower		**6**	
Other telecommunications operators in the PRC		**1,204**	782
		33,276	24,040
Less: Allowance for doubtful debts		**(4,199)**	(2,935)
		29,077	21,105

Note:

(i) China Telecommunications Corporation together with its subsidiaries other than the Group are referred to as China Telecom Group .

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for the six-month period ended 30 June 2016

4. **Accounts Receivable, Net** (continued)

Ageing analysis of accounts receivable from telephone and Internet subscribers based on the billing dates is as follows:

	30 June 2016 RMB millions	31 December 2015 RMB millions
Current, within 1 month	**10,818**	10,001
1 to 3 months	**3,273**	2,181
4 to 12 months	**2,279**	1,821
More than 12 months	**1,574**	731
	17,944	14,734
Less: Allowance for doubtful debts	**(3,548)**	(2,393)
	14,396	12,341

Ageing analysis of accounts receivable from other telecommunications operators and enterprise customers based on dates of rendering of services is as follows:

	30 June 2016 RMB millions	31 December 2015 RMB millions
Current, within 1 month	**5,191**	3,648
1 to 3 months	**3,962**	1,618
4 to 12 months	**4,063**	2,199
More than 12 months	**2,116**	1,841
	15,332	9,306
Less: Allowance for doubtful debts	**(651)**	(542)
	14,681	8,764

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for the six-month period ended 30 June 2016

5. Cash and Cash Equivalents

	30 June 2016 RMB millions	31 December 2015 RMB millions
Cash at bank and in hand	**28,560**	30,916
Time deposits with original maturity within three months	**1,516**	953
	30,076	31,869

6. Short-term and Long-term Debt and Payable

Short-term debt comprises:

	30 June 2016 RMB millions	31 December 2015 RMB millions
Loans from banks unsecured	**4,910**	5,361
Super short-term commercial papers unsecured	**18,197**	33,995
Other loans unsecured	**182**	182
Loans from China Telecom Group unsecured	**12,023**	12,098
Total short-term debt	**35,312**	51,636

The weighted average interest rate of the Group s total short-term debt as at 30 June 2016 was 3.2% (31 December 2015: 3.1%) per annum. As at 30 June 2016, the Group s loans from banks and other loans bear interest at rates ranging from 3.9% to 5.1% (31 December 2015: 3.9% to 5.6%) per annum, and are repayable within one year; super short-term commercial papers bear interest at rates ranging from 2.4% to 2.5% (31 December 2015: 2.1% to 3.0%) per annum, and are repayable by September 2016; the loans from China Telecom Group bear interest at rates from 3.5% to 4.5% (31 December 2015: 3.5% to 4.5%) per annum and are repayable within one year.

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Notes to the Unaudited Interim Financial Statements

for the six-month period ended 30 June 2016

6. Short-term and Long-term Debt and Payable (continued)

Long-term debt and payable comprises:

	Note	**30 June 2016 RMB millions**	31 December 2015 RMB millions
Loans from banks unsecured	*(i)*	**9,012**	3,203
Other loans unsecured	*(i)*	**1**	1
Amounts due to China Telecommunications Corporation unsecured			
Deferred consideration of Mobile Network Acquisition	*(ii)*	**61,710**	61,710
Total long-term debt and payable		**70,723**	64,914
Less: current portion		**(153)**	(84)
Non-current portion		**70,570**	64,830

Note:

(i) The loans from banks includes long-term RMB denominated government loans with below-market interest rates ranging from 1.08% to 1.20% per annum obtained by the Group through banks. The Group recognised the loans at their fair value on initial recognition, and accreted the discount to profit or loss using the effective interest rate method. The difference between the fair value and face value of the loans was recognised as government grants in deferred revenue.

As at 30 June 2016, the loans from banks and other loans bear interest at rates ranging from 1.00% to 8.30% (31 December 2015: 1.00% to 8.30%) per annum with maturity through 2060.

(ii) Represents the remaining balance of the deferred consideration payable to China Telecommunications Corporation in respect of the acquisition of certain CDMA network assets and associated liabilities, which were held by China Telecommunications Corporation through network branches located in 30 provinces, municipalities and autonomous regions in the PRC (hereinafter referred to as the Mobile Network

Acquisition). The Company may, from time to time, pay all or part of the deferred payment at any time after the completion date without penalty until the fifth anniversary of the completion date of the Mobile Network Acquisition. The Company pays interest on the deferred payment to China Telecommunications Corporation at half-yearly intervals and the interest accrues from the day following the completion of the Mobile Network Acquisition. The interest rate is set at a 5 basis points premium to the yield of the 5-year super AAA rated Medium Term Notes most recently published by the National Association of Financial Market Institutional Investors before the completion date of the Mobile Network Acquisition and will be adjusted once a year in accordance with the last yield of the 5-year super AAA rated Medium Term Notes most recently published by the National Association of Financial Market Institutional Investors at the end of each year. The annual interest rates for 2015 and 2016 are 5.11% and 4.00%, respectively.

If the amount is not paid when due, the Company is required to pay the liquidated damages on such amount at a daily rate of 0.03% of the amount in arrears from the day following the applicable due date to the date that such amount has actually been paid in full.

The Group s short-term and long-term debt and payable do not contain any financial covenants. As at 30 June 2016, the Group had unutilised committed credit facilities amounting to RMB126,857 million (31 December 2015: RMB128,839 million).

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for the six-month period ended 30 June 2016

7. Accounts Payable

Accounts payable are analysed as follows:

	30 June 2016 RMB millions	31 December 2015 RMB millions
Third parties	**95,753**	95,305
China Telecom Group	**19,576**	18,702
China Tower	**9,915**	3,272
Other telecommunications operators in the PRC	**868**	776
	126,112	118,055

Amounts due to China Telecom Group are payable in accordance with contractual terms which are similar to those terms offered by third parties.

Ageing analysis of accounts payable based on the due dates is as follows:

	30 June 2016 RMB millions	31 December 2015 RMB millions
Due within 1 month or on demand	**26,964**	21,486
Due after 1 month but within 3 months	**19,991**	18,624
Due after 3 months but within 6 months	**22,667**	19,430
Due after 6 months	**56,490**	58,515
	126,112	118,055

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for the six-month period ended 30 June 2016

8. Deferred Tax Assets and Liabilities

The components of deferred tax assets and deferred tax liabilities recognised in the consolidated statement of financial position and the movements are as follows:

	Assets		**Liabilities**		**Net Balance**	
	30 June 2016 RMB millions	31 December 2015 RMB millions	**30 June 2016 RMB millions**	31 December 2015 RMB millions	**30 June 2016 RMB millions**	31 December 2015 RMB millions
Provisions and impairment losses, primarily for doubtful debts	**1,590**	1,291			**1,590**	1,291
Property, plant and equipment and others	**2,957**	3,174	**(3,394)**	(1,605)	**(437)**	1,569
Deferred revenues and installation costs	**154**	190	**(107)**	(130)	**47**	60
Available-for-sale equity securities			**(240)**	(326)	**(240)**	(326)
Deferred tax assets/(liabilities)	**4,701**	4,655	**(3,741)**	(2,061)	**960**	2,594

	Balance at 1 January 2016 RMB millions	Recognised in consolidated statement of comprehensive income RMB millions	**Balance at 30 June 2016 RMB millions**
Provisions and impairment losses, primarily for doubtful debts	1,291	299	**1,590**
Property, plant and equipment and others	1,569	(2,006)	**(437)**
Deferred revenues and installation costs	60	(13)	**47**
Available-for-sale equity securities	(326)	86	**(240)**
Net deferred tax assets	2,594	(1,634)	**960**

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Notes to the Unaudited Interim Financial Statements

for the six-month period ended 30 June 2016

9. Operating Revenues

Operating revenues represent revenues from the provision of telecommunications services. The components of the Group s operating revenues are as follows:

		Six-month period ended 30 June	
		2016	2015
	Note	**RMB millions**	RMB millions
Wireline voice	*(i)*	**13,580**	15,268
Mobile voice	*(ii)*	**22,839**	24,889
Internet	*(iii)*	**73,017**	62,274
Value-added services	*(iv)*	**20,839**	20,128
Integrated information application services	*(v)*	**13,987**	13,966
Telecommunications network resource services and lease of network equipment	*(vi)*	**8,928**	8,667
Others	*(vii)*	**23,638**	19,761
		176,828	164,953

Note:

(i) Represent the aggregate amount of monthly fees, local usage fees, domestic long distance usage fees, international, Hong Kong, Macau and Taiwan long distance usage fees, interconnections fees and installation fees charged to customers for the provision of wireline telephony services.

(ii) Represent the aggregate amount of monthly fees, local usage fees, domestic long distance usage fees, international, Hong Kong, Macau and Taiwan long distance usage fees and interconnections fees charged to customers for the provision of mobile telephony services.

(iii) Represent amounts charged to customers for the provision of Internet access services.

(iv) Represent the aggregate amount of fees charged to customers for the provision of value-added services, which comprise primarily caller ID services, short messaging services, Colour Ring Tone, Internet data centre and Virtual Private Network services and etc.

(v) Represent primarily the aggregate amount of fees charged to customers for Best Tone information services and IT services and applications.

(vi) Represent primarily the aggregate amount of fees charged to customers for the provision of telecommunications network resource services and lease income from other domestic telecommunications operators and enterprise customers for the usage of the Group s telecommunications networks and equipment.

(vii)

Represent primarily revenue from sale, and repair and maintenance of equipment as well as the resale of mobile services (MVNO).

Notes to the Unaudited Interim Financial Statements

for the six-month period ended 30 June 2016

10. Network Operations and Support Expenses

Included in the Group s network operations and support expenses are as follows:

	Six-month period ended 30 June	
	2016	2015
	RMB millions	RMB millions
Operating and maintenance	**21,768**	20,713
Utility	**6,454**	5,944
Property rental and management fee	**11,669**	5,648
Others	**4,060**	4,919
	43,951	37,224

11. Personnel Expenses

Personnel expenses are attributable to the following functions:

	Six-month period ended 30 June	
	2016	2015
	RMB millions	RMB millions
Network operations and support	**19,273**	18,171
Selling, general and administrative	**9,636**	9,908
	28,909	28,079

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Notes to the Unaudited Interim Financial Statements

for the six-month period ended 30 June 2016

12. Other Operating Expenses

Other operating expenses consist of:

		Six-month period ended 30 June	
		2016	2015
	Note	**RMB millions**	RMB millions
Interconnection charges	*(i)*	**5,726**	6,170
Cost of goods sold	*(ii)*	**19,816**	16,872
Donations		**3**	2
Others	*(iii)*	**549**	805
		26,094	23,849

Note:

(i) Interconnection charges represent amounts incurred for the use of other domestic and foreign telecommunications operators networks for delivery of voice and data traffic that originate from the Group s telecommunications networks.

(ii) Cost of goods sold primarily represents cost of telecommunications equipment sold.

(iii) Others mainly include other surcharges related to VAT.

13. Net Finance Costs

Net finance costs comprise:

	Six-month period ended 30 June	
	2016	2015
	RMB millions	RMB millions
Interest expense incurred	**2,110**	2,517
Less: Interest expense capitalised*	**(211)**	(155)
Net interest expense	**1,899**	2,362
Interest income	**(170)**	(164)
Foreign exchange losses	**38**	11

Foreign exchange gains	**(39)**	(49)
	1,728	2,160
* Interest expense was capitalised in construction in progress at the following rates per annum	**3.3% 5.0%**	3.8% 5.7%

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Notes to the Unaudited Interim Financial Statements

for the six-month period ended 30 June 2016

14. Income Tax

Income tax in the profit or loss comprises:

	Six-month period ended 30 June	
	2016	2015
	RMB millions	RMB millions
Provision for PRC income tax	**1,967**	3,922
Provision for income tax in other tax jurisdictions	**60**	28
Deferred taxation	**1,720**	(414)
	3,747	3,536

A reconciliation of the expected tax expense with the actual tax expense is as follows:

		Six-month period ended 30 June	
		2016	2015
	Note	**RMB millions**	RMB millions
Profit before taxation		**15,469**	14,544
Expected income tax expense at statutory tax rate of 25%	*(i)*	**3,867**	3,636
Differential tax rate on PRC subsidiaries and branches income	*(i)*	**(211)**	(185)
Differential tax rate on other subsidiaries income	*(ii)*	**(20)**	(16)
Non-deductible expenses	*(iii)*	**182**	141
Non-taxable income	*(iv)*	**(36)**	(39)
Others	*(v)*	**(35)**	(1)
Actual income tax expense		**3,747**	3,536

Note:

(i) Except for certain subsidiaries and branches which are mainly taxed at preferential rate of 15%, the provision

for mainland China income tax is based on a statutory rate of 25% of the assessable income of the Company, its mainland China subsidiaries and branches as determined in accordance with the relevant income tax rules and regulations of the PRC.

(ii) Income tax provisions of the Company s subsidiaries in Hong Kong and Macau Special Administrative Regions of the PRC, and in other countries are based on the subsidiaries assessable income and income tax rates applicable in the respective tax jurisdictions which range from 12% to 38%.

(iii) Amounts represent miscellaneous expenses in excess of statutory deductible limits for tax purposes.

(iv) Amounts represent miscellaneous income which are not subject to income tax.

(v) Amounts primarily represent tax deduction on prior year research and development expenses, losses on disposal of property, plant and equipment approved by tax authorities and other tax benefits.

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Notes to the Unaudited Interim Financial Statements

for the six-month period ended 30 June 2016

15. Dividends

Pursuant to the shareholders approval at the Annual General Meeting held on 25 May 2016, a final dividend of RMB0.080182 (equivalent to HK$0.095) per share totaling RMB6,489 million in respect of the year ended 31 December 2015 was declared and paid on 15 July 2016.

Pursuant to the shareholders approval at the Annual General Meeting held on 27 May 2015, a final dividend of RMB0.076120 (equivalent to HK$0.095) per share totaling RMB6,160 million in respect of the year ended 31 December 2014 was declared and paid on 17 July 2015.

The Board of Directors has resolved not to pay an interim dividend.

16. Basic Earnings per Share

The calculation of basic earnings per share for the six-month period ended 30 June 2016 and 2015 is based on the profit attributable to equity holders of the Company of RMB11,673 million and RMB10,980 million, respectively, divided by 80,932,368,321 shares.

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

17. Capital Commitments

As at 30 June 2016 and 31 December 2015, the Group had capital commitments as follows:

	30 June 2016 RMB millions	31 December 2015 RMB millions
Contracted for but not provided		
Property	**514**	403
Telecommunications network plant and equipment	**9,039**	9,745
	9,553	10,148

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Notes to the Unaudited Interim Financial Statements

for the six-month period ended 30 June 2016

18. Fair Value Measurements of Financial Instruments

Financial assets of the Group include cash and cash equivalents, bank deposits, investments, accounts receivable, prepayments and other receivables. Financial liabilities of the Group include short-term and long-term debt and payable, other non-current liabilities, accounts payable, accrued expenses and other payables. The Group does not hold nor issue financial instruments for trading purposes.

Fair Value Measurements

Based on IFRS 13, *Fair Value Measurement*, the fair value of each financial instrument is categorised in its entirety based on the lowest level of input that is significant to that fair value measurement. The levels are defined as follows:

Level 1:	fair values measured using quoted prices (unadjusted) in active markets for identical financial instruments
Level 2:	fair values measured using quoted prices in active markets for similar financial instruments, or using valuation techniques in which all significant inputs are directly or indirectly based on observable market data
Level 3:	fair values measured using valuation techniques in which any significant input is not based on observable market data

The fair values of the Group s financial instruments (other than long-term debt and payable, other non-current liabilities and available-for-sale equity investment securities) approximate their carrying amounts due to the short-term maturity of these instruments.

The Group s available-for-sale equity investment securities are categorised as level 1 financial instruments. The fair value of the Group s available-for-sale equity investment securities is RMB1,255 million as at 30 June 2016 (31 December 2015: RMB1,597 million), based on quoted market price on PRC stock exchanges. The Group s long-term investments, other than the available-for-sale equity investment securities, are unlisted equity interests for which no quoted market prices exist in the PRC and because their fair values cannot be measured reliably, so their fair values were not disclosed.

The fair values of long-term debt and payable and other non-current liabilities 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. The fair value measurement of long-term debt and payable and other non-current liabilities is categorised as level 2. The interest rates used by the Group in estimating the fair values of long-term debt and payable and other non-current liabilities, having considered the foreign currency denomination of the debt, ranged from 1.0% to 4.9% (31 December 2015: 1.0% to 4.9%). As at 30 June 2016 and 31 December 2015, the carrying amounts and fair values of the Group s long-term debt and payable and other non-current liabilities were as follows:

	30 June 2016		31 December 2015	
	Carrying amount RMB millions	**Fair value RMB millions**	Carrying amount RMB millions	Fair value RMB millions
Long-term debt and payable	**70,723**	**71,150**	64,914	65,156
Other non-current liabilities	**469**	**434**	455	419

During both periods, there were no transfers among instruments in level 1, level 2 or level 3.

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Notes to the Unaudited Interim Financial Statements

for the six-month period ended 30 June 2016

19. Related Party Transactions

(a) Transactions with China Telecom Group

The Group is a part of companies under China Telecommunications Corporation, a company owned by the PRC government, and has significant transactions and business relationships with members of China Telecom Group.

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

		Six-month period ended 30 June	
		2016	2015
	Note	**RMB millions**	RMB millions
Purchases of telecommunications equipment and materials	*(i)*	**2,385**	2,209
Sales of telecommunications equipment and materials	*(i)*	**1,415**	1,606
Construction and engineering services	*(ii)*	**7,742**	7,830
Provision of IT services	*(iii)*	**124**	66
Receiving IT services	*(iii)*	**394**	362
Receiving community services	*(iv)*	**1,200**	1,147
Receiving ancillary services	*(v)*	**5,985**	5,556
Property lease income	*(vi)*	**15**	15
Property lease expenses	*(vi)*	**197**	297
Net transaction amount of centralised services	*(vii)*	**264**	224
Interconnection revenues	*(viii)*	**33**	30
Interconnection charges	*(viii)*	**145**	212
Internet applications channel services	*(ix)*	**150**	188
Interest on amounts due to and loans from China Telecom Group	*(x)*	**1,462**	2,042
Lease of CDMA network facilities	*(xi)*	**64**	108
Lease of inter-provincial transmission optic fibres	*(xii)*	**8**	10
Lease of land use rights	*(xiii)*	**4**	8

Note:

(i) Represent the amount of telecommunications equipment and materials purchased from/sold to China Telecom Group and commission paid and payable for procurement services provided by China Telecom Group.

(ii)

Represent construction and engineering as well as design and supervisory services provided by China Telecom Group.

(iii) *Represent IT services provided to and received from China Telecom Group.*

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Notes to the Unaudited Interim Financial Statements

for the six-month period ended 30 June 2016

19. Related Party Transactions (continued)

(a) Transactions with China Telecom Group (continued)

Note: (continued)

(iv) Represent amounts paid and payable to China Telecom Group in respect of cultural, educational, health care and other community services.

(v) Represent amounts paid and payable to China Telecom Group in respect of ancillary services such as repairs and maintenance of telecommunications equipment and facilities and certain customer services.

(vi) Represent amounts of property lease fee received and receivable from/paid and payable to China Telecom Group for mutual leasing of properties.

(vii) Represent net amount shared between the Company and China Telecom Group for costs associated with centralised services. The amount represents amounts received or receivable for the net amount of centralised services.

(viii) Represent amounts received and receivable from/paid and payable to China Telecom Group for interconnection of local and domestic long distance calls.

(ix) Represent amounts received and receivable from China Telecom Group in respect of Internet applications channel services, including the provision of telecommunications channel and applications support platform and billing and deduction services, etc.

(x) Represent interest paid and payable to China Telecom Group with respect to the amounts due to China Telecommunications Corporation and loans from China Telecom Group (Note 6).

(xi) Represent amounts paid and payable to China Telecom Group primarily for lease of certain CDMA mobile telecommunications network (CDMA network) facilities located in Xizang Autonomous Region.

(xii) Represent amounts paid and payable to China Telecom Group for lease of certain inter-provincial transmission optic fibres within its service regions.

(xiii) Represent amounts paid and payable to China Telecom Group for leases of land use rights.

Amounts due from/to China Telecom Group are summarised as follows:

	30 June 2016 RMB millions	31 December 2015 RMB millions
Accounts receivable	**905**	492
Prepayments and other current assets	**912**	732
Total amounts due from China Telecom Group	**1,817**	1,224

Accounts payable	**19,576**	18,702
Accrued expenses and other payables	**6,179**	1,464
Short-term debt	**12,023**	12,098
Long-term debt and payable	**61,710**	61,710
Total amounts due to China Telecom Group	**99,488**	93,974

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Notes to the Unaudited Interim Financial Statements

for the six-month period ended 30 June 2016

19. Related Party Transactions (continued)

(a) Transactions with China Telecom Group (continued)

Amounts due from/to China Telecom Group, other than short-term debt and long-term debt and payable, bear no interest, are unsecured and are repayable in accordance with contractual terms which are similar to those terms offered by third parties. The terms and conditions associated with short-term debt and long-term debt and payable due to China Telecom Group are set out in Note 6.

As at 30 June 2016 and 31 December 2015, no material allowance for doubtful debts was recognised in respect of amounts due from China Telecom Group.

(b) Transactions with China Tower

The principal transactions with China Tower are as follows:

		Six-month period ended 30 June	
		2016	2015
	Note	**RMB millions**	RMB millions
Tower assets lease fee	*(i)*	**6,922**	
Provision of IT services	*(ii)*	**6**	

Note:

(i) Represent amounts paid and payable to China Tower for the lease of telecommunications towers and related assets.

Upon completion of the Tower Assets Disposal, the Company and China Tower entered into an agreement on 8 July 2016 to finally confirm the pricing and related arrangements in relation to the lease of telecommunications towers and related assets (including the Tower Assets and the tower products newly built by China Tower). The respective provincial branches of the Company and China Tower will enter into provincial service agreements in accordance with the actual demand for services. The service periods of these respective agreements are five years.

(ii) Represent IT services provided to China Tower.

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Notes to the Unaudited Interim Financial Statements

for the six-month period ended 30 June 2016

19. Related Party Transactions (continued)

(b) Transactions with China Tower (continued)

Amounts due from/to China Tower are summarised as follows:

	30 June 2016 RMB millions	31 December 2015 RMB millions
Accounts Receivable	**6**	
Prepayments and other current assets	**1,906**	1,789
Total amounts due from China Tower	**1,912**	1,789
Accounts payable	**9,915**	3,272
Accrued expenses and other payables	**178**	3,097
Total amounts due to China Tower	**10,093**	6,369

Amounts due from/to China Tower bear no interest, are unsecured and are repayable in accordance with contractual terms which are similar to those terms offered by third parties.

As at 30 June 2016 and 31 December 2015, no material allowance for doubtful debts was recognised in respect of amounts due from China Tower.

(c) Key management personnel compensation

Key management personnel are those persons having authority and responsibility for planning, directing and controlling the activities of the Group, directly or indirectly, including directors and supervisors of the Group.

Key management personnel compensation of the Group is summarised as follows:

Six-month period ended 30 June

	2016	2015
	RMB thousands	RMB thousands
Short-term employee benefits	3,171	2,970
Post-employment benefits	392	461
	3,563	3,431

Notes to the Unaudited Interim Financial Statements

for the six-month period ended 30 June 2016

19. Related Party Transactions (continued)

(d) Contributions to post-employment benefit plans

As stipulated by the regulations of the PRC, the Group participates in various defined contribution retirement plans organised by municipal, autonomous regional and provincial governments for its employees. The Group is required to make contributions to the retirement plans at rates ranging from 14% to 21% 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. Other than the above, the Group also participates in supplementary defined contribution retirement plans managed by independent external parties whereby the Group is required to make contributions to the retirement plans at fixed rates of the employees salaries, bonuses and certain allowances. 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 above plans for the six-month period ended 30 June 2016 were RMB3,198 million (six-month period ended 30 June 2015: RMB2,998 million).

The amount payable for contributions to the above defined contribution retirement plans as at 30 June 2016 was RMB748 million (31 December 2015: RMB791 million).

(e) Transactions with other government-related entities in the PRC

The Group is a government-related enterprise and operates in an economic regime currently dominated by entities directly or indirectly controlled by the People s Republic of China through government authorities, agencies, affiliations and other organisations (collectively referred to as government-related entities).

Apart from transactions with parent company and its fellow subsidiaries (Note 19(a)), the Group has transactions that are collectively but not individually significant with other government-related entities, which include but not limited to the following:

rendering and receiving services, including but not limited to telecommunications services

sales and purchases of goods, properties and other assets

lease of assets

depositing and borrowing

use of public utilities

These transactions are conducted in the ordinary course of the Group s business on terms comparable to the terms of transactions with other entities that are not government-related. The Group prices its telecommunications services and products based on government-regulated tariff rates, where applicable, or based on commercial negotiations. The Group has also established procurement policies and approval processes for purchases of products and services, which do not depend on whether the counterparties are government-related entities or not.

The directors of the Company believe the above information provides appropriate disclosure of related party transactions.

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Other Information

Management Discussion and Analysis

According to paragraph 40 of Appendix 16 of the Rules Governing the Listing of Securities on The Stock Exchange of Hong Kong Limited (the Listing Rules), save as disclosed herein, the Company confirms that the current company information in relation to those matters set out in paragraph 32 of Appendix 16 has not changed materially from the information disclosed in the Company s 2015 Annual Report.

Purchase, Sale or Redemption of Securities

During the six-month period ended 30 June 2016, neither the Company nor any of its subsidiaries has purchased, sold or redeemed any of the Company s listed securities.

Directors and Supervisors Interests and Short Positions in Shares, Underlying Shares and Debentures

As at 30 June 2016, none of the Directors or Supervisors of the Company had any interests or short positions in any shares, underlying shares of equity derivatives or debentures of the Company or its associated corporations (as defined in Part XV of the Securities and Futures Ordinance (Chapter 571 of the laws of Hong Kong) (the SFO)) as recorded in the register required to be maintained under Section 352 of the SFO or as otherwise notified to the Company and The Stock Exchange of Hong Kong Limited pursuant to the Model Code for Securities Transactions by Directors of Listed Issuers (the Model Code).

As at 30 June 2016, the Company has not granted its Directors or Supervisors, or their respective spouses or children below the age of 18 any rights to subscribe for the shares or debentures of the Company or any of its associated corporations and none of them has ever exercised any such right to subscribe for the shares or debentures.

Change of Directors and Supervisors since the Date of the 2015 Annual Report

The changes in the information relating to the Directors and Supervisors since the date of the Company s 2015 Annual Report are set out below:

On 25 April 2016, the Executive Director of the Company, Mr. Yang Jie was appointed as the Chairman and Chief Executive Officer of the Company. On the same day, he no longer held the offices of the President and Chief Operating Officer of the Company.

On 25 April 2016, the Executive Director of the Company, Mr. Yang Xiaowei was appointed as the President and Chief Operating Officer of the Company. On the same day, he no longer held the office of the Executive Vice President of the Company.

On 10 May 2016, Mr. Zhu Wei resigned from his position as a Non-Executive Director of the Company due to change in work arrangement.

On 19 August 2016, Mr. Zhang Jiping retired from his positions as an Executive Director and Executive Vice President of the Company due to his age.

Save as stated above, there is no other information of the Directors or Supervisors of the Company required to be disclosed pursuant to Rule 13.51B(1) of the Listing Rules. The updated biographical details of the Directors and

Supervisors are available on the website of the Company *(www.chinatelecom-h.com)*.

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Material Interests and Short Positions in Shares and Underlying Shares of the Company

As at 30 June 2016, the interests or short position of persons who are entitled to exercise or control the exercise of 5% or more of the voting power at any of the Company s general meetings (excluding the Directors and Supervisors) in the shares and underlying shares of equity derivatives of the Company as recorded in the register required to be maintained under Section 336 of the SFO are as follows:

Name of Shareholders	Number of shares held	Type of Shares	Percentage of the respective type of shares in issue (%)	Percentage of the total number of shares in issue (%)	Capacity
China Telecommunications Corporation	57,377,053,317 (Long position)	Domestic shares	85.57%	70.89%	Beneficial owner
Guangdong Rising Assets Management Co., Ltd.	5,614,082,653 (Long position)	Domestic shares	8.37%	6.94%	Beneficial owner
JPMorgan Chase & Co.	1,668,882,703 (Long position)	H shares	12.02%	2.06%	348,035,935 shares as beneficial owner; 248,602,000 shares as investment manager; 10,700 shares as trustee (other than a bare trustee) and 1,072,234,068 shares as custodian corporation/ approved lending agent
	54,101,278 (Short position)	H shares	0.38%	0.07%	Beneficial owner
	1,072,234,068 (Shares available for lending)	H shares	7.72%	1.32%	Custodian corporation/ approved lending agent
BlackRock, Inc.		H shares	6.97%	1.20%	

967,847,607 (Long position)				Interest of controlled corporation
2,200,000 (Short position)	H shares	0.02%	0.00%	Interest of controlled corporation

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Name of Shareholders	Number of shares held	Type of Shares	Percentage of the respective type of shares in issue (%)	Percentage of the total number of shares in issue (%)	Capacity
The Bank of New York Mellon Corporation	834,090,669 (Long position)	H shares	6.01%	1.03%	Interest of controlled corporation
	805,835,485 (Shares available for lending)	H shares	5.81%	1.00%	Interest of controlled corporation
Citigroup Inc.	753,487,404 (Long position)	H shares	5.42%	0.93%	36,425,608 shares as Interest of controlled corporation; 717,061,796 shares as custodian corporation/ approved lending agent
	21,742,064 (Short position)	H shares	0.15%	0.03%	Interest of controlled corporation
	717,061,796 (Shares available for lending)	H shares	5.16%	0.89%	Custodian corporation/ approved lending agent

Save as disclosed above, as at 30 June 2016, in the register required to be maintained under Section 336 of the SFO, no other persons were recorded to hold any interests or short positions in the shares or underlying shares of the equity derivatives of the Company.

Audit Committee

The audit committee has reviewed with management and the Company s international auditor, Deloitte Touche Tohmatsu, the accounting principles and practices adopted by the Group and discussed internal control and financial reporting matters including the review of the Company s Interim Report for the six months ended 30 June 2016.

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Compliance with the Corporate Governance Code

The Company attaches great importance to corporate governance. We continued to make efforts in improving the Company s internal control mechanisms, strengthening information disclosure and enhancing the Company s transparency, developing corporate governance practices and protecting shareholders interests to the maximum degree.

The roles of Chairman and Chief Executive Officer of the Company were performed by the same individual, for the six-month period ended 30 June 2016. In the Company s opinion, through supervision of the Board of Directors and Independent Non-Executive Directors, and effective control of the Company s internal check and balance mechanism, the same individual performing the roles of Chairman and Chief Executive Officer can achieve the goal of improving the Company s efficiency in decision-making and execution and effectively capture business opportunities. Many international leading corporations also have a similar arrangement.

Save as stated above, the Company has been in compliance with all the code provisions under the Corporate Governance Code as set out in Appendix 14 of the Listing Rules throughout the six-month period ended 30 June 2016.

Compliance with the Model Code for Securities Transactions by Directors and Supervisors

The Company has adopted the Model Code as set out in Appendix 10 of the Listing Rules to govern securities transactions by Directors and Supervisors. Further to the specific enquiries made by the Company to Directors and Supervisors, they have confirmed their compliance with the Model Code throughout the period from 1 January 2016 to 30 June 2016.