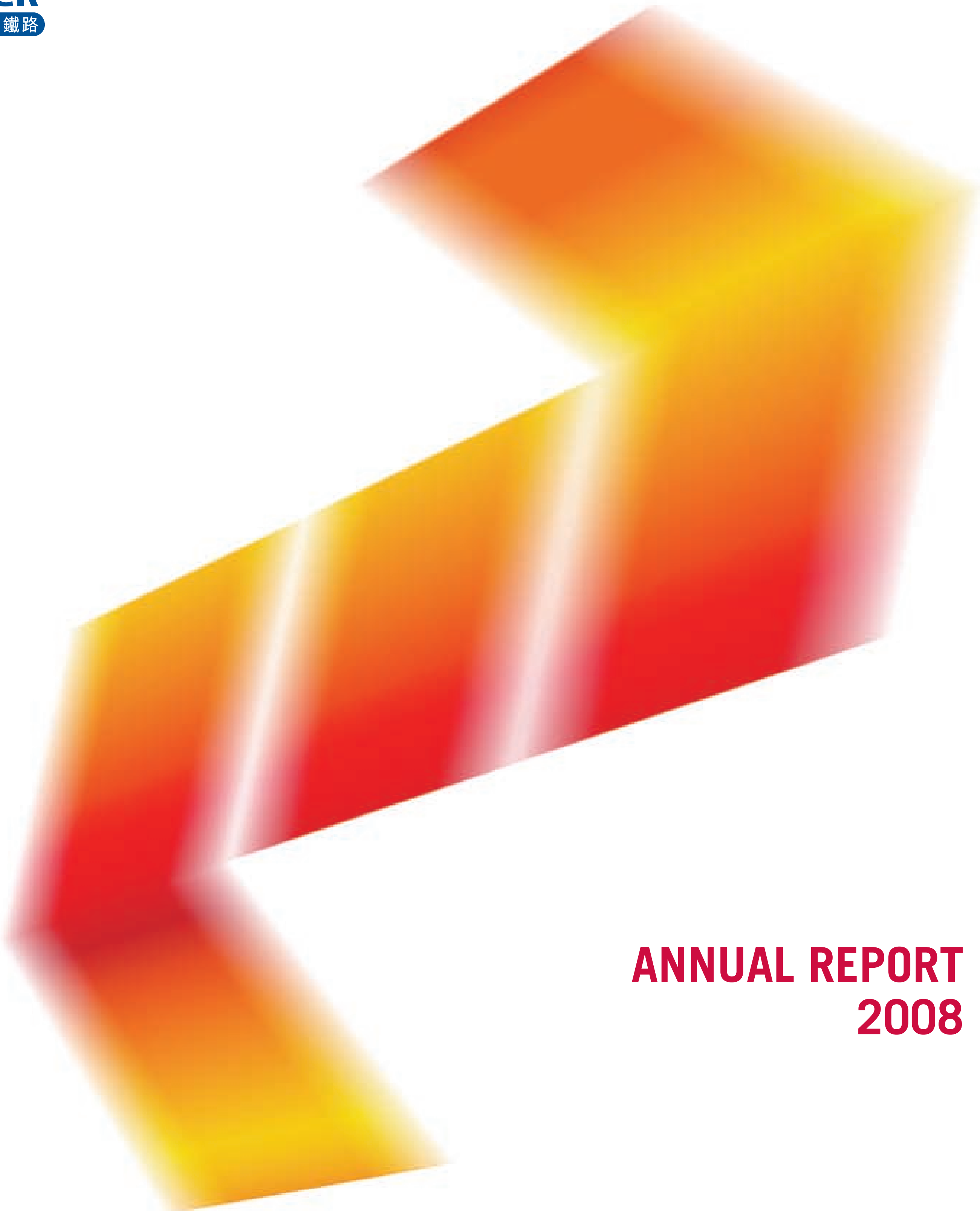
KCR
九廣鐵路



ANNUAL REPORT 2008

KOWLOON-CANTON RAILWAY CORPORATION

CONTENTS

MANAGING BOARD & KEY MANAGEMENT

MANAGING BOARD


Prof K C Chan SBS, JP (Left)
PhD
Chairman
Secretary for Financial Services and the Treasury of the Hong Kong Special Administrative Region Government

Eva Cheng Yu-wah JP (Right)
B Soc Sc
Secretary for Transport and Housing of the Hong Kong Special Administrative Region Government


Stanley Y H Ying JP (Left)
Member of Audit Committee
Permanent Secretary for Financial Services and the Treasury (Treasury) of the Hong Kong Special Administrative Region Government

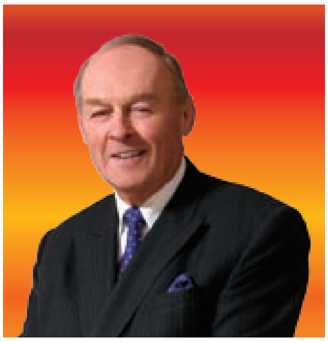
Francis Ho Suen-wai JP (Right)
Permanent Secretary for Transport and Housing (Transport) of the Hong Kong Special Administrative Region Government


Lucia Li Li Ka-lai JP (Left)
FCCA, FCPA
Chairman of Audit Committee
Director of Accounting Services of the Hong Kong Special Administrative Region Government (Until 16 January 2009)

Clement Leung Cheuk-man JP (Right)
Member of Audit Committee
Deputy Secretary for Financial Services and the Treasury (Treasury) of the Hong Kong Special Administrative Region Government

K T Li JP (Left)
FCCA, CPA
Chairman of Audit Committee
Director of Accounting Services of the Hong Kong Special Administrative Region Government
(With effect from 16 January 2009)

KEY MANAGEMENT



Ir James Blake OBE, JP

CEng, FHKIE, FHKEng, FICE, FIStructE, FIHT

Chief Officer

Michael J Arnold

BSc, CEng, MICE, MIHT

Senior Manager-Administration

Company Secretary

Julian P Walsh

MA, ACA, CPA,

Senior Manager-Finance

CHAIRMAN'S STATEMENT

The Corporation's long-term future is secure, as indeed is its ability to continue playing an important role in serving the community of Hong Kong.

2008 was a successful year for the Corporation, following the Corporation granting a Service Concession to the MTR Corporation Limited to operate the KCRC railway network for an initial period of 50 years with effect from 2 December 2007. Despite this fundamental change in both nature and scale of the Corporation's activities, the transition has taken place smoothly with the Managing Board and the Corporation's small management team settling quickly into their new roles. Equally smoothly the integrated rail network has become an accepted part of travel convenience throughout the length and breadth of Hong Kong.

The net loss recorded in 2008, the first since 1986, was anticipated and occurred primarily as a result of the heavy depreciation and interest charges arising from the major investments made by the Corporation during its past ten years of rapidly expanding the KCRC network. This financial picture will see little change over the next few years, but thereafter the Corporation is projected to return to sustained long-term profitability.

This picture results from the terms of the Service Concession, which provides for only a fixed annual payment of HK$750 million by the MTR Corporation Limited until 2010. From 2 December 2010 onwards, however, the Corporation will receive, in addition to the fixed annual payment, a variable annual payment based on a sliding scale percentage of annual gross revenue above HK$2.5 billion generated from the KCRC network assets. With this assured increasing revenue stream, the Corporation's long-term future is secure, as indeed is its ability to continue playing an important role in serving the community of Hong Kong.

Finally, my thanks on behalf of the shareholder for the continuing efforts of everyone who has contributed towards setting the Corporation on its new track, thus far a successful journey. May I single out Mrs Lucia Li for special mention, and a note of gratitude, since upon her retirement from the Hong Kong Special Administrative Region Government she stepped down from the Managing Board on 16 January 2009, where, in addition to being a Member of the Board, she held the responsibility of chairing the Audit Committee.

Prof K C Chan
Chairman
9 March 2009

CHIEF OFFICER'S STATEMENT AND FINANCIAL REVIEW

The Corporation now derives its core income by way of the fixed annual payment of HK$750 million from MTRCL under the Service Concession Agreement, and will continue to do so until the additional variable annual payments begin to fall due from 2 December 2010 onwards.

To make the overnight transition from a major public transport operator employing some 6,000 staff to an asset holding business directly employing only a very small number of staff required prior detailed planning on the part of the Corporation and the MTR Corporation Limited (MTRCL) with the Government fully in support. All of this hard work and detailed planning enabled the change to take place on 2 December 2007 almost seamlessly and the Corporation began the year 2008 on a very sound footing.

Both corporations, however, continue to be independent bodies under separate management. The Corporation on its part must comply with its statutory obligations under the Kowloon-Canton Railway Corporation Ordinance. While the Corporation continues to retain title over the KCRC network railway land, and ownership of its pre-merger railway assets with a book value as at 31 December 2008 close to HK$80 billion, MTRCL has a licence to access and use the land, and the right to operate those assets, for railway purposes under a 50-year Service Concession Agreement. This Agreement requires MTRCL to make annual payments to the Corporation, and should the Service Concession come to an end, the assets, including any replacement or new assets acquired during the concession period for the purposes of operating the KCRC network, must be returned to the Corporation fit for use as an operating railway.

Although the Corporation remains an independent statutory body, to do so with only the smallest possible executive management team, the decision was taken pre-merger to outsource many of the Corporation's routine day-to-day administrative support functions, but retaining the final authority for approving all financial management, land, property, staff, IT and legal matters. Initially this outsourcing has predominantly been to MTRCL because the relevant former Corporation staff upon their transfer to MTRCL, being already familiar with the work, could assist when required. This arrangement has operated smoothly, enabling both corporations to settle down quickly within the merger framework as envisaged.

In those areas where there might be a potential risk of a conflict of interest between the two corporations, the Corporation has appointed independent advisors, for example, in the drafting of documentation relating to ownership and use of railway land, where the Service Concession requires the Corporation to retain legal title.

The Corporation continues to lease out where possible those property assets remaining after the merger transaction with MTRCL. During 2008 this produced HK$12 million in revenue, and the amount is set to increase following the leasing in early December 2008 of two of the four floors retained by the Corporation in Citylink Plaza.

Action was taken during 2008 to strengthen the Corporation's ability in due course to recover from West Rail Property Development Limited (WRPDL) the expenditure previously incurred in protecting property development opportunities along West Rail. WRPDL's share of the profits from those developments, net of KCRC expenditure, will eventually pass to the Government, offsetting some of the Government's investment in West Rail.

The Corporation retains responsibility for funding of the Kowloon Southern Link (KSL) project, with MTRCL being appointed at the time of the merger as the project manager to oversee the construction works on behalf of the Corporation. Upon the commissioning of KSL, MTRCL will be responsible for railway operations as provided for under the Service Concession Agreement, with the Corporation retaining the assets involved in its books in like fashion to other service concession assets.

The Corporation's ongoing capital works account also funds capital expenditure on the purchase of an additional 22 Light Rail vehicles, a procurement contract which was placed pre-merger to cater for the additional passenger demand in the North West New Territories arising from the forecast increase in patronage on Light Rail feeder services to West Rail after the KSL becomes operational. When completed, KSL will provide the final link in the Corporation's ten-year strategy of establishing a fast and convenient rail corridor between the eastern and western areas of the New Territories via Kowloon.

Likewise the Corporation is funding expenditure on the installation of mechanical gap fillers at Lo Wu Station platforms, part of an ongoing initiative at the time of the merger to improve passenger safety, as well as expenditure committed pre merger to secure the asset life of the older East Rail rolling stock. These expenditures will also increase the value of KCRC assets.

Despite the financial statements for 2008 being much simpler than previous years, no benefit can be gained from directly comparing the financial results in 2008 with those of 2007, given the radically changed nature of the Corporation's business after the Territory-wide merger of rail operations. The Corporation now derives its core income by way of the fixed annual payment of HK$750 million from MTRCL under the Service Concession Agreement, and will continue to do so until the additional variable annual payments begin to fall due from 2 December 2010 onwards. KCRC direct staff costs in 2008 amounted to HK$5 million, with the bulk of the remaining recurrent operating expenses of HK$64 million arising from expenditure on the outsourcing arrangements with MTRCL, provision of other professional services and settlement of legal claims initiated before the merger.

Operating profit for 2008 before depreciation and amortisation amounted to some HK$801 million. Interest and finance income for 2008 was HK$450 million, arising mainly from earnings on the upfront payment of HK$12.04 billion received from MTRCL on the date of the merger. Interest and finance expenses were HK$1,362 million, and depreciation and amortisation charges HK$2,595 million, reflecting the major investments made by the Corporation in network expansion and service improvements over the past ten years. The net loss for the year was HK$1.815 billion.

Turning to the future, the Corporation's annual financial statements are expected to show a net loss due to non-cash depreciation charges for several years until the additional annual variable payments from MTRCL after 2010 quickly return the Corporation to a position of sustained net profitability.

During 2009 the Corporation will launch its second Medium Term Note Programme to meet funding requirements as and when the existing borrowing facilities fall due, particularly in 2009 and 2010. Discussions with banks and rating agencies commenced during 2008, and the Corporation's Managing Board has recently approved the strategy and arrangements required to launch this new MTN Programme early in 2009.

Finally, on behalf of myself and other senior colleagues, I would like to take this opportunity to express appreciation for the efforts of all those who have worked during the year on behalf of the Corporation, either directly or indirectly as the case may be.

Ir James Blake, OBE, JP
CEng, FHKIE, FHKEng, FICE, FIStructE, FIHT
Chief Officer
9 March 2009

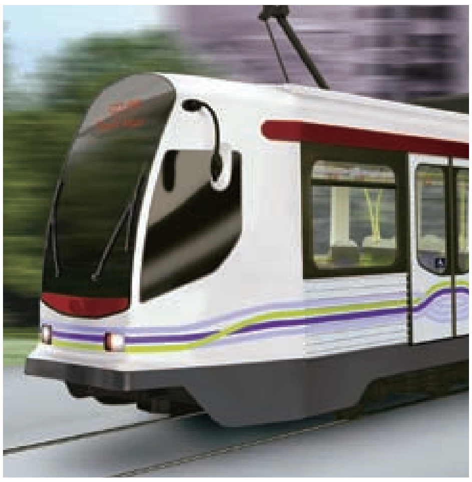
KOWLOON SOUTHERN LINK

Responsibility remains with the Corporation for the construction of the Kowloon Southern Link (KSL), which upon completion will enable West Rail passengers to enjoy a convenient cross-platform interchange to East Rail, and vice versa, at Hung Hom Station. Only when the project is completed and ready for revenue operation, will it be taken over and operated by the MTR Corporation Limited (MTRCL) under the terms of the Service Concession Agreement signed between the two corporations in 2007. To facilitate this process, the Corporation agreed to appoint MTRCL from the date of the merger as the project manager for the construction of the then remaining works of the project, in return for which MTRCL receives a lump sum fee paid in monthly instalments plus an incentive payment determined according to an agreed formula should the project be completed within the approved budget of HK$8.303 billion and before the end of 2009.

Forming an essential element of the KSL project is the purchase by the Corporation of six SP1900 EMU train sets and 22 new Light Rail Vehicles. The new EMU train sets are needed to both handle the anticipated passenger increase and maintain West Rail train service frequencies because of the additional end-to-end journey time as a result of the KSL extending West Rail from its current terminus at Nam Cheong Station to Austin, East Tsim Sha Tsui and Hung Hom Stations. New Light Rail Vehicles are required to meet the associated increase in Light-Rail passengers interchanging with West Rail.

Also forming part of the KSL project is the construction by the Corporation of the Middle Road Subway Extension to provide direct and convenient access between the East Tsim Sha Tsui Station and the Canton Road shopping and commercial area. The Corporation has further conditionally agreed with the Government to undertake essential advance works to enable the future Express Rail Link to pass under the KSL to its planned terminus at West Kowloon.

New Austin Station



New Light Rail vehicle

The KSL is on track for commissioning in the second half of 2009

Progress on the project was excellent in 2008. By the end of 2008 the project was 97% completed, with the permanent way having been laid and energised between Nam Cheong and East Tsim Sha Tsui Stations, permitting initial testing of the signalling and other E&M systems by West Rail trains operating on the KSL outside of normal service hours. Construction of the new Austin Station was nearing completion by year end. By October 2008, all six new EMU train sets had also been delivered and brought into revenue service on West Rail. Although some reinstatement works to surrounding roads, building services installations, and other testing and commissioning works remain to be completed, the KSL should be ready for full revenue operation in the latter half of 2009.

Progress on excavation for and construction of the Middle Road Subway Extension also proceeded steadily despite the contractor having to overcome difficult rock conditions in some areas. The programme also remains on track for sufficient new Light Rail Vehicles to be delivered and ready to meet the anticipated initial increase in patronage on Light Rail when the KSL opens, with the remainder of the vehicles following shortly thereafter.

By the end of 2009 residents of Tuen Mun, Yuen Long and Tin Shui Wai will be able to enjoy a direct rail service from home to Tsim Sha Tsui or Hung Hom taking only about 40 minutes, representing a saving of 10 minutes or more on the present journey time because of the current need to interchange to the MTR Tsuen Wan to Central line at Mei Foo Station.

CORPORATE GOVERNANCE

The Corporation maintains high standards of corporate governance. Being a statutory Corporation established in Hong Kong by the Kowloon-Canton Railway Corporation Ordinance (Chapter 372 of the Laws of Hong Kong) (the KCRC Ordinance), it is not bound by The Stock Exchange of Hong Kong Limited Listing Rules. Nonetheless, it supports the principles of good corporate governance contained in the Cadbury Committee's Code of Best Practice to the extent that they are applicable to the Corporation. As a matter of policy, the Corporation complies with The Stock Exchange of Hong Kong Limited Code of Corporate Governance Practices (the Code) as set out in Appendix 14 to the Listing Rules to the extent that they are applicable to the Corporation, International Financial Reporting Standards issued by the International Accounting Standards Board and all applicable Hong Kong Financial Reporting Standards issued by the Hong Kong Institute of Certified Public Accountants, accounting principles generally accepted in Hong Kong and the disclosure requirements of the Hong Kong Companies Ordinance.

THE MANAGING BOARD

The Corporation and its wholly or majority owned subsidiary companies are controlled through its Managing Board (the Board). The Board's main roles are to ensure that the Corporation complies in every respect with the provisions of the Ordinance to create value for its sole shareholder, to provide leadership to the Corporation, to approve the Corporation's strategic objectives and to ensure that the necessary financial and other resources are made available to Management to enable them to meet those objectives. The Board, which meets at least four times a year, has a schedule of matters reserved for its approval. The specific responsibilities reserved for the Board include but are not limited to:

(a) Rules for conduct of the Corporation's business;
(b) Three Year Business Plans, including revenue, expenses and capital budgets for the ensuing year, annual manpower plan and pay review;
(c) Annual budget;
(d) Annual report and audited financial statements;
(e) Recommendations with respect to dividend payments;
(f) Major business strategies; and
(g) Award of major contracts and significant variations to those contracts.

In addition to the above, Management must report to the Board monthly on significant developments, together with the operating and financial results, information on use of the Corporate Seal, letting of major contracts, public complaints and any other matters which may be required by the Board from time to time. The Board has delegated all other authorities to carry out the Corporation's activities to the Chief Officer.

THE ROLES OF THE CHAIRMAN AND THE CHIEF OFFICER

The division of responsibilities between the Chairman of the Board and the Chief Officer is clearly defined and has been approved by the Board. The non-executive Chairman leads the Board in the determination of its strategy and in the achievement of its objectives. The Chairman is responsible for the conduct of the business of the Board, ensuring its effectiveness and setting its agenda. The Chairman is not involved in the day-to-day business of the Corporation. The Chairman facilitates the effective contribution of non-executive Members of the Board and constructive relations between executive management and Members, ensuring that Members receive accurate, timely and clear information, as well as ensuring effective communication with the Corporation's sole shareholder. The Chief Officer has direct charge of the Corporation on a day-to-day basis and is accountable to the Board for the Corporation's financial and operational performance.

MEMBERS AND MEMBERS' INDEPENDENCE

The Board currently comprises the Chairman and five other non-executive Members, all of whom are senior public office holders in the Government of the Hong Kong Special Administrative Region. All are appointed to the Board on an ex-officio basis by the Chief Executive of the Hong Kong Special Administrative Region. Members have, if required, access to independent professional advice at the Corporation's expense, in order for them to carry out their responsibilities. Notwithstanding that they are public office holders, Members are expected to be independent in their judgement. The names of Members together with their biographical details are set out on page 2.

INFORMATION

On appointment, each Member receives information about the Corporation, the role of the Board and the matters reserved for its decision, the terms of reference and membership of the Board and its committees, and the powers delegated to those committees, the Corporation's corporate governance practices and procedures, including the powers reserved for the Corporation's senior executives, and the latest financial information about the Corporation. This is supplemented by visits to key locations and meetings with key senior executives. Throughout their period in office, Members are continually updated on the Corporation's business, the competitive and regulatory environments in which it operates, corporate social responsibility matters and other changes affecting the Corporation, and the industry it operates in as a whole, by written briefing papers and meetings with senior executives. Members are also advised, on appointment, of their legal and other duties and obligations as a Member of the Board, by the Company Secretary. They are regularly reminded of these duties and updated on changes to the legal and governance requirements which impact on the Corporation and themselves as Members of the Board.

Regular reports and papers are circulated to Members in a timely manner in preparation for Board and Committee meetings. These papers are supplemented by information specifically requested by Members from time to time. All Members receive monthly management accounts and regular management reports, which enable them to scrutinise the Corporation's and management's performance against agreed objectives.

THE COMPANY SECRETARY

The Company Secretary is responsible for advising the Board, through the Chairman, on all governance matters. Members have access to the advice and services of the Company Secretary.

RELATIONS WITH THE SOLE SHAREHOLDER

To fulfil the Chairman's obligations under the Ordinance and the Code, the Chairman gives feedback to the Board on issues raised with him by the Corporation's sole shareholder. The Corporation maintains a corporate website, www.kcrc.com, containing a wide range of information of interest to all stakeholders.

INTERNAL CONTROL

The Board is ultimately responsible for the Corporation's system of internal control. It ensures through the Audit Committee that appropriate policies on internal control are in place and through this Committee seeks assurance that enables it to satisfy itself that the system is functioning effectively, and that the system of internal control is effective in managing risks in the manner which they are approved. Members have continued to review the effectiveness of the Corporation's system of internal controls through the Audit Committee, including operational and compliance controls, risk management and the

Corporation's internal control arrangements. These reviews have included an assessment of internal control and, in particular, internal financial control, by the internal audit function; management assurance of the maintenance of control; and reports from the external auditor on matters identified during the course of statutory audit work.

The Corporation views the careful management of risk as a key management activity. Managing business risk to deliver opportunities is a key element of all activities. This is done using a simple and flexible framework that provides a consistent and sustained way of implementing the Corporation's values. These business risks, which may be strategic, operational, or reputation-related are made known to Members. The business context determines in each situation the level of acceptable risk and controls.

BOARD AND AUDIT COMMITTEE MEETINGS

The Board meets quarterly, and on an ad hoc basis when appropriate. It is responsible, inter alia, for overall corporate strategy, approval of the Corporation's annual budget, major financing arrangements, and ensuring that sound administrative systems and procedures are in place. It reviews monthly the Corporation's operating results, and the progress made towards annual targets. With the position of Chief Executive Officer being left vacant from December 2007, the Board has delegated to the Chief Officer the authority for the management of day-to-day operations.

There were four Board and three Audit Committee Meetings held during the year up to 31 December 2008 and attended by Members as listed in the table below.

	Board Meetings	Audit Committee Meetings
Professor K C Chan *(Note 1)*	4	N.A.
Ms Eva Cheng	3	N.A.
Mr Stanley Ying	4	3
Mr Francis Ho *(Note 2)*	4	N.A.
Mr Clement Leung	4	3
Mrs Lucia Li *(Note 3)*	4	3

Note 1. Chairman of the Board

Note 2. One meeting attended by the Acting Permanent Secretary for Transport and Housing (Transport)

Note 3. Chairman of the Audit Committee

AUDIT COMMITTEE

During the year, the Audit Committee comprised Mrs Lucia Li Li Ka-lai (Chairman), Mr Stanley Ying Yiu-hong and Mr Clement Leung Cheuk-man. All members of the Committee are non-executive Members. The Committee has at least one member possessing "recent and relevant experience", namely, Mrs Lucia Li Li Ka-lai who is a chartered accountant and was also the Director of Accounting Services of the Government of the Hong Kong SAR. On 16 January 2009, Mr K T Li, on taking up the appointment of Director of Accounting Services, replaced Mrs Li as member of the board and the Chairman of Audit Committee.

Under its terms of reference, the Audit Committee monitors the integrity of the financial statements and any formal announcements relating to the Corporation's performance. The Committee is responsible for monitoring the effectiveness of the external audit process and making recommendations to the Board in relation to the appointment, reappointment and remuneration of the external auditor. It is responsible for ensuring that an appropriate relationship between the Corporation and the external auditor is maintained, including reviewing non-audit services and fees. It also monitors the effectiveness of the Corporation's systems of internal control and the processes for monitoring and evaluating the risks facing the Corporation. The Committee reviews the effectiveness of the internal audit function, which is currently provided by the internal audit department of the MTR Corporation Limited under an outsourcing arrangement, and is responsible for recommending to the Managing Board the renewal and termination of that outsourced service function. The Committee has undertaken to review its terms of reference at least once every three years and its effectiveness and, if appropriate, will recommend to the Board any changes required as a result of the review.

The Committee meets with Management, as well as privately with both the external and internal auditors. The Committee's terms of reference are available from the Company Secretary and are displayed on the Corporation's website, www.kcrc.com. In 2008 the Audit Committee discharged its responsibilities by:

(a) reviewing the Corporation's draft financial statements prior to Board approval;
(b) reviewing the external auditor's reports thereon;
(c) reviewing the appropriateness of the Corporation's accounting policies;
(d) reviewing at various times the potential impact of the generally accepted accounting principles in Hong Kong on the Corporation's financial statements;
(e) reviewing, recommending or pre-approving audit fees or non-audit fees;
(f) reviewing the external auditor's plan for the audit of the Corporation's financial statements, which includes key areas of focus; and
(g) approving the annual internal audit plan and reviewing reports on the adequacy and effectiveness of systems of internal control, financial reporting and risk management.

The Audit Committee has taken on responsibility for monitoring the Corporation's whistle blowing procedures, which ensure that appropriate arrangements are in place for employees to be able to raise matters of possible impropriety in confidence, with suitable subsequent follow-up action.

Auditors' Independence and Objectivity

The Audit Committee monitors regularly and closely the non-audit services being provided to the Corporation and its subsidiary companies by its external auditor, who is appointed by the Chief Executive of the Hong Kong Special Administrative Region, to ensure that the provision of such services does not impair the external auditor's independence or objectivity. If and when appropriate the Committee will engage the services of alternative, appropriately qualified accounting firms to undertake non-audit services. When considering any non-audit work to be undertaken by the external auditor, the Committee is mindful of the need to be satisfied that the external auditor should not audit its own work, make management decisions for the Corporation or its subsidiaries, have a mutuality of financial interest with the Corporation or its subsidiaries, or be put in the role of advocate for the Corporation or its subsidiaries. The Committee also takes into consideration relevant professional and regulatory requirements so that these are not impaired by the provision of permissible non-audit services by the external auditor. Prior approval by the Audit Committee is required for any services provided by the external auditor. Any activities that may be perceived to be in conflict with the role of the external auditor must be submitted to the Committee for its consideration and approval prior to engagement. Details of the amounts paid to the external auditor during the year for audit and other services are set out in the notes to the financial statements on page 51.

REPORT OF THE MEMBERS OF THE MANAGING BOARD

The Members of the Managing Board have pleasure in submitting herewith their report and audited financial statements for the financial year ended 31 December 2008.

KOWLOON-CANTON RAILWAY CORPORATION ORDINANCE

The Kowloon-Canton Railway Corporation Ordinance (the KCRC Ordinance), enacted in 1982, established the Corporation and empowered it to operate the Kowloon-Canton Railway. Amendments in 1986 and 1998 empowered the Corporation to construct and operate Light Rail and new railways, and enabled the Government to inject equity into the Corporation to fund the construction of such new railways. Inter alia, the KCRC Ordinance contains provisions covering the appointments and roles of the Members of the Managing Board.

An amendment of the KCRC Ordinance in December 2001 provided for the separation of the functions and duties of the Chairman from those of the Chief Executive by creating the office of Chief Executive Officer of the Corporation. The Chief Executive Officer was also appointed as a Member of the Managing Board.

On 2 December 2007, following the enactment of the Rail Merger Ordinance, the MTR Corporation Limited commenced operating KCRC's railway assets by way of a service concession for an initial period of 50 years, which is extendable. KCRC retains ownership of the railway assets covered in the service concession agreement and should the MTR Corporation Limited fail to observe the terms of the agreement, there is provision for KCRC to take back and operate its assets. The Rail Merger Ordinance also made provision for the position of Chief Executive Officer to be left vacant, which the Managing Board agreed should be the case from 2 December 2007. Instead the Corporation appointed a Chief Officer, who is not a Member of the Managing Board, to head the executive management team.

PRINCIPAL ACTIVITIES OF THE CORPORATION

From 2 December 2007, the principal activities of the Corporation have become –

- railway asset holder, with responsibility for monitoring that the MTR Corporation Limited complies with the terms of the service concession agreement
- investing the upfront payment of HK$12.04 billion and subsequent annual payments from the MTR Corporation Limited
- servicing the Corporation's outstanding debts
- managing its remaining subsidiaries

The principal activities of the subsidiary companies incorporated to facilitate the undertaking of the above activities are set out in Note 17 to the financial statements.

THE MANAGING BOARD

The Board is the governing body of the Corporation with authority to exercise the duties conferred upon it by the KCRC Ordinance.

Members of the Board are all public officers (appointed ex-officio), being Prof K C Chan (Chairman) (the Secretary for Financial Services and the Treasury), Ms Eva Cheng (the Secretary for Transport and Housing), Mr Stanley Ying Yiu-hong (the Permanent Secretary for Financial Services and the Treasury (Treasury)), Mr Francis Ho Suen-wai (the

Permanent Secretary for Transport and Housing (Transport)), Mr Clement Leung Cheuk-man, (the Deputy Secretary for Financial Services and the Treasury (Treasury)), and Mrs Lucia Li Li Ka-lai (the Director of Accounting Services) until 16 January 2009, when she was replaced by Mr K T Li.

Brief biographical details of Board Members are set out on page 2.

LONG-TERM PLANNING, BUSINESS PLANNING AND FINANCIAL MANAGEMENT FRAMEWORK

Business plans, incorporating triennial forecasts of income and expenditure, are prepared each year for submission to the Managing Board. The first year of the Business Plan forms the basis for formulating the Budget for that year.

There are defined procedures and regular quality reviews of the operation of the Corporation's computerised systems to ensure the accuracy and completeness of financial records and the efficiency of data processing. There are defined procedures for the appraisal, review and approval of all major capital projects, and all major expenditure and revenue contracts. All contracts over HK$50 million and all consultancy services over HK$10 million require the approval of the Managing Board. Operating and financial reports, comparing results against their respective budgets and providing updates on significant events, are put to and considered by the Managing Board on a monthly basis.

CORPORATE GOVERNANCE

As set out in the Corporate Governance Report, the Managing Board maintains high standards of corporate governance.

INTERESTS IN CONTRACTS OF MEMBERS OF THE MANAGING BOARD AND SENIOR EXECUTIVE STAFF

No contracts of significance to which the Corporation or any of its subsidiaries was a party and in which a Member of the Managing Board, or Senior Executive Staff, had a material interest subsisted at the end of the year or at any time during the year.

At no time during the year was the Corporation or any of its subsidiaries a party to any arrangements to enable Members of the Managing Board, or Senior Executive Staff, to acquire benefits by means of the acquisition of shares in or debt securities of the Corporation or subsidiaries of the Corporation.

FINANCIAL STATEMENTS

The results of the Group for the year ended 31 December 2008 and the state of affairs of the Corporation and of the Group at that date are set out in the financial statements on pages 24 to 95.

FIXED ASSETS

Movements in fixed assets during the year are set out in Note 13 to the financial statements.

SHARE CAPITAL

Details of the Corporation's share capital are set out in Note 27 to the financial statements. Any further contributions of capital will be determined by the Government in consultation with the Corporation.

DIVIDEND

No dividend to the Government is proposed.

CAPITALISED INTEREST AND FINANCE INCOME/EXPENSES

Details of the Corporation's capitalised interest and finance income/expenses are set out in Note 8 to the financial statements.

INTEREST-BEARING BORROWINGS

Details of the Corporation's interest-bearing borrowings are set out in Note 25 to the financial statements.

TURNOVER, FINANCIAL RESULTS AND FINANCIAL POSITION

Details of the Corporation's turnover, financial results and financial position are set out in the financial statements, the Chief Officer's Statement and Financial Review, and the Five-year Statistics of the Annual Report.

GOING CONCERN

The financial statements on pages 24 to 95 have been prepared on a going concern basis. The Managing Board has approved the Corporation's budget for 2009 and is satisfied that the Corporation can operate in a viable manner for the foreseeable future.

RESPONSIBILITY FOR THE FINANCIAL STATEMENTS

The KCRC Ordinance requires the Corporation to produce financial statements. In doing so, the Corporation complies with all applicable International Financial Reporting Standards issued by the International Accounting Standards Board, Hong Kong Financial Reporting Standards issued by the Hong Kong Institute of Certified Public Accountants, accounting principles generally accepted in Hong Kong, the disclosure requirements of the Hong Kong Companies Ordinance, and produces financial statements that give a true and fair view of the Corporation's financial results and position for the financial year to which they relate.

AUDITOR

In accordance with section 14B (4) of the Kowloon-Canton Railway Corporation Ordinance, KPMG were appointed as auditors by the Chief Executive of the Hong Kong Special Administrative Region.

By order of the Managing Board

Michael J Arnold
Company Secretary
9 March 2009

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INDEPENDENT AUDITOR'S REPORT

INDEPENDENT AUDITOR'S REPORT TO THE MEMBERS OF THE MANAGING BOARD OF THE KOWLOON-CANTON RAILWAY CORPORATION

We have audited the consolidated financial statements of the Kowloon-Canton Railway Corporation ("the Corporation") set out on pages 24 to 95, which comprise the consolidated and the Corporation balance sheets as at 31 December 2008, the consolidated income statement, the consolidated statement of changes in equity and the consolidated cash flow statement for the year then ended and a summary of significant accounting policies and other explanatory notes.

BOARD MEMBERS' RESPONSIBILITIES FOR THE FINANCIAL STATEMENTS

The Board Members of the Corporation are responsible for the preparation and the true and fair presentation of these financial statements in accordance with International Financial Reporting Standards issued by the International Accounting Standards Board, Hong Kong Financial Reporting Standards issued by the Hong Kong Institute of Certified Public Accountants and the Kowloon-Canton Railway Corporation Ordinance. This responsibility includes designing, implementing and maintaining internal control relevant to the preparation and the true and fair presentation of financial statements that are free from material misstatement, whether due to fraud or error; selecting and applying appropriate accounting policies; and making accounting estimates that are reasonable in the circumstances.

AUDITOR'S RESPONSIBILITY

Our responsibility is to express an opinion on these financial statements based on our audit. This report is made solely to you, as a body, in accordance with section 14B(3) of the Kowloon-Canton Railway Corporation Ordinance, and for no other purpose. We do not assume responsibility towards or accept liability to any other person for the contents of this report.

We conducted our audit in accordance with Hong Kong Standards on Auditing issued by the Hong Kong Institute of Certified Public Accountants. Those standards require that we comply with ethical requirements and plan and perform the audit to obtain reasonable assurance as to whether the financial statements are free from material misstatement.

An audit involves performing procedures to obtain audit evidence about the amounts and disclosures in the financial statements. The procedures selected depend on the auditor's judgement, including the assessment of the risks of material misstatement of the financial statements, whether due to fraud or error. In making those risk assessments, the auditor considers internal control relevant to the Corporation's preparation and true and fair presentation of the financial statements in order to design audit procedures that are appropriate in the circumstances, but not for the purpose of expressing an opinion on the effectiveness of the Corporation's internal control. An audit also includes evaluating the appropriateness of accounting policies used and the reasonableness of accounting estimates made by the Board Members, as well as evaluating the overall presentation of the financial statements.

We believe that the audit evidence we have obtained is sufficient and appropriate to provide a basis for our audit opinion.

OPINION

In our opinion, the consolidated financial statements give a true and fair view of the state of affairs of the Corporation and of the Group as at 31 December 2008 and of the Group's loss and cash flows for the year then ended in accordance with International Financial Reporting Standards and Hong Kong Financial Reporting Standards and have been properly prepared in accordance with the applicable disclosure requirements of the Hong Kong Companies Ordinance.

KPMG
Certified Public Accountants
8th Floor, Prince's Building
10 Chater Road
Central, Hong Kong
9 March 2009

CONSOLIDATED INCOME STATEMENT

for the year ended 31 December 2008 (Expressed in Hong Kong dollars)

	Note	**2008 $ million**	2007 $ million
Turnover	4	**870**	5,581
Operating costs before depreciation and amortisation	5	**(69)**	(2,818)
Operating profit before depreciation and amortisation	6	**801**	2,763
Depreciation and amortisation	7	**(2,595)**	(2,418)
Operating (loss)/profit after depreciation and amortisation		**(1,794)**	345
Gain on sale of property development rights		**–**	4,868
Gain on sale of investment properties and other property, plant and equipment		**–**	1,318
Gain on sale of property management and telecommunication businesses		**–**	48
Merger-related expenses		**–**	(216)
Impairment of properties under development	16	**(20)**	–
Interest and finance income	8(a)	**450**	476
Interest and finance expenses	8(b)	**(1,362)**	(1,323)
Share of profit of associate		**51**	39
(Loss)/profit before unrealised gains/losses		**(2,675)**	5,555
Gains on changes in fair value of financial instruments	9	**183**	541
Net valuation gains on investment properties	13	**–**	9
(Loss)/profit before taxation		**(2,492)**	6,105
Income tax	10(a)	**677**	(784)
(Loss)/profit for the year wholly attributable to the sole shareholder of the Corporation	11	**(1,815)**	5,321

The notes on pages 30 to 95 form part of these financial statements.

CONSOLIDATED BALANCE SHEET

at 31 December 2008 (Expressed in Hong Kong dollars)

	Note	2008 $ million	2007 $ million
Assets			
Fixed assets	13(a)	**65,937**	67,260
Interest in leasehold land held for own use under operating leases	13(a)	**5,820**	5,931
Construction in progress	14	**6,926**	5,509
Deferred expenditure	15	**1,612**	1,585
Properties under development	16	**–**	20
Interest in associate	18	**147**	138
Loan to non-controlled subsidiary	19	**4,406**	4,407
Derivative financial assets	29(e)	**317**	132
Investments	20	**3,095**	2,585
Interest and other receivables	21	**716**	681
Cash and cash equivalents	22	**2,493**	6,636
		91,469	94,884
Liabilities			
Short-term bank loans	25	**–**	45
Interest and other payables	23	**736**	1,222
Accrued charges and provisions for capital projects	24	**1,507**	1,935
Derivative financial liabilities	29(e)	**9**	54
Interest-bearing borrowings	25	**17,503**	17,857
Deferred income	26	**5,001**	4,566
Deferred tax liabilities	10(d)	**3,356**	4,033
		28,112	29,712
Net Assets		**63,357**	65,172
Capital and Reserves			
Share capital	27	**39,120**	39,120
Retained profits	28	**24,237**	26,052
Total equity		**63,357**	65,172

Approved and authorised for issue by the Managing Board on 9 March 2009

Professor K C Chan
Mr K T Li
Members of the Managing Board

Mr James Blake
Chief Officer

The notes on pages 30 to 95 form part of these financial statements.

CORPORATION BALANCE SHEET

at 31 December 2008 (Expressed in Hong Kong dollars)

	Note	2008 $ million	2007 $ million
Assets			
Fixed assets	13(b)	**65,937**	67,260
Interest in leasehold land held for own use under operating leases	13(b)	**5,820**	5,931
Construction in progress	14	**6,926**	5,509
Deferred expenditure	15	**1,612**	1,585
Properties under development	16	**–**	20
Interest in associate	18	**9**	42
Loan to non-controlled subsidiary	19	**4,406**	4,407
Derivative financial assets	29(e)	**317**	132
Investments	20	**3,095**	2,585
Interest and other receivables	21	**716**	681
Cash and cash equivalents	22	**2,493**	6,636
		91,331	94,788
Liabilities			
Short-term bank loans	25	**–**	45
Interest and other payables	23	**736**	1,222
Accrued charges and provisions for capital projects	24	**1,507**	1,935
Derivative financial liabilities	29(e)	**9**	54
Interest-bearing borrowings	25	**17,503**	17,857
Deferred income	26	**5,001**	4,566
Deferred tax liabilities	10(d)	**3,356**	4,033
		28,112	29,712
Net Assets		**63,219**	65,076
Capital and Reserves			
Share capital	27	**39,120**	39,120
Retained profits	28	**24,099**	25,956
Total equity		**63,219**	65,076

Approved and authorised for issue by the Managing Board on 9 March 2009

Professor K C Chan
Mr K T Li
Members of the Managing Board

Mr James Blake
Chief Officer

The notes on pages 30 to 95 form part of these financial statements.

CONSOLIDATED STATEMENT OF CHANGES IN EQUITY

for the year ended 31 December 2008 (Expressed in Hong Kong dollars)

	Note	**2008 $ million**	2007 $ million
Total equity at 1 January		**65,172**	59,933
Net (loss)/profit for the year	28	**(1,815)**	5,321
Dividend approved and paid during the year	12	**–**	(82)
Total equity at 31 December		**63,357**	65,172

The notes on pages 30 to 95 form part of these financial statements.

CONSOLIDATED CASH FLOW STATEMENT

for the year ended 31 December 2008 (Expressed in Hong Kong dollars)

	Note	2008 $ million	2007 $ million
Operating activities			
Net cash inflow from operations	30	**494**	2,889
Upfront payment for the Service Concession		**–**	4,250
Net payment for liabilities and assets transferred to MTRCL		**–**	(728)
Receipt on sale of property development rights after netting off $70 million relating to enabling work costs reimbursement		**–**	4,840
Net cash outflow relating to property development		**–**	(38)
Hong Kong profits tax paid		**–**	(1)
Net cash inflow from operating activities		**494**	11,212
Investing activities			
Decrease/(increase) in deposits with banks with maturity more than three months when placed		**2,474**	(2,003)
Payments for capital expenditure:			
– Kowloon Southern Link project		**(2,147)**	(1,865)
– Other capital projects and purchase of fixed assets		**(502)**	(1,876)
Interest received		**176**	53
Loan to non-controlled subsidiary		**–**	(37)
Payment for the purchase of investments		**(535)**	(2,574)
Dividend received from associate		**9**	–
Loans repaid by associate		**33**	–
Receipts on sale of fixed assets		**–**	1
Receipts on sale of investment properties and other property, plant and equipment after netting off $162 million for the transfer of cash and cash equivalents of certain subsidiaries to MTRCL		**–**	2,678
Receipts on sale of property management businesses		**–**	40
Net cash outflow from investing activities		**(492)**	(5,583)
Net cash inflow before financing carried forward		**2**	5,629

The notes on pages 30 to 95 form part of these financial statements.

	Note	2008 $ million	2007 $ million
Net cash inflow before financing brought forward		**2**	5,629
Financing activities			
Net cash outflow on repayment of loans		**(345)**	(1,360)
Dividend paid		**–**	(82)
Interest paid		**(1,304)**	(1,396)
Net cash outflow relating to derivative financial instruments		**(19)**	(98)
Finance expenses paid		**(3)**	(7)
Net cash outflow from financing activities		**(1,671)**	(2,943)
Net (decrease)/increase in cash and cash equivalents		**(1,669)**	2,686
Cash and cash equivalents at 1 January		**4,162**	1,476
Cash and cash equivalents at 31 December		**2,493**	4,162
Analysis of the balances of cash and cash equivalents			
Cash at bank and in hand	22	**12**	35
Deposits with banks with maturity of less than three months when placed	22	**2,481**	4,127
		2,493	4,162

The notes on pages 30 to 95 form part of these financial statements.

NOTES TO THE FINANCIAL STATEMENTS

(Expressed in Hong Kong dollars)

1 ESTABLISHMENT OF THE CORPORATION

The Kowloon-Canton Railway Corporation ("the Corporation") was incorporated in Hong Kong under the Kowloon-Canton Railway Corporation Ordinance ("the Ordinance") on 24 December 1982 to undertake the operation of the Hong Kong section of the Kowloon-Canton Railway. The assets, rights and liabilities of the then existing railway were vested in the Corporation on 1 February 1983 in accordance with Section 7 of the Ordinance.

The Ordinance was amended in 1986, 1998, 2001 and 2007. The amendment in 1986 enabled the Corporation to construct and operate the Light Rail system. The amendment in 1998 expanded the Corporation's power by permitting the Corporation to construct and operate any additional railway that the Secretary for Transport and Housing (the Secretary for Transport at the time of amendment) may authorise the Corporation to construct. The amendment in December 2001 provided for the separation of the functions and duties of the Chairman from those of the Chief Executive Officer by creating the office of Chief Executive Officer. The Chief Executive Officer was also appointed as a member of the Managing Board.

On 8 June 2007, the Legislative Council passed the Rail Merger Bill (which was published in the Hong Kong Special Administrative Region ("HKSAR") Government Gazette on 11 June 2007). Following agreement by the respective parties to the detailed merger transaction terms, the Rail Merger took place on 2 December 2007 (the "Appointed Day"). The Chief Executive of the HKSAR appointed six public officers as members of the Managing Board with effect from the Appointed Day. As provided for under the amendments made to the Ordinance by the Rail Merger Bill, the position of Chief Executive Officer has been left vacant, with a Chief Officer, who is not a member of the Managing Board, being appointed by the Board to be responsible for managing the day-to-day business of the Corporation.

2 RAIL MERGER WITH MTR CORPORATION LIMITED ("MTRCL")

The Rail Merger Ordinance permitted the granting of a long-term service concession (the "Service Concession") in respect of the Corporation's rail and bus operations, and the sale of certain rail-related assets (the "Purchased Rail Assets"), subsidiaries (namely Hanford Garden Property Management Company Limited, Pierhead Garden Management Company Limited, Royal Ascot Management Company Limited, Sun Tuen Mun Centre Management Company Limited and V-Connect Limited) and property-related rights and interests of the Corporation, to MTRCL.

Since the Appointed Day, the Corporation has been responsible for monitoring MTRCL's compliance with its obligations under the merger transaction, including revenue sharing, annual payments and the specified day-to-day activities of the Corporation outsourced to MTRCL. The Corporation, besides meeting its obligations under the merger transaction, retains responsibility for the management and financing of its debts, for investing any available funds and for managing its remaining subsidiaries and other assets excluded from the merger transaction (the "Excluded Assets").

2 RAIL MERGER WITH MTR CORPORATION LIMITED ("MTRCL") (continued)

Service Concession

The Service Concession grants MTRCL the right to operate the Corporation's existing railway lines (including the Kowloon Southern Link upon completion) and other rail-related businesses ("concession assets") for a period of 50 years (the "Concession Period"). Under the Service Concession, MTRCL receives all revenues generated from the operation of the Corporation's rail network and other rail-related businesses. During the Concession Period, except for projects retained by the Corporation as specified under the Merger Framework Agreement, MTRCL is responsible for the daily operations and maintenance of the transport operations and will fund all related operating capital expenditure, including the improvement and replacement of the Corporation's railway network assets. The Corporation does not have responsibility for any railway or bus operations during the Concession Period.

In consideration for the Service Concession and the Purchased Rail Assets, MTRCL agreed to make an upfront payment on the Appointed Day to the Corporation of $4.25 billion (received on 3 December 2007), at the end of every year thereafter a fixed annual payment of $750 million and commencing after the first 36 months, an additional variable annual payment based on revenue generated above the first $2.5 billion from the operation of the Corporation's rail network and other rail-related businesses during each financial year of MTRCL. The variable payments are computed at 10% of such revenue between $2.5 billion and $5 billion; 15% of such revenue between $5 billion and $7.5 billion; and 35% of such revenue beyond $7.5 billion.

The Corporation's role during the Concession Period essentially comprises the following duties:

(i) acting as the grantor of the Service Concession to MTRCL, monitoring the compliance of MTRCL with the terms of the Service Concession and receiving concession payments from MTRCL;

(ii) holding legal and beneficial title to all assets not forming part of the sale to MTRCL, such as the initial concession assets, which are defined as the physical assets including the Corporation's railway land required for the operation of the Corporation's railway system which were capitalised by the Corporation immediately prior to the Appointed Day, the Corporation's shares in Octopus Holdings Limited and the Excluded Assets;

(iii) acting as the borrower and obligor in relation to the Corporation's existing financial obligations and contingent liabilities; and

(iv) holding legal and beneficial title to and funding all capital expenditure for any new railway project that was under construction as of the Appointed Day, such as the Kowloon Southern Link, and acting as the principal of the project management agreement with MTRCL under which the Corporation, among other things, employs MTRCL as its agent, and in other capacities, to complete the construction of the Kowloon Southern Link.

Should the Corporation undertake any new railway projects during the Concession Period, these would be subject to a service concession granted by the Corporation in favour of MTRCL, with the parties entering into a Supplemental Service Concession Agreement.

NOTES TO THE FINANCIAL STATEMENTS

(Expressed in Hong Kong dollars)

3 SIGNIFICANT ACCOUNTING POLICIES

(a) Statement of compliance

Although not required to do so under the Ordinance, the Corporation has prepared these financial statements in accordance with all applicable International Financial Reporting Standards ("IFRSs") issued by the International Accounting Standards Board ("IASB"). These financial statements also comply with the applicable disclosure provisions of the Rules Governing the Listing of Securities on The Stock Exchange of Hong Kong Limited and the Hong Kong Companies Ordinance. A summary of the significant accounting policies adopted by the Corporation and its controlled subsidiaries (the "Group") is set out below.

These financial statements have also been prepared in accordance with all applicable Hong Kong Financial Reporting Standards ("HKFRSs") issued by the Hong Kong Institute of Certified Public Accountants ("HKICPA") and accounting principles generally accepted in Hong Kong.

(b) Basis of preparation of the financial statements

The measurement basis used in the preparation of the financial statements is the historical cost basis except where stated otherwise in the accounting policies set out below.

As set out in more detail in note 25(h) to the financial statements, existing borrowings of the Group totalling $15,560 million at 31 December 2008 are due to mature and be repaid during 2009 and 2010. The Corporation is currently seeking additional financing to replace the existing borrowings which are due to be repaid in 2009 and 2010 and to meet the ongoing cash flow requirements of the Corporation. Management is confident that such additional financing will be obtained on terms acceptable to the Corporation and, on this basis, consider that the Corporation will be able to meet its future liabilities as they fall due and that it is appropriate to prepare the financial statements on a going concern basis.

The preparation of financial statements in conformity with IFRSs and HKFRSs requires management to make judgements, estimates and assumptions that affect the application of policies and reported amounts of assets, liabilities, income and expenses. The estimates and associated assumptions are based on historical experience and various other factors that are believed to be reasonable under the prevailing circumstances, the results of which form the basis of making the judgements about carrying values of assets and liabilities that are not readily apparent from other sources. Actual results may differ from these estimates.

The estimates and underlying assumptions are reviewed on an ongoing basis. Revisions to accounting estimates are recognised in the period in which the estimate is revised if the revision affects only that period, or in the period of the revision and future periods if the revision affects both current and future periods.

Judgements with significant effect on the financial statements and estimates with significant risk of material adjustment are discussed in note 37.

The accounting policies set out below have been applied consistently to each period presented in these financial statements, except where the adoption of a new or revised accounting standard is not permitted to be applied retrospectively.

3 SIGNIFICANT ACCOUNTING POLICIES (continued)

(c) Basis of consolidation

The consolidated financial statements comprise the Corporation and its controlled subsidiaries and the Group's interest in associate made up to 31 December each year.

The financial statements of certain subsidiaries held by the Corporation for the sole purpose of developing, on behalf of the Government of the HKSAR ("the Government"), commercial or residential properties along the West Rail, Phase I route are excluded from the consolidation on the basis that these are not considered to be controlled subsidiaries as the Corporation has no effective control over nor beneficial interests in the net assets of these subsidiaries, other than the amount of capital provided. The Corporation is not entitled to any earnings distribution, nor is it required to ultimately fund any losses which may be sustained by these subsidiaries.

Furthermore, the financial statements of the Metropolis Management Company Limited ("MMC"), which was established for the sole purpose of rendering property management services to a commercial property, are also excluded from the consolidation on the basis that, under the Equity Sub-participation Agreement which formed part of the merger transaction, the Corporation is obliged to act on MTRCL's instructions in respect of the exercise of any and all rights the Corporation has as a shareholder of MMC. All the beneficial interests to which the Corporation was previously entitled now rest with MTRCL although there has been no direct disposition of the shares of MMC to MTRCL.

(d) Investments in subsidiaries

Subsidiaries are entities controlled by the Corporation. Control exists when the Corporation has the power to govern the financial and operating policies of an entity so as to obtain benefits from its activities. In assessing control, potential voting rights that presently are exercisable are taken into account.

An investment in a controlled subsidiary is consolidated into the consolidated financial statements from the date that control commences until the date that control ceases. An investment in a non-controlled subsidiary is excluded from consolidation and is stated at cost less impairment losses, if any, in the Group's and Corporation's balance sheet.

Intra-group balances and transactions and any unrealised profits arising from intra-group transactions with controlled subsidiaries are eliminated in full in preparing the consolidated financial statements. Unrealised losses resulting from intra-group transactions with controlled subsidiaries are eliminated in the same way as unrealised gains but only to the extent that there is no evidence of impairment.

In the Corporation's balance sheet, an investment in a controlled subsidiary is stated at cost less impairment losses, if any.

NOTES TO THE FINANCIAL STATEMENTS

(Expressed in Hong Kong dollars)

3 SIGNIFICANT ACCOUNTING POLICIES (continued)

(e) Interest in associate

An associate is an entity in which the Group or Corporation has significant influence, but not control or joint control, over its management, including participation in the financial and operating policy decisions.

An investment in an associate is accounted for in the Group's consolidated financial statements under the equity method and is initially recorded at cost and adjusted thereafter for the post acquisition change in the Group's share of the associate's net assets. The consolidated income statement includes the Group's share of the post-acquisition and post-tax results of associates for the year.

Unrealised profits and losses resulting from transactions between the Group and its associates are eliminated to the extent of the Group's interest in the associate, except where unrealised losses provide evidence of an impairment of the asset transferred, in which case they are recognised immediately in the income statement.

The results of the associates are included in the Corporation's income statement to the extent of dividends received and receivable, providing the dividend in respect of a period ending on or before the Corporation's financial year and the Corporation's right to receive the dividend is established before the balance sheet date.

In the Corporation's balance sheet, an investment in an associate is stated at cost less impairment losses, if any.

(f) Investments

Investments comprise:

(i) temporary investment of funds from the equity injection received and borrowings obtained specifically for the construction of the East Rail Extensions and Kowloon Southern Link before the funds are used for such purposes ("pre-funding investments"); and

(ii) investment of surplus funds from the Corporation's operations and receipts arising from the Rail Merger with MTRCL ("other investments").

All the pre-funding investments are available-for-sale investments and are recognised initially at fair value at the date of recognition plus transaction costs. The fair value is remeasured at the balance sheet date, with any resultant gain or loss, together with all income generated from such investments, including interest income, foreign exchange gains or losses, impairment losses, realised gains or losses arising from transactions in derivative financial instruments entered into for hedging foreign currency pre-funding investments and gains or losses arising from the derecognition of such investments, capitalised to the related projects.

3 SIGNIFICANT ACCOUNTING POLICIES (continued)

(f) Investments (continued)

Other investments comprise:

(i) dated debt securities that the Group has the positive ability and intention to hold to maturity which are classified as held-to-maturity securities and are stated in the balance sheet at amortised cost less impairment losses, if any; and

(ii) dated debt securities that include embedded derivatives with economic characteristics and risks different from that of the host contracts are designated as at fair value through profit or loss. At each balance sheet date the fair value is remeasured, with any resultant gain or loss being recognised in the income statement.

Investments are recognised/derecognised on the trade date, which is the date the Group commits to purchase/sell the investments or when the investments expire.

(g) Derivative financial assets and liabilities

The Group uses derivative financial instruments to hedge its exposure to foreign exchange and interest rate risks arising from operational, financing and investment activities. In accordance with its policies, the Group does not hold or issue derivative financial instruments for trading purposes.

All the Group's derivative financial instruments are recognised initially as derivative financial assets or liabilities at fair value. The fair value of each derivative financial instrument is remeasured at each balance sheet date, with any resultant gain or loss recognised immediately in the income statement, except where the derivatives qualify for cash flow hedge accounting, in which case recognition of any resultant gain or loss depends on the item being hedged as covered by the policy statement below.

(i) Cash flow hedges

Currency swaps are designated as hedges of the variability in cash flows attributable to the foreign exchange risk of certain of the Group's interest-bearing borrowings denominated in foreign currencies and recognised in the financial statements.

Changes in fair value of currency swaps that hedge recognised monetary liabilities in foreign currencies are recognised in the income statement as required under IAS 39 and HKAS 39.

NOTES TO THE FINANCIAL STATEMENTS

(Expressed in Hong Kong dollars)

3 SIGNIFICANT ACCOUNTING POLICIES (continued)

(g) Derivative financial assets and liabilities (continued)

(ii) Fair value hedges

Interest rate swaps are designated as hedges of the variability in the fair value attributable to interest rate risk of certain of the Group's fixed rate interest-bearing borrowings recognised in the financial statements.

Changes in fair value of interest rate swaps designated as hedging instruments in a fair value hedge are recognised in the income statement.

When a hedging relationship ceases to meet the requirements for hedge accounting, any adjustment to the carrying amount of the then hedged item is amortised to the income statement over the remaining life of the item based on a recalculated effective interest rate from the date the hedging relationship ceases.

(h) Investment properties

Investment properties comprise land and/or buildings which are owned or held under a leasehold interest to earn rental income and are held for their investment potential.

Investment properties are stated in the balance sheet at fair value. Any gain or loss arising from a change in fair value is recognised in the income statement.

Gains or losses arising from the retirement or disposal of an investment property are determined as the difference between the net disposal proceeds and the carrying amount of the item and are recognised in the income statement on the date of retirement or disposal.

(i) Property, plant and equipment

(i) Property, plant and equipment, including those assets which are the subject of the Service Concession with MTRCL, is stated in the balance sheet at cost less accumulated depreciation and impairment losses, if any.

During the Concession Period, MTRCL is responsible for the daily operations and maintenance of the railway operations and will fund all related expenditure including the improvement and replacement of the Corporation's railway network assets. Such expenditure on improvement and replacement of the Corporation's railway network assets is defined as Additional Concession Property ("ACP") pursuant to the Service Concession Agreement. According to the Service Concession Agreement, the ACP will be returned to the Corporation at no cost, together with the initial concession assets acquired by the Corporation, upon the expiry or termination of the Concession Period subject to a threshold of $115.8 billion of cumulative expenditure funded by MTRCL which will be adjusted from time to time pursuant to the provisions of Service Concession Agreement. As the ACP will be returned together with the initial concession assets acquired by the Corporation before the Rail Merger, the ACP, although funded by MTRCL, is treated in the same way as the initial concession assets and is capitalised in the balance sheet at cost less accumulated depreciation and impairment losses, if any. The cost of ACP that is funded by MTRCL is credited to deferred income and amortised to the income statement over the shorter of the useful life of the ACP and the remaining Concession Period.

3 SIGNIFICANT ACCOUNTING POLICIES (continued)

(i) Property, plant and equipment (continued)

Property, plant and equipment relating to rail networks and ancillary commercial activities which is the subject of the Service Concession comprises:

– buildings which are situated on leasehold land, where the fair value of the building could be measured separately from the fair value of the leasehold land at the inception of the lease; and

– other items of plant and equipment including tunnels, bridges, roads, permanent way, rolling stock and other equipment.

The cost of property, plant and equipment vested by the Government has been determined as follows:

– for property, plant and equipment vested on 1 February 1983 – as determined by the Financial Secretary; and

– for property, plant and equipment vested subsequent to 1 February 1983 – based on actual cost as reflected in the Government's records.

The cost of property, plant and equipment acquired by the Group and ACP funded by MTRCL comprises:

– its purchase price, including import duties and non-refundable purchase taxes, after deducting trade discounts and rebates;

– any costs, such as the costs of material, direct labour, an appropriate proportion of production overheads and interest and finance income/expenses directly attributable to bringing the asset to the location and condition capable of operating in the manner intended by management; and

– the initial estimate of the costs of dismantling and removing the item and restoring the site on which it is located, where the obligation is incurred by the Group when the item is acquired.

Expenditure incurred by the Group on property, plant and equipment, which is below $20,000 per item or expected to be fully used within one year, is expensed to the income statement when incurred.

NOTES TO THE FINANCIAL STATEMENTS

(Expressed in Hong Kong dollars)

3 SIGNIFICANT ACCOUNTING POLICIES (continued)

(i) Property, plant and equipment (continued)

(ii) Subsequent expenditure on existing property, plant and equipment, for both concession assets and non-concession assets, is added to the carrying amount of the asset if, either future economic benefits will flow to the Group, or the condition of the asset will improve beyond its originally assessed standard of performance.

Expenditure incurred by the Group on repairs or maintenance of existing property, plant and equipment to restore or maintain the originally assessed standard of performance of the asset is recognised as an expense when incurred.

Expenditure incurred by MTRCL after the Appointed Day on repairs or maintenance of concession assets is borne by MTRCL.

(iii) Gains or losses arising from the retirement or disposal of an item of property, plant and equipment, including concession assets, are determined as the difference between the net disposal proceeds and the carrying amount of the item and are recognised in the income statement on the date of retirement or disposal.

(j) Depreciation and amortisation

(i) Depreciation for property, plant and equipment is calculated to write off the cost of an item of property, plant and equipment less its estimated residual value, if any, using the straight-line basis over its estimated useful life as follows:

	No. of years
Tunnels, bridges and roads (see note 3(j)(iii))	43-65
Buildings (see note 3(j)(iii))	50
Rolling stock	30-40
Locomotives and wagons	15-35
Lifts and escalators	20
Permanent way comprising rails, ballast, sleepers and concrete civil works (see note 3(j)(iii))	10-50
Machinery and equipment	10-30
Telecommunication and signalling systems and air-conditioning plant	5-15
Fare collection systems	15
Mobile phone systems	7-10
Furniture and fixtures	3-15
Computer and office equipment (including computer software)	3-5
Buses	10-17
Other motor vehicles	4-15

3 SIGNIFICANT ACCOUNTING POLICIES (continued)

(j) Depreciation and amortisation (continued)

(ii) Where parts of an item of property, plant and equipment have different useful lives, the cost of the item is allocated on a measurable basis between the parts and each part is depreciated separately. Both the useful life of an asset and its residual value, if any, are reviewed annually. The residual value of an asset is the estimated amount that the Group could currently obtain from disposal of the asset, after deducting the estimated costs of disposal, if the asset was already of the age and in the condition expected at the end of its useful life.

(iii) Tunnels, bridges, roads, concrete civil works and buildings situated on leasehold land are depreciated over the shorter of the unexpired term of the related lease and their estimated useful lives.

(k) Leased assets

(i) Classification of leased assets

Leases of assets under which the lessee assumes substantially all the risks and rewards of ownership are classified as finance leases. Leases of assets under which the lessor has not transferred substantially all the risks and rewards of ownership are classified as operating leases, except that property held under an operating lease that would otherwise meet the definition of an investment property may be classified as an investment property on a property-by-property basis.

(ii) Assets leased out under operating leases

Where the Group leases out assets under operating leases, the assets are included in the balance sheet according to their nature and, where applicable, are depreciated in accordance with the Group's depreciation policies.

(iii) Operating lease charges

Where the Group has the use of assets held under operating leases, payments made under the leases are charged to the income statement in equal instalments over the accounting periods covered by the lease term, except where an alternative basis is more representative of the pattern of benefits to be derived from the leased asset.

Land lease premiums, land resumption costs and other costs directly associated with the acquisition of leasehold land held for own use under operating leases are amortised on a straight-line basis over the period of the lease term. The cost in relation to leasehold land vested by the Government has been determined as follows:

- vested on 1 February 1983 – as determined by the Financial Secretary; and

- vested subsequent to 1 February 1983 – based on actual cost as reflected in the Government's records or the costs incurred by the Corporation directly associated with the acquisition of leasehold land.

NOTES TO THE FINANCIAL STATEMENTS

(Expressed in Hong Kong dollars)

3 SIGNIFICANT ACCOUNTING POLICIES (continued)

(l) Impairment of assets

(i) Impairment of financial assets

All financial assets are reviewed at each balance sheet date to determine whether there is objective evidence of impairment. Objective evidence of impairment includes observable data that comes to the attention of the Group about one or more of the following loss events:

– significant financial difficulties being experienced by a debtor;

– a breach of contract, such as a default or delinquency in interest or principal payments;

– it becomes probable that the debtor will enter bankruptcy or some form of financial reorganisation;

– significant changes in the technological, market, economic or legal environment that have an adverse effect on the debtor; and

– a significant or prolonged decline in the fair value of an investment in an equity instrument below its cost.

If any such evidence exists, an impairment loss is determined and recognised as follows:

– For interest and other receivables carried at cost or amortised cost, an impairment loss is measured as the difference between the asset's carrying amount and the estimated future cash flows (taking into account bad and doubtful debts), discounted at the current market rate of return of a similar financial asset where the effect of discounting is material. This assessment is made collectively where financial assets carried at amortised cost share similar risk characteristics, such as similar past due status, and have not been individually assessed as impaired. Future cash flows for financial assets which are assessed for impairment collectively are based on historical loss experience for assets with credit risk characteristics similar to the collective group.

– For loan to non-controlled subsidiary carried at cost, an impairment loss is measured as the difference between the asset's carrying amount and the present value of estimated future cash flows (taking into account bad and doubtful debts), discounted at the financial asset's original effective interest rate (i.e. the effective interest rate computed at the date of initial recognition of these assets), except where the present value is not determinable as there are no fixed repayment terms.

– For held-to-maturity securities carried at amortised cost, the impairment loss is measured as the difference between the carrying amount of the financial asset and the estimated future cash flows, discounted at the current market rate of return of a similar financial asset where the effect of discounting is material.

– Impairment losses are reversed if the subsequent increase in fair value can be objectively related to an event occurring after the impairment loss was recognised. Reversals of impairment losses in such circumstances are recognised in the income statement to the extent that the cumulative impairment loss has been charged to the income statement.

3 SIGNIFICANT ACCOUNTING POLICIES (continued)

(l) Impairment of assets (continued)

(ii) Impairment of other assets

Internal and external sources of information are reviewed at each balance sheet date to identify indications that the following assets may be impaired or an impairment loss previously recognised no longer exists or may have decreased:

– property, plant and equipment;

– interest in leasehold land held for own use under operating leases;

– construction in progress;

– deferred expenditure;

– properties under development;

– investments in subsidiaries; and

– interest in associate.

If any such indication exists, the asset's recoverable amount is estimated.

– Calculation of recoverable amount

The recoverable amount of an asset is the greater of its net selling price and value in use. In assessing value in use, the estimated future cash flows are discounted to their present value using a pre-tax discount rate that reflects current market assessments of time value of money and the risks specific to the asset. Where an asset does not generate cash inflows largely independent of those from other assets, the recoverable amount is determined for the smallest group of assets that generates cash inflows independently (i.e. a cash-generating unit).

– Recognition of impairment losses

An impairment loss is recognised in the income statement whenever the carrying amount of an asset, or the cash-generating unit to which it belongs, exceeds its recoverable amount. Impairment losses recognised in respect of cash-generating units are allocated to reduce the carrying amount of the other assets in the unit (or group of units) on a pro rata basis, except that the carrying value of an asset will not be reduced below its individual fair value less costs to sell, or value in use, if determinable.

– Reversals of impairment losses

An impairment loss is reversed if there has been a favourable change in the estimates used to determine the recoverable amount.

A reversal of an impairment loss is limited to the asset's carrying amount that would have been determined had no impairment loss been recognised in prior years. Reversals of impairment losses are credited to the income statement in the year in which the reversals are recognised.

NOTES TO THE FINANCIAL STATEMENTS

(Expressed in Hong Kong dollars)

3 SIGNIFICANT ACCOUNTING POLICIES (continued)

(m) Construction in progress

Assets under construction and capital works for the operating railways are stated at cost incurred by the Corporation (or by MTRCL in the case of ACP) less impairment losses, if any. Costs comprise direct costs of construction, including materials, staff costs and overheads, interest and finance income/expenses and gains or losses arising from changes in fair value of pre-funding investments capitalised during the period of construction or installation and testing. Capitalisation of these costs is suspended or ceases when substantially all the activities necessary to prepare the qualifying asset for its intended use are interrupted or completed. The assets concerned are transferred to fixed assets when substantially all the activities necessary to prepare the assets for their intended use are completed, at which time the assets begin to be depreciated in accordance with the relevant policies. Land lease premiums, land resumption costs and other related costs incurred by the Corporation for the purpose of acquiring the land on which the new railways or extensions to existing railways are to be operated are initially included in construction in progress. These costs are transferred to interest in leasehold land held for own use under operating leases when the related assets are completed and ready for their intended use at which time the costs begin to be amortised in accordance with the relevant policies.

Costs incurred by the Corporation (or MTRCL in the case of ACP) in respect of feasibility studies on proposed railway related construction projects (including consultancy fees, in-house staff costs and overheads) are dealt with as follows:

– where the proposed projects are at a preliminary review stage with no certainty of the proposed project proceeding, the costs concerned are written off to the income statement as incurred; and

– where the proposed projects are at a detailed study stage, having demonstrated an acceptable financial viability and having obtained the Managing Board's approval to proceed further, the costs concerned are initially dealt with as deferred expenditure and then transferred to construction in progress after the relevant project agreements are reached with the Government.

(n) Deferred expenditure

Deferred expenditure relates to costs incurred for proposed railway related construction projects which will be transferred to construction in progress after the relevant project agreements are reached with the Government.

(o) Property development

When the Corporation determines or reaches agreement with property developers to develop a site for resale or for rent, the carrying amount of the leasehold land and existing buildings on the development site are transferred to properties under development. Costs related to the respective projects incurred by the Corporation are also dealt with as properties under development until such time that profit on the development is recognised by the Corporation.

3 SIGNIFICANT ACCOUNTING POLICIES (continued)

(o) Property development (continued)

Profits on property development undertaken in conjunction with property developers are recognised in the income statement as follows:

– where the Corporation receives payments from property developers as a consequence of their participation in a project to develop a property, such payments are set off against the balance in properties under development in respect of that project. Any surplus amounts of payments received from property developers in excess of the balance in properties under development are transferred to deferred income. In such circumstances, further costs subsequently incurred by the Corporation in respect of that project are charged against the related balance of deferred income and any excess is charged to properties under development to the extent it is considered to be recoverable. The balance of deferred income is credited to the income statement when the property enabling works are completed and acceptable for development, and after taking into account the outstanding risks and obligations in connection with the development, if any, retained by the Corporation. The balance of properties under development not previously offset by payments received from property developers is charged to the income statement where the costs are considered to be irrecoverable, together with provision for losses, if any, borne by the Corporation in respect of the development;

– where the Corporation receives a share of profits from the sale of properties, profits are recognised upon the issue of occupation permits provided the amounts of revenue and related costs can be measured reliably; and

– where the Corporation retains certain assets of the development, profits are measured based on the fair value of such assets and are recognised at the time of receipt after taking into account the costs incurred by the Corporation in respect of the development and the outstanding risks, if any, retained by the Corporation in connection with the development.

(p) Jointly controlled operations

Assets that the Corporation owns and the liabilities that it incurs for the purpose of jointly controlled operations are recognised in the balance sheet and classified according to the nature of the relevant item. The Corporation's share of revenue from the jointly controlled operations along with the expenses that it incurs are included in the income statement when it is probable that economic benefits associated with the transactions will flow to or from the Corporation, as applicable.

Before the Appointed Day, jointly controlled operations included intercity train services to and from Hong Kong and Mainland China which were jointly provided by the Corporation and its Mainland China railway counterparts. The related revenue sharing arrangements were negotiated and agreed between the relevant parties on commercial terms with reference to the ratio of distance travelled within Hong Kong and Mainland China for each route. The term of the revenue sharing arrangements was not fixed but either party was entitled to terminate the operation with advance notice.

NOTES TO THE FINANCIAL STATEMENTS

(Expressed in Hong Kong dollars)

3 SIGNIFICANT ACCOUNTING POLICIES (continued)

(q) Loan to non-controlled subsidiary

Loan to non-controlled subsidiary is a non-derivative financial asset without fixed or determinable repayment terms and is not quoted in an active market. It arose when the Group entered into a shareholding agreement with the Government for the formation of a sub-group of the Corporation under an intermediate holding company, West Rail Property Development Limited ("WRPDL"), to undertake all property developments along the West Rail, Phase I route. Loan to non-controlled subsidiary is initially recognised at fair value, which is equivalent to cost, and thereafter is stated at cost less impairment losses, if any.

(r) Cash and cash equivalents

Cash and cash equivalents comprise cash at bank and on hand, demand deposits with banks and other financial institutions and short-term, highly liquid investments. Cash equivalents are readily convertible into known amounts of cash with an insignificant risk of changes in value and have a maturity of less than three months at acquisition.

For the purposes of the consolidated cash flow statement, cash equivalents would exclude bank deposits with a maturity of more than three months when placed but include bank overdrafts that are repayable on demand and form an integral part of the Group's cash management.

(s) Interest and other receivables

Interest and other receivables are initially recognised at fair value and thereafter are stated at amortised cost less impairment losses, if any, except where the present value is not determinable because there is no fixed repayment term. In such cases, interest and other receivables are stated at cost less impairment losses, if any.

(t) Interest-bearing borrowings

Interest-bearing borrowings are recognised initially at fair value less attributable transaction costs. Subsequent to initial recognition, the unhedged portion of interest-bearing borrowings is stated at amortised cost with any difference between the cost and redemption value being recognised in the income statement over the period of the borrowings using the effective interest method.

Subsequent to initial recognition, the carrying amount of the portion of interest-bearing borrowings, which is the subject of a fair value hedge, is remeasured and the change in fair value attributable to the risk being hedged is recognised in the income statement to offset the effect of the gain or loss on the related hedging instrument.

(u) Interest and other payables

Interest and other payables are initially recognised at fair value and thereafter are stated at amortised cost except where the present value is not determinable because there are no fixed payment terms. In such cases, other payables are stated at cost.

3 SIGNIFICANT ACCOUNTING POLICIES (continued)

(v) Employee benefits

(i) Short term employee benefits and contributions to defined contribution retirement plans

Salaries, annual bonuses, paid annual leave, contributions to defined contribution retirement plans and the cost of non-monetary benefits are accrued in the year in which the associated services are rendered by employees.

(ii) Termination benefits

Termination benefits are recognised when, and only when, the Group demonstrably commits itself to terminate employment or to provide benefits as a result of voluntary redundancy by having a detailed formal plan which is without realistic possibility of withdrawal.

(w) Income tax

(i) Income tax for the year comprises current tax and movements in deferred tax assets and liabilities. Current tax and movements in deferred tax assets and liabilities are recognised in the income statement except to the extent that they relate to items recognised directly to equity, in which case they are recognised in equity.

(ii) Current tax is the expected tax payable on the taxable income for the year, using tax rates enacted or substantively enacted at the balance sheet date and any adjustment to tax payable in respect of previous years.

(iii) Deferred tax assets and liabilities arise from deductible and taxable temporary differences respectively, being the differences between the carrying amounts of assets and liabilities for financial reporting purposes and the amounts for tax purposes. Deferred tax assets also arise from unused tax losses and unused tax credits.

All deferred tax assets, to the extent that it is probable that future taxable profits will be available against which the assets can be utilised, are recognised. All deferred tax liabilities are recognised.

The amount of deferred tax provided is based on the expected manner of realisation or settlement of the carrying amount of the assets and liabilities, using tax rates enacted or substantively enacted at the balance sheet date. Deferred tax assets and liabilities are not discounted.

The carrying amount of a deferred tax asset is reviewed at each balance sheet date and is reduced to the extent that it is no longer probable that sufficient taxable profits will be available to allow the related tax benefit to be utilised. Such reduction is reversed to the extent that it becomes probable that sufficient taxable profits will be available.

NOTES TO THE FINANCIAL STATEMENTS

(Expressed in Hong Kong dollars)

3 SIGNIFICANT ACCOUNTING POLICIES (continued)

(w) Income tax (continued)

(iv) Current tax balances and deferred tax balances, and movements therein, are presented separately from each other and are not offset. Current tax assets are offset against current tax liabilities, and deferred tax assets against deferred tax liabilities if the Group or Corporation has the legally enforceable right to set off current tax assets against current tax liabilities and the following additional conditions are met:

- in the case of current tax assets and liabilities, the Group or Corporation intends either to settle on a net basis, or to realise the asset and settle the liability simultaneously; or

- in the case of deferred tax assets and liabilities, they relate to income taxes levied by the same taxation authority on either:

  - the same taxable entity; or

  - different taxable entities which intend to realise the current tax assets and settle the current tax liabilities on a net basis in the same period.

(x) Provisions and contingent liabilities

Provisions are recognised for liabilities of uncertain timing or amount when the Group or the Corporation has a legal or constructive obligation arising as a result of a past event, and it is probable that an outflow of economic benefits will be required to settle the obligation and a reliable estimate can be made. Where the time value of money is material, provisions are stated at the present value of the expenditure expected to settle the obligation.

Where it is not probable that an outflow of economic benefits will be required, or the amount cannot be estimated reliably, the possibility of an obligation arising as a result of a past event is disclosed as a contingent liability, unless the probability of outflow of economic benefits is remote. Possible obligations, whose existence will only be confirmed by the occurrence or non-occurrence of one or more future events are also disclosed as contingent liabilities unless the probability of outflow of economic benefits is remote.

(y) Revenue recognition

Provided it is probable that the economic benefits will flow to the Group and the revenue and costs, if applicable, can be measured reliably, revenue is recognised in the income statement as follows:

(i) Passenger and freight services

Revenue is recognised when the services are provided.

3 SIGNIFICANT ACCOUNTING POLICIES (continued)

(y) Revenue recognition (continued)

(ii) Rental and licence income

Rental and licence income receivable under operating leases is recognised in the income statement in equal instalments over the periods covered by the lease term, except where an alternative basis is more representative of the pattern of benefits to be derived from the use of the leased asset. Lease incentives granted are recognised in the income statement as an integral part of the aggregate net lease payment receivable. Contingent rentals are recognised as income in the accounting period in which they are earned.

(iii) Interest income

Interest income is recognised as it accrues using the effective interest method.

(iv) Concession income

Different components of concession income are recognised in the income statement as follows:

– Fixed annual payments of $750 million and variable annual payments based on revenue generated from the operation of the Corporation's rail network and other rail-related businesses are recognised when earned during the Concession Period;

– The upfront payment received less the cost of Purchased Rail Assets for the Service Concession and the assets and liabilities assumed by MTRCL are amortised over the Concession Period on a straight-line basis; and

– ACP funded by MTRCL is recognised as deferred income and amortised over the shorter of its useful life and the remaining Concession Period.

(v) Other income

Other income is recognised once the related services or goods are delivered and the related risks and rewards of ownership have been transferred.

(z) Lease out and lease back transactions

A series of lease out and lease back transactions with third parties is linked and accounted for as one arrangement when the overall economic effect cannot be understood without reference to the series of transactions as a whole and when the series of transactions is closely interrelated, negotiated as a single arrangement and takes place concurrently or in a continued sequence.

The primary purpose of such arrangements is to achieve a particular tax result for the third parties in return for a fee. The arrangements do not, in substance, involve a lease under IAS 17 and HKAS 17 since the Group retains all the risks and rewards incidental to the ownership of the underlying assets and enjoys substantially the same rights to their use as before the transactions were entered into. The transactions are, therefore, not accounted for as leases.

3 SIGNIFICANT ACCOUNTING POLICIES (continued)

(z) Lease out and lease back transactions (continued)

Where commitments to make long-term lease payments have been defeased by the placement of security deposits or by the advance of loans to third parties, they are not recognised in the balance sheet. Where commitments and deposits or advances of loans to third parties meet the definition of a liability and an asset, they are recognised in the balance sheet.

The income and expenses arising from the arrangements are accounted for on a net basis in order to reflect the overall commercial effect of the transactions. The net amounts are accounted for as deferred income and are amortised over the applicable lease terms of the transactions.

(aa) Translation of foreign currencies

Foreign currency transactions during the year are translated into Hong Kong dollars at the exchange rates ruling at the transaction dates. Monetary assets and liabilities denominated in foreign currencies are translated into Hong Kong dollars at the foreign exchange rates ruling at the balance sheet date.

Non-monetary assets and liabilities that are measured in terms of historical cost in a foreign currency are translated using the foreign exchange rates ruling at the transaction dates. Non-monetary assets and liabilities denominated in foreign currencies that are stated at fair value are translated into Hong Kong dollars using the foreign exchange rates ruling at the dates the fair value was determined.

(ab) Interest and finance income/expenses

(i) Interest and finance income includes:

- interest income from bank deposits and investments;
- interest income arising from delayed reimbursement from MTRCL relating to property development enabling works;
- realised gains arising from derivative financial instruments designated as hedges for borrowings;
- net gains on redemption and disposal of investments; and
- net exchange gains arising from foreign currency transactions.

(ii) The Group's interest and finance income arising from non-derivative financial assets are not classified as at fair value through the income statement, except for those financial assets that include embedded derivatives with economic characteristics and risks different from that of the host contracts.

Interest and finance income is credited to the income statement in the period in which it is earned, except for the portion generated from pre-funding investments which is credited to construction in progress or deferred expenditure, as appropriate.

3 SIGNIFICANT ACCOUNTING POLICIES (continued)

(ab) Interest and finance income/expenses (continued)

(iii) Interest and finance expenses include:

- interest payable on borrowings;
- finance expenses including amortisation of discounts/premiums and ancillary costs incurred in connection with the arrangement of borrowings calculated using the effective interest rate;
- realised losses arising from derivative financial instruments designated as hedges for borrowings;
- net realised losses on redemption and disposal of investments; and
- net exchange losses arising from foreign currency transactions.

(iv) The Group's interest and finance expenses arising from non-derivative financial liabilities are not classified as at fair value through the income statement.

Interest and finance expenses are expensed in the income statement in the period in which they are incurred, except to the extent that they are capitalised as being directly attributable to the acquisition, construction or production of an asset which necessarily takes a substantial period of time to get ready for its intended use or sale.

(ac) Related parties

For the purposes of these financial statements, parties are considered to be related to the Group if the Group has the ability, directly or indirectly, to control the party or exercise significant influence over the party in making financial and operating decisions, or vice versa, or where the Group and the party are subject to common control or common significant influence. Related parties may be individuals (being members of key management personnel and/or their close family members) or other entities and include entities which are under the significant influence of related parties of the Group where those parties are individuals.

(ad) Segment reporting

A segment is a distinguishable component of the Group that is engaged either in providing products or services (business segment), or in providing products or services within a particular economic environment (geographical segment), which is subject to risks and rewards that are different from those of other segments.

NOTES TO THE FINANCIAL STATEMENTS

(Expressed in Hong Kong dollars)

4 TURNOVER

Turnover principally represents revenue from passenger, freight, property services and the Service Concession after eliminating inter-company transactions. The revenue relating to the principal activities of the Corporation prior to the Appointed Day were passenger, freight and property services whereas, after the Appointed Day, the main stream of revenue to the Corporation is generated from the Service Concession. The amounts of revenue recognised in turnover during the year are as follows:

	2008 $ million	2007 $ million
Transport services		
Passenger services		
– East Rail	**–**	3,580
– West Rail and Light Rail	**–**	889
Freight services	**–**	38
	–	4,507
Property services	**12**	987
Income from lease out and lease back transactions	**19**	17
Service Concession income	**839**	70
	870	5,581

No business and geographical segment information is disclosed in accordance with IAS 14 and HKAS 14 as the Service Concession is the only reportable segment and virtually all of the turnover and operating loss is derived from activities in Hong Kong.

5 OPERATING COSTS BEFORE DEPRECIATION AND AMORTISATION

	2008 $ million	2007 $ million
Staff costs		
– Gross amount including retirement costs of nil (2007: $127 million) after a forfeiture of unvested contributions of nil (2007: $1 million)	**5**	1,965
– Staff costs capitalised	**–**	(501)
	5	1,464
Electricity and fuel	**–**	471
Repairs and maintenance	**1**	243
Stores and spares consumed	**–**	191
General supplies	**–**	24
Government rent and rates	**–**	55
Octopus cards usage fees	**–**	37
Cost of services acquired (including services outsourced to MTRCL of $20 million (2007: $2 million))	**33**	144
Property ownership and management expenses	**–**	50
Others	**30**	139
	69	2,818

6 OPERATING PROFIT BEFORE DEPRECIATION AND AMORTISATION

(a) Operating profit before depreciation and amortisation is arrived at after charging:

	2008 $ million	2007 $ million
Fixed assets written off on disposal	**18**	30
Auditors' remuneration		
– Current year provision	**2**	5
– Reversal of over-provision in prior year	**(2)**	–
– Other professional services	**–**	6
Operating lease charges (minimum lease payments)		
– Hire of plant and machinery	**–**	26
– Rental of property	**2**	9
Remuneration of Members of the Managing Board, Executive Directors and Chief Officer who are not Members of the Managing Board		
– Fees for Members of the Managing Board including the Chairman but excluding the Chief Executive Officer	**–**	1
– Contributions to retirement benefit schemes for the Chief Executive Officer, Executive Directors and Chief Officer who are not Members of the Managing Board	**–**	1
– Emoluments of the Chief Executive Officer, Executive Directors and Chief Officer who are not Members of the Managing Board	**2**	23
and after crediting:		
Rentals receivable from operating leases less direct outgoings of nil (2007: $21 million) (including contingent rentals of nil (2007: $73 million))	**12**	837
Rentals receivable from investment properties less direct outgoings of nil (2007: $10 million)	**–**	80

NOTES TO THE FINANCIAL STATEMENTS

(Expressed in Hong Kong dollars)

6 OPERATING PROFIT BEFORE DEPRECIATION AND AMORTISATION (continued)

(b) Fees for Members of the Managing Board including the Chairman but excluding the Chief Officer are shown below:

	2008 $'000	2007 $'000
Chairman		
Professor K C Chan in the capacity of Secretary for Financial Services and the Treasury *	–	46
Mr Michael P S Tien #	–	202
Members		
Ms Eva Cheng in the capacity of Secretary for Transport and Housing **	–	46
Mr Francis Ho in the capacity of Permanent Secretary for Transport and Housing (Transport) ***	–	–
Mr Stanley Ying in the capacity of Permanent Secretary for Financial Services and the Treasury (Treasury)***	–	–
Mr Clement Leung in the capacity of Deputy Secretary for Financial Services and the Treasury (Treasury)***	–	–
Mrs Lucia Li in the capacity of Director of Accounting Services ***	–	–
Mr Vincent W S Lo #	–	101
Mr L S Ng #	–	101
Mr Patrick B Paul #	–	101
The Honourable Abraham L H Shek #	–	101
Professor Richard Y C Wong #	–	101
Mr M Y Wan ##	–	64
Dr Sarah S T Liao in the capacity of Secretary for the Environment, Transport and Works ###	–	55
Mr Frederick S H Ma in the capacity of Secretary for Financial Services and the Treasury ###	–	55
	–	973

* Professor K C Chan in the capacity of Secretary for Financial Services and the Treasury was appointed on 1 July 2007. He was also appointed as Chairman on 2 December 2007. No fees were payable to him subsequent to 2 December 2007.

** Ms Eva Cheng in the capacity of Secretary for Transport and Housing was appointed on 1 July 2007. No fees were payable to her subsequent to 2 December 2007.

*** On the Appointed Day, the Chief Executive of the HKSAR appointed public officers as Members of the Managing Board. No fees were payable to these Members subsequent to 2 December 2007.

\# The appointment ended on 1 December 2007.

\## Mr M Y Wan's appointment ended on 31 July 2007.

\### The appointment of Dr Sarah S T Liao in the capacity of Secretary for the Environment, Transport and Works and Mr Frederick S H Ma in the capacity of Secretary for Financial Services and the Treasury ended on 30 June 2007.

6 OPERATING PROFIT BEFORE DEPRECIATION AND AMORTISATION (continued)

(c) Emoluments of the Chief Executive Officer, Executive Directors and the Chief Officer who are not Members of the Managing Board include fixed remuneration which comprises base pay, allowances and gratuities; benefits-in-kind; retirement benefit scheme contributions and variable remuneration. Details of emoluments are shown below:

	2008 $ million			2007 $ million		
	Fixed remuneration and benefits-in-kind	**Contribution to retirement benefit scheme**	**Total**	Fixed remuneration and benefits-in-kind	Contribution to retirement benefit scheme	Total
Mr James Blake #	**2.11**	**–**	**2.11**	4.97	–	4.97
Mr K K Lee ##	**–**	**–**	**–**	3.72	0.31	4.03
Mr Y T Li ##	**–**	**–**	**–**	3.84	0.27	4.11
Mr Daniel C Lam ###	**–**	**–**	**–**	4.04	0.01	4.05
Mr Lawrence C P Li ##	**–**	**–**	**–**	2.59	0.20	2.79
Mrs Mimi Cunningham ##	**–**	**–**	**–**	3.68	0.01	3.69
	2.11	**–**	**2.11**	22.84	0.80	23.64

Mr James Blake joined the Corporation on 22 March 2006 as the Chief Executive Officer and was re-appointed as the Chief Officer on 2 December 2007.

The employment contracts with these employees were vested in MTRCL on the Appointed Day.

Mr Daniel C Lam left the Corporation on 2 December 2007.

The ranges of remuneration set out below include the five highest paid employees of the Corporation.

	No of employees	
	2008*	2007
The remuneration of the highest five employees ranges from		
$ 4,000,001 – $ 5,000,000	**–**	4
$ 3,000,001 – $ 4,000,000	**–**	1
$ 2,000,001 – $ 3,000,000	**1**	–
$ 1,000,001 – $ 2,000,000	**1**	–
Nil – $ 1,000,000	**2**	–

* The Corporation only employed four employees during the year ended 31 December 2008.

NOTES TO THE FINANCIAL STATEMENTS

(Expressed in Hong Kong dollars)

7 DEPRECIATION AND AMORTISATION

	2008 $ million	2007 $ million
Depreciation:		
– assets leased out under operating leases	**2**	31
– other assets	**2,465**	2,266
– depreciation charge capitalised	**(2)**	(3)
	2,465	2,294
Amortisation:		
– amortisation of interest of leasehold land held for own use under operating leases	**130**	124
	2,595	2,418

8 INTEREST AND FINANCE INCOME/EXPENSES

(a) Interest and finance income

	2008 $ million	2007 $ million
Interest income from deposits	**105**	58
Interest income from MTRCL relating to property development enabling works	**24**	25
Interest income from investments	**113**	3
Interest income from loan to non-controlled subsidiary	**–**	364
Interest income from non-derivative financial assets	**242**	450
Realised gains arising from derivative financial instruments	**112**	26
Exchange gain (net)	**96**	–
	450	476

8 INTEREST AND FINANCE INCOME/EXPENSES (continued)

(b) Interest and finance expenses

	2008 $ million	2007 $ million
Interest expenses on loans	**1,313**	1,417
Finance expenses	**8**	9
Interest and finance expenses on non-derivative financial liabilities	**1,321**	1,426
Realised losses arising from derivative financial instruments	**103**	124
Exchange loss (net)	**–**	44
	1,424	1,594
Less: Amount capitalised #	**(62)**	(271)
	1,362	1,323

Interest expenses capitalised were charged at average interest rates ranging between 7.25% (2007: 7.69%) and 7.50% (2007: 7.91%) per annum.

9 GAINS ON CHANGES IN FAIR VALUE OF FINANCIAL INSTRUMENTS

	2008 $ million	2007 $ million
Net gain arising from derivative financial instruments	**230**	526
Net (loss)/gain arising from hedged interest-bearing borrowings	**(40)**	15
Net unrealised loss on investments designated as at fair value through profit or loss	**(7)**	–
	183	541

10 INCOME TAX

(a) Income tax in the consolidated income statement represents:

	2008 $ million	2007 $ million
Current tax		
Provision for Hong Kong Profits Tax at 16.5% (2007: 17.5%) of the estimated assessable profits for the year	**–**	1
Deferred tax(credit)/charge		
Origination and reversal of temporary differences	**(447)**	783
Effect on deferred tax balance at 1 January resulting from a change in tax rate	**(230)**	–
	(677)	784

In 2007, the provision for Hong Kong Profits Tax was in respect of the estimated assessable profits for the year of the subsidiaries of the Corporation. The Corporation sustained a loss for tax purposes during the year and has accumulated tax losses carried forward of approximately $12,000 million at 31 December 2008 (2007: approximately $7,900 million) which are available to set off against future assessable profits. The tax losses do not expire under current tax legislation.

In February 2008, the Government announced a decrease in the Profits Tax rate from 17.5% to 16.5% applicable to the Group as from the year ended 31 December 2008. This decrease is taken into account in the preparation of these financial statements.

(b) Reconciliation between tax (credit)/expense and accounting (loss)/profit at applicable tax rates:

	2008 $ million	2007 $ million
(Loss)/profit before taxation	**(2,492)**	6,105
Tax (credit)/charge on accounting (loss)/profit before taxation at 16.5% (2007: 17.5%)	**(411)**	1,068
Tax effect of non-deductible expenses	**38**	46
Tax effect of non-taxable revenue	**(74)**	(330)
Effect on deferred tax balance at 1 January resulting from a change in tax rate	**(230)**	–
Actual tax (credit)/expense	**(677)**	784

10 INCOME TAX (continued)

(c) Current tax in the balance sheet represents:

	Group		Corporation	
	2008 $ million	2007 $ million	**2008 $ million**	2007 $ million
Provision for Hong Kong Profits Tax for the year	**–**	1	**–**	–
Provisional Profits Tax paid	**–**	(1)	**–**	–
	–	–	**–**	–

(d) Deferred tax assets and liabilities of the Group and the Corporation recognised:

The components of deferred tax (assets)/liabilities of the Group and the Corporation recognised in the Group's and the Corporation's balance sheet and the movements during the year are as follows:

The Group

	Future benefit of tax losses $ million	Depreciation allowances in excess of the related depreciation $ million	Revaluation of investment properties $ million	Total $ million
At 1 January 2007	(1,896)	5,052	94	3,250
Charged/(credited) to the income statement	517	360	(94)	783
At 31 December 2007	(1,379)	5,412	–	4,033
At 1 January 2008	**(1,379)**	**5,412**	**–**	**4,033**
Effect from change in tax rate	**79**	**(309)**	**–**	**(230)**
(Credited)/charged to the income statement	**(674)**	**227**	**–**	**(447)**
At 31 December 2008	**(1,974)**	**5,330**	**–**	**3,356**

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(Expressed in Hong Kong dollars)

10 INCOME TAX (continued)

(d) Deferred tax assets and liabilities of the Group and the Corporation recognised: (continued)

The Corporation

	Future benefit of tax losses $ million	Depreciation allowances in excess of the related depreciation $ million	Revaluation of investment properties $ million	Total $ million
At 1 January 2007	(1,896)	5,053	94	3,251
Charged/(credited) to the income statement	517	359	(94)	782
At 31 December 2007	(1,379)	5,412	–	4,033
At 1 January 2008	**(1,379)**	**5,412**	**–**	**4,033**
Effect from change in tax rate	**79**	**(309)**	**–**	**(230)**
(Credited)/charged to the income statement	**(674)**	**227**	**–**	**(447)**
At 31 December 2008	**(1,974)**	**5,330**	**–**	**3,356**

11 (LOSS)/PROFIT FOR THE YEAR WHOLLY ATTRIBUTABLE TO THE SOLE SHAREHOLDER OF THE CORPORATION

Of the consolidated loss for the year amounting to $1,815 million (2007: profit of $5,321 million), loss of $1,857 million (2007: profit of $5,277 million) has been dealt with in the financial statements of the Corporation.

12 PROPOSED DIVIDEND

Dividend payable to the sole shareholder of the Corporation attributable to the previous financial year, approved and paid during the year:

	2008 $ million	2007 $ million
Final dividend in respect of the previous financial year, approved and paid during the year, of nil per share (2007: $209.61 per share)	**–**	82

13 FIXED ASSETS AND INTEREST IN LEASEHOLD LAND HELD FOR OWN USE UNDER OPERATING LEASES

(a) The Group

	Investment properties $ million	Tunnels, bridges, roads and permanent way $ million	Buildings $ million	Rolling stock $ million	Other equipment $ million	Total fixed assets $ million	Interest in leasehold land held for own use $ million
Cost or valuation:							
At 1 January 2007	1,378	20,210	29,686	9,273	11,642	72,189	5,983
Transfer from construction in progress	2	5,945	3,873	81	1,230	11,131	536
Additions	–	40	29	–	35	104	16
Disposals	(1,389)	(14)	(115)	(5)	(295)	(1,818)	(31)
Fair value adjustment	9	–	–	–	–	9	–
At 31 December 2007	–	26,181	33,473	9,349	12,612	81,615	6,504
At 1 January 2008	**–**	**26,181**	**33,473**	**9,349**	**12,612**	**81,615**	**6,504**
Transfer from construction in progress	**–**	**7**	**53**	**892**	**192**	**1,144**	**4**
Additions	**–**	**4**	**3**	**–**	**–**	**7**	**15**
Purchase of ACP by MTRCL	**–**	**–**	**–**	**–**	**11**	**11**	**–**
Disposals	**–**	**(17)**	**(1)**	**–**	**(69)**	**(87)**	**–**
At 31 December 2008	**–**	**26,175**	**33,528**	**10,241**	**12,746**	**82,690**	**6,523**
Accumulated depreciation and amortisation:							
At 1 January 2007	–	1,318	2,625	2,790	5,580	12,313	459
Charge for the year	–	523	643	275	856	2,297	124
Written back on disposals	–	(3)	(40)	(5)	(207)	(255)	(10)
At 31 December 2007	–	1,838	3,228	3,060	6,229	14,355	573
At 1 January 2008	**–**	**1,838**	**3,228**	**3,060**	**6,229**	**14,355**	**573**
Charge for the year	**–**	**603**	**691**	**298**	**875**	**2,467**	**130**
Written back on disposals	**–**	**(5)**	**–**	**–**	**(64)**	**(69)**	**–**
At 31 December 2008	**–**	**2,436**	**3,919**	**3,358**	**7,040**	**16,753**	**703**
Carrying amounts:							
At 31 December 2008	**–**	**23,739**	**29,609**	**6,883**	**5,706**	**65,937**	**5,820**
At 31 December 2007	–	24,343	30,245	6,289	6,383	67,260	5,931

NOTES TO THE FINANCIAL STATEMENTS

(Expressed in Hong Kong dollars)

13 FIXED ASSETS AND INTEREST IN LEASEHOLD LAND HELD FOR OWN USE UNDER OPERATING LEASES (continued)

(b) The Corporation

	Investment properties $ million	Tunnels, bridges, roads and permanent way $ million	Buildings $ million	Rolling stock $ million	Other equipment $ million	Total fixed assets $ million	Interest in leasehold land held for own use $ million
Cost or valuation:							
At 1 January 2007	1,378	20,210	29,686	9,273	11,591	72,138	5,983
Transfer from construction in progress	2	5,945	3,873	81	1,230	11,131	536
Additions	–	40	29	–	35	104	16
Disposals	(1,389)	(14)	(115)	(5)	(244)	(1,767)	(31)
Fair value adjustment	9	–	–	–	–	9	–
At 31 December 2007	–	26,181	33,473	9,349	12,612	81,615	6,504
At 1 January 2008	**–**	**26,181**	**33,473**	**9,349**	**12,612**	**81,615**	**6,504**
Transfer from construction in progress	**–**	**7**	**53**	**892**	**192**	**1,144**	**4**
Additions	**–**	**4**	**3**	**–**	**–**	**7**	**15**
Purchase of ACP by MTRCL	**–**	**–**	**–**	**–**	**11**	**11**	**–**
Disposals	**–**	**(17)**	**(1)**	**–**	**(69)**	**(87)**	**–**
At 31 December 2008	**–**	**26,175**	**33,528**	**10,241**	**12,746**	**82,690**	**6,523**
Accumulated depreciation and amortisation:							
At 1 January 2007	–	1,318	2,625	2,790	5,565	12,298	459
Charge for the year	–	523	643	275	851	2,292	124
Written back on disposals	–	(3)	(40)	(5)	(187)	(235)	(10)
At 31 December 2007	–	1,838	3,228	3,060	6,229	14,355	573
At 1 January 2008	**–**	**1,838**	**3,228**	**3,060**	**6,229**	**14,355**	**573**
Charge for the year	**–**	**603**	**691**	**298**	**875**	**2,467**	**130**
Written back on disposals	**–**	**(5)**	**–**	**–**	**(64)**	**(69)**	**–**
At 31 December 2008	**–**	**2,436**	**3,919**	**3,358**	**7,040**	**16,753**	**703**
Carrying amounts:							
At 31 December 2008	**–**	**23,739**	**29,609**	**6,883**	**5,706**	**65,937**	**5,820**
At 31 December 2007	–	24,343	30,245	6,289	6,383	67,260	5,931

13 FIXED ASSETS AND INTEREST IN LEASEHOLD LAND HELD FOR OWN USE UNDER OPERATING LEASES (continued)

(c) Permanent way principally comprises the cost of rail tracks, sleepers, track base and ballast.

(d) Other equipment comprises lifts and escalators, telecommunication and signalling systems, machinery, furniture and fixtures, motor vehicles and computer and office equipment.

(e) Prior to the Appointed Day, the Group and the Corporation leased out investment properties and certain properties which were either used in or ancillary to the Group's and Corporation's rail business, under operating leases. The leases typically ran for an initial period of two to five years, with an option to renew the lease after that date at which time all terms would be re-negotiated. Certain leases included additional rentals based on sales revenue of the tenants in excess of the basic rentals. On the Appointed Day, all the investment properties and most of the other properties were either disposed of or, under the Service Concession Agreement, transferred to MTRCL.

(f) Included in fixed assets are assets leased out under operating leases with gross carrying amount and related deprecation charges as follows:

	2008		2007	
	Gross carrying amount $ million	**Related accumulated depreciation $ million**	Gross carrying amount $ million	Related accumulated depreciation $ million
Citylink Plaza at Sha Tin Station	**53**	**21**	16	8

(g) The minimum total future amounts receivable by the Group and Corporation under non-cancellable operating leases are expected to be received as follows:

	2008 $ million	2007 $ million
Within one year	**29**	10
After one year but within five years	**23**	20
	52	30

13 FIXED ASSETS AND INTEREST IN LEASEHOLD LAND HELD FOR OWN USE UNDER OPERATING LEASES (continued)

(h) The Group and Corporation have entered into a number of individually structured transactions or arrangements with unrelated parties to lease out and lease back assets which include rolling stock, signalling equipment, revenue collection equipment and railway infrastructure. Under each arrangement, the Group and Corporation have leased the assets to an overseas investor, who has prepaid all the rentals in relation to a lease agreement. Simultaneously, the Group and Corporation have leased the assets back from the overseas investor and will pay the rentals on a semi-annual or annual basis in accordance with a pre-determined payment schedule. The Group and Corporation have an option to purchase the overseas investor's leasehold interest in the assets at a pre-determined date for a fixed or agreed amount and it is the intention of the Group and Corporation to exercise such purchase options. The rental prepayments received from the overseas investor have been placed in deposits or invested in debt securities, the repayments of which are expected to be sufficient to meet the Group's and Corporation's rental obligations and the amounts payable for exercising the purchase options under the lease agreements. As long as the Group and Corporation comply with the requirements of the lease agreements, the Group and Corporation will continue to be entitled to quiet enjoyment of and continued possession, use or operation of the assets subject to these arrangements. The arrangements have been entered with investors in the United States.

As at 31 December 2008, a portion of the Group's and Corporation's assets (including assets replaced during the lease periods) with a total cost of $10,211 million (2007: $10,114 million) and net book value of $4,930 million (2007: $5,221 million) is covered by eight arrangements (2007: eight arrangements). Five arrangements involve rolling stock, with basic lease terms of 15 to 28 years. Two arrangements, one involving signalling equipment and the other involving the revenue collection system, have a basic lease term of 15 years. The remaining arrangement involving railway infrastructure has basic lease terms of between 24 years and 27 years. Since the Group and Corporation retain risks and rewards incidental to ownership of the underlying assets in respect of each arrangement and enjoy substantially the same rights to their use as before the arrangements were entered into, no adjustment has been made to fixed assets. As a result of the eight arrangements, the Group and Corporation have received cash of $10,805 million (2007: $10,805 million) and, assuming exercise of the purchase option in each arrangement, will be obligated to make long-term lease payments over the duration of the relevant leases with a total estimated net present value at the inception of the arrangements of $10,292 million (2007: $10,292 million), the obligations of which are expected to be funded by the proceeds to be generated from existing deposits and investments over the relevant lease periods.

The total net amounts of cash received by the Group and Corporation from the arrangements have been recorded as deferred income and are being amortised to the income statement over the applicable lease terms of the arrangements.

13 FIXED ASSETS AND INTEREST IN LEASEHOLD LAND HELD FOR OWN USE UNDER OPERATING LEASES (continued)

(i) Included in additions are amounts paid and payable to the Government by the Corporation in respect of the following:

– $22 million (2007: $17 million) for land resumption work on the West Rail and East Rail Extensions projects undertaken by the Government on behalf of the Corporation and for lease of land required for construction sites.

(j) In compliance with IAS 16 and HKAS 16 which require an annual review of the estimated useful lives of fixed assets, an extensive review of the estimated useful lives of all major fixed asset categories was undertaken by in-house engineers of MTRCL during the year. The review has not been fully completed as at 31 December 2008 and, based on the preliminary results, management considers the potential impact of changes in useful lives of fixed assets to be immaterial in the context of these financial statements.

(k) The carrying value of the Group's and Corporation's interest in leasehold land held in Hong Kong is $5,798 million (2007: $5,909 million) under medium-term leases (less than 50 years) and $22 million (2007: $22 million) under long-term leases (50 years or above).

14 CONSTRUCTION IN PROGRESS

(a) Construction in progress comprises:

The Group and the Corporation

2008

	Kowloon Southern Link $ million	East Rail Extensions $ million	Other assets $ million	Total construction in progress $ million
Balance as at 1 January 2008	5,040	17	452	5,509
Costs incurred/(adjusted) during the year	1,918	(5)	137	2,050
Purchase of ACP by MTRCL	–	–	515	515
Transfer to fixed assets or leasehold land	(796)	3	(355)	(1,148)
Balance as at 31 December 2008	6,162	15	749	6,926

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(Expressed in Hong Kong dollars)

14 CONSTRUCTION IN PROGRESS (continued)

(a) Construction in progress comprises: (continued)

The Group and the Corporation

2007

	Kowloon Southern Link $ million	East Rail Extensions $ million	Other assets $ million	Total construction in progress $ million
Balance as at 1 January 2007	2,840	10,493	311	13,644
Costs incurred during the year	2,200	838	445	3,483
Purchase of ACP by MTRCL	–	–	49	49
Transfer to fixed assets or leasehold land	–	(11,314)	(353)	(11,667)
Balance as at 31 December 2007	5,040	17	452	5,509

(b) As at 31 December 2008, land resumption costs and other costs totalling approximately $2 million (2007: $1 million) and $118 million (2007: $79 million) directly associated with the acquisition of leasehold land for the construction of the East Rail Extensions and the Kowloon Southern Link respectively are included in the balance of construction in progress. These costs will be transferred to interest in leasehold land when the land is vested in the Corporation by the Government, at which time the costs will begin to be amortised in accordance with relevant policies.

(c) Included in costs incurred during the year are amounts paid and payable to the Government by the Corporation in respect of the following:

– $48 million (2007: $40 million) for the lease of land required for construction sites for the East Rail Extensions and Kowloon Southern Link projects. The land does not have a measurable value as it cannot be assigned and can only be used by the Corporation and/or its contractors.

– $10 million (2007: $18 million) for land resumption work undertaken by the Government and compensation in respect of resumed land paid and payable by the Government on behalf of the Corporation in respect of the Kowloon Southern Link project. The Corporation is obligated to reimburse such sums to the Government.

14 CONSTRUCTION IN PROGRESS (continued)

(d) The costs incurred during the year are arrived at after crediting $9 million (2007: nil) on-cost recovery from the Government for certain essential public infrastructure works and other works along the railways undertaken by the Corporation on its behalf pursuant to the entrustment agreements in respect of such entrustment works and from the subsidiary, West Rail Property Development Limited, for property development along the West Rail, Phase I route as governed by the Shareholding Agreement between the Corporation and the Government (see note 19).

(e) During the year, project management fees of $341 million (2007: $28 million) were paid and payable to MTRCL by the Corporation for the management of design and construction of the Kowloon Southern Link project on its behalf pursuant to the Kowloon Southern Link Project Management Agreement.

(f) During the year, project management fees of $28 million (2007: nil) were paid and payable to MTRCL by the Corporation for the reimbursement of staff costs for the management of the operations of the East Rail Extensions and West Rail projects pursuant to the Service Concession Agreement.

(g) Included in the transfer to fixed assets under the Kowloon Southern Link project are amounts totalling $796 million representing the cost of rolling stock that has been put into operation along the West Rail in 2008. The Kowloon Southern Link will be connected to the West Rail upon completion and, in turn, the rolling stock will be able to operate through the West Rail and Kowloon Southern Link lines.

15 DEFERRED EXPENDITURE

(a) Deferred expenditure comprises:

The Group and the Corporation

2008

	Shatin to Central Link $ million	Express Rail Link/ Northern Link $ million	Total deferred expenditure $ million
Balance as at 1 January 2008	1,188	397	1,585
Expenditure incurred during the year	–	27	27
Balance as at 31 December 2008	1,188	424	1,612

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(Expressed in Hong Kong dollars)

15 DEFERRED EXPENDITURE (continued)

(a) Deferred expenditure comprises: (continued)

The Group and the Corporation

2007

	Shatin to Central Link $ million	Express Rail Link/ Northern Link $ million	Total deferred expenditure $ million
Balance as at 1 January 2007	1,188	201	1,389
Expenditure incurred during the year	–	196	196
Balance as at 31 December 2007	1,188	397	1,585

(b) The Government has indicated that the Shatin to Central Link ("the SCL"), upon completion, is likely to be vested in the Corporation and operated by MTRCL through a service concession arrangement. A final decision on the detailed arrangements will be subject to Government policy approval which is expected to be available in late 2009/early 2010. Although the final details of the arrangement are subject to Government policy approval as noted above, management are confident that the recovery of the costs incurred to date by the Corporation on the SCL will be achieved over the duration of the additional or supplemental service concession arrangement with MTRCL.

(c) As at 31 December 2008, land related costs totalling approximately $6 million (2007: $6 million) directly associated with the acquisition of leasehold land for the purpose of the SCL are included in the balance of deferred expenditure. These costs will be transferred to interest in leasehold land when the land is vested in the Corporation by the Government, at which time the costs will begin to be amortised in accordance with the relevant policies.

16 PROPERTIES UNDER DEVELOPMENT

The Group and the Corporation

	2008 $ million	2007 $ million
Balance as at 1 January	20	449
Expenditure incurred during the year	–	33
Transfer to other receivables	–	(462)
Impairment loss recognised in the income statement	(20)	–
Balance as at 31 December	–	20

The balance of expenditure on properties under development that mainly related to the property design and development in respect of Hung Hom Mass Transportation Centre has been considered to be impaired and written off as the management considers that the development plan for the properties concerned has changed as time has elapsed and it is uncertain as to whether the expenditure incurred could be recovered.

On the Appointed Day, the Corporation received from MTRCL an amount of $4.91 billion as proceeds for the economic benefit of the property development rights of eight development sites along the East Rail, the Ma On Shan Rail, the Light Rail and the Kowloon Southern Link. Separately, MTRCL agreed to reimburse the Corporation for enabling works costs incurred or to be incurred for by the latter in relation to the developments acquired by MTRCL once the joint venture for the respective property development site is formed. The balance of the enabling works due from MTRCL on the Appointed Day has been transferred to other receivables.

17 INVESTMENTS IN SUBSIDIARIES

	Corporation	
	2008 $ million	2007 $ million
Unlisted shares, at cost	–	–

NOTES TO THE FINANCIAL STATEMENTS

(Expressed in Hong Kong dollars)

17 INVESTMENTS IN SUBSIDIARIES (continued)

Details of the subsidiaries listed by principal activities are as follows:

Name of company	Place of incorporation and operation	Number of issued and fully paid ordinary shares	Par value of shares	Percentage of shares held by the Corporation
Asset Leasing				
Buoyant Asset Limited	Hong Kong	100	$10	100%
Advanced Asset Limited	Hong Kong	100	$10	100%
Quality Asset Limited	Hong Kong	100	$10	100%
Kasey Asset Limited	Hong Kong	100	$10	100%
Circuit Asset Limited	Hong Kong	100	$10	100%
Shining Asset Limited	Hong Kong	100	$10	100%
Fluent Asset Limited	Hong Kong	100	$10	100%
Kudos Asset Limited &	Hong Kong	100	$10	100%
Unique Asset Limited &	Hong Kong	100	$10	100%
Bowman Asset Limited	Cayman Islands	1,000	US$1	100%
Statesman Asset Limited	Cayman Islands	1,000	US$1	100%
Non-controlled subsidiaries				
Property development:				
West Rail Property Development Limited,	Hong Kong	51 'A'	$10	100%
and its 13 wholly owned subsidiaries *		49 'B'	$10	Nil
Property management:				
The Metropolis Management	Hong Kong	25,500 'A'	$1	100%
Company Limited **		24,500 'B'	$1	Nil

& At 31 December 2008, these subsidiaries were in the process of being wound up as the related leasing transaction was terminated in 2006.

* These subsidiaries are held by the Corporation for the sole purpose of developing commercial or residential property along the West Rail, Phase I route on behalf of the Government. Their financial statements are excluded from consolidation as the Corporation has no effective control over nor beneficial interests in the net assets of these subsidiaries, other than the amount of capital provided.

** The subsidiary is held by the Corporation for the sole purpose of rendering property management services to a commercial property. The financial statements are excluded from the consolidation on the basis that, under the Equity Sub-participation Agreement which formed part of the merger transaction, the Corporation is obliged to act on MTRCL's instructions in respect of the exercise of any and all rights the Corporation has as a shareholder of the MMC. All the beneficial interests to which the Corporation was previously entitled now rest with MTRCL although there has been no direct disposition of the shares of MMC to MTRCL.

17 INVESTMENTS IN SUBSIDIARIES (continued)

A summary of consolidated financial information of WRPDL and its subsidiaries based on the management accounts of these companies as of 31 December is as follows:

	2008 $ million	2007 $ million
Assets	**4,552**	4,434
Liabilities	**4,557**	4,435
Equity	**(5)**	(1)
Turnover	**–**	–
(Loss)/profit after taxation for the year	**(4)**	1

18 INTEREST IN ASSOCIATE

The interest in associate is as follows:

	Group		Corporation	
	2008 $ million	2007 $ million	**2008 $ million**	2007 $ million
Unlisted shares, at cost	**–**	–	**9**	9
Share of net assets	**147**	105	**–**	–
Loan to associate	**–**	33	**–**	33
	147	138	**9**	42

Details of the associate, which is incorporated and operates in Hong Kong, are as follows:

Name of company	Number of issued and fully paid ordinary shares	Par value of shares	Percentage of shares held
Octopus Holdings Limited	42,000,000	$1	22.1%

The Corporation and four other local transport companies (including MTRCL) entered into an agreement in 1994 to develop and operate the Octopus cards system through a central body called Octopus Cards Limited.

On 21 October 2005, the Corporation and the other shareholders of Octopus Cards Limited divested themselves of all their shares in Octopus Cards Limited to a new holding company, Octopus Holdings Limited, in consideration for the issue to them of new shares in Octopus Holdings Limited.

NOTES TO THE FINANCIAL STATEMENTS

(Expressed in Hong Kong dollars)

18 INTEREST IN ASSOCIATE (continued)

Immediately after completion of the sale and purchase of shares in Octopus Cards Limited, the shareholders of Octopus Holdings Limited made a loan in aggregate amounting to $150 million to Octopus Holdings Limited, pursuant to a Subordinated Loan Agreement, with each shareholder lending an amount in proportion to its shareholding in Octopus Holdings Limited. The loan to associate from the Corporation bore interest at 5.5% per annum. It was unsecured and repayable in whole or in part at any time before 20 October 2010. During the year, the Group received an interest payment from Octopus Holdings Limited, amounting to nil (2007: $2 million). The loan has been fully settled during the year ended 31 December 2008.

During the year, the Group made payments to Octopus Cards Limited, amounting to nil (2007: $37 million) in respect of fees for the use of the Octopus cards system. These payments were based on the fare revenue generated from Octopus cards. No other charges were made or incurred by the Group in respect of the administration of the Octopus cards system. The Group received nil (2007: $7 million) from Octopus Cards Limited in respect of ticket loading agent fees for providing add-value amounts on Octopus cards and handling fees for issuing new cards and handling refunds for returned cards.

A summary of financial information of the associate based on the consolidated management accounts of Octopus Holdings Limited as of 31 December is as follows:

	2008		2007	
	100% $ million	**Group's effective interest (22.1%) $ million**	100% $ million	Group's effective interest (22.1%) $ million
Assets	**2,716**	**600**	2,466	545
Liabilities	**2,052**	**453**	1,990	440
Equity	**664**	**147**	476	105
Turnover	**557**	**123**	461	102
Profit after tax for the year	**229**	**51**	178	39

19 LOAN TO NON-CONTROLLED SUBSIDIARY

On 24 February 2000, the Corporation and the Government entered into a shareholding agreement (the "Shareholding Agreement") for the formation of a sub-group of the Corporation under an intermediate holding company, West Rail Property Development Limited ("WRPDL"), to undertake all property developments along the West Rail, Phase I route. The issued share capital of WRPDL comprises 51 ordinary "A" shares and 49 ordinary "B" shares, which are held by the Corporation and the Government respectively. The holders of ordinary "A" shares are not entitled to any distribution by WRPDL other than a return of capital, and the holders of ordinary "B" shares are entitled to all dividends declared by WRPDL and a return of capital. In other words, the Corporation is not entitled to any earnings distribution, nor is it required to ultimately fund any losses which may be sustained by WRPDL and its subsidiaries.

19 LOAN TO NON-CONTROLLED SUBSIDIARY (continued)

Subsidiaries of WRPDL have been formed to handle the property developments along the West Rail, Phase I route. The Government will receive the profits less losses from the developments whereas the Corporation was to recover the on-costs for the handling of the property developments along the route.

Since the Appointed Day, the Corporation, WRPDL and its subsidiaries (the "WRPDL Group") have appointed MTRCL as an agent to handle the property developments and an agency fee is payable by each subsidiary of WRPDL to MTRCL as remuneration. All costs incurred up to the Appointed Day in relation to the West Rail property developments were funded by loans from the Corporation to WRPDL bearing interest at an annual rate of 1% over the Corporation's average cost of funds in the preceding year. The Corporation agreed to stop accruing further interest on the loan with effect from 1 January 2008. To the extent that WRPDL may be unable to repay the loan, the Government shall seek the necessary authority to reimburse costs incurred by the Corporation. The Government has also undertaken to indemnify the Corporation against all liabilities properly incurred by the Corporation in relation to such property developments.

The recoverability of the loan to WRPDL depends on the nature and extent of the development conditions which the relevant statutory authorities impose on the property developments along the West Rail, Phase I route. The timetable for the projects' tender programme may need to be extended and it is uncertain as to whether the scope and design of such projects will be changed or delayed or whether additional costs will arise. Whilst there is uncertainty as to whether the Corporation will be able to recover the loan in full, based on current projections, which involve an estimation of future development plans and economic data, management are confident that the loan to WRPDL will be recovered in full.

The loan to non-controlled subsidiary is expected to be recovered as follows:

The Group and the Corporation

	2008 $ million	2007 $ million
Within one year	**–**	170
After one year	**4,406**	4,237
	4,406	4,407

20 INVESTMENTS

Investments comprise:

The Group and the Corporation

	2008 $ million	2007 $ million
Held-to-maturity debt securities		
– Listed outside Hong Kong	**257**	235
– Unlisted	**2,455**	2,350
Unlisted debt securities designated as at fair value through profit or loss	**383**	–
Total carrying amount of investments	**3,095**	2,585
Total market value of listed investments	**260**	236

21 INTEREST AND OTHER RECEIVABLES

(a) Interest and other receivables comprise:

The Group and the Corporation

	2008 $ million	2007 $ million
Interest receivable	**61**	13
Amount due from the Government	**21**	67
Debtors, deposits, prepayments and revenue in arrears	**121**	99
Amount due from MTRCL relating to property under development	**513**	502
	716	681

The amount due from the Government represents amounts receivable for certain essential public infrastructure works and other works along the railways undertaken on behalf of the Government pursuant to the respective entrustment agreements and project agreements with the Government.

The amount due from MTRCL relating to property under development represents property development enabling work costs incurred by the Corporation. The amount will be reimbursed from MTRCL once the joint venture for the respective property development site is formed in accordance with the Merger Framework Agreement.

(b) Interest and other receivables are expected to be recovered as follows:

The Group and the Corporation

	2008 $ million	2007 $ million
Within one year	**203**	239
After one year	**513**	442
	716	681

21 INTEREST AND OTHER RECEIVABLES (continued)

(c) Included in interest and other receivables are debtors with the following ageing analysis:

The Group and the Corporation

	2008 $ million	2007 $ million
Current	58	30
Less than one month overdue	–	–
One to three months overdue	–	–
More than three months overdue	–	–
Total debtors	58	30
Deposits, prepayments and revenue in arrears	63	69
	121	99

Normally, no credit is allowed except for revenue sharing arrangements in which the normal credit period is one month. For the amount due from the Government regarding the entrustment works undertaken by the Corporation on behalf of the Government, the normal credit period is 21 days pursuant to the respective entrustment agreements.

22 CASH AND CASH EQUIVALENTS

Cash and cash equivalents comprise:

The Group and the Corporation

	2008 $ million	2007 $ million
Deposits with banks		
– Within three months to maturity when placed	2,481	4,127
– More than three months to maturity when placed	–	2,474
Cash at bank and in hand	12	35
Cash and cash equivalents in the balance sheets	2,493	6,636
Less: deposits with banks with more than three months to maturity when placed	–	(2,474)
Cash and cash equivalents in the consolidated cash flow statement	2,493	4,162

NOTES TO THE FINANCIAL STATEMENTS

(Expressed in Hong Kong dollars)

23 INTEREST AND OTHER PAYABLES

(a) Interest and other payables comprise:

The Group and the Corporation

	2008 $ million	2007 $ million
Interest payable	456	462
Deposits and advances	196	296
Creditors and accrued charges	63	319
Amount due to MTRCL	21	145
	736	1,222

(b) Interest and other payables are expected to be settled as follows:

The Group and the Corporation

	2008 $ million	2007 $ million
Within one year	612	906
After one year	124	316
	736	1,222

(c) Included in interest and other payables are creditors with the following ageing analysis:

The Group and the Corporation

	2008 $ million	2007 $ million
Due within one month or on demand	271	400
Due between one month to three months	185	220
Due between three months to six months	26	27
Due after six months	–	127
Total creditors	482	774
Deposits and advances	196	296
Accrued charges	58	152
	736	1,222

24 ACCRUED CHARGES AND PROVISIONS FOR CAPITAL PROJECTS

The balance includes accrued charges and provisions for claims related to capital projects. Accrued charges will be settled upon certification of work done. Provisions for claims relate to the West Rail, East Rail Extensions and Kowloon Southern Link projects.

The balance includes an aggregate amount of $1,324 million (2007: $1,348 million) payable to the Government mainly for land premium, land resumption and associated costs in relation to the West Rail, East Rail Extensions and Shatin to Central Link projects.

During the year, the Corporation made additional provisions for claims and land premium, land resumption and associated costs of $127 million and reversed or utilised amounts totalling $154 million. As of 31 December 2008, provisions for claims and land premium, land resumption and associated costs totalled $1,332 million.

Accrued charges and provisions for capital projects are expected to be settled or utilised as follows:

The Group and the Corporation

	2008 $ million	2007 $ million
Within one year	**211**	1,029
After one year	**1,296**	906
	1,507	1,935

25 SHORT-TERM BANK LOANS AND INTEREST-BEARING BORROWINGS

(a) Interest-bearing borrowings comprise:

The Group and the Corporation

	2008		2007	
	Carrying amount $ million	**Fair value $ million**	Carrying amount $ million	Fair value $ million
Capital market instruments				
HK dollar retail notes due 2008 and 2013 – see (c) below	**679**	**770**	973	1,020
US dollar notes due 2010 – see (d) below	**7,770**	**8,343**	7,814	8,414
US dollar notes due 2009 – see (e) below	**7,790**	**8,016**	7,864	8,155
HK dollar notes due 2013 – see (e) below	**876**	**876**	816	816
US dollar notes due 2014 – see (e) below	**388**	**481**	390	449
Interest-bearing borrowings	**17,503**	**18,486**	17,857	18,854
Short-term bank loans – see (f) below	**–**	**–**	45	45
	17,503	**18,486**	17,902	18,899

NOTES TO THE FINANCIAL STATEMENTS

(Expressed in Hong Kong dollars)

25 SHORT-TERM BANK LOANS AND INTEREST-BEARING BORROWINGS (continued)

(b) The fair values of capital market instruments were determined using discounted cash flow techniques.

(c) The Corporation issued 3.00% notes due 2008 with an aggregate nominal value of HK$300 million at a premium and 4.80% notes due 2013 with an aggregate nominal value of HK$700 million at a premium on 6 June 2003. All the notes issued are unsecured and rank equally with all of the Corporation's other unsecured senior indebtedness. During the year, the Corporation redeemed the 3.00% notes on maturity.

(d) The Corporation issued 8.00% notes due 2010 with an aggregate nominal value of US$1 billion at a discount on 16 March 2000. These notes are listed on The Stock Exchange of Hong Kong Limited and the London Stock Exchange plc. All the notes issued are unsecured and rank equally with all of the Corporation's other unsecured senior indebtedness.

(e) The Corporation issued 7.25% notes due 2009 with an aggregate nominal value of US$1 billion at a discount on 27 July 1999, 7.77% notes due 2014 with an aggregate nominal value of US$50 million at a discount on 17 November 1999, and 4.65% notes due 2013 with an aggregate nominal value of HK$800 million at par on 9 June 2003 under its US$3 billion medium term note programme. All the notes issued are unsecured and rank equally with all of the Corporation's other unsecured senior indebtedness.

(f) In January 2008, the short-term bank loans were repaid.

(g) The covenants attached to the Corporation's interest-bearing borrowings are customary ones.

(h) The interest-bearing borrowings were repayable as follows:

	2008 $ million	2007 $ million
Within one year	**7,790**	298
After one year but within two years	**7,770**	7,864
After two years but within five years	**1,555**	7,814
After five years	**388**	1,881
	17,503	17,857

26 DEFERRED INCOME

(a) The balance of deferred income at 31 December 2008 includes cash received from property developers for property development sites along East Rail and Ma On Shan Rail; cash receipts arising from the lease out and lease back arrangements; the upfront payment received less the cost of Purchased Rail Assets for the Service Concession; assets and liabilities assumed by MTRCL as part of the merger transaction; and the cost of Additional Concession Property ("ACP") funded by MTRCL less related amortisation. Under the Property Package, the Corporation shall continue to be responsible for the funding of the property enabling works for the eight development sites sold to MTRCL. The cash received from property developers will be set off against costs to be incurred by the Corporation in respect of each property development. The unutilised balance will be credited to the income statement when the property enabling works are completed and accepted for development and after taking into account the outstanding risks and obligations in connection with the development, if any, retained by the Corporation. The balance relating to the lease out and lease back arrangements is being amortised and credited to the income statement over the applicable lease terms. The balance relating to the net upfront payment received for the Service Concession and assets and liabilities assumed by MTRCL is being amortised and credited to the income statement over the Concession Period. The balance relating to ACP is being amortised to the income statement over the shorter of the useful life of the ACP and the remaining Concession Period.

(b) Movements on deferred income comprise:

	Group		Corporation	
	2008 $ million	2007 $ million	**2008 $ million**	2007 $ million
Balance at 1 January	**4,566**	527	**4,566**	492
Net amount received and receivable/ (net amount paid and payable)	**22**	(16)	**22**	(16)
Net upfront payment received and assets and liabilities assumed by MTRCL for the Service Concession	**–**	4,135	**–**	4,135
Deferred income relating to ACP funded by MTRCL	**526**	49	**526**	49
Deferred income relating to the telecommunication business transferred to MTRCL	**–**	(63)	**–**	(32)
Recognised in the income statement	**(113)**	(66)	**(113)**	(62)
Balance at 31 December	**5,001**	4,566	**5,001**	4,566

NOTES TO THE FINANCIAL STATEMENTS

(Expressed in Hong Kong dollars)

26 DEFERRED INCOME (continued)

(c) Deferred income is expected to be recognised in the income statement as follows:

The Group and the Corporation

	2008 $ million	2007 $ million
Within one year	**117**	108
After one year	**4,884**	4,458
	5,001	4,566

27 SHARE CAPITAL

	2008		2007	
	No. of shares	**$ million**	No. of shares	$ million
Share capital:				
Authorised:				
Shares of $100,000 each	**425,000**	**42,500**	425,000	42,500
Issued and fully paid:				
At 31 December	**391,200**	**39,120**	391,200	39,120

Capital management

The Corporation's capital includes share capital and reserves.

The entire issued share capital of the Corporation is held by the Financial Secretary Incorporated.

The Corporation received $14.5 billion, $6.0 billion and $8.5 billion in April 1998, January 1999 and April 1999 respectively, constituting a total equity injection of $29.0 billion from the Government in connection with the development of the West Rail. In March 2001, the Corporation received $8.0 billion from the Government in connection with the development of the Tsim Sha Tsui Extension and the Ma On Shan Rail. Any further contributions of capital will be determined by the Government in consultation with the Corporation.

Pursuant to the relevant provisions of the Ordinance, the Corporation may declare dividends to the Government as its sole shareholder. The Financial Secretary may, after consultation with the Corporation and after taking into account the extent of its loans and other obligations, direct the Corporation to declare a dividend.

28 RETAINED PROFITS

The Group

	$ million
Balance at 1 January 2007	20,813
Dividend approved and paid in respect of previous years	(82)
Profit for the year	5,321
Balance at 31 December 2007	26,052
Balance at 1 January 2008	**26,052**
Loss for the year	**(1,815)**
Balance at 31 December 2008	**24,237**

The Corporation

	$ million
Balance at 1 January 2007	20,761
Dividend approved and paid in respect of previous year	(82)
Profit for the year	5,277
Balance at 31 December 2007	25,956
Balance at 1 January 2008	**25,956**
Loss for the year	**(1,857)**
Balance at 31 December 2008	**24,099**

(a) Included in the retained profits of the Group is an amount of $138 million (2007: $96 million) being the retained profits attributable to an associate.

(b) Pursuant to the relevant provisions of the Ordinance, the reserves available for distribution comprise an amount out of the whole or part of the profits of the Corporation in any financial year after making allowance for any sums carried to the credit of the development reserve and any accumulated loss at the end of the financial year prior to the year in which the distribution is declared. The fair value change of financial assets and liabilities and investment properties, net of related deferred tax, recognised in retained profits are not available for distribution to the sole shareholder because they are not realised profits of the Corporation. As at 31 December 2008, the amount of reserves available for distribution to the sole shareholder amounted to $23,900 million (2007: $25,910 million).

NOTES TO THE FINANCIAL STATEMENTS

(Expressed in Hong Kong dollars)

29 FINANCIAL RISK MANAGEMENT AND FAIR VALUES

In the normal course of its business, the Group is exposed to a variety of financial risks: foreign exchange risk, interest rate risk, credit risk and liquidity risk. The Group uses derivative financial instruments to hedge certain risk exposures.

The Managing Board has approved policies in respect of foreign exchange risk, interest-rate risk, credit risk, use of derivative financial instruments and investment of surplus funds. As part of its risk management, the Group identifies and evaluates the financial risks and, where appropriate, hedges those risks in accordance with the policies established by the Managing Board.

The Group documents at the inception of each hedging transaction the relationship between the hedging instrument and hedged item, as well as its risk management objective and strategy for undertaking the transaction. The Group also documents its assessment, both at inception and on an ongoing basis, of whether the derivatives that are used in hedging transactions are effective in offsetting changes in fair values or cash flows of the hedged items.

(a) Credit risk

The Group's credit risk is primarily attributable to its investment in debt securities, its deposits and over-the-counter derivative financial instruments entered into for hedging purposes.

The Group has no significant concentrations of credit risk. It has policies in place that limit the amount of credit exposure to any financial institution with which the Group has transactions. The Group can only invest in debt securities issued by or place deposits with financial institutions that meet the established credit rating or other criteria. Derivative counterparties are limited to high-credit-quality financial institutions. The exposures to these credit risks are monitored on an ongoing basis.

The maximum exposure to credit risk is represented by the carrying amount of each financial asset, including derivative financial assets and liabilities, in the balance sheet.

The Group and the Corporation

	2008 $ million	2007 $ million
Loan to non-controlled subsidiary	**4,406**	4,407
Investments	**3,095**	2,585
Interest rate swaps	**234**	119
Currency swaps	**81**	5
Forward foreign exchange contracts	**2**	8
Interest and other receivables	**716**	681
	8,534	7,805

29 FINANCIAL RISK MANAGEMENT AND FAIR VALUES (continued)

(b) Interest rate risk

(i) Hedging

The Group's interest rate risk arises from its long-term borrowings. Borrowings at variable rates expose the Group to cash flow interest rate risk. Borrowings at fixed rates expose the Group to fair value interest rate risk. The Group aims to maintain the proportion of its fixed rate borrowings at between 30% and 75% of total borrowings. At 31 December 2008, 75% (2007: 73%) of total borrowings were at fixed rates.

The Group enters into receive-fixed-pay-floating interest rate swaps to hedge the fair value interest rate risk arising from fixed rate borrowings as well as to achieve an appropriate mix of fixed and floating rate exposure.

At 31 December 2008, the Group had interest rate swaps with a notional contract amount of $800 million (2007: $800 million) which qualify as fair value hedges. These interest rate swaps are stated at fair value with changes in fair value being recognised in the income statement to offset the effect of the gain or loss on the related hedged portion of interest-bearing borrowings.

The net fair value of interest rate swaps entered into by the Group at 31 December 2008 was $75 million (assets) (2007: $15 million (assets)).

Occasionally, the Group manages its cash flow interest rate risk by using receive-floating-pay-fixed interest rate swaps. There were no such swaps outstanding as at 31 December 2008.

(ii) Fair value through income statement

For interest rate swaps where the hedging relationships do not qualify as fair value hedges, changes in their fair values are recognised in the income statement.

At 31 December 2008, the Group had such interest rate swaps with a notional contract amount of $3,618 million (2007: $3,937 million) and net fair value of $159 million (assets) (2007: $102 million (assets)), which comprises assets of $159 million (2007: $104 million) and liabilities of nil (2007: $2 million).

(iii) Sensitivity analysis

The sensitivity analysis below indicates the instantaneous change in the Group's loss after taxation (and retained profits) that would arise assuming that changes in interest rates of +/- 100 basis points (bps) had occurred at the balance sheet date and such changes had been applied to re-measure those financial instruments held by the Group which expose the Group to fair value risk at the balance sheet date. In respect of the exposure to cash flow interest rate risk arising from floating rate non-derivative instruments held by the Group at the balance sheet date, the impact on the Group's loss after taxation is estimated as an annualised impact on interest expense or income of such a change in interest rates. The analysis was performed on the same basis for each balance sheet date presented below.

29 FINANCIAL RISK MANAGEMENT AND FAIR VALUES (continued)

(b) Interest rate risk (continued)

(iii) Sensitivity analysis (continued)

Other than for currency swaps where the forward exchange rates are slightly changed by a parallel shift in the interest rates of the underlying currencies, all other variables, in particular spot foreign currency rates, remain constant.

The estimated impact of a general increase/decrease of 100 basis points in interest rates, with all other variables held constant, on the Group's and the Corporation's loss after taxation is shown below:

The Group and the Corporation

	2008		2007	
	$ million +100bps	**$ million -100bps**	$ million +100bps	$ million -100bps
Loan to non-controlled subsidiary	**–**	**–**	36	(36)
Interest rate swaps	**(72)**	**75**	(99)	104
Currency swaps	**(2)**	**2**	(1)	1
Interest-bearing borrowings	**29**	**(30)**	31	(33)
(Increase)/decrease in loss after taxation (2007: Increase/(decrease) in profit after taxation)	**(45)**	**47**	(33)	36

(c) Currency risk

The Group derives its revenues almost entirely in Hong Kong dollars and is, therefore, exposed to currency risk arising only from borrowings, purchases and capital expenditure payments in relation to the development of new railways that are denominated in foreign currencies.

The Corporation uses forward exchange contracts and currency swaps to hedge its foreign exchange risk. The Corporation's risk management policy is to hedge its foreign currency borrowings into either Hong Kong dollars or United States dollars and limit its exposure to United States dollars to no greater than 30% of its total borrowings. Any contract for purchases or capital expenditure denominated in foreign currencies and exceeding $10 million equivalent is required to be reported to Corporate Treasury, which uses forward contracts to hedge the related foreign currency risk as and when necessary.

The Corporation may have investments in debt securities and other financial assets from time to time. Where these investments are denominated in foreign currencies other than United States dollars or Hong Kong dollars, the Corporation hedges the exposure into either United States dollars or Hong Kong dollars.

29 FINANCIAL RISK MANAGEMENT AND FAIR VALUES (continued)

(c) Currency risk (continued)

(i) Recognised assets and liabilities

Changes in the fair value of currency swaps that economically hedge recognised monetary liabilities denominated in foreign currencies are recognised in the income statement. The net fair value of currency swaps used by the Corporation as economic hedges of monetary assets and liabilities in foreign currencies at 31 December 2008 and recognised as net derivative financial assets was $73 million (2007: $29 million (liabilities)), comprising assets of $81 million (2007: $5 million) and liabilities of $8 million (2007: $34 million).

(ii) Fair value through income statement

Changes in the fair value of forward exchange contracts for which no hedge accounting is applied are recognised in the income statement. At 31 December 2008, the net fair value of forward exchange contracts recognised as net derivative financial assets or liabilities was $1 million (assets) (2007: $10 million (liabilities)), which comprises assets of $2 million (2007: $8 million) and liabilities of $1 million (2007: $18 million).

In respect of other receivables and other payables denominated in currencies other than the functional currency, the Corporation ensures that the net exposure is kept to an acceptable level by buying or selling foreign currencies at spot or forward rates where necessary.

All the Group's borrowings are denominated in either Hong Kong dollars or United States dollars. Given this, management does not expect that there will be any significant currency risk associated with the Group's borrowings.

(iii) Exposure to currency risk

Based on the notional amounts of the financial assets and liabilities, the following table shows the Group's and the Corporation's exposure at the balance sheet date to currency risk arising from recognised assets or liabilities denominated in a currency other than the functional currency of the Group.

NOTES TO THE FINANCIAL STATEMENTS

(Expressed in Hong Kong dollars)

29 FINANCIAL RISK MANAGEMENT AND FAIR VALUES (continued)

(c) Currency risk (continued)

(iii) Exposure to currency risk (continued)

The Group and the Corporation

	US dollars million	Euros million (Expressed in foreign currency)	Japanese yen million
2008			
– Investments	**399**	**–**	**–**
– Interest and other receivables	**12**	**–**	**–**
– Cash and cash equivalents	**57**	**4**	**362**
– Currency swaps	**1,950**	**–**	**–**
– Forward foreign exchange contracts	**67**	**–**	**214**
– Interest and other payables	**(56)**	**–**	**–**
– Interest-bearing borrowings	**(2,050)**	**–**	**–**
Overall net exposure	**379**	**4**	**576**
2007			
– Investments	330	–	–
– Interest and other receivables	2	–	–
– Cash and cash equivalents	54	3	413
– Currency swaps	1,950	–	–
– Forward foreign exchange contracts	195	–	4,135
– Interest and other payables	(56)	–	–
– Interest-bearing borrowings	(2,050)	–	–
Overall net exposure	425	3	4,548

(iv) Sensitivity analysis

The following table indicates the approximate change in the Group's loss after taxation that would have arisen upon changes to foreign exchange rates to which the Group had exposure at the balance sheet date, assuming all other risk variables remained constant. Such exposure relates to the portion of United States dollars borrowings which is unhedged, and other assets and liabilities, such as deposits and future contract payments, denominated in foreign currencies.

29 FINANCIAL RISK MANAGEMENT AND FAIR VALUES (continued)

(c) Currency risk (continued)

(iv) Sensitivity analysis (continued)

	Increase/(decrease) in foreign exchange rate	**2008** **Decrease/ (increase) in loss after taxation $ million**	2007 Increase/ (decrease) in profit after taxation $ million
US dollars	1%	**27**	21
	(1%)	**(27)**	(21)
Euros	10%	**4**	3
	(10%)	**(4)**	(3)
Japanese yen	10%	**5**	26
	(10%)	**(5)**	(26)

Results of the analysis as presented in the above table represent an aggregation of the instantaneous effects on the Group's loss after taxation measured in the respective functional currencies, translated into Hong Kong dollars at exchange rates, based on direct quotes, prevailing at the balance sheet date for presentation purposes.

The sensitivity analysis assumes that the change in foreign exchange rates had been applied to re-measure those financial instruments held by the Group which expose the Group to foreign currency risk at the balance sheet date.

The analysis was performed on the same basis for the years ended 31 December 2007 and 2008.

(d) Liquidity risk

Liquidity risk represents the Group's ability to meet its contractual obligations. The Group evaluates its liquidity requirements on an ongoing basis. It employs projected cash flow analyses to forecast its future funding requirements. The Group's approach to managing liquidity is to ensure there will be sufficient liquidity to meet its liabilities when they fall due, under both normal and stressed conditions.

The Group aims to secure committed credit facilities well ahead of funding needs. This protects the Group against adverse market conditions which may result in difficulties in raising funds to meet payment obligations. The Group has put in place committed revolving facilities and uncommitted stand-by facilities to cater for short-term liquidity requirements.

NOTES TO THE FINANCIAL STATEMENTS

(Expressed in Hong Kong dollars)

29 FINANCIAL RISK MANAGEMENT AND FAIR VALUES (continued)

(d) Liquidity risk (continued)

The following table shows the time periods after the balance sheet date during which contractual payments, presented on an undiscounted basis, are due to be made. These payments include, inter alia, interest payments computed using contractual rates (for fixed rate instruments) and rates prevalent at the balance sheet date (for floating rate instruments), in respect of the Group's and the Corporation's non-derivative and derivative financial liabilities which are due to be paid.

The Group and the Corporation

	Contractual undiscounted cash outflow					
	Within 1 year or on demand $ million	More than 1 year but less than 2 years $ million	More than 2 years but less than 5 years $ million	More than 5 years $ million	Total $ million	Balance sheet carrying amount $ million
2008						
Interest and other payables	**(612)**	**(119)**	**(5)**	**–**	**(736)**	**736**
Currency swaps						
– outflow	**(7,878)**	**(7,034)**	**(4)**	**(391)**	**(15,307)**	**8**
– inflow	**7,780**	**7,002**	**–**	**389**	**15,171**	**(81)**
Forward foreign exchange contracts						
– outflow	**(281)**	**(256)**	**–**	**–**	**(537)**	**1**
– inflow	**284**	**257**	**–**	**–**	**541**	**(2)**
Interest-bearing borrowings	**(8,611)**	**(8,192)**	**(1,787)**	**(419)**	**(19,009)**	**17,503**
	(9,318)	**(8,342)**	**(1,796)**	**(421)**	**(19,877)**	**18,165**
2007						
Short-term bank loans	(46)	–	–	–	(46)	45
Interest and other payables	(911)	(85)	(235)	–	(1,231)	1,222
Interest rate swaps	(2)	–	(1)	–	(3)	2
Currency swaps						
– outflow	(103)	(7,878)	(7,037)	(392)	(15,410)	34
– inflow	–	7,833	7,049	391	15,273	(5)
Forward foreign exchange contracts						
– outflow	(1,276)	(281)	(256)	–	(1,813)	18
– inflow	1,280	282	259	–	1,821	(8)
Interest-bearing borrowings	(1,601)	(9,128)	(8,450)	(2,006)	(21,185)	17,857
	(2,659)	(9,257)	(8,671)	(2,007)	(22,594)	19,165

29 FINANCIAL RISK MANAGEMENT AND FAIR VALUES (continued)

(e) Fair value

The fair values of all financial assets and liabilities are set out in the following tables except for those financial assets and liabilities with carrying amounts not materially different from their fair values as at balance sheet date.

The Group and the Corporation

	2008		2007	
	Carrying amount $ million	Fair value $ million	Carrying amount $ million	Fair value $ million
Non-derivative financial assets				
– Loan to non-controlled subsidiary	4,406	#	4,407	4,809
– Investments	3,095	3,129	2,585	2,590
	7,501	3,129	6,992	7,399
Derivative financial assets				
– Interest rate swaps	234	234	119	119
– Currency swaps	81	81	5	5
– Forward foreign exchange contracts	2	2	8	8
	317	317	132	132
Non-derivative financial liabilities				
– Short-term bank loans	–	–	(45)	(45)
– Interest-bearing borrowings	(17,503)	(18,486)	(17,857)	(18,854)
	(17,503)	(18,486)	(17,902)	(18,899)
Derivative financial liabilities				
– Interest rate swaps	–	–	(2)	(2)
– Currency swaps	(8)	(8)	(34)	(34)
– Forward foreign exchange contracts	(1)	(1)	(18)	(18)
	(9)	(9)	(54)	(54)

Since the Appointed Day, the Corporation, WRPDL and its subsidiaries (the "WRPDL Group") have appointed MTRCL as an agent to handle the property developments in respect of which the costs, including the agency fees as well as any disbursements paid by MTRCL, would be recovered from the WRPDL Group, at a higher priority than the Corporation. As a result, the fair value of the loan to non-controlled subsidiary cannot be measured reliably as its present value is not determinable in the absence of fixed repayment terms.

NOTES TO THE FINANCIAL STATEMENTS

(Expressed in Hong Kong dollars)

29 FINANCIAL RISK MANAGEMENT AND FAIR VALUES (continued)

(f) Estimation of fair value

The following summarises the major methods and assumptions used in estimating the fair values of financial assets and liabilities.

(i) Investments

The fair value of financial assets traded in active markets was based on quoted market prices at the balance sheet date.

(ii) Interest rate swaps, currency swaps and forward exchange contracts

The fair value of interest rate swaps and currency swaps was based on the present value of the estimated amount that the Group would receive or pay to terminate the swap at the balance sheet date, taking into account prevailing interest rates, foreign exchange rates and creditworthiness of the swap counterparties. The fair value of forward exchange contracts was based on the quoted market price at the balance sheet date, being the present value of the quoted forward price. Discounted cash flows techniques were used in determining the fair value of swaps.

(iii) Loan to non-controlled subsidiary and interest-bearing borrowings

Where applicable, fair value was calculated based on discounted cash flows of expected future principal and interest payments.

(iv) Discount rates used for determining fair value

The Corporation used the applicable yield curve at the balance sheet date plus an appropriate constant credit spread to discount financial assets and liabilities. The interest rates used were as follows:

	2008	2007
Interest rate swaps, currency swaps	**0.67% – 3.05%**	3.42% – 4.87%
Loan to non-controlled subsidiary and interest-bearing borrowings	**1.50% – 3.44%**	3.29% – 5.61%

30 NOTES TO THE CONSOLIDATED CASH FLOW STATEMENT

Reconciliation of operating (loss)/profit after depreciation and amortisation to net cash inflow from operations

	2008 $ million	2007 $ million
Operating (loss)/profit after depreciation and amortisation	(1,794)	345
Merger-related expenses	–	(216)
Depreciation and amortisation	2,595	2,418
Fixed assets written off	18	30
Increase in stores and spares	–	(13)
Decrease in other receivables	156	317
(Decrease)/increase in other payables	(481)	8
Net cash inflow from operations	494	2,889

31 RELATED PARTIES

The Corporation is wholly owned by the Government. The Corporation has entered into transactions with the Government in respect of the developments of the West Rail, Phase I route, East Rail Extensions and Kowloon Southern Link which are considered to be related party transactions under IAS 24 and HKAS 24 and these are disclosed in notes 1, 3(c) and (i), 6, 13(i), 14(b), (c) and (d), 15(b) and (c), 17, 19, 21 and 24 to the financial statements. Transactions with Government departments and agencies in the course of their normal dealings with the Corporation are not considered to be related party transactions.

Members of the Managing Board, the Executive Directors who are not Members of the Managing Board, members of the Management Committee and parties related to them are also related parties of the Corporation. During the year there were no significant transactions with any such parties other than their remuneration which is disclosed in note 6 to the financial statements.

MTRCL is considered to be a related party of the Corporation under IAS 24 and HKAS 24 as they share a common shareholder, the Government. The Corporation has entered into transactions with MTRCL since the Appointed Day which are considered to be related party transactions and these are disclosed in notes 2, 3(c), (i), (m) and (ab), 4, 5, 8(a), 13(e), 14(e) and (f), 16, 17, 19, 21, 23, 26 and 33 to the financial statements.

NOTES TO THE FINANCIAL STATEMENTS
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31 RELATED PARTIES (continued)

Major related party transactions entered into by the Group in prior years which are still relevant for the current year comprise:

(i) On 15 September 1998, the Government approved the construction of West Rail, Phase I to be undertaken by the Corporation. The West Rail Project Agreement, which set out how the project was to be undertaken and the respective obligations of the Government and the Corporation in terms of the financing, design, construction and operation of West Rail, Phase I, was signed on 23 October 1998. On 24 February 2000, the Corporation and the Government entered into a shareholding agreement for undertaking all property developments along the West Rail, Phase I route (note 19).

(ii) The Corporation entered into a project agreement for the East Rail Extensions with the Government on 28 February 2003. The project agreement provided for the financing, design, construction and operations of the East Rail Extensions and related services and facilities.

(iii) The Corporation entered into a project agreement for the financing, design, construction and operation of Kowloon Southern Link with the Government on 6 October 2005. Under the terms of the KSL Project Agreement, the Corporation will be responsible for, and will finance the entire capital cost of constructing the Kowloon Southern Link, along with the costs of the removal, replacement, modification or improvement of existing facilities affected by or required as a consequence of the construction of the Kowloon Southern Link.

(iv) The Corporation accepted an offer from the Government to allow the Corporation to proceed with the development of the site at Ho Tung Lau, Wu Kai Sha and Tai Wai Maintenance Centre in March 2003, October 2005 and July 2006 respectively.

During the year, the Group entered into the following material related party transactions:

– In the construction of the new railway projects, certain essential project works are embedded within the infrastructure works to be undertaken by the Government or its related parties. The Government and its related parties have entered into entrustment agreements and certain services agreements with the Corporation under which the Corporation has agreed to carry out works on behalf of the Government and provide operational services such as maintenance and building management services. The works done and services provided by the Corporation are reimbursable and the details of amounts receivable and payable as at 31 December 2008 are provided in notes 21 and 24 respectively.

32 OUTSTANDING COMMITMENTS

(a) Commitments outstanding in respect of capital expenditure not provided for in the financial statements were as follows:

	2008 $ million	2007 $ million
Property, plant and equipment		
– authorised and contracted for	**1,136**	2,758
– authorised but not contracted for	**592**	1,086
Interest in leasehold land held for own use under operating leases		
– authorised and contracted for	**96**	164
– authorised but not contracted for	**155**	37
Balance at 31 December	**1,979**	4,045

(b) The total future minimum lease payments under non-cancellable operating leases for property with varying terms and renewal rights are payable as follows:

	2008 $ million	2007 $ million
Within one year	**28**	38
After one year but within five years	**3**	14
Balance at 31 December	**31**	52

The operating leases are mainly related to work areas used for construction of new railways. During the year, amounts payable under operating leases totalling $33 million (2007: $33 million) were capitalised as part of construction in progress or deferred expenditure, as appropriate.

33 RETIREMENT BENEFIT SCHEME

The Kowloon-Canton Railway Corporation Retirement Benefit Scheme ("RBS Scheme") was established on 1 February 1983 under trust. With effect from 16 November 1994, the RBS Scheme was registered under Section 18 of the Occupational Retirement Schemes Ordinance.

All benefits payable under the RBS Scheme are calculated by reference to the Corporation's contributions and members' own contributions, together with investment returns on these contributions.

For members joining the RBS Scheme before 1 January 2000, the Corporation's contribution rates were 12% and 16% of the respective salaries of non-management staff and management staff. For members joining on or after 1 January 2000, the Corporation's contribution rates for the first eight years were 8% and 12% of the respective salaries of non-management staff and management staff and, thereafter, the contribution rates were to be 10% and 15% of the respective salaries of non-management staff and management staff.

Where employees left the RBS Scheme prior to their entitlement to all or part of the Corporation's contributions vesting fully, such contributions were used to reduce the future contributions of the Corporation due under the RBS Scheme.

The Group also operated a Mandatory Provident Fund Scheme ("MPF Scheme") under the Hong Kong Mandatory Provident Fund Schemes Ordinance. The MPF Scheme was a defined contribution retirement plan administrated by independent trustees. Under the MPF Scheme, the employer and its employees were required to make contributions to the plan at 5% of the employees' relevant income, subject to a cap of monthly relevant income of $20,000. The MPF Scheme was introduced on 1 April 2000 to employees who did not opt for or who were not eligible for RBS Scheme.

The Group's total retirement cost charged to the income statement includes the retirement costs for both RBS and MPF Schemes.

Pursuant to the Rail Merger Ordinance, all rights and obligations to which the Corporation was entitled or subject to immediately before the Appointed Day in relation to the RBS Scheme were vested in MTRCL.

34 DEBT FACILITIES

(a) Total debt facilities comprise:

	2008 HK$/US$ million	2007 HK$/US$ million
In HK dollars		
Short-term uncommitted revolving credit facilities	**800**	3,100
Letters of credit	**–**	20
Overdraft facilities	**25**	25
Syndicated loan facilities	**8,000**	8,000
	8,825	11,145
In US dollars		
Letters of credit for leveraged leases	**318**	314

(b) Total unutilised debt facilities available to the Group and the Corporation comprise:

	2008 $ million	2007 $ million
Short-term uncommitted revolving credit facilities	**800**	3,055
Letters of credit	**–**	20
Overdraft facilities	**25**	25
Syndicated loan facilities	**8,000**	8,000
Letters of credit for leveraged leases	**2,474**	2,459
	11,299	13,559

(c) The unutilised debt facilities are expected to expire as follows:

	2008 $ million	2007 $ million
Floating rate		
– expiring within one year	**4,862**	3,648
– expiring after one year	**6,437**	9,911
	11,299	13,559

NOTES TO THE FINANCIAL STATEMENTS

(Expressed in Hong Kong dollars)

35 CONTINGENT LIABILITIES

At 31 December 2008, the Group had contingent liabilities arising from the land resumption claims and certain contractors' claims in respect of the construction of the Kowloon Southern Link, West Rail and East Rail Extensions projects. The Group has made provision in the financial statements at 31 December 2008 for its best estimate of amounts which are likely to be payable in connection with these claims which the Group is in the process of resolving.

36 IMPAIRMENT OF RAILWAY ASSETS

At 31 December 2008, the Group assessed whether there was any indication of impairment of the Group's railway assets at that date in accordance with the Group's accounting policies for the assessment of asset impairment by comparing the key determinant factors, such as inflation, cost of debt, expected return on equity, to those of 2007.

As a result of this assessment, management considers that no indication of impairment of the railway assets of the Group exists at 31 December 2008 and, accordingly, that no provision for impairment of the Group's railway assets is required at that date.

37 ACCOUNTING ESTIMATES AND JUDGEMENTS

(a) Key sources of estimation uncertainty

Note 29 contains information about the assumptions and their risk factors relating to financial instruments. Other key sources of estimation uncertainty include the assessment of useful lives for depreciation of fixed assets (see note 3(j)), assessment of provisions and contingent liabilities (see notes 3(x), 24 and 35), determination of the recoverability of deferred tax assets (see note 10(d)), assessment of the possibility of implementation of Shatin to Central Link project (see note 15(b)), assessment of the recoverability of the loan to non-controlled subsidiary (see note 19) and assessment of the outstanding risk and obligations in recognition of profit from property development (see note 26).

(b) Critical accounting judgements in applying the Group's accounting policies

Critical accounting judgements in applying the Group's accounting policies include the classification of revenue and expenditure as capital or revenue in nature (see note 3(i)(i)), the classification of revenue and cost-recovery, the classification of operating leases or lease-out and lease-back transactions (see note 3(k)(i) and (z)), transfers from construction in progress to fixed assets (see note 3(m)), assessment of controlled and non-controlled subsidiaries (see note 3(c)), the categorisation of financial assets and liabilities, adoption of hedge accounting (see note 29) and impairment of railway assets (see note 36).

38 POSSIBLE IMPACT OF AMENDMENTS, NEW STANDARDS AND INTERPRETATIONS ISSUED BUT NOT YET EFFECTIVE FOR THE ANNUAL ACCOUNTING YEAR ENDED 31 DECEMBER 2008

Up to the date of issue of these financial statements, the IASB and HKICPA have issued a number of amendments, new standards and interpretations which are not yet effective for the year ended 31 December 2008 and which have not been adopted in these financial statements.

The Group is in the process of making an assessment of what the impact of these amendments, new standards and new interpretations is expected to be in the period of initial application. So far it has concluded that the adoption of them is unlikely to have a significant impact on the Group's and the Corporation's results of operations and financial position.

In addition, the following developments may result in new or amended disclosures in the financial statements:

	Effective for accounting periods beginning on or after
IAS 23 and HKAS 23, Borrowing costs	1 January 2009
IAS 1 and HKAS 1, Presentation of financial statements	1 January 2009
IAS 27 and HKAS 27, Consolidated and separate financial statements	1 July 2009

FIVE-YEAR STATISTICS

FINANCIAL (HK$ million)	**2008**	2007	2006	2005	2004
Income Statement					
Revenue from operations	**870**	5,581	5,622	5,383	4,976
Operating profit before depreciation and amortisation	**801**	2,763	2,600	2,356	2,172
Gain on sale of property development rights	**–**	4,868	–	–	–
Gain on sale of investment properties and other property, plant and equipment	**–**	1,318	–	–	–
Gain on sales of property management and telecommunication businesses	**–**	48	–	–	–
Merger-related expenses	**–**	(216)	(20)	–	–
Net interest and finance expenses/(income)	**912**	847	316	298	41
Profit on property development	**–**	–	427	–	–
(Loss)/profit before unrealised gains/losses	**(2,675)**	5,555	430	(185)	465
(Loss)/profit after unrealised gains/losses and taxation	**(1,815)**	5,321	278	317	513
Dividend	**–**	–	82	–	172
Balance Sheet					
Fixed assets (including interest in leasehold land held for own use under operating leases)	**71,757**	73,191	65,400	66,943	67,746
Construction in progress	**6,926**	5,509	13,644	10,411	6,991
Deferred expenditure	**1,612**	1,585	1,389	1,210	1,462
Properties under development	**–**	20	449	1,537	1,892
Loan to non-controlled subsidiary	**4,406**	4,407	4,022	3,863	3,576
Investments	**3,095**	2,585	–	449	4,323
Cash and cash equivalents	**2,493**	6,636	1,947	3,394	3,531
Other assets	**1,180**	951	1,124	1,945	1,865
Total assets	**91,469**	94,884	87,975	89,752	91,386
Interest-bearing borrowings	**17,503**	17,857	19,212	19,474	19,748
Deferred tax liabilities	**3,356**	4,033	3,250	3,198	3,251
Deferred income	**5,001**	4,566	527	541	708
Other liabilities	**2,252**	3,256	5,053	6,886	7,617
Total liabilities	**28,112**	29,712	28,042	30,099	31,324
Equity	**63,357**	65,172	59,933	59,653	60,062
Key Financial Data					
Capital expenditure (including additional concession assets)	**2,561**	3,574	3,317	3,835	9,025
Return on equity (%)	**(3)**	8	–	1	1
Debt / equity ratio	**1:3.6**	1:3.7	1:3.1	1:3.1	1:3.0
Debt to total capitalisation (%)	**22**	22	24	25	25
Interest cover (times)	**0.9**	5.8	2.2	1.9	1.8

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