



KOWLOON-CANTON RAILWAY CORPORATION

ANNUAL REPORT 2018



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Managing Board



James H. Lau Jr., JP
Chairman
Secretary for Financial
Services and the Treasury
of the Hong Kong Special
Administrative Region
Government



Joseph Lai Yee-tak, JP
Permanent Secretary for
Transport and Housing
(Transport) of the Hong Kong
Special Administrative Region
Government



Tommy Yuen Man-chung, JP
Member of Audit Committee
Government Property
Administrator of the
Hong Kong Special
Administrative Region
Government
(up to 27 January 2019)



Vincent Liu Ming-kwong, JP
Member of Audit Committee
Government Property
Administrator of the
Hong Kong Special
Administrative Region
Government
(from 28 January 2019)

Key Management



Edmund K H Leung,
SBS, OBE, JP
BSc(Eng), CEng, R.P.E., FHKIE,
FIMechE, FCIBSE, FIEAust., FHKEng
Chief Officer



K. K. Kwok
BA, MPA
Senior Manager-
Administration
Company Secretary



Martin Siu Man-tat, JP
FCCA, CPA
Chairperson of Audit Committee
Director of Accounting
Services of the Hong Kong
Special Administrative
Region Government
(up to 2 January 2018)



Charlix Wong Shing-hei, JP
FCPA
Chairperson of Audit Committee
Director of Accounting
Services of the Hong Kong
Special Administrative
Region Government
(from 3 January 2018)



Carol Yuen Siu-wai, JP
Member of Audit Committee
Deputy Secretary for
Financial Services and the
Treasury (Treasury) 1 of the
Hong Kong Special
Administrative Region
Government



Wallace Lau Ka-ki, JP
Deputy Secretary for
Transport and Housing
(Transport) 4 of the
Hong Kong Special
Administrative Region
Government



Julian P Walsh
MA, ACA, CPA
Senior Manager-Finance

Chairman's Statement

2018 was a very successful year for the Corporation. Financially, we recorded an accounting profit of HK\$574 million, the first time since the Rail Merger in 2007. The Corporation also took on a major challenge during the year.

After the Rail Merger, the Corporation has transferred its railway operation function to MTR Corporation Limited (MTRCL) under a Service Concession Agreement. Over the years, the service concession payments from the MTRCL have increased steadily, allowing the Corporation to enjoy a growing operating profit before depreciation, amortisation and impairment. In 2018, the Corporation's Fixed and Variable Annual Payments from MTRCL increased by HK\$274 million to a record high of HK\$2,957 million. I am confident that our financial performance will continue to improve in the years to come and the Corporation will soon be achieving long-term accounting profitability.

The Government vested the Hong Kong Section of the Guangzhou-Shenzhen-Hong Kong Express Rail Link (XRL) in the Corporation in August 2018. The XRL is an important gateway to the vast Mainland high speed railway network and has ushered the Hong Kong railway transportation to a new era. I am pleased that the Corporation can participate in this important transport infrastructure, which contributes to enhanced connectivity between Hong Kong and various Mainland cities, realising the benefits of the swift and efficient railway network.

The Corporation has granted a supplemental service concession to MTRCL to operate the XRL. Since its commencement of operation on 23 September 2018, the XRL recorded an average daily patronage of about 53,000 passengers in 2018. Both the performance and services of the XRL are reassuring, in line with the Corporation's expectation.

Finally, I wish to thank all members on the Board for their continued support and the sterling effort of the management team in this memorable year.

James H. Lau Jr., JP

Chairman

4 April 2019

“ Financially, we recorded an accounting profit of HK\$574 million, the first time since the Rail Merger in 2007 ”



Chief Officer's Statement and Business Review

“

*The Fixed and
Variable Annual Payments
for the Corporation totalled
HK\$2,957 million in 2018*

”



In 2018, for the first time after the Rail Merger in 2007, the Corporation recorded an accounting profit of HK\$574 million. With the expansion of the railway network and improvements in railway services over the past decade, the Corporation has enjoyed a relatively steady stream of income under the Service Concession Agreement. The vesting of the Hong Kong Section of the Guangzhou-Shenzhen-Hong Kong Express Rail Link (XRL) in the Corporation in August 2018 marked another milestone. The XRL is well received by the public as an important link between Hong Kong and the Mainland. Since its commissioning on 23 September 2018, patronage of the XRL has been encouraging. With the further development of the Guangdong-Hong Kong-Macao Greater Bay Area (Greater Bay Area) and the Mainland high speed rail network, we are optimistic that the patronage of the XRL would continue to grow in the upcoming years. This will not only bring significant revenue to the Corporation, but also allow the general public much easier and speedier access to Mainland cities.

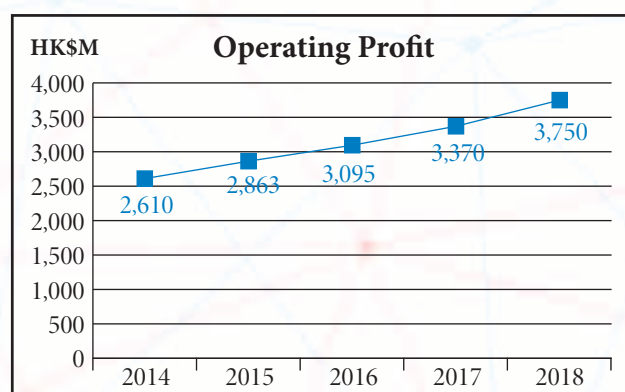
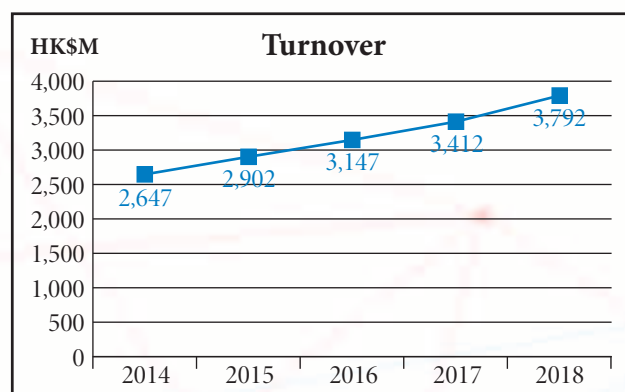
With its business focus on investment and asset management after the Rail Merger, the commercial risks faced by the Corporation in railway operation have significantly reduced, making the Corporation's business prospects ever more promising. Although not being publicly listed, the Corporation, for good corporate governance, complies with the requirements for listed companies of the Stock Exchange of Hong Kong Limited as far as practicable and has been preparing its annual accounts following the commercial accounting standards as required under the Kowloon-Canton Railway Corporation Ordinance (Cap. 372) (the KCRC Ordinance). In 2018, the Corporation continued to fully comply with all relevant laws and regulations.

The Corporation has not been involved in the construction of any new railway projects after the completion of the Kowloon Southern link and has no major capital cost or railway asset replacement expenditure after the project. Subsequent to the booking of the depreciation charges of the Kowloon Southern Link in the Corporation's accounts in 2009, the Corporation has been able to report steady reductions in accounting losses as the depreciation

charges on initial concession assets gradually decreased, coupled with the receipt of increasing Variable Annual Payments from MTR Corporation Limited (MTRCL) from December 2010 onwards.

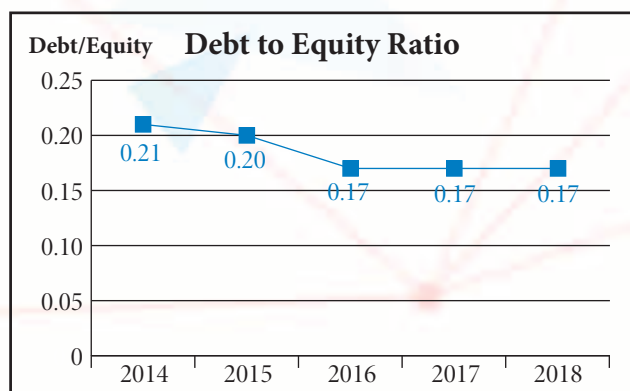
The Corporation is wholly owned by the Government of the HKSAR, and it conducts its business according to prudent commercial principles as required under the KCRC Ordinance. The MTRCL is the Corporation's business partner in operating the Corporation's rail network under the Service Concession Agreement and the Supplemental Service Concession Agreement. The Corporation has been conducting its business with these two key stakeholders in a spirit of cooperation and mutual support.

The Corporation adopts five Key Performance Indicators, namely Turnover, Operating Profit, Debt to Equity Ratio, Interest Cover and Accounting Profit/(Loss). These indicators reflect the financial position of the Corporation which demonstrates a stable and improving financial performance, with the ultimate goal of maintaining sustained long-term accounting profitability.

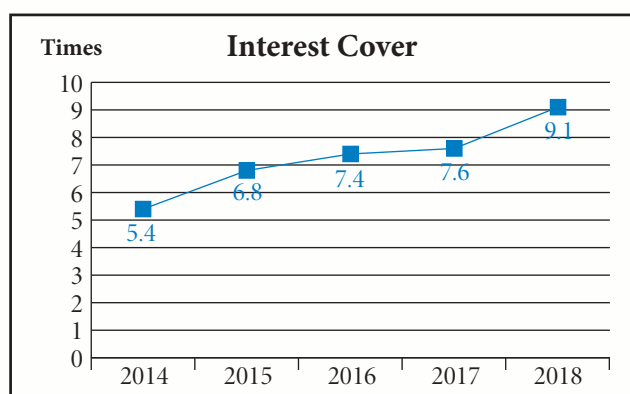


See Note 1

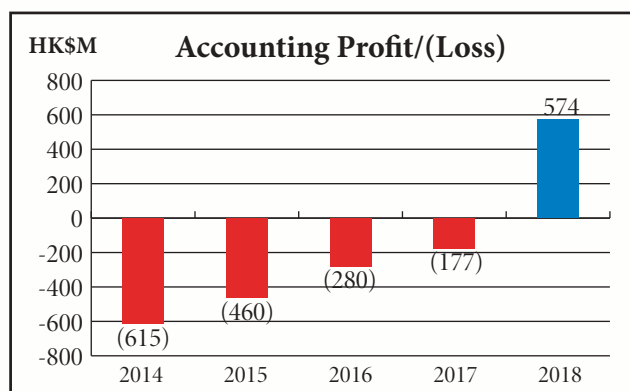
Chief Officer's Statement and Business Review



See Note 2



See Note 3



Note 1: Operating Profit is before depreciation, amortisation and impairment.

Note 2: Debt to Equity Ratio = $\frac{\text{Interest-bearing borrowings}}{\text{Total equity}}$

Note 3: Interest Cover = $\frac{\text{Operating profit before depreciation, amortisation and impairment} + \text{Interest and finance income} + \text{Share of profit of associate}}{\text{Interest and finance expenses}}$

The majority of revenues received by the Corporation arise from the annual payments made by the MTRCL under the Service Concession Agreement and the Supplemental Service Concession Agreement, comprising Fixed and Variable Annual Payments.

The Fixed and Variable Annual Payments for the Corporation totalled HK\$2,957 million in 2018. The Variable Annual Payment for 2018 increased by about 14% when compared with 2017, from HK\$1,933 million to HK\$2,207 million. The increase in the Variable Annual Payment reflects the continued growth in fare and non-fare revenues earned by MTRCL from the Corporation's rail network and the XRL which commenced operation on 23 September 2018.

The Corporation also received property rental income of HK\$38 million from leasing the 7th to 10th floors of Citylink Plaza, dividends of HK\$60 million arising from KCRC's 22.1% shareholding in Octopus Holdings Limited and an interest income of HK\$235 million from investment of the Corporation's retained cash.

Operating costs of the Corporation (before depreciation, amortisation and impairment) plus interest and finance expenses amounted to HK\$494 million for 2018, of which HK\$441 million was interest charges on the Corporation's debt portfolio. Other major expenditure items include HK\$8 million of direct staff costs and HK\$31 million for outsourced support services provided by MTRCL and others.

The Corporation's operating profit for the year before depreciation, amortisation and impairment amounted to HK\$3,750 million, an increase of HK\$380 million (11.3%) over 2017.

Non-cash depreciation and amortisation charges for 2018 amounted to HK\$2,931 million, compared with HK\$3,269 million in 2017. The accounting profit for the year was HK\$574 million, representing a significant increase of some HK\$751 million when compared with the accounting loss of HK\$177 million recorded in 2017.

For the Cross-Border Leases the Corporation entered into before the Rail Merger, the Corporation has managed to arrange for the early termination of the remaining two lease agreements in 2018, bringing an accounting profit of HK\$63 million to the Corporation. With the closure of the two lease agreements, all Cross-Border lease agreements in the Corporation's portfolio were cleared.

The Corporation has benefited from the low interest rate environment by swapping a significant portion of the Corporation's fixed rate interest on debt instruments to floating rates in the past few years. With the last floating rate debt maturing in 2019, the Corporation would then be servicing only fixed rate debts, which would significantly reduce the Corporation's exposure to financial risks associated with interest rate movements. The Corporation has sufficient cash to fully repay the maturing notes and bonds without the need for refinancing. After repaying the last floating rate debt in 2019, the Corporation would still have some residual debts but at a much reduced level, and this would further enhance the Corporation's financial position.

Under the West Rail Shareholding Agreement signed with the Government in February 2000, the Corporation is the majority shareholder of the West Rail Property Development Limited and its subsidiary companies. These companies, employing the MTRCL as their project management agent, are responsible for developing 11 residential and commercial sites along the West Rail.

The property developments adjacent to several West Rail stations have been completed and the pre-sale of residential units in these developments has been received with good response from the market. Most of the residential units for the developments adjacent to the Tuen Mun Station, Tsuen Wan West Station, Long Ping Station and Nam Cheong Station (Phase I and Phase II) have been sold. The site at Pat Heung Maintenance Depot is the only remaining site for development.

The land or interests or other rights in respect of the land for the operation of the XRL were vested in and the movable assets of the XRL were assigned to the Corporation on 23 August 2018. The XRL commenced operation on 23 September 2018 and the patronage in 2018 was encouraging given that it was a completely new line serving the local as well as Mainland travellers. The introduction of the XRL services has also boosted the overall patronage of cross-boundary railway services. We are delighted to see the new business opportunities brought forward by the XRL's connection to the vast Mainland high speed rail network. With the further development of the Greater Bay Area, we have confidence that the patronage on the XRL should continue to rise.

The Government announced in February 2018 that the land or interests or other rights in respect of the land for the operation of the Shatin to Central Link (SCL) would be vested in and the movable assets of SCL be assigned to the Corporation. We will continue to monitor developments in respect of the construction of the SCL, which, upon its completion, will be fully integrated with the Corporation's existing rail network, i.e. East Rail, Ma On Shan Rail and West Rail.

I would like to express my gratitude to the Members of the Managing Board for their inspirational leadership in guiding the management team over the past 12 months.

Edmund K H Leung, SBS, OBE, JP

BSc(Eng), CEng, R.P.E., FHKIE, FIMechE, FCIBSE, FIEAust, FHKEng
Chief Officer
4 April 2019

Corporate Governance Report

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 Rules Governing the Listing of Securities on The Stock Exchange of Hong Kong Limited (the Listing Rules). As a matter of policy, the Corporation complies with the Corporate Governance Code (the Code) as set out in Appendix 14 to the Listing Rules issued by The Stock Exchange of Hong Kong Limited to the extent that they are applicable to the Corporation, 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 and the applicable 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 KCRC 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 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 Plan, including revenue, expenses and capital budget 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, awarding of major contracts, 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 pages 2 to 3.

Professionalism

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. 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 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 KCRC 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 and Risk Management

The Board is ultimately responsible for the Corporation's system of internal control. It ensures through the Audit Committee and the outsourced internal audit function that appropriate policies on internal control are in place and through this team 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 material controls in the manner which they are approved. The Board is required to review on an annual basis the effectiveness of the Corporation's system of internal controls through the Audit Committee, including

Corporate Governance Report

financial, operational and compliance controls, and the Corporation's internal control arrangements, and to consider and take appropriate action in respect of reports received 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 and the Board is also ultimately responsible for the effectiveness of risk management. The Board ensures through the Audit Committee that opportunities be captured through managing business risk. 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. The Board is required to review the effectiveness of risk management on an annual basis through the Audit Committee.

The annual review in 2018 concluded that the existing risk management and internal control systems are effective and adequate.

Board and Audit Committee Meetings

The Board usually 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 five Board and three Audit Committee Meetings held during the year up to 31 December 2018 and attended by Members as listed in the following table.

| | Board Meetings | Audit Committee Meetings |
|------------------------------------|-----------------------|---------------------------------|
| Mr James H. Lau Jr. (Note 1) | 5 | N.A. |
| Mr Joseph Lai Yee-tak (Note 2) | 5 | N.A. |
| Ms Carol Yuen Siu-wai | 5 | 3 |
| Mr Charlix Wong Shing-hei (Note 3) | 5 | 3 |
| Mr Tommy Yuen Man-chung | 5 | 3 |
| Mr Wallace Lau Ka-ki | 5 | N.A. |

Note 1. Chairman of the Board.

Note 2. One Board meeting was attended by Ms Rebecca Pun, the Acting Permanent Secretary for Transport and Housing (Transport)

Note 3. Chairperson of the Audit Committee. One Board meeting was attended by Ms Susanna Cheung, the Acting Director of Accounting Services

In 2018, a total of 49 decision and information papers were considered by Board Members.

Audit Committee

During the year, the Audit Committee comprised Mr Martin Siu Man-tat (Chairperson up to 2 January 2018), Mr Charlix Wong Shing-hei (Chairperson from 3 January 2018), Ms Carol Yuen Siu-wai, and Mr Tommy Yuen Man-chung. All members of the Audit Committee are non-executive Members. The Audit Committee has at least one member possessing “recent and relevant experience”, namely, Mr Charlix Wong Shing-hei, who is a certified public accountant and is also the Director of Accounting Services of the Government of the Hong Kong Special Administrative Region.

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 Audit 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 Audit Committee reviews the effectiveness of the internal audit function, which is currently provided by the internal audit department of MTRCL under an outsourcing arrangement, and is responsible for recommending to the Managing Board the renewal and termination of that outsourced service function. The Audit 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 Audit Committee meets with Management, as well as privately with both the external and internal auditors. The Audit Committee’s terms of reference are available from the Company Secretary and are displayed on the Corporation’s website, www.kcrc.com. In 2018 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 report thereon;
- (c) reviewing the appropriateness of the Corporation’s accounting policies;
- (d) reviewing 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; 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.

Auditor's 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 Audit 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 Audit 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 Audit 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 Audit 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 Note 7(a) to the Financial Statements.

Dividend Policy

Details of the dividend policy for the Corporation are set out in Note 27(c) to the Financial Statements.

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 2018.

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

The principal activities of the Corporation are –

- railway asset holder, with responsibility for monitoring that the MTR Corporation Limited complies with the terms of the Service Concession Agreement and the Supplemental Service Concession Agreement
- investing the annual payments from the MTR Corporation Limited
- servicing the Corporation's outstanding debts
- managing its subsidiaries

The principal activities of the subsidiary companies incorporated to facilitate the undertaking of the above activities are set out in Note 18 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 –

- Secretary for Financial Services and the Treasury, Mr James H. Lau Jr. (Chairman);
- Permanent Secretary for Transport and Housing (Transport), Mr Joseph Lai Yee-tak;
- Deputy Secretary for Financial Services and the Treasury (Treasury) I, Ms Carol Yuen Siu-wai;
- Director of Accounting Services, Mr Martin Siu Man-tat (up to 2 January 2018) and Mr Charlix Wong Shing-hei (from 3 January 2018);

Report of the Members of the Managing Board

- Government Property Administrator, Mr Tommy Yuen Man-chung (up to 27 January 2019) and Mr Vincent Liu Ming-kwong (from 28 January 2019); and
- Deputy Secretary for Transport and Housing (Transport) 4, Mr Wallace Lau Ka-ki.

Brief biographical details of Board Members are set out on pages 2 and 3.

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.

Indemnity of Members of the Managing Board

A permitted indemnity provision (as defined in section 469 of the Hong Kong Companies Ordinance) for the benefit of the Members of the Managing Board of the Corporation is currently in force and was in force throughout this year.

Interests in Transactions, Arrangements or Contracts of Members of the Managing Board and Senior Executive Staff

No transactions, arrangements or 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 2018 and the Group's financial position at that date are set out in the Financial Statements on pages 24 to 83.

Property, Plant and Equipment and Interest in Leasehold Land

Movements in property, plant and equipment and interest in leasehold land during the year are set out in Note 14 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.

Interest and Finance Income/Expenses

Details of the Corporation's interest and finance income/expenses are set out in Note 9 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 Business Review, and the Five-Year Statistics of the Annual Report.

Going Concern

The Financial Statements on pages 24 to 83 have been prepared on a going concern basis. The Managing Board has approved the Corporation's budget for 2019 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 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 applicable 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 KCRC Ordinance, KPMG were appointed as the auditor by the Chief Executive of the Hong Kong Special Administrative Region.

By order of the Managing Board

K.K. Kwok

Company Secretary
4 April 2019

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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

Opinion

We have audited the consolidated financial statements of the Kowloon-Canton Railway Corporation ("the Corporation") and its subsidiaries ("the Group") set out on pages 24 to 83, which comprise the consolidated statement of financial position as at 31 December 2018, the consolidated statement of comprehensive income, the consolidated statement of changes in equity and the consolidated cash flow statement for the year then ended and notes to the consolidated financial statements, including a summary of significant accounting policies.

In our opinion, the consolidated financial statements give a true and fair view of the consolidated financial position of the Group as at 31 December 2018 and of its consolidated financial performance and its consolidated cash flows for the year then ended in accordance with International Financial Reporting Standards ("IFRSs") issued by the International Accounting Standards Board ("IASB") and Hong Kong Financial Reporting Standards ("HKFRSs") issued by the Hong Kong Institute of Certified Public Accountants ("HKICPA") and have been properly prepared in compliance with the applicable disclosure requirements of the Hong Kong Companies Ordinance.

Basis for opinion

We conducted our audit in accordance with Hong Kong Standards on Auditing ("HKSA") issued by the HKICPA. Our responsibilities under those standards are further described in the Auditor's responsibilities for the audit of the consolidated financial statements section of our report. We are independent of the Group in accordance with the HKICPA's Code of Ethics for Professional Accountants ("the Code") and we have fulfilled our other ethical responsibilities in accordance with the Code. We believe that the audit evidence we have obtained is sufficient and appropriate to provide a basis for our opinion.

Key audit matters

Key audit matters are those matters that, in our professional judgement, were of most significance in our audit of the consolidated financial statements of the current period. These matters were addressed in the context of our audit of the consolidated financial statements as a whole, and in forming our opinion thereon, and we do not provide a separate opinion on these matters.

Independent Auditor's Report

| Recognition of revenue under the Service Concession and the Supplemental Service Concession | |
|--|---|
| <i>Refer to notes 2 and 5 and the accounting policies in note 3(x) to the consolidated financial statements</i> | |
| The Key Audit Matter | How the matter was addressed in our audit |
| <p>As disclosed in note 2 to the consolidated financial statements, the Corporation and MTR Corporation Limited ("MTRCL") entered into the Service Concession in respect of the Corporation's existing railway lines and other rail-related businesses ("the KCR Network") for a period of 50 years starting from December 2007 and the Supplemental Service Concession relating to the Hong Kong Section of the Guangzhou-Shenzhen-Hong Kong Express Rail Link ("the XRL"), for a period of 10 years starting from September 2018 ("the service concession arrangements").</p> <p>During the respective concession periods, MTRCL is responsible for the daily operations and maintenance of the transport operations and will fund related operating capital expenditure, and will receive all revenues generated from the operation of the rail networks and other rail-related businesses.</p> <p>The consideration exchanged between MTRCL and the Corporation under the service concession arrangements includes both fixed amounts and amounts which vary based on the revenue generated from the operation of the rail networks and in accordance with the formulae set out in the service concession agreements, as disclosed in note 2 to the consolidated financial statements.</p> <p>The Corporation recognised total annual payments receivable from MTRCL, net of fixed annual payments and other adjustments relating to the XRL, of \$2,957 million as revenue for the year ended 31 December 2018.</p> | <p>Our audit procedures to assess the recognition of revenue under the Service Concession and the Supplemental Service Concession included the following:</p> <ul style="list-style-type: none"> • inspecting the agreements relating to the Supplemental Service Concession to identify any terms of accounting significance and assessing the accounting treatments and adequacy of disclosures in the consolidated financial statements with reference to the requirements of the prevailing accounting standards; • inspecting the agreements relating to the Service Concession and the Supplemental Service Concession and documentation provided by MTRCL to the Corporation in relation to the amounts of revenue from the KCR Network and the XRL and the amounts due under the service concession agreements, and discussing with the Corporation's management their review procedures exercised thereon; • evaluating the competence and objectivity of the two independent experts; • assessing the adequacy of the procedures performed by the two independent experts for the purposes of our audit; and • obtaining the reports issued by the two independent experts and inspecting the findings and conclusions therein. <p>In addition, our audit procedures included comparing the payments under the Service Concession and the Supplemental Service Concession to the forecasts prepared by management in order to assess whether there was any indication of impairment of the KCR network or the intangible assets relating to the XRL.</p> |

Recognition of revenue under the Service Concession and the Supplemental Service Concession

Refer to notes 2 and 5 and the accounting policies in note 3(x) to the consolidated financial statements

| The Key Audit Matter | How the matter was addressed in our audit |
|---|---|
| <p>MTRCL is responsible for designing, implementing and maintaining internal controls over the revenue from the KCR Network and the XRL and for calculating the amounts due under the service concession agreements and reporting such amounts to the Corporation. MTRCL has appointed its external auditors and another firm of auditors as independent experts, pursuant to and as defined in the Service Concession agreement, to perform certain procedures on the calculation of these amounts and to report thereon.</p> <p>We identified the recognition of revenue under the Service Concession and the Supplemental Service Concession as a key audit matter because of its significance to the Corporation's total revenue and its significance in assessing the recoverable amounts of the KCR network and the intangible assets relating to the XRL; and because the amounts are recognised in reliance on the information reported by MTRCL and the reports issued by the two independent experts.</p> | |

Information other than the consolidated financial statements and auditor's report thereon

The Board Members are responsible for the other information. The other information comprises all the information included in the annual report, other than the consolidated financial statements and our auditor's report thereon.

Our opinion on the consolidated financial statements does not cover the other information and we do not express any form of assurance conclusion thereon.

In connection with our audit of the consolidated financial statements, our responsibility is to read the other information and, in doing so, consider whether the other information is materially inconsistent with the consolidated financial statements or our knowledge obtained in the audit or otherwise appears to be materially misstated.

If, based on the work we have performed, we conclude that there is a material misstatement of this other information, we are required to report that fact. We have nothing to report in this regard.

Independent Auditor's Report

Responsibilities of the Board Members for the consolidated financial statements

The Board Members are responsible for the preparation of consolidated financial statements that give a true and fair view in accordance with IFRSs issued by the IASB, HKFRSs issued by the HKICPA and the Kowloon-Canton Railway Corporation Ordinance and for such internal control as the Board Members determine is necessary to enable the preparation of consolidated financial statements that are free from material misstatement, whether due to fraud or error.

In preparing the consolidated financial statements, the Board Members are responsible for assessing the Group's ability to continue as a going concern, disclosing, as applicable, matters related to going concern and using the going concern basis of accounting unless the Board Members either intend to liquidate the Group or to cease operations, or have no realistic alternative but to do so.

The Board Members are assisted by the Audit Committee in discharging their responsibilities for overseeing the Group's financial reporting process.

Auditor's responsibilities for the audit of the consolidated financial statements

Our objectives are to obtain reasonable assurance about whether the consolidated financial statements as a whole are free from material misstatement, whether due to fraud or error, and to issue an auditor's report that includes our opinion. 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.

Reasonable assurance is a high level of assurance but is not a guarantee that an audit conducted in accordance with HKSAs will always detect a material misstatement when it exists. Misstatements can arise from fraud or error and are considered material if, individually or in the aggregate, they could reasonably be expected to influence the economic decisions of users taken on the basis of these consolidated financial statements.

As part of an audit in accordance with HKSAs, we exercise professional judgement and maintain professional scepticism throughout the audit. We also:

- Identify and assess the risks of material misstatement of the consolidated financial statements, whether due to fraud or error, design and perform audit procedures responsive to those risks, and obtain audit evidence that is sufficient and appropriate to provide a basis for our opinion. The risk of not detecting a material misstatement resulting from fraud is higher than for one resulting from error, as fraud may involve collusion, forgery, intentional omissions, misrepresentations or the override of internal control.
- Obtain an understanding of internal control relevant to the audit 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 Group's internal control.
- Evaluate the appropriateness of accounting policies used and the reasonableness of accounting estimates and related disclosures made by the Board Members.
- Conclude on the appropriateness of the Board Members' use of the going concern basis of accounting and, based on the audit evidence obtained, whether a material uncertainty exists related to events or conditions that may cast significant doubt on the Group's ability to continue as a going concern. If we conclude that a material uncertainty exists, we are required to draw attention in our auditor's report to the related disclosures in the consolidated financial statements or, if such disclosures are inadequate, to modify our opinion. Our conclusions are based on the audit evidence obtained up to the date of our auditor's report. However, future events or conditions may cause the Group to cease to continue as a going concern.

- Evaluate the overall presentation, structure and content of the consolidated financial statements, including the disclosures, and whether the consolidated financial statements represent the underlying transactions and events in a manner that achieves fair presentation.
- Obtain sufficient appropriate audit evidence regarding the financial information of the entities or business activities within the Group to express an opinion on the consolidated financial statements. We are responsible for the direction, supervision and performance of the group audit. We remain solely responsible for our audit opinion.

We communicate with the Audit Committee regarding, among other matters, the planned scope and timing of the audit and significant audit findings, including any significant deficiencies in internal control that we identify during our audit.

We also provide the Audit Committee with a statement that we have complied with relevant ethical requirements regarding independence and communicate with them all relationships and other matters that may reasonably be thought to bear on our independence and, where applicable, related safeguards.

From the matters communicated with the Audit Committee, we determine those matters that were of most significance in the audit of the consolidated financial statements of the current period and are therefore the key audit matters. We describe these matters in our auditor's report unless law or regulation precludes public disclosure about the matter or when, in extremely rare circumstances, we determine that a matter should not be communicated in our report because the adverse consequences of doing so would reasonably be expected to outweigh the public interest benefits of such communication.

The engagement partner on the audit resulting in this independent auditor's report is Stephen George Mercer.

KPMG

Certified Public Accountants
8th Floor, Prince's Building
10 Chater Road
Central, Hong Kong
4 April 2019

Consolidated Statement of Comprehensive Income

for the year ended 31 December 2018 (Expressed in Hong Kong dollars)

| | Note | 2018 \$ million | 2017 \$ million |
|---|-------|--------------------|--------------------|
| Turnover | 5 | 3,792 | 3,412 |
| Operating costs before depreciation, amortisation and impairment | 6 | (42) | (42) |
| Operating profit before depreciation, amortisation and impairment | 7 | 3,750 | 3,370 |
| Depreciation and amortisation | 8 | (2,931) | (3,269) |
| Loss on disposal of property, plant and equipment | | (37) | (55) |
| Operating profit after depreciation, amortisation and impairment | | 782 | 46 |
| Interest and finance income | 9(a) | 289 | 177 |
| Interest and finance expenses | 9(b) | (452) | (478) |
| Share of profit of associate | 19 | 85 | 67 |
| Profit/(loss) before unrealised losses | | 704 | (188) |
| Net losses on changes in fair value of financial instruments | 10 | (34) | (48) |
| Profit/(loss) before taxation | | 670 | (236) |
| Income tax | 11(a) | (96) | 59 |
| Profit/(loss) and total comprehensive income for the year wholly attributable to the sole shareholder of the Corporation | 12 | 574 | (177) |

The notes on pages 28 to 83 form part of these financial statements.

Consolidated Statement of Financial Position

at 31 December 2018 (Expressed in Hong Kong dollars)

| | Note | 2018 \$ million | 2017 \$ million |
|---|-------|--------------------|--------------------|
| Assets | | | |
| Investment properties and other property, plant and equipment | 14(a) | 54,757 | 55,689 |
| Interest in leasehold land held for own use under operating leases | 14(a) | 3,746 | 3,823 |
| Intangible assets | 15 | 667 | – |
| Construction in progress | 16 | 4,841 | 4,402 |
| Deferred expenditure | 17 | 1,188 | 1,188 |
| Interest in associate | 19 | 376 | 351 |
| Derivative financial assets | 28(e) | 84 | 118 |
| Other financial assets | 20 | 557 | 556 |
| Interest and other receivables | 21 | 2,511 | 2,026 |
| Cash and cash equivalents | 22 | 12,801 | 10,279 |
| | | 81,528 | 78,432 |
| Liabilities | | | |
| Interest and other payables | 23 | 965 | 85 |
| Accrued charges and provisions for capital projects | 24 | 21 | 43 |
| Interest-bearing borrowings | 25 | 9,285 | 9,263 |
| Deferred income | 26 | 15,847 | 14,301 |
| Deferred tax liabilities | 11(c) | 497 | 401 |
| | | 26,615 | 24,093 |
| Net Assets | | 54,913 | 54,339 |
| Capital and Reserves | | | |
| Share capital | 27(b) | 39,120 | 39,120 |
| Reserves | | 15,793 | 15,219 |
| Total Equity | | 54,913 | 54,339 |

Approved and authorised for issue by the Managing Board on 4 April 2019

James H. Lau Jr.

Chairman of the Managing Board

Wallace Lau Ka-ki

Member of the Managing Board

Edmund K H Leung

Chief Officer

The notes on pages 28 to 83 form part of these financial statements.

Consolidated Statement of Changes in Equity

for the year ended 31 December 2018 (Expressed in Hong Kong dollars)

| | Share capital \$ million | Retained profits \$ million | Total equity \$ million |
|--|--------------------------------|-----------------------------------|-------------------------------|
| Balance at 1 January 2017 | 39,120 | 15,396 | 54,516 |
| Changes in equity for 2017: | | | |
| Loss for the year | – | (177) | (177) |
| Total comprehensive income for the year | – | (177) | (177) |
| Balance at 31 December 2017 and 1 January 2018 | 39,120 | 15,219 | 54,339 |
| Changes in equity for 2018: | | | |
| Profit for the year | – | 574 | 574 |
| Total comprehensive income for the year | – | 574 | 574 |
| Balance at 31 December 2018 | 39,120 | 15,793 | 54,913 |

The notes on pages 28 to 83 form part of these financial statements.

Consolidated Cash Flow Statement

for the year ended 31 December 2018 (Expressed in Hong Kong dollars)

| | Note | 2018 \$ million | 2017 \$ million |
|--|-------|--------------------|--------------------|
| Operating activities | | | |
| Net cash inflow from operations | 29(a) | 2,675 | 2,526 |
| Investing activities | | | |
| Decrease/(increase) in deposits with banks with more than three months to maturity when placed | | 106 | (3,007) |
| Payments for capital expenditure | | (64) | (16) |
| Interest received | | 224 | 108 |
| Payment for purchase of other financial assets | | – | (555) |
| Proceeds from maturity of other financial assets | | – | 556 |
| Dividend received from associate | | 60 | 51 |
| Net cash inflow/(outflow) from investing activities | | 326 | (2,863) |
| Net cash inflow/(outflow) before financing activities | | 3,001 | (337) |
| Financing activities | | | |
| Interest paid | 29(b) | (431) | (427) |
| Net interest received relating to derivative financial instruments | 29(b) | 59 | 63 |
| Finance expenses paid | | (1) | (4) |
| Net cash outflow from financing activities | | (373) | (368) |
| Net increase/(decrease) in cash and cash equivalents | | 2,628 | (705) |
| Cash and cash equivalents at 1 January | | 2,803 | 3,508 |
| Cash and cash equivalents at 31 December | | 5,431 | 2,803 |
| Analysis of the balances of cash and cash equivalents | | | |
| Cash and cash equivalents in the consolidated statement of financial position | | 12,801 | 10,279 |
| Less: deposits with banks with more than three months to maturity when placed | | (7,370) | (7,476) |
| Cash and cash equivalents in the consolidated cash flow statement | 22 | 5,431 | 2,803 |

The notes on pages 28 to 83 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 KCRC 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 KCRC Ordinance.

On 8 June 2007, the Legislative Council passed the Rail Merger Bill. 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 KCRC 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”), certain subsidiaries 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”).

Service Concession

The Service Concession grants MTRCL the right to operate the Corporation’s existing railway lines (including the Kowloon Southern Link which was commissioned in August 2009 but excluding the Hong Kong Section of the Guangzhou-Shenzhen-Hong Kong Express Rail Link (the “XRL”) which was commissioned in September 2018) 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, MTRCL is responsible for the daily operations and maintenance of the transport operations and will fund 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, MTRCL agreed to make 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 above \$7.5 billion.

2 Rail Merger with MTR Corporation Limited (“MTRCL”) (continued)

Service Concession (continued)

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 the associate and the Excluded Assets; and
- (iii) acting as the borrower and obligor in relation to the Corporation’s existing financial obligations and contingent liabilities.

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.

Supplemental Service Concession for the XRL

In August 2018, the land or interests or other rights in respect of the land for the operation of the XRL were vested in and the movable assets of the XRL were assigned to the Corporation by the Government.

On 23 September 2018, the XRL commenced its commercial operations. The right to operate the XRL was granted by the Corporation to MTRCL (the “Supplemental Service Concession”) for a concession period of 10 years (the “Concession Period (XRL)”) under a Supplemental Service Concession Agreement (the “SSCA”). Pursuant to the SSCA, the Corporation shall reimburse MTRCL the pre-operating costs incurred for the planning and commissioning of the XRL and shall pay to MTRCL fixed annual payments totalling \$7,965 million during the Concession Period (XRL). In return, the Corporation is entitled to receive a variable annual payment from MTRCL, calculated based on the revenue generated from the operation of the XRL. The applicable rate is as set out in the Service Concession above and based on the combined revenue from the Corporation’s rail network and other rail-related businesses and the XRL. In addition, the SSCA contains the following revenue-related arrangements for the XRL.

- (a) If, and to the extent, the actual patronage of the XRL deviates from the projected patronage set out in the SSCA by more than 15%, MTRCL and the Corporation shall share the impact of such shortfall/surplus according to a ratio of 30:70.
- (b) If the XRL results in a reduction in the patronage of the existing cross-boundary and intercity rail network operated by MTRCL under the Service Concession, the Corporation is to bear the impact of such reduction calculated according to a formula set out in the SSCA and subject to a cap of \$1.5 billion over the Concession Period (XRL).
- (c) The Corporation agrees to reimburse to MTRCL the service fees for Mainland journey tickets purchased at the West Kowloon Station and the fare discounts applicable to students and disabled army men as special classes of passengers in Mainland China.

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 KCRC 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. 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. A summary of the significant accounting policies adopted by the Corporation and its controlled subsidiaries (the “Group”) is set out below.

The IASB has issued certain new and revised IFRSs that are first effective or available for early adoption for the current accounting period of the Group and the Corporation. The equivalent new and revised HKFRSs consequently issued by the HKICPA have the same effective date as those issued by the IASB and are in all material respects identical to the pronouncements issued by the IASB. Note 4 provides information on any changes in accounting policies resulting from initial application of these developments to the extent that they are relevant to the Group and the Corporation for the current and prior accounting periods reflected in these financial statements.

(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.

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 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 major sources of estimation uncertainty are discussed in note 37.

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 entities 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 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 entities, 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 entities.

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 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 prior to the Rail Merger now rest with MTRCL although there has been no direct disposition of the shares of MMC to MTRCL.

(d) Investments in subsidiaries

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. The Corporation controls an entity when it is exposed, or has rights, to variable returns from its involvement with the entity and has the ability to affect those returns through its power over the entity. When assessing whether the Corporation has power, only substantive rights (held by the Corporation and other parties) are considered.

An investment in an entity in which the Corporation, directly or indirectly, holds more than half of the issued share capital but does not have control or significant influence is excluded from consolidation or equity accounting and is stated at cost less impairment losses, if any, in the Group's and the Corporation's statements of financial position.

Intra-group balances, transactions and cash flows 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 statement of financial position, 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 the 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, adjusted for any excess of the Group's share of the acquisition-date fair values of the associate's identifiable net assets over the cost of the investment (if any). Thereafter, the investment is adjusted for the post acquisition change in the Group's share of the associate's net assets and any impairment losses relating to the investment (see note 3(m)(ii)). The Group's share of the post-acquisition post-tax results of an associate and any impairment losses for the year are recognised in profit or loss, whereas the Group's share of the post-acquisition post-tax items of an associate's other comprehensive income is recognised in other comprehensive income.

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 profit or loss.

When the Group ceases to have significant influence over an associate, it is accounted for as a disposal of the entire interest in that associate, with a resulting gain or loss being recognised in profit or loss. Any interest retained in that former associate at the date when significant influence is lost is recognised at fair value and this amount is regarded as the fair value on initial recognition of a financial asset.

In the Corporation's statement of financial position, an investment in an associate is stated at cost less impairment losses, if any.

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

3 Significant accounting policies (continued)

(f) Investments in debt securities

The Group's and the Corporation's policies for investments in debt securities, other than investments in subsidiaries and associates, are as follows.

Investments in debt securities are recognised/derecognised on the trade date, which is the date the Group commits to purchase/sell the investments or when the investments expire. The investments are initially stated at fair value plus directly attributable transaction costs.

(A) Policy applicable from 1 January 2018

The investments are subsequently accounted for and measured at amortised cost, if the investment is held for the collection of contractual cash flows which represent solely payments of principal and interest. Interest income from the investment is calculated using the effective interest method (see note 3(x)(ii)).

(B) Policy applicable prior to 1 January 2018

Dated debt securities that the Group and the Corporation had the positive ability and intention to hold to maturity were classified as held-to-maturity securities and stated at amortised cost less impairment losses, if any.

(g) Derivative financial assets and liabilities

The Group uses derivative financial instruments to hedge its exposure to currency 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 the end of each reporting period, with any resultant gain or loss recognised immediately in profit or loss.

(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 at cost less accumulated depreciation and impairment losses, if any. Depreciation is calculated to write off the cost of investment properties, using the straight-line method over the shorter of the unexpired term of leases and their estimated useful lives.

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 profit or loss on the date of retirement or disposal.

Notes to the Financial Statements

(Expressed in Hong Kong dollars)

3 Significant accounting policies (continued)

(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 statement of financial position 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 the 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 statement of financial position 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 profit or loss over the shorter of the useful life of the ACP and the remaining Concession Period.

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 being classified as held under operating leases (see note 3(1)); 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.

3 Significant accounting policies (continued)

(i) Property, plant and equipment (continued)

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; and
- 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.

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 profit or loss when incurred.

- (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 attributable to the Group, if any, and the carrying amount of the item and are recognised in profit or loss on the date of retirement or disposal.

Notes to the Financial Statements

(Expressed in Hong Kong dollars)

3 Significant accounting policies (continued)

(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 method over its estimated useful life as follows:

| | No. of years |
|--|--------------|
| Tunnels, bridges and roads (see note 3(j)(iii)) | 15-64 |
| Buildings (see note 3(j)(iii)) | 7-50 |
| Rolling stock | 2-50 |
| Locomotives and wagons | 5-35 |
| Lifts and escalators | 20-25 |
| Permanent way comprising rails, ballast, sleepers and concrete civil works (see note 3(j)(iii)) | 10-50 |
| Machinery and equipment | 3-45 |
| Telecommunication and signalling systems and air-conditioning plant | 3-50 |
| Fare collection systems | 5-20 |
| Mobile phone systems | 7-15 |
| Tools | 10-40 |
| Furniture and fixtures | 3-40 |
| Computer and office equipment (including computer software) | 3-20 |
| Buses | 4-17 |
| Other motor vehicles | 4-15 |

- (ii) Where parts of an item of property, plant and equipment have different useful lives, the cost of the item is allocated on a reasonable 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) Intangible assets for the XRL under the SCA

The land or interests or other rights in respect of the land for the operation of the XRL were vested in and the movable assets of the XRL were assigned to the Corporation by the Government for a term of 50 years at a nominal premium of \$1,000 and \$1 respectively. These costs represent the adopted value for the acquisition of the right of use of the land and the related assets. Furthermore, the pre-operating costs incurred by MTRCL for the planning and commissioning of the XRL and reimbursed by the Corporation (see note 2) are also an integral part of the assets for the XRL. All these costs are carried as intangible assets on the statement of financial position and are amortised to profit or loss on a straight-line basis over the unexpired lease term of the land vested.

3 Significant accounting policies (continued)

(l) 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) Operating lease charges

Where the Group has the use of assets held under operating leases, payments made under the leases are charged to profit or loss 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.

(m) Credit losses and impairment of assets

(i) Credit losses from financial assets

(A) Policy applicable from 1 January 2018

The Group recognises a loss allowance for expected credit losses ("ECLs") on financial assets measured at amortised cost (including cash and cash equivalents, interest and other receivables and debt securities). Financial assets measured at fair value, including derivative financial assets, are not subject to the ECL assessment.

ECLs are a probability-weighted estimate of credit losses. Credit losses are measured as the present value of all expected cash shortfalls (i.e. the difference between the cash flows due to the Group in accordance with the contract and the cash flows that the Group expects to receive). The expected cash shortfalls for fixed-rate financial assets and interest and other receivables are discounted using the effective interest rate determined at initial recognition or an approximation thereof where the effect of discounting is material.

Notes to the Financial Statements

(Expressed in Hong Kong dollars)

3 Significant accounting policies (continued)

(m) Credit losses and impairment of assets (continued)

- (i) Credit losses from financial assets (continued)
- (B) Policy applicable prior to 1 January 2018

Prior to 1 January 2018, an “incurred loss” model was used to measure impairment losses on financial assets not classified as at fair value through profit or loss (e.g. interest and other receivables and held-to-maturity debt securities). Under the “incurred loss” model, an impairment loss was recognised only when there was objective evidence of impairment.

- (ii) Impairment of other assets

Internal and external sources of information are reviewed at the end of each reporting period to identify indications that any assets, other than financial assets, may be impaired or an impairment loss previously recognised no longer exists or may have decreased.

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 fair value less costs of disposal 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 the 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 profit or loss if 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 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 of disposal, 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 profit or loss in the year in which the reversals are recognised.

3 Significant accounting policies (continued)

(n) 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 property, plant and equipment 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 profit or loss 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.

(o) 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. The composition of costs and their capitalisation criteria follow that of construction in progress as set out in note 3(n).

Notes to the Financial Statements

(Expressed in Hong Kong dollars)

3 Significant accounting policies (continued)

(p) 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.

Profits on property development undertaken in conjunction with property developers are recognised in profit or loss 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 profit or loss 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 profit or loss where the costs are considered to be irrecoverable, together with provision for losses, if any, borne by the Corporation in respect of the development; 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.

(q) Cash and cash equivalents

Cash and cash equivalents comprise cash at bank and in 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. Cash and cash equivalents are assessed for ECLs in accordance with the policy set out in note 3(m)(i).

For the purposes of the consolidated cash flow statement, cash equivalents 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.

3 Significant accounting policies (continued)

(r) Interest and other receivables

A receivable is recognised when the Group has an unconditional right to receive consideration. A right to receive consideration is unconditional if only the passage of time is required before payment of that consideration is due.

Interest and other receivables are stated at amortised cost using the effective interest method, less allowance for credit losses (see note 3(m)(i)).

(s) Interest-bearing borrowings

Interest-bearing borrowings are measured initially at fair value less transaction costs. Subsequent to initial recognition, the unhedged portion of interest-bearing borrowings is stated at amortised cost using the effective interest method. Interest expense is recognised in accordance with the Group's accounting policy for borrowing costs (see note 3(aa)(ii)).

(t) 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.

(u) 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.

(v) 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 profit or loss except to the extent that they relate to items recognised in other comprehensive income or directly in equity, in which case the relevant amounts of tax are recognised in other comprehensive income or direct in equity, respectively.
- (ii) Current tax is the expected tax payable on the taxable income for the year, using tax rates enacted or substantively enacted at the end of the reporting period and any adjustment to tax payable in respect of previous years.

Notes to the Financial Statements

(Expressed in Hong Kong dollars)

3 Significant accounting policies (continued)

(v) Income tax (continued)

- (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 their tax bases. 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 recognised is measured 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 end of the reporting period. Deferred tax assets and liabilities are not discounted.

The carrying amount of a deferred tax asset is reviewed at the end of each reporting period 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. Any such reduction is reversed to the extent that it becomes probable that sufficient taxable profits will be available.

- (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 the 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 the 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, if 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.

3 Significant accounting policies (continued)

(w) Provisions and contingent liabilities

Provisions are recognised for liabilities of uncertain timing or amount when the Group 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 obligation 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.

(x) Revenue and other income

(i) Concession income

Different components of concession income are recognised in profit or loss as follows:

Service Concession

- 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.

Notes to the Financial Statements

(Expressed in Hong Kong dollars)

3 Significant accounting policies (continued)

(x) Revenue and other income (continued)

(i) Concession income (continued)

Supplemental Service Concession

- Variable annual payments based on revenue generated from the operation of the XRL, net of fixed annual payments and any amounts under the revenue-related arrangements as set out in note 2, are recognised when earned during the Concession Period (XRL).
- The fixed annual payments to MTRCL totalling \$7,965 million (see note 2) are executory in nature and are accrued on a straight line basis over the Concession Period (XRL). The payment pattern of these payments, as set out in the SSCA, gives rise to a financing component which provides financing benefit to the Group. The fixed annual payments are therefore measured at the present value of the amount payable. The related interest component is accrued separately under the effective interest method (see note 3(aa)(ii)).

(ii) Interest income

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

(iii) Rental income

Rental income receivable under operating leases is recognised in profit or loss 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 profit or loss as an integral part of the aggregate net lease payments receivable. Contingent rentals are recognised as income in the accounting period in which they are earned.

(iv) Other income

Other income is recognised once the related services or goods are delivered and control has transferred.

(y) 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.

3 Significant accounting policies (continued)

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

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.

Where commitments to make long-term lease payments have been defeased by the placement of security deposits or by the advances of loans to third parties, they are not recognised in the statement of financial position. 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 statement of financial position.

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.

(z) Translation of foreign currencies

Foreign currency transactions during the year are translated into Hong Kong dollars at the foreign exchange rates ruling at the transaction dates. The transaction date is the date on which the Corporation initially recognises such non-monetary assets or liabilities. Monetary assets and liabilities denominated in foreign currencies are translated into Hong Kong dollars at the foreign exchange rates ruling at the end of the reporting period.

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.

Exchange gains and losses are recognised in profit or loss.

(aa) Interest and finance income/expenses

(i) Interest and finance income includes:

- interest income from bank deposits and investments;
- realised gains arising from derivative financial instruments;
- net gains on redemption and disposal of investments; and
- net exchange gains arising from foreign currency transactions.

Interest and finance income is credited to profit or loss in the period in which it is earned.

Notes to the Financial Statements

(Expressed in Hong Kong dollars)

3 Significant accounting policies (continued)

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

(ii) Interest and finance expenses include:

- interest payable on borrowings;
- interest accrued in relation to fixed annual payments for the XRL;
- 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;
- net losses on redemption and disposal of investments; and
- net exchange losses arising from foreign currency transactions.

Interest and finance expenses are expensed in profit or loss 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.

(ab) Related parties

(a) A person, or a close member of that person's family, is related to the Group if that person:

- (i) has control or joint control over the Group;
- (ii) has significant influence over the Group; or
- (iii) is a member of the key management personnel of the Group or the Group's parent.

(b) An entity is related to the Group if any of the following conditions applies:

- (i) The entity and the Group are members of the same group (which means that each parent, subsidiary and fellow subsidiary is related to the others).
- (ii) One entity is an associate or joint venture of the other entity (or an associate or joint venture of a member of a group of which the other entity is a member).
- (iii) Both entities are joint ventures of the same third party.
- (iv) One entity is a joint venture of a third entity and the other entity is an associate of the third entity.
- (v) The entity is a post-employment benefit plan for the benefit of employees of either the Group or an entity related to the Group.

3 Significant accounting policies (continued)

(ab) Related parties (continued)

- (vi) The entity is controlled or jointly controlled by a person identified in (a).
- (vii) A person identified in (a)(i) has significant influence over the entity or is a member of the key management personnel of the entity (or of a parent of the entity).
- (viii) The entity, or any member of a group of which it is a part, provides key management personnel services to the Group or to the Group's parent.

Close members of the family of a person are those family members who may be expected to influence, or be influenced by, that person in their dealings with the entity.

(ac) Segment reporting

Operating segments, and the amounts of each segment item reported in the financial statements, are identified from the financial information provided regularly to the Group's direct management team for the purposes of allocating resources to, and assessing the performance of, the Group's various lines of business and geographical locations.

4 Changes in accounting policies

The IASB has issued a number of new IFRSs and amendments to IFRSs that are first effective for the current accounting period of the Group and the Corporation. The equivalent revised HKFRSs consequently issued by the HKICPA have the same effective date as those issued by the IASB and are in all material respects identical to the pronouncements issued by the IASB. Of these, IFRS 9 and HKFRS 9, *Financial instruments*, have had an impact on the Group's financial statements.

The Group has not applied any new standard or interpretation that is not yet effective for the current accounting period.

IFRS 9 and HKFRS 9, *Financial instruments*

IFRS 9 and HKFRS 9 replaced IAS 39 and HKAS 39, *Financial instruments: recognition and measurement* and introduced new requirements for recognising and measuring financial assets, financial liabilities and some contracts to buy or sell non-financial items.

The Group has applied IFRS 9 and HKFRS 9 retrospectively to items that existed at 1 January 2018 in accordance with the transition requirements. Comparative information continues to be reported under IAS 39 and HKAS 39.

Details of the changes to previous accounting policies are set out in notes 3(f) and (m)(i).

The adoption of IFRS 9 and HKFRS 9 did not change the carrying amounts of the Group's financial assets or financial liabilities as at 1 January 2018.

Notes to the Financial Statements

(Expressed in Hong Kong dollars)

5 Turnover

Turnover principally represents revenue from the Service Concession and the Supplemental Service Concession (“Concession Income”). The amounts of revenue recognised in turnover during the year are as follows:

| | 2018 \$ million | 2017 \$ million |
|---|--------------------|--------------------|
| Concession Income | | |
| — fixed and variable annual payments | 2,957 | 2,683 |
| — amortisation of upfront payment and net liabilities transferred to MTRCL | 83 | 83 |
| Income relating to ACP funded by MTRCL | 651 | 610 |
| Property services (including rental income from MTRCL of \$14 million (2017: \$14 million)) | 38 | 36 |
| Income from lease out and lease back transactions | 63 | – |
| | 3,792 | 3,412 |

6 Operating costs before depreciation, amortisation and impairment

| | 2018 \$ million | 2017 \$ million |
|---|--------------------|--------------------|
| Staff costs | 8 | 8 |
| Government rent and rates | 1 | 1 |
| Cost of services acquired (including services outsourced to MTRCL of \$18 million (2017: \$18 million)) | 31 | 31 |
| Others | 2 | 2 |
| | 42 | 42 |

7 Operating profit before depreciation, amortisation and impairment

- (a) Operating profit before depreciation, amortisation and impairment is arrived at after charging/ (crediting):

| | 2018 \$ million | 2017 \$ million |
|---|--------------------|--------------------|
| Auditor's remuneration | | |
| – audit services | 2.0 | 1.8 |
| – other services | 0.5 | – |
| Emoluments of the Chief Officer who is not a Member of the Managing Board | 2 | 2 |
| and after crediting: | | |
| Rentals receivable from operating leases less direct outgoings of \$1 million (2017: \$1 million) (including contingent rentals of nil (2017: nil)) | (37) | (35) |

- (b) No fees have been paid nor are payable to any Member of the Managing Board, including the Chairman, in 2018 and 2017.
- (c) Emoluments of the Chief Officer, who is not a Member of the Managing Board, include fixed remuneration which comprises base pay, allowances and gratuities and benefits-in-kind. Details of emoluments are shown below:

| | 2018 \$ million | 2017 \$ million |
|---------------------|--------------------|--------------------|
| Mr Edmund K H Leung | 1.72 | 1.69 |

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

| | No. of employees | |
|--|------------------|------|
| | 2018 | 2017 |
| The remuneration of the highest five employees ranges from | | |
| \$2,500,001 – \$3,000,000 | 1 | 1 |
| \$2,000,001 – \$2,500,000 | 1 | – |
| \$1,500,001 – \$2,000,000 | 1 | 2 |
| Nil – \$1,000,000 | 2 | 2 |

Notes to the Financial Statements

(Expressed in Hong Kong dollars)

8 Depreciation and amortisation

| | 2018 \$ million | 2017 \$ million |
|--|--------------------|--------------------|
| Depreciation | | |
| — investment properties | 2 | 2 |
| — other property, plant and equipment | 2,818 | 3,159 |
| | 2,820 | 3,161 |
| Amortisation | | |
| — amortisation of interest in leasehold land held for own use under operating leases | 108 | 108 |
| — amortisation of intangible assets | 3 | – |
| | 2,931 | 3,269 |

9 Interest and finance income/expenses**(a) Interest and finance income**

| | 2018 \$ million | 2017 \$ million |
|--|--------------------|--------------------|
| Interest income from deposits | 226 | 109 |
| Interest income from other financial assets | 9 | 5 |
| Interest income from non-derivative financial assets | 235 | 114 |
| Realised gains arising from derivative financial instruments (net) | 54 | 63 |
| | 289 | 177 |

(b) Interest and finance expenses

| | 2018 \$ million | 2017 \$ million |
|---|--------------------|--------------------|
| Interest expenses on loans | 441 | 437 |
| Interest accrued in relation to fixed annual payments for the XRL | 1 | – |
| Finance expenses | 1 | 2 |
| Interest and finance expenses on non-derivative financial liabilities | 443 | 439 |
| Exchange loss (net) | 9 | 39 |
| | 452 | 478 |

10 Net losses on changes in fair value of financial instruments

| | 2018 \$ million | 2017 \$ million |
|--|--------------------|--------------------|
| Net losses on derivative financial instruments | (34) | (48) |

11 Income tax

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

| | 2018 \$ million | 2017 \$ million |
|--|--------------------|--------------------|
| <i>Current tax</i> | | |
| Provision for Hong Kong Profits Tax at 16.5% (2017: 16.5%) of the estimated assessable profits for the year | - | - |
| <i>Deferred tax expense/(credit)</i> | | |
| Origination and reversal of temporary differences | 96 | (59) |
| | 96 | (59) |

The Corporation has sufficient tax losses brought forward to set off against the estimated assessable profit for the year and accumulated tax losses carried forward of approximately \$34,600 million at 31 December 2018 (2017: approximately \$34,800 million) which are available to set off against future assessable profits. The tax losses do not expire under current tax legislation.

The Corporation sustained a loss for tax purposes for the year ended 31 December 2017.

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

| | 2018 \$ million | 2017 \$ million |
|--|--------------------|--------------------|
| Profit/(loss) before taxation | 670 | (236) |
| Tax expense/(credit) on accounting profit/(loss) before taxation at 16.5% (2017: 16.5%) | 110 | (39) |
| Tax effect of non-deductible expenses | 160 | 124 |
| Tax effect of non-taxable income | (174) | (144) |
| Actual tax expense/(credit) | 96 | (59) |

Notes to the Financial Statements

(Expressed in Hong Kong dollars)

11 Income tax (continued)

(c) Deferred tax assets and liabilities recognised:

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

| | Future benefit of tax losses \$ million | Depreciation allowances in excess of the related depreciation \$ million | Total \$ million |
|--------------------------------------|---|---|---------------------|
| At 1 January 2017 | (5,661) | 6,121 | 460 |
| (Credited)/charged to profit or loss | (77) | 18 | (59) |
| At 31 December 2017 | (5,738) | 6,139 | 401 |
| At 1 January 2018 | (5,738) | 6,139 | 401 |
| Charged to profit or loss | 22 | 74 | 96 |
| At 31 December 2018 | (5,716) | 6,213 | 497 |

12 Profit/loss for the year wholly attributable to the sole shareholder of the Corporation

Of the consolidated profit for the year amounting to \$574 million (2017: loss of \$177 million), a profit of \$549 million (2017: loss of \$193 million) has been dealt with in the financial statements of the Corporation.

13 Segment reporting

The Group manages its businesses as a whole as virtually all of the turnover and operating profit is derived from activities in Hong Kong. The financial statements are already presented in a manner consistent with the way in which information is reported internally to the Group's direct management team for the purposes of resource allocation and performance assessment. Accordingly, no business and geographical segment information is disclosed in accordance with IFRS 8 and HKFRS 8.

14 Investment properties, other property, plant and equipment and interest in leasehold land held for own use under operating leases

- (a) Movements in investment properties, other property, plant and equipment and interest in leasehold land held for own use under operating leases comprise:

| | Other property, plant and equipment | | | | | Total \$ million | Interest in leasehold land held for own use \$ million |
|---|--|---|-------------------------|--------------------------------|----------------------------------|---------------------|---|
| | Investment properties \$ million | Tunnels, bridges, roads and permanent way \$ million | Buildings \$ million | Rolling stock \$ million | Other equipment \$ million | | |
| Cost: | | | | | | | |
| At 1 January 2017 | 70 | 29,296 | 31,193 | 12,215 | 22,171 | 94,945 | 5,598 |
| Transfer from construction in progress | – | 119 | 47 | 1,070 | 1,042 | 2,278 | – |
| Additions/(reversal of over-accruals) | – | 3 | – | – | – | 3 | (3) |
| Purchase of ACP by MTRCL | – | – | – | 1 | 58 | 59 | – |
| Disposals | – | (50) | (11) | (108) | (308) | (477) | – |
| Reclassification | – | – | – | – | 4 | 4 | (4) |
| At 31 December 2017 | 70 | 29,368 | 31,229 | 13,178 | 22,967 | 96,812 | 5,591 |
| At 1 January 2018 | 70 | 29,368 | 31,229 | 13,178 | 22,967 | 96,812 | 5,591 |
| Transfer from construction in progress | – | 141 | 167 | 230 | 1,325 | 1,863 | – |
| Additions | – | 6 | – | – | – | 6 | 31 |
| Purchase of ACP by MTRCL | – | – | – | – | 56 | 56 | – |
| Disposals | – | (41) | (9) | (84) | (515) | (649) | – |
| Reclassification | – | – | 38 | 2 | (40) | – | – |
| At 31 December 2018 | 70 | 29,474 | 31,425 | 13,326 | 23,793 | 98,088 | 5,622 |
| Accumulated depreciation, amortisation and impairment: | | | | | | | |
| At 1 January 2017 | 48 | 7,805 | 9,509 | 7,186 | 13,836 | 38,384 | 1,660 |
| Charge for the year | 2 | 698 | 767 | 763 | 931 | 3,161 | 108 |
| Written back on disposals | – | (44) | (5) | (80) | (293) | (422) | – |
| At 31 December 2017 | 50 | 8,459 | 10,271 | 7,869 | 14,474 | 41,123 | 1,768 |
| At 1 January 2018 | 50 | 8,459 | 10,271 | 7,869 | 14,474 | 41,123 | 1,768 |
| Charge for the year | 2 | 703 | 765 | 444 | 906 | 2,820 | 108 |
| Written back on disposals | – | (36) | (5) | (80) | (491) | (612) | – |
| At 31 December 2018 | 52 | 9,126 | 11,031 | 8,233 | 14,889 | 43,331 | 1,876 |
| Carrying amount: | | | | | | | |
| At 31 December 2018 | 18 | 20,348 | 20,394 | 5,093 | 8,904 | 54,757 | 3,746 |
| At 31 December 2017 | 20 | 20,909 | 20,958 | 5,309 | 8,493 | 55,689 | 3,823 |

Notes to the Financial Statements

(Expressed in Hong Kong dollars)

14 Investment properties, other property, plant and equipment and interest in leasehold land held for own use under operating leases (continued)

- (b) Permanent way principally comprises the cost of rail tracks, sleepers, track base and ballast.
- (c) Other equipment comprises lifts and escalators, telecommunication and signalling systems, machinery, furniture and fixtures, motor vehicles and computer and office equipment.
- (d) The minimum total future amounts receivable under non-cancellable operating leases are expected to be received as follows:

| | 2018 \$ million | 2017 \$ million |
|--------------------------------------|----------------------------------|--------------------|
| Within one year | 28 | 35 |
| After one year but within five years | 14 | 27 |
| | 42 | 62 |

- (e) The Group has previously 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 has leased the assets to an overseas investor, who has prepaid all the rentals in relation to a lease agreement. Simultaneously, the Group has leased the assets back from the overseas investor and the commitments to make long-term lease payments as set out in pre-determined schedules have been defeased by the placement of security deposits or by the advance of loans to third parties that are not recognised in the consolidated statement of financial position (see note 3(y)). The Group has 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 to exercise such purchase options. As long as the Group complies with the requirements of the lease agreements, the Group 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 into with investors in the United States.

As at 31 December 2017, a portion of the Group's assets (including assets replaced during the lease periods) with a total cost of \$3,634 million and net book value of \$1,438 million was covered by two arrangements. One of the arrangements involved rolling stock, with a basic lease term of 28 years. The other arrangement involving railway infrastructure had basic lease terms of between 24 years and 27 years from the date of inception. Since the Group retained risks and rewards incidental to ownership of the underlying assets in respect of each arrangement and enjoyed substantially the same rights to their use as before the arrangements were entered into, no adjustment had been made to other property, plant and equipment. As a result of these arrangements, the Group had received cash of \$3,327 million at the inception of the arrangements. Assuming exercise of the purchase option in each arrangement, the obligations to make long-term lease payments over the duration of the relevant leases by the Group were expected to be funded by the proceeds to be generated from existing deposits and investments, which were not recognised in the consolidated statement of financial position, over the relevant lease periods. The total estimated net present value of these obligations at the inception of the arrangements amounted to \$3,156 million. These two arrangements were early terminated during the year ended 31 December 2018.

14 Investment properties, other property, plant and equipment and interest in leasehold land held for own use under operating leases (continued)

- (e) The total net amounts of cash received by the Group from the arrangements were recorded as deferred income and amortised to profit or loss over the applicable lease terms of the arrangements. Upon early termination of these two arrangements, the remaining unamortised deferred income was credited to profit or loss.

Under these lease arrangements, letters of credit were arranged by the Group to secure the lease obligations. In 2012, a letter of credit arranged under one of the lease arrangements expired and the Group acquired other financial assets as replacement to pledge against the lease obligations (see note 20).

- (f) In compliance with IAS 16 and HKAS 16, *Property, plant and equipment* which require an annual review of the estimated useful lives of property, plant and equipment, a review of the estimated useful lives of all major asset categories was undertaken by in-house engineers of MTRCL during the year. As a result, the depreciation charge for the year increased by \$23 million.
- (g) The Group's interest in leasehold land held in Hong Kong under medium-term leases (less than 50 years) amounted to \$3,746 million (2017: \$3,823 million) at 31 December 2018.
- (h) As at 31 December 2018, the Corporation held certain floors of Citylink Plaza at Sha Tin Station as investment properties. The carrying amount and fair value of these investment properties and the level of fair value hierarchy (as defined in note 28(e)) are disclosed as below:

| | Carrying amount at 31 December 2018 \$ million | Fair value at 31 December 2018 \$ million | Fair value measurements as at 31 December 2018 categorised into | | |
|-----------------------|---|--|---|-----------------------|-----------------------|
| | | | Level 1 \$ million | Level 2 \$ million | Level 3 \$ million |
| Investment properties | 18 | 2,113 | - | 2,113 | - |
| | 18 | 2,113 | - | 2,113 | - |

Notes to the Financial Statements

(Expressed in Hong Kong dollars)

14 Investment properties, other property, plant and equipment and interest in leasehold land held for own use under operating leases (continued)

| | Carrying amount at 31 December 2017 \$ million | Fair value at 31 December 2017 \$ million | Fair value measurements as at 31 December 2017 categorised into | | |
|--|---|--|---|-----------------------|-----------------------|
| | | | Level 1 \$ million | Level 2 \$ million | Level 3 \$ million |
| | | | Investment properties | 20 | 2,071 |
| | 20 | 2,071 | – | 2,071 | – |

Valuation techniques and inputs used in Level 2 fair value measurements:

- The fair value of the investment properties was estimated with reference to recent average transaction prices of properties with comparable rental value.

15 Intangible assets

Intangible assets comprise:

| | XRL \$ million |
|----------------------------------|-------------------|
| Cost: | |
| At 1 January 2018 | – |
| Additions | 670 |
| At 31 December 2018 | 670 |
| Accumulated amortisation: | |
| At 1 January 2018 | – |
| Charge for the year | 3 |
| At 31 December 2018 | 3 |
| Net book value: | |
| At 31 December 2018 | 667 |

As at 31 December 2018, the pre-operating costs reimbursable to MTRCL (see note 2) have not yet been finalised and agreed with MTRCL. The accrued amount of \$670 million recognised above represents management's best estimate based on information available to date. The actual costs to be reimbursed by the Corporation are subject to the final result of the ongoing negotiations with MTRCL.

16 Construction in progress

Construction in progress comprises:

| | 2018 \$ million | 2017 \$ million |
|---|--------------------|--------------------|
| Balance at 1 January | 4,402 | 4,295 |
| Costs incurred by the Corporation during the year | 2 | 7 |
| Costs incurred for ACP funded by MTRCL | 2,300 | 2,378 |
| Transfer to other property, plant and equipment | (1,863) | (2,278) |
| Balance at 31 December | 4,841 | 4,402 |

17 Deferred expenditure

(a) Deferred expenditure comprises:

| | 2018 \$ million | 2017 \$ million |
|--------------------------------------|--------------------|--------------------|
| Shatin to Central Link | | |
| Balance at 1 January and 31 December | 1,188 | 1,188 |

- (b) In February 2018, the Government announced that the land or interests or other rights in respect of the land for the operation of the Shatin to Central Link (“the SCL”) be vested in and the movable assets of the SCL be assigned to the Corporation and then operated by MTRCL through a supplemental service concession arrangement. Although the terms of vesting and supplemental service concession arrangements have not yet been agreed and finalised, 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 supplemental service concession arrangement with MTRCL.
- (c) As at 31 December 2018, land related costs totalling approximately \$6 million (2017: \$6 million) directly associated with the acquisition of leasehold land for the purpose of the SCL are included in the balance of deferred expenditure.

Notes to the Financial Statements

(Expressed in Hong Kong dollars)

18 Investments in subsidiaries

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

| Name of company | Place of incorporation and operation | Particulars of issued and paid up capital | Percentage of shares held by the Corporation |
|--------------------------------------|--------------------------------------|---|--|
| Asset leasing | | | |
| Buoyant Asset Limited [^] | Hong Kong | 100 ordinary shares | 100% |
| Kasey Asset Limited [#] | Hong Kong | 100 ordinary shares | 100% |
| Fluent Asset Limited [#] | Hong Kong | 100 ordinary shares | 100% |
| Bowman Asset Limited [*] | Cayman Islands | 1,000 ordinary shares of US\$1 each | 100% |
| Statesman Asset Limited [*] | Cayman Islands | 1,000 ordinary shares of US\$1 each | 100% |

[^] Buoyant Asset Limited was de-registered from the Companies Registry on 11 May 2018.[#] As both Kasey Asset Limited and Fluent Asset Limited would not have any further accounting transactions to be recognised in the financial statements in the coming years, the Companies Registry approved the dormant status of these companies with effect from 1 September 2017.^{*} Bowman Asset Limited and Statesman Asset Limited were struck off from the Registrar of Companies in the Cayman Islands with effect from 31 December 2018.

(b) Details of entities in which the Corporation holds more than half of the issued share capital but does not have control are as follows:

| Name of company | Place of incorporation and operation | Particulars of issued and paid up capital | Percentage of shares held by the Corporation |
|---|--------------------------------------|---|--|
| Property development | | | |
| West Rail Property Development Limited, and its 11 wholly owned subsidiaries [*] | Hong Kong | 51 'A' shares 49 'B' shares | 100% Nil |
| Property management | | | |
| The Metropolis Management Company Limited ^{**} | Hong Kong | 25,500 'A' shares 24,500 'B' shares | 100% Nil |

^{*} These entities are held by the Corporation for the sole purpose of developing commercial or residential properties 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 interest in the net assets of these entities, other than the amount of capital provided.^{**} This entity is held by the Corporation for the sole purpose of rendering property management services to a commercial property. The financial statements are excluded from 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 prior to the Rail Merger now rest with MTRCL although there has been no direct disposition of the shares of MMC to MTRCL.

18 Investments in subsidiaries (continued)

- (c) A summary of consolidated financial information of West Rail Property Development Limited and its subsidiaries based on the management accounts of these companies as of 31 December is as follows:

| | 2018 \$ million | 2017 \$ million |
|--|--------------------|--------------------|
| Assets | 3,555 | 11,418 |
| Liabilities | 762 | 2,063 |
| Equity | 2,793 | 9,355 |
| Turnover | 1,486 | 8,226 |
| Profit after taxation and total comprehensive income for the year | 1,438 | 6,917 |
| Dividend paid | 8,000 | – |

19 Interest in associate

The interest in associate is as follows:

| | 2018 \$ million | 2017 \$ million |
|---------------------|--------------------|--------------------|
| Share of net assets | 376 | 351 |

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

| Name of company | Particulars of issued and paid up capital | Percentage of shares held by the Corporation | Principal activity |
|--------------------------|---|---|---|
| Octopus Holdings Limited | 42,000,000 ordinary shares | 22.1% | Operates a common payment system using Octopus Cards * |

* Octopus Holdings Limited facilitates commuters to use the Octopus Cards for the transportation services along the KCR railway system.

Notes to the Financial Statements

(Expressed in Hong Kong dollars)

19 Interest in associate (continued)

A summary of financial information of the associate based on its consolidated management accounts as of 31 December and a reconciliation of the net assets of the associate to the carrying amount in the consolidated financial statements are as follows:

| | 2018 | | 2017 | |
|---|---|--|---|--|
| | Gross amounts of the associate (100%) \$ million | Group's effective interest (22.1%) \$ million | Gross amounts of the associate (100%) \$ million | Group's effective interest (22.1%) \$ million |
| Assets | 7,206 | 1,593 | 6,667 | 1,473 |
| Liabilities | 5,508 | 1,217 | 5,079 | 1,122 |
| Equity (Net assets) | 1,698 | 376 | 1,588 | 351 |
| Turnover | 1,107 | 245 | 941 | 208 |
| Profit after taxation and total comprehensive income for the year | 380 | 85 | 301 | 67 |
| Dividend paid | 270 | 60 | 230 | 51 |

20 Other financial assets

Other financial assets comprise:

| | 2018 \$ million | 2017 \$ million |
|--|--------------------|--------------------|
| Debt securities measured at amortised cost — unlisted | 557 | 556 |

In 2012, the Group acquired certain financial assets to replace the expired letter of credit arranged under one of the lease arrangements as pledge of the lease obligations (see note 14(e)). The financial assets matured on 31 August 2017 and the Group reinvested the principal proceeds into the same class of financial assets. Upon early termination of the respective lease arrangement during 2018, all these financial assets were released from pledge under the lease arrangement.

Prior to 1 January 2018, debt securities were classified as held-to-maturity investments and measured at amortised cost in accordance with IAS 39 and HKAS 39, *Financial instruments: recognition and measurement*.

21 Interest and other receivables

(a) Interest and other receivables comprise:

| | 2018 \$ million | 2017 \$ million |
|--|--------------------|--------------------|
| Interest receivable relating to deposits with banks and other financial assets | 26 | 15 |
| Net interest receivable relating to derivative financial instruments | 7 | 12 |
| Deposits, prepayments and revenue in arrears | 5 | 8 |
| Amount receivable from MTRCL | 2,473 | 1,991 |
| | 2,511 | 2,026 |

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

| | 2018 \$ million | 2017 \$ million |
|-----------------|--------------------|--------------------|
| Within one year | 2,508 | 2,021 |
| After one year | 3 | 5 |
| | 2,511 | 2,026 |

22 Cash and cash equivalents

Cash and cash equivalents comprise:

| | 2018 \$ million | 2017 \$ million |
|---|--------------------|--------------------|
| Deposits with banks | | |
| – within three months to maturity when placed | 5,357 | 2,786 |
| – more than three months to maturity when placed | 7,370 | 7,476 |
| Cash at bank and in hand | 74 | 17 |
| Cash and cash equivalents in the consolidated statement of financial position | 12,801 | 10,279 |
| Less: deposits with banks with more than three months to maturity when placed | (7,370) | (7,476) |
| Cash and cash equivalents in the consolidated cash flow statement | 5,431 | 2,803 |

Notes to the Financial Statements

(Expressed in Hong Kong dollars)

23 Interest and other payables

(a) Interest and other payables comprise:

| | 2018 \$ million | 2017 \$ million |
|-------------------------------|----------------------------------|--------------------|
| Interest payable | 67 | 67 |
| Deposits and advances | 12 | 12 |
| Creditors and accrued charges | 681 | 6 |
| Amount payable to MTRCL | 205 | – |
| | 965 | 85 |

As at 31 December 2018, accruals for fixed annual payments and the related interest component of \$198 million and pre-operating costs of \$670 million (see note 15) under the Supplemental Service Concession are included in amount payable to MTRCL and creditors and accrued charges above respectively. During the year, the fixed annual payments of \$197 million are presented net of variable annual payments under Concession Income in Note 5.

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

| | 2018 \$ million | 2017 \$ million |
|-----------------|----------------------------------|--------------------|
| Within one year | 752 | 69 |
| After one year | 213 | 16 |
| | 965 | 85 |

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

| | 2018 \$ million | 2017 \$ million |
|---|----------------------------------|--------------------|
| Due within one month or on demand | 24 | 24 |
| Due between three months and six months | 46 | 46 |
| Total interest payable and creditors | 70 | 70 |
| Deposits and advances | 12 | 12 |
| Accrued charges | 678 | 3 |
| Amount payable to MTRCL | 205 | – |
| | 965 | 85 |

24 Accrued charges and provisions for capital projects

The balance includes accrued charges and provisions for claims on land resumption and business losses related to capital projects. Accrued charges will be settled upon certification of work done. Provisions for claims relate to the West Rail and East Rail Extensions projects.

The balance includes an aggregate amount of \$21 million (2017: \$43 million) payable to the Government for accrued charges and provisions for claims in relation to the West Rail, East Rail Extensions and Shatin to Central Link projects. The provisions for claims amounted to \$15 million (2017: \$37 million).

The movement of provisions for claims and accrued charges related to capital projects is as follows:

| | 2018 \$ million | 2017 \$ million |
|--------------------------------------|--------------------|--------------------|
| Provisions for claims | | |
| Balance at 1 January | 37 | 40 |
| Amount utilised | (22) | (3) |
| Balance at 31 December | 15 | 37 |
| Accrued charges | | |
| Balance at 1 January and 31 December | 6 | 6 |
| | 21 | 43 |

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

| | 2018 \$ million | 2017 \$ million |
|-----------------|--------------------|--------------------|
| Within one year | – | 21 |
| After one year | 21 | 22 |
| | 21 | 43 |

Notes to the Financial Statements

(Expressed in Hong Kong dollars)

25 Interest-bearing borrowings

(a) Interest-bearing borrowings comprise:

| | 2018 | | 2017 | |
|--|-------------------------------|--------------------------|-------------------------------|--------------------------|
| | Carrying amount \$ million | Fair value \$ million | Carrying amount \$ million | Fair value \$ million |
| Capital market instruments | | | | |
| HK dollar notes due 2019 – see (c) below | 1,299 | 1,303 | 1,296 | 1,317 |
| HK dollar notes due 2024 – see (c) below | 414 | 437 | 414 | 444 |
| US dollar notes due 2019 – see (c) below | 5,893 | 5,907 | 5,876 | 5,982 |
| HK dollar notes due 2021 – see (c) below | 498 | 517 | 497 | 527 |
| HK dollar notes due 2021 – see (c) below | 746 | 767 | 745 | 777 |
| HK dollar notes due 2019 – see (c) below | 435 | 438 | 435 | 445 |
| | 9,285 | 9,369 | 9,263 | 9,492 |

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

(c) The Corporation issued the following notes under its 2009 US\$3 billion medium term note programme:

| Date of issue | Nominal value | Interest rate | Maturity | Pricing |
|---------------|-----------------|---------------|----------|---------------|
| 28 April 2009 | \$1.3 billion | 3.5% | 2019 | At a discount |
| 15 May 2009 | \$415 million | 4.13% | 2024 | At a discount |
| 18 May 2009 | US\$750 million | 5.125% | 2019 | At a discount |
| 15 June 2009 | \$500 million | 3.88% | 2021 | At a discount |
| 9 July 2009 | \$750 million | 3.82% | 2021 | At a discount |
| 24 July 2009 | \$435 million | 3.64% | 2019 | At a discount |

All the notes issued are unsecured and ranked equally with all of the Corporation's other unsecured senior indebtedness.

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

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

| | 2018 \$ million | 2017 \$ million |
|---------------------------------------|--------------------|--------------------|
| Within one year | 7,627 | – |
| After one year but within two years | – | 7,607 |
| After two years but within five years | 1,244 | 1,242 |
| After five years | 414 | 414 |
| | 9,285 | 9,263 |

26 Deferred income

- (a) The balance of deferred income at 31 December 2018 includes cash received from property developers for property development sites along the Light Rail; 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 ACP funded by MTRCL less related amortisation. Under the property package of the Rail Merger, 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 profit or loss 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 net upfront payment received for the Service Concession and assets and liabilities assumed by MTRCL is being amortised and credited to profit or loss over the Concession Period. The balance relating to ACP is being amortised to profit or loss over the shorter of the useful life of the ACP and the remaining Concession Period.
- (b) Movements in deferred income comprise:

| | 2018 \$ million | 2017 \$ million |
|---|----------------------------------|--------------------|
| Balance at 1 January | 14,301 | 12,574 |
| Net amount paid and payable | (3) | (5) |
| Deferred income relating to ACP funded by MTRCL | 2,356 | 2,437 |
| Recognised in profit or loss | (807) | (705) |
| Balance at 31 December | 15,847 | 14,301 |

- (c) Deferred income is expected to be recognised in profit or loss as follows:

| | 2018 \$ million | 2017 \$ million |
|-----------------|----------------------------------|--------------------|
| Within one year | 722 | 685 |
| After one year | 15,125 | 13,616 |
| | 15,847 | 14,301 |

Notes to the Financial Statements

(Expressed in Hong Kong dollars)

27 Capital, reserves and dividends

(a) Movements in components of equity

The reconciliation between the opening and closing balances of each component of the Group's consolidated equity is set out in the consolidated statement of changes in equity. Details of the changes in the Corporation's individual components of equity between the beginning and the end of the year are set out below:

The Corporation

| | Share capital \$ million | Retained profits \$ million | Total equity \$ million |
|---|-----------------------------|-----------------------------------|-------------------------------|
| Balance at 1 January 2017 | 39,120 | 15,070 | 54,190 |
| Changes in equity for 2017: | | | |
| Total comprehensive income for the year | – | (193) | (193) |
| Balance at 31 December 2017 and 1 January 2018 | 39,120 | 14,877 | 53,997 |
| Changes in equity for 2018: | | | |
| Total comprehensive income for the year | – | 549 | 549 |
| Balance at 31 December 2018 | 39,120 | 15,426 | 54,546 |

- (i) Included in the retained profits of the Group is an amount of \$367 million (2017: \$342 million) being the retained profits attributable to the associate.
- (ii) Pursuant to the relevant provisions of the KCRC 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 accumulated loss at the end of the financial year prior to the year in which the distribution is declared. The fair value changes of financial assets and liabilities, 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 2018, the amount of reserves available for distribution to the sole shareholder amounted to \$15,378 million (2017: \$14,801 million).

27 Capital, reserves and dividends (continued)

(b) Share capital

The Corporation

| | 2018 | | 2017 | |
|-------------------------------|---------------|------------|---------------|------------|
| | No. of shares | \$ million | No. of shares | \$ million |
| 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 |

* The authorised share capital of the Corporation disclosed above is governed by the KCRC Ordinance, which sets out the maximum number of shares which can be allotted and issued by the Corporation.

(c) 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.

Pursuant to the relevant provisions of the KCRC 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.

Notes to the Financial Statements

(Expressed in Hong Kong dollars)

28 Financial risk management and fair values of financial instruments

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

The Managing Board has approved policies in respect of credit risk, interest rate risk, currency 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.

(a) Credit risk

The Group's credit risk is primarily attributable to its 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, in the consolidated statement of financial position.

28 Financial risk management and fair values of financial instruments (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 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.

(ii) Fair value through profit or loss

For interest rate swaps where the hedging relationships do not qualify as fair value hedges or the Corporation does not opt for hedge accounting, changes in their fair values are recognised in profit or loss.

At 31 December 2018, the Group had such interest rate swaps with a notional contract amount of \$1,735 million (2017: \$1,735 million) and net fair value of \$6 million (assets) (2017: \$27 million (assets)), which comprises assets of \$6 million (2017: \$27 million) and liabilities of nil (2017: nil).

(iii) Sensitivity analysis

The sensitivity analysis below indicates the instantaneous change in the Group's profit after taxation (and retained profits) that would arise assuming that a general increase/decrease of 100 basis points (bps) in interest rates had occurred at the end of the reporting period 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 end of the reporting period. In respect of the exposure to cash flow interest rate risk arising from floating rate non-derivative instruments held by the Group at the end of the reporting period, the impact on the Group's profit after taxation (and retained profits) is estimated as an annualised impact on interest expense or income of such a change in interest rates. The analysis is performed on the same basis for 2017.

Notes to the Financial Statements

(Expressed in Hong Kong dollars)

28 Financial risk management and fair values of financial instruments (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 other than the exception mentioned above, on the Group's profit after taxation (and retained profits) is shown below:

| | 2018 | | 2017 | |
|---------------------------|--|------------|--|------------|
| | (Decrease)/increase in profit after taxation | | (Increase)/decrease in loss after taxation | |
| | +100 bps | -100 bps | +100 bps | -100 bps |
| | \$ million | \$ million | \$ million | \$ million |
| Effect on profit or loss: | | | | |
| Interest rate swaps | (2) | 2 | (16) | 16 |
| Currency swaps | - | - | (1) | 1 |
| | (2) | 2 | (17) | 17 |

(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.

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.

28 Financial risk management and fair values of financial instruments (continued)

(c) Currency risk (continued)

(i) Recognised assets and liabilities

Changes in the fair value of currency swaps are recognised in profit or loss. The net fair value of currency swaps used by the Corporation as economic hedges of monetary liabilities in foreign currencies at 31 December 2018 and recognised as net derivative financial assets was \$78 million (2017: \$91 million), comprising assets of \$78 million (2017: \$91 million) and liabilities of nil (2017: nil).

(ii) Fair value through profit or loss

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 exposure at the end of the reporting period to currency risk arising from recognised assets or liabilities denominated in a currency other than the functional currency of the Group.

| | 2018 US dollars million (Expressed in foreign currency) | 2017 US dollars million (Expressed in foreign currency) |
|--------------------------------|--|--|
| Other financial assets | 71 | 71 |
| Interest and other receivables | 5 | 4 |
| Cash and cash equivalents | 44 | 42 |
| Currency swaps | 750 | 750 |
| Interest and other payables | (4) | (4) |
| Interest-bearing borrowings | (750) | (750) |
| Overall net exposure | 116 | 113 |

Notes to the Financial Statements

(Expressed in Hong Kong dollars)

28 Financial risk management and fair values of financial instruments (continued)**(c) Currency risk (continued)**

(iv) Sensitivity analysis

The following table indicates the instantaneous change in the Group's profit after taxation (and retained profits) that would have arisen upon changes to foreign exchange rates to which the Group had exposure at the end of the reporting period, assuming all other risk variables remained constant. Such exposure relates to the portion of United States dollars borrowings, currency swaps, and other assets and liabilities, such as deposits and future contract payments, denominated in foreign currencies.

| | Increase/ (decrease) in foreign exchange rate | 2018 Increase/ (decrease) in profit after taxation \$ million | 2017 Decrease/ (increase) in loss after taxation \$ million |
|------------|--|--|--|
| US dollars | 1% (1%) | 9 (9) | 10 (10) |

Results of the analysis as presented in the above table represent an aggregation of the instantaneous effects on the Group's profit after taxation (and retained profits) measured in the respective functional currencies, translated into Hong Kong dollars at exchange rates, based on direct quotes, prevailing at the end of the reporting period 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 end of the reporting period. The analysis is performed on the same basis for 2017.

(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 manage 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 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 stand-by facilities to cater for short-term liquidity requirements.

28 Financial risk management and fair values of financial instruments (continued)

(d) Liquidity risk (continued)

The following table shows the time periods after the end of the reporting period 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 end of the reporting period (for floating rate instruments), in respect of the Group's non-derivative and derivative financial liabilities which are due to be paid.

| | Contractual undiscounted cash outflow | | | | Total \$ million | Carrying amount at 31 December \$ million |
|-----------------------------|--|---|--|------------------------------------|---------------------|--|
| | 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 | | |
| 2018 | | | | | | |
| Interest and other payables | (752) | (6) | (198) | (9) | (965) | 965 |
| Interest rate swaps | - | - | - | - | - | (6) |
| Currency swaps | | | | | | |
| – outflow | (5,946) | - | - | - | (5,946) | - |
| – inflow | 6,047 | - | - | - | 6,047 | (78) |
| Interest-bearing borrowings | (7,819) | (65) | (1,340) | (423) | (9,647) | 9,285 |
| | (8,470) | (71) | (1,538) | (432) | (10,511) | 10,166 |
| 2017 | | | | | | |
| Interest and other payables | (69) | (4) | (8) | (4) | (85) | 85 |
| Interest rate swaps | - | - | - | - | - | (27) |
| Currency swaps | | | | | | |
| – outflow | (269) | (5,946) | - | - | (6,215) | - |
| – inflow | 302 | 6,036 | - | - | 6,338 | (91) |
| Interest-bearing borrowings | (361) | (7,874) | (1,388) | (441) | (10,064) | 9,263 |
| | (397) | (7,788) | (1,396) | (445) | (10,026) | 9,230 |

Notes to the Financial Statements

(Expressed in Hong Kong dollars)

28 Financial risk management and fair values of financial instruments (continued)

(e) Fair value measurement

(i) Financial assets and liabilities measured at fair value

The following table presents the fair value of the financial instruments measured at the end of the reporting period on a recurring basis, categorised into the three-level fair value hierarchy as defined in IFRS 13 and HKFRS 13, *Fair value measurement*. The level into which a fair value measurement is classified is determined with reference to the observability and significance of the inputs used in the valuation technique as follows:

- Level 1 valuations: Fair value measured using only Level 1 inputs i.e. unadjusted quoted prices in active markets for identical assets or liabilities at the measurement date
- Level 2 valuations: Fair value measured using Level 2 inputs i.e. observable inputs which fail to meet Level 1, and not using significant unobservable inputs. Unobservable inputs are inputs for which market data are not available.
- Level 3 valuations: Fair value measured using significant unobservable inputs

Recurring fair value measurements

| | Fair value at 31 December 2018 \$ million | Fair value measurements as at 31 December 2018 categorised into | | |
|-----------------------------|--|--|-----------------------|-----------------------|
| | | Level 1 \$ million | Level 2 \$ million | Level 3 \$ million |
| Assets | | | | |
| Derivative financial assets | | | | |
| — interest rate swaps | 6 | — | 6 | — |
| — currency swaps | 78 | — | 78 | — |
| | 84 | — | 84 | — |

| | Fair value at 31 December 2017 \$ million | Fair value measurements as at 31 December 2017 categorised into | | |
|-----------------------------|--|--|-----------------------|-----------------------|
| | | Level 1 \$ million | Level 2 \$ million | Level 3 \$ million |
| Assets | | | | |
| Derivative financial assets | | | | |
| — interest rate swaps | 27 | — | 27 | — |
| — currency swaps | 91 | — | 91 | — |
| | 118 | — | 118 | — |

28 Financial risk management and fair values of financial instruments (continued)

(e) Fair value measurement (continued)

(i) Financial assets and liabilities measured at fair value (continued)

Valuation techniques and inputs used in Level 2 fair value measurements:

- The fair value of the 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 end of the reporting period, taking into account prevailing interest rates, foreign exchange rates and creditworthiness of the swap counterparties. Discounted cash flow techniques were used in determining the fair value of swaps.

(ii) Fair values of financial assets and liabilities carried at other than fair value

The carrying amounts of the Group's financial instruments carried at cost or amortised cost are not materially different from their fair values as at 31 December 2018 and 2017 except for the following financial instruments, for which their carrying amounts and fair values and the level of fair value hierarchy are disclosed below:

| | Carrying amount at 31 December 2018 \$ million | Fair value at 31 December 2018 \$ million | Fair value measurements as at 31 December 2018 categorised into | | |
|--------------------------------|---|---|---|-----------------------|-----------------------|
| | | | Level 1 \$ million | Level 2 \$ million | Level 3 \$ million |
| Assets | | | | | |
| Other financial assets | 557 | 541 | 541 | – | – |
| | 557 | 541 | 541 | – | – |
| Liabilities | | | | | |
| Interest-bearing borrowings | (9,285) | (9,369) | – | (9,369) | – |
| | (9,285) | (9,369) | – | (9,369) | – |

Notes to the Financial Statements

(Expressed in Hong Kong dollars)

28 Financial risk management and fair values of financial instruments (continued)

(e) Fair value measurement (continued)

(ii) Fair values of financial assets and liabilities carried at other than fair value (continued)

| | Carrying amount at 31 December 2017 \$ million | Fair value at 31 December 2017 \$ million | Fair value measurements as at 31 December 2017 categorised into | | |
|--------------------------------|---|---|--|-----------------------|-----------------------|
| | | | Level 1 \$ million | Level 2 \$ million | Level 3 \$ million |
| Assets | | | | | |
| Other financial assets | 556 | 541 | 541 | – | – |
| | 556 | 541 | 541 | – | – |
| Liabilities | | | | | |
| Interest-bearing borrowings | (9,263) | (9,492) | – | (9,492) | – |
| | (9,263) | (9,492) | – | (9,492) | – |

Valuation techniques and inputs used in Level 2 fair value measurements:

- The fair value of the interest-bearing borrowings was calculated based on discounted cash flows of expected future principal and interest payments.

29 Notes to the consolidated cash flow statement

(a) Reconciliation of operating profit after depreciation, amortisation and impairment to net cash inflow from operations

| | 2018 \$ million | 2017 \$ million |
|--|--------------------|--------------------|
| Operating profit after depreciation, amortisation and impairment | 782 | 46 |
| Depreciation and amortisation | 2,931 | 3,269 |
| Loss on disposal of property, plant and equipment | 37 | 55 |
| Increase in other receivables | (478) | (145) |
| Decrease in other payables and deferred income | (597) | (699) |
| Net cash inflow from operations | 2,675 | 2,526 |

29 Notes to the consolidated cash flow statement (continued)

(b) Reconciliation of liabilities/(assets) arising from financing activities

The table below details changes in the Group's liabilities from financing activities, including both cash and non-cash changes. Liabilities arising from financing activities are liabilities for which cash flows were, or future cash flows will be, classified in the Group's consolidated cash flow statement as cash flows from financing activities.

| | Interest-bearing borrowings \$ million (note 25) | Derivative financial assets \$ million (note 28(e)) | Interest payable \$ million (note 23(a)) | Interest receivable \$ million (note 21(a)) | Total \$ million |
|--|--|---|--|---|---------------------|
| Carrying amount at 1 January 2018 | 9,263 | (118) | 67 | (12) | 9,200 |
| Changes from financing cash flows: | | | | | |
| Interest paid relating to interest-bearing borrowings | - | - | (431) | - | (431) |
| Net interest received relating to derivative financial instruments | - | - | - | 59 | 59 |
| Total changes from financing cash flows | - | - | (431) | 59 | (372) |
| Exchange adjustments | 12 | - | - | - | 12 |
| Changes in fair value (note 10) | - | 34 | - | - | 34 |
| Other changes: | | | | | |
| Interest expenses (note 9(b)) | 10 | - | 431 | - | 441 |
| Realised gains arising from derivative financial instruments (net) (note 9(a)) | - | - | - | (54) | (54) |
| Total other changes | 10 | - | 431 | (54) | 387 |
| Carrying amount at 31 December 2018 | 9,285 | (84) | 67 | (7) | 9,261 |

Notes to the Financial Statements

(Expressed in Hong Kong dollars)

29 Notes to the consolidated cash flow statement (continued)

(b) Reconciliation of liabilities/(assets) arising from financing activities (continued)

| | Interest-bearing borrowings \$ million (note 25) | Derivative financial assets \$ million (note 28(e)) | Interest payable \$ million (note 23(a)) | Interest receivable \$ million (note 21(a)) | Total \$ million |
|--|--|---|--|---|---------------------|
| Carrying amount at 1 January 2017 | 9,208 | (166) | 67 | (12) | 9,097 |
| Changes from financing cash flows: | | | | | |
| Interest paid relating to interest-bearing borrowings | – | – | (427) | – | (427) |
| Net interest received relating to derivative financial instruments | – | – | – | 63 | 63 |
| Total changes from financing cash flows | – | – | (427) | 63 | (364) |
| Exchange adjustments | 45 | – | – | – | 45 |
| Changes in fair value (note 10) | – | 48 | – | – | 48 |
| Other changes: | | | | | |
| Interest expenses (note 9(b)) | 10 | – | 427 | – | 437 |
| Realised gains arising from derivative financial instruments (net) (note 9(a)) | – | – | – | (63) | (63) |
| Total other changes | 10 | – | 427 | (63) | 374 |
| Carrying amount at 31 December 2017 | 9,263 | (118) | 67 | (12) | 9,200 |

30 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, Shatin to Central Link, Kowloon Southern Link and the Hong Kong Section of the Guangzhou-Shenzhen-Hong Kong Express Rail Link which are considered to be related party transactions under IAS 24 and HKAS 24, *Related party disclosures* and these are disclosed in notes 1, 3(c), (i) and (k), 6, 17(b) and (c), 18 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 key management who are not Members of the Managing Board 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 7 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), (k), (n), (x) and (aa), 5, 6, 9(b), 14, 15, 16, 18, 21, 23 and 26 to the financial statements.

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 the 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 the 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.
- (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 operation of the East Rail Extensions and related services and facilities.
- (iii) The Corporation accepted an offer from the Government to allow the Corporation to proceed with the development of the sites at Ho Tung Lau, Wu Kai Sha and Tai Wai Maintenance Centre in March 2003, October 2005 and July 2006 respectively.

Notes to the Financial Statements

(Expressed in Hong Kong dollars)

31 Corporation statement of financial position

at 31 December 2018

| | Note | 2018 \$ million | 2017 \$ million |
|--|-------|--------------------|--------------------|
| Assets | | | |
| Investment properties and other property, plant and equipment | | 54,757 | 55,689 |
| Interest in leasehold land held for own use under operating leases | | 3,746 | 3,823 |
| Intangible assets | | 667 | – |
| Construction in progress | | 4,841 | 4,402 |
| Deferred expenditure | | 1,188 | 1,188 |
| Interest in associate | | 9 | 9 |
| Derivative financial assets | | 84 | 118 |
| Other financial assets | | 557 | 556 |
| Interest and other receivables | | 2,511 | 2,026 |
| Cash and cash equivalents | | 12,801 | 10,279 |
| | | 81,161 | 78,090 |
| Liabilities | | | |
| Interest and other payables | | 965 | 85 |
| Accrued charges and provisions for capital projects | | 21 | 43 |
| Interest-bearing borrowings | | 9,285 | 9,263 |
| Deferred income | | 15,847 | 14,301 |
| Deferred tax liabilities | | 497 | 401 |
| | | 26,615 | 24,093 |
| Net Assets | | 54,546 | 53,997 |
| Capital and Reserves | | | |
| Share capital | 27(b) | 39,120 | 39,120 |
| Reserves | 27(a) | 15,426 | 14,877 |
| Total Equity | | 54,546 | 53,997 |

Approved and authorised for issue by the Managing Board on 4 April 2019

James H. Lau Jr.

Chairman of the Managing Board

Wallace Lau Ka-ki

Member of the Managing Board

Edmund K H Leung

Chief Officer

32 Outstanding commitments

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

| | 2018 \$ million | 2017 \$ million |
|--|--------------------|--------------------|
| Property, plant and equipment — authorised but not contracted for | 384 | 374 |
| Balance at 31 December | 384 | 374 |

The above commitments include a capped cost of \$350 million to be borne by the Corporation in respect of park and ride facilities associated with a property development project being undertaken by a subsidiary of West Rail Property Development Limited.

33 Retirement benefit scheme

The Group operates a Mandatory Provident Fund Scheme (“MPF Scheme”) under the Hong Kong Mandatory Provident Fund Schemes Ordinance. The MPF Scheme is a defined contribution retirement plan administered by independent trustees. Under the MPF Scheme, the employer and its employees are required to make contributions to the plan at 5% of the employees’ relevant income, subject to a cap of monthly relevant income of \$30,000.

34 Debt facilities

(a) Total unutilised debt facilities available to the Group comprise:

| | 2018 \$ million | 2017 \$ million |
|--|--------------------|--------------------|
| Short-term uncommitted revolving credit facilities | 400 | 400 |
| Overdraft facilities | 30 | 30 |
| Letters of credit for leveraged leases | — | 471 |
| | 430 | 901 |

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

| | 2018 \$ million | 2017 \$ million |
|----------------------------|--------------------|--------------------|
| Floating rate | | |
| — expiring within one year | 430 | 430 |
| — expiring after one year | — | 471 |
| | 430 | 901 |

Notes to the Financial Statements

(Expressed in Hong Kong dollars)

35 Contingent liabilities

At 31 December 2018, the Group had contingent liabilities arising from the land resumption claims and certain contractors' claims in respect of the construction of the West Rail and East Rail Extensions projects. The Group has made provisions in the financial statements at 31 December 2018 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. The details of the provisions are set out in note 24 to the financial statements.

36 Impairment of railway assets and intangible assets

At 31 December 2018, 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 2017. The Group assessed whether there was any indication of impairment of the Group's intangible assets by estimating the recoverable amount based on projections of future cash flows from the operation of the XRL at a discount rate that reflects current market assessments of the time value of money and the risks specific to the assets.

As a result of this assessment, management considers that no indication of impairment of the railway assets and intangible assets of the Group exists at 31 December 2018 and, accordingly, that no provision for impairment of the Group's railway assets and intangible assets is required at that date.

37 Accounting estimates and judgements

(a) Key sources of estimation uncertainty

Note 28 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 property, plant and equipment (see note 3(j)), assessment of provisions and contingent liabilities (see notes 3(w), 24 and 35), determination of the recoverability of deferred tax assets (see note 11(c)), assessment of the recoverability of costs incurred in relation to the Shatin to Central Link project (see note 17(b)), estimation of pre-operating costs incurred by MTRCL for the planning and commissioning of the XRL and most likely to be reimbursed by the Corporation (see note 15) and assessment of the outstanding risks 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(l)(i) and (y)), transfers from construction in progress to property, plant and equipment (see note 3(n)), assessment of controlled subsidiaries and non-controlled entities (see note 3(c)), the categorisation of financial assets and liabilities and impairment of railway assets and intangible 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 2018

Up to the date of issue of these financial statements, the IASB and HKICPA have issued a few amendments, new standards and interpretations which are not yet effective for the year ended 31 December 2018 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 interpretations is expected to be in the period of initial application. So far the Group has concluded that the adoption of them is unlikely to have a significant impact on the Group's results of operations and financial position. While the assessment has been substantially completed for IFRS 16 and HKFRS 16, the actual impacts upon the initial adoption of the standards may differ as the assessment completed to date is based on the information currently available to the Group, and further impacts may be identified before the standards are initially applied in the Group's financial statements for the year ending 31 December 2019. The Group may also change its accounting policy elections, including the transition options, until the standards are initially applied in that financial report.

The following developments may result in new or amended disclosures in the financial statements:

| | Effective for accounting periods beginning on or after |
|--|---|
| IFRS 16 and HKFRS 16, <i>Leases</i> | 1 January 2019 |
| IFRIC 23 and HK(IFRIC) 23, <i>Uncertainty over income tax treatments</i> | 1 January 2019 |
| Annual Improvements to IFRSs 2015-2017 Cycle and HKFRSs 2015-2017 Cycle | 1 January 2019 |
| Amendments to IAS 28 and HKAS 28, <i>Long-term interest in associates and joint ventures</i> | 1 January 2019 |

Five-Year Statistics

| FINANCIAL (HK\$ million) | 2018 | 2017 | 2016 | 2015 | 2014 |
|---|---------------|--------|--------|--------|--------|
| Statement of Comprehensive Income | | | | | |
| Turnover | 3,792 | 3,412 | 3,147 | 2,902 | 2,647 |
| Operating profit before depreciation, amortisation and impairment | 3,750 | 3,370 | 3,095 | 2,863 | 2,610 |
| Net interest and finance expenses | 163 | 301 | 316 | 312 | 351 |
| Profit/(loss) before unrealised gains/losses | 704 | (188) | (372) | (509) | (805) |
| Profit/(loss) after unrealised gains/losses and taxation | 574 | (177) | (280) | (460) | (615) |
| Statement of Financial Position | | | | | |
| Investment properties, other property, plant and equipment and interest in leasehold land held for own use under operating leases | 58,503 | 59,512 | 60,499 | 62,382 | 64,715 |
| Intangible assets | 667 | – | – | – | – |
| Construction in progress | 4,841 | 4,402 | 4,295 | 3,371 | 2,164 |
| Deferred expenditure | 1,188 | 1,188 | 1,188 | 1,188 | 1,188 |
| Other financial assets | 557 | 556 | 552 | 552 | 552 |
| Cash and cash equivalents | 12,801 | 10,279 | 7,977 | 7,358 | 6,381 |
| Other assets | 2,971 | 2,495 | 2,376 | 2,206 | 2,097 |
| Total assets | 81,528 | 78,432 | 76,887 | 77,057 | 77,097 |
| Interest-bearing borrowings | 9,285 | 9,263 | 9,208 | 10,695 | 11,690 |
| Deferred tax liabilities | 497 | 401 | 460 | 542 | 659 |
| Deferred income | 15,847 | 14,301 | 12,574 | 10,892 | 9,119 |
| Other liabilities | 986 | 128 | 129 | 132 | 373 |
| Total liabilities | 26,615 | 24,093 | 22,371 | 22,261 | 21,841 |
| Total equity | 54,913 | 54,339 | 54,516 | 54,796 | 55,256 |
| Key financial data | | | | | |
| Return on equity (%) | 1 | – | (1) | (1) | (1) |
| Debt / equity ratio | 1:5.9 | 1:5.9 | 1:5.9 | 1:5.1 | 1:4.7 |
| Debt to total capitalisation (%) | 14 | 15 | 14 | 16 | 17 |
| Interest cover (times) | 9.1 | 7.6 | 7.4 | 6.8 | 5.4 |



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