Notes to the unaudited interim financial report

1 Basis of preparation

This interim financial report is unaudited, but has been reviewed by KPMG in accordance with Statement of Auditing Standards 700 "Engagements to review interim financial reports", issued by the Hong Kong Society of Accountants ("HKSA"). KPMG's independent review report to the Board of Directors is set out on page 28. In addition, this interim financial report has been reviewed by the Company's Audit Committee.

This interim financial report has been prepared in accordance with the requirements of the Main Board Listing Rules of The Stock Exchange of Hong Kong Limited, including compliance with Statement of Standard Accounting Practice ("SSAP") 25 (revised) "Interim financial reporting" issued by the HKSA.

The financial information relating to the financial year ended 31 December 2002 included in the interim financial report does not constitute the Company's statutory accounts for that financial year but is derived from those accounts. Statutory accounts for the year ended 31 December 2002, on which the auditors have expressed an unqualified opinion on those accounts in their report dated 6 March 2003, are available from the Company's registered office.

The same accounting policies adopted in the 2002 annual accounts have been applied to the interim financial statements except as disclosed under Note 16 below.

The notes on the interim financial report include an explanation of events and transactions that are significant to an understanding of the changes in financial position and performance of the Group since the issuance of the 2002 annual accounts.

2 Profit on property developments

Profit on property developments includes cost of properties sold of HK$43 million *(2002: HK$64 million)*.

3 Change in depreciation rates

Depreciation for the half-year period ended 30 June 2003 includes charges relating to assets capitalised upon commissioning of the Tseung Kwan O Line in August 2002.

In accordance with the Company's policy to conduct asset life review at regular intervals, a review of the estimated useful lives of the Company's fixed assets was carried out during the period, taking into account the assets' actual condition, level of technical obsolescence, future maintenance and replacement programmes as well as depreciation lives adopted by international rail transportation companies. As a result of the review, the estimated useful lives of certain assets were extended whilst those of others reduced. The changes took effect from 1 January 2003 with the following resultant financial effects for the half-year period:

	Typical useful life within asset category		Net decrease / (increase) in depreciation charge
Asset category	Original life (years)	Revised life (years)	(HK$ million)
Rolling stock	10–40	7–40	14
Power supply systems	20–30	20–40	33
Station architectural finishes	20–25	20–30	32
Fixture and fitting	10	10–15	12
Automatic fare collection systems	15	20	6
Fire protection and drainage systems	20–25	20–30	11
Station announcement and telecommunication systems	10	15	15
Computer software licences and applications	7	5–7	(5)
			118

4 Dividends

in HK$ million	**Half-year ended 30 June 2003**	Half-year ended 30 June 2002
Dividend paid		
2002 final dividend of 28 cents *(2001: 28 cents)* per share approved and paid in 2003	**1,444**	1,415
Dividend declared		
Interim dividend declared after the balance sheet date of 14 cents *(2002: 14 cents)* per share	**734**	717

5 Earnings per share

The calculation of basic earnings per share is based on the profit for the half-year period ended 30 June 2003 attributable to shareholders of HK$113 million *(2002: HK$1,612 million, as restated)* and the weighted average number of ordinary shares of 5,167,723,476 in issue during the period *(2002: 5,062,329,930)*.

The calculation of diluted earnings per share is based on the profit for the half-year period ended 30 June 2003 attributable to shareholders of HK$113 million *(2002: HK$1,612 million, as restated)* and the weighted average number of ordinary shares of 5,168,873,569 *(2002: 5,072,272,412)* after adjusting for the number of dilutive potential ordinary shares under the employee share option scheme calculated as follows:

	Half-year ended 30 June 2003	Half-year ended 30 June 2002
Weighted average number of ordinary shares used in calculating basic earnings per share	**5,167,723,476**	5,062,329,930
Number of ordinary shares deemed to be issued for no consideration	**1,150,093**	9,942,482
Weighted average number of ordinary shares used for calculating the diluted earnings per share	**5,168,873,569**	5,072,272,412

6 Taxation

Income tax for the period comprises current and deferred taxes.

Taxation in the consolidated profit and loss account represents:

in HK$ million	**Half-year ended 30 June 2003 (Unaudited)**	Half-year ended 30 June 2002 (Unaudited)
Deferred tax expense relating to the origination and reversal of temporary differences (Note 16A)	**75**	251
Deferred tax expense resulting from increase in tax rate on deferred tax balances at 1 January	**300**	–
	375	251
Share of deferred tax of non-controlled subsidiary	**–**	2
	375	253

No provision for current Hong Kong profits tax has been made in the consolidated profit and loss account in respect of the Company and its subsidiaries, as the Company and its subsidiaries either have substantial accumulated tax losses brought forward which are available for set off against current period's assessable profits or have tax losses for the period ended 30 June 2003.

Deferred tax provided is based on the expected manner of realisation or settlement of the carrying amount of the assets and liabilities, using tax rates enacted or substantially enacted at the balance sheet date. In March 2003, the Hong Kong Government announced an increase in the Profits Tax rate applicable to the Group's operations in Hong Kong from 16% to 17.5%, which was passed by the Legislative Council in July 2003. This increase is taken into account in the preparation of the Group's 2003 Interim Financial Report.

7 Segmental information

The Group's results of major business activities for the half-year ended 30 June 2003, with comparative figures for the half-year ended 30 June 2002, are summarised below:

in HK$ million	Railway operations	Station commercial and other businesses	Property ownership and management	Total railway operations and related activities	Property developments	Total
Half-year ended 30 June 2003 (Unaudited)						
Revenue	2,567	512	488	3,567	–	3,567
Less: Operating expenses before depreciation	1,371	135	90	1,596	–	1,596
	1,196	377	398	1,971	–	1,971
Profit on property developments	–	–	–	–	678	678
Operating profit before depreciation	1,196	377	398	1,971	678	2,649
Less: Depreciation	1,126	55	1	1,182	–	1,182
	70	**322**	**397**	**789**	**678**	1,467
Unallocated corporate expenses						(168)
Interest and finance charges (net)						(824)
Share of profit of non-controlled subsidiary						11
Taxation						(375)
Minority interests						2
Profit for the period ended 30 June 2003						**113**
Half-year ended 30 June 2002 (Unaudited)						
Revenue	2,752	473	491	3,716	–	3,716
Less: Operating expenses before depreciation	1,303	85	75	1,463	–	1,463
	1,449	388	416	2,253	–	2,253
Profit on property developments	–	–	–	–	1,314	1,314
Operating profit before depreciation	1,449	388	416	2,253	1,314	3,567
Less: Depreciation	1,085	44	1	1,130	–	1,130
	364	344	415	1,123	1,314	2,437
Unallocated corporate expenses						(212)
Interest and finance charges (net)						(380)
Share of profit of non-controlled subsidiary						20
Taxation						(253)
Profit for the period ended 30 June 2002						1,612

No geographical analysis is shown as substantially all the principal activities of the Group are carried out in Hong Kong.

Profit on property developments for the half-years ended 30 June 2002 and 2003 were mainly recognised from the deferred income account.

8 Investments in subsidiaries

The following are new subsidiary companies established or acquired during the half-year ended 30 June 2003:

Name of company	Issued and paid up ordinary / registered share capital	Proportion of ownership interest: Group's effective interest	Held by the Company	Held by subsidiary	Place of incorporation and operation	Principal activities
MTR Finance Lease (001) Limited	US$1,000	100%	100%	–	Cayman Islands	Finance
Beijing Premier Property Management Co. Ltd.	US$150,000	60%	–	60%	The People's Republic of China (Incorporated)	Property management

On 1 June 2003, the Company increased its investment in TraxComm Limited ("TraxComm"), a wholly-owned subsidiary, by subscribing 14,999,000 ordinary shares in TraxComm at a consideration of HK$14,999,000. The additional capital raised by TraxComm was used for acquisition of assets and to provide general working capital.

9 Debtors, deposits and payments in advance

The Group's credit policy in respect of receivables arising from its principal activities is as follows:

i Rentals, advertising and telecommunications fees are billed monthly with due dates ranging from 7 to 50 days. Tenants of the Group's investment properties and station kiosks are required to pay three months' rental deposit upon the signing of lease agreements.

ii Amounts receivable under interest rate swap and currency swap agreements with financial institutions are due in accordance with the respective terms of the agreements.

iii Debtors in relation to capital works entrusted to the Group, subject to any agreed retentions, are due within 21 days upon the certification of work in progress.

The ageing of debtors relating to the above activities is analysed as follows:

in HK$ million	**At 30 June 2003 (Unaudited)**	At 31 December 2002 (Audited)
Amount not yet due	**503**	548
Overdue by 30 days	**60**	82
Overdue by 60 days	**8**	10
Overdue by 90 days	**5**	4
Overdue by more than 90 days	**6**	13
Total debtors	**582**	657
Deposits and payments in advance	**82**	70
	664	727

10 Creditors, accrued charges and provisions

Creditors, accrued charges and provisions are mainly related to capital projects which are settled upon certification of work in progress and swap interest payable. The Group has no significant balances of trade creditors resulting from its provision of transportation services.

The analysis of creditors by due dates is as follows:

in HK$ million	**At 30 June 2003 (Unaudited)**	At 31 December 2002 (Audited)
Due within 30 days or on demand	**465**	547
Due after 30 days but within 60 days	**595**	667
Due after 60 days but within 90 days	**53**	50
Due after 90 days	**2,140**	2,043
	3,253	3,307
Rental and other refundable deposits	**600**	295
Accrued employee benefits	**161**	158
Total	**4,014**	3,760

11 Bonds and notes issued

Bonds and notes issued by the Group during the half-years ended 30 June 2003 and 2002 comprise:

	Half-year ended 30 June 2003		Half-year ended 30 June 2002	
	Principal amount	Net consideration received	Principal amount	Net consideration received
in HK$ million	**(Unaudited)**		(Unaudited)	
Debt issuance programme notes	**1,600**	**1,593**	–	–
HK dollar retail bonds	**–**	**–**	3,500	3,553
	1,600	**1,593**	3,500	3,553

The notes and retail bonds issued during the half-years ended 30 June 2003 and 2002 were issued by a subsidiary, MTR Corporation (C.I.) Limited. The bonds and notes issued are unconditionally and irrevocably guaranteed by the Company, are direct, unsecured, unconditional and unsubordinated to other unsecured and unsubordinated obligations of MTR Corporation (C.I.) Limited. The obligations of the Company under the guarantee are direct, unsecured, unconditional, and unsubordinated to other unsecured and unsubordinated obligations of the Company. The net proceeds from the issues were on lent to the Company for general working capital, refinancing or other corporate purposes.

12 Share capital, share premium and capital reserve

in HK$ million	**At 30 June 2003 (Unaudited)**	At 31 December 2002 (Audited)
Authorised:		
6,500,000,000 shares of HK$1.00 each	**6,500**	6,500
Issued and fully paid:		
5,242,553,821 shares *(2002: 5,158,748,655 shares)* of HK$1.00 each	**5,243**	5,159
Share premium	**2,216**	1,563
Capital reserve	**27,188**	27,188
	34,647	33,910

Pursuant to the Articles of Association of the Company, the capital reserve can only be applied in paying up in full unissued shares to be allotted and distributed as fully paid bonus shares to the shareholders of the Company.

Share premium represents the amount by which the issue price of shares exceeds the par value of those shares. The application of the share premium account is governed by section 48B of the Hong Kong Companies Ordinance.

New shares issued and fully paid up during the period comprise:

			Proceeds credited to		
	Number of shares	Option / scrip price *HK$*	Share capital account *HK$ million*	Share premium account *HK$ million*	Total *HK$ million*
Employee share options exercised	1,786,500	8.44	2	13	15
Issued as 2002 final scrip dividends	82,018,666	8.80	82	640	722
	83,805,166		84	653	737

During the half-year ended 30 June 2003, 417,000 options to subscribe for shares were vested and 1,786,500 share options previously vested have been exercised. The weighted average closing price in respect of the share options exercised during the period was HK$9.24 per share. In addition, 886,500 share options lapsed as a result of the resignation of certain option holders during the period. As at 30 June 2003, total options to subscribe for 34,090,500 shares remained outstanding. Details of the movements in respect of the Employee Share Option Scheme during the half-year ended 30 June 2003 are set out under the Corporate Governance and Other Information section on page 12.

13 Other reserves

in HK$ million	Investment property revaluation reserve	Fixed asset revaluation reserve	Retained profits	Total
30 June 2003 (Unaudited)				
Balance as at 1 January 2003 as previously reported	**6,406**	**24**	**16,487**	**22,917**
Prior period adjustments in respect of deferred tax (Note 16A)	**–**	**–**	**(3,253)**	**(3,253)**
Balance as at 1 January 2003 as restated	**6,406**	**24**	**13,234**	**19,664**
Dividend paid	**–**	**–**	**(1,444)**	**(1,444)**
Profit for the period	**–**	**–**	**113**	**113**
Balance as at 30 June 2003	**6,406**	**24**	**11,903**	**18,333**
31 December 2002 (Audited)				
Balance as at 1 January 2002 as previously reported	6,518	116	14,407	21,041
Prior period adjustments in respect of deferred tax (Note 16A)	–	–	(2,620)	(2,620)
Balance as at 1 January 2002 as restated	6,518	116	11,787	18,421
Dividends paid	–	–	(2,132)	(2,132)
Deficit on revaluation	(112)	(92)	–	(204)
Profit for the year, as restated	–	–	3,579	3,579
Balance as at 31 December 2002	6,406	24	13,234	19,664

The investment property and fixed asset revaluation reserves are not available for distribution to shareholders because they do not constitute realised profits. As at 30 June 2003, the total amount of reserves available for distribution to shareholders under the Hong Kong Companies Ordinance amounted to HK$11,751 million *(2002: HK$13,104 million, as restated)*.

14 Material related party transactions

The Financial Secretary Incorporated, which holds approximately 76% of the Company's issued share capital on trust for the Government of the Hong Kong SAR, is the majority shareholder of the Company. Transactions between the Group and Government departments, agencies or Government controlled entities, other than those transactions arising in the normal dealings between the Government and the Group, are considered to be related party transactions pursuant to SSAP 20 "Related party disclosures" and are identified separately in this interim financial report.

The Group has had the following material transactions with Government and other related parties during the half-year ended 30 June 2003:

in HK$ million	Balance at 1 January 2003 (Audited)	Increased / (Decreased)	**Balance at 30 June 2003 (Unaudited)**
Amount due from related parties in respect of infrastructure entrustment works:			
– the Government	57	63	**120**
– the Housing Authority	30	(12)	**18**
– the Kowloon-Canton Railway Corporation	8	(5)	**3**
	95	46	**141**
Amount due to related parties in respect of railway project works entrusted to:			
– the Government	129	(14)	**115**
– the Airport Authority	76	(22)	**54**
Amount due to non-controlled subsidiary	4	(1)	**3**
	209	(37)	**172**

in HK$ million	**Half-year ended 30 June 2003 (Unaudited)**	Half-year ended 30 June 2002 (Unaudited)
Dividend paid to Government	**1,100**	1,084

During the half-year ended 30 June 2003, the Group also had the following transactions with its non-controlled subsidiary, Octopus Cards Limited ("OCL"):

in HK$ million	**Half-year ended 30 June 2003 (Unaudited)**	Half-year ended 30 June 2002 (Unaudited)
Payment to OCL in respect of central clearing services	**21**	21
Fees received from OCL in respect of load agency services and management services	**6**	5

15 Capital commitments

i Outstanding capital commitments as at 30 June 2003 not provided for in the accounts were as follows:

in HK$ million	Railway operations	Penny's Bay Rail Link and Tung Chung Cable Car Projects	Property development projects	Total
At 30 June 2003 (Unaudited)				
Authorised but not yet contracted for	**649**	**–**	**1,884**	**2,533**
Authorised and contracted for	**1,079**	**889**	**74**	**2,042**
	1,728	**889**	**1,958**	**4,575**
At 31 December 2002 (Audited)				
Authorised but not yet contracted for	499	–	1,934	2,433
Authorised and contracted for	1,321	1,017	67	2,405
	1,820	1,017	2,001	4,838

Included in the amounts authorised but not yet contracted for are costs that will not be subject to construction contracts such as staff costs, overhead expenses and capitalised interest.

ii The commitments under railway operations comprise the following:

in HK$ million	Improvement and enhancement works	Acquisition of property, plant and equipment	Total
At 30 June 2003 (Unaudited)			
Authorised but not yet contracted for	**399**	**250**	**649**
Authorised and contracted for	**522**	**557**	**1,079**
	921	**807**	**1,728**
At 31 December 2002 (Audited)			
Authorised but not yet contracted for	338	161	499
Authorised and contracted for	665	656	1,321
	1,003	817	1,820

iii Commitments in respect of jointly controlled operations have been included in the commitments for Property Development Projects above and were as follows:

in HK$ million	**At 30 June 2003 (Unaudited)**	At 31 December 2002 (Audited)
Authorised but not yet contracted for	**1,884**	1,931
Authorised and contracted for	**65**	57
	1,949	1,988

16 Adoption of new accounting policies

A Deferred tax

The Hong Kong Society of Accountants issued SSAP 12 "Income taxes" in August 2002, which supercedes the previous SSAP 12 "Accounting for deferred taxes". The new standard became effective for accounting period beginning on or after 1 January 2003. The Group has therefore adopted the new standard for preparation of the Group's financial statements for the half-year ended 30 June 2003.

The new SSAP 12 requires deferred tax assets and liabilities to be provided in full using the liability method, on temporary differences arising between the tax base of an asset or a liability and its carrying value in the financial statements at the balance sheet date. Deferred tax assets or liabilities arising from temporary differences need to be measured at the tax rates enacted or substantially enacted by the balance sheet date. The principal temporary differences in respect of the Company arise from depreciation of fixed assets, various expense provisions and tax losses carried forward.

Deferred tax liabilities are provided in full on all taxable temporary differences while deferred tax assets are recognised to the extent that it is probable that future taxable profit will be available against which the deductible temporary difference can be utilised.

In accordance with the already repealed old SSAP 12, the Group had previously adopted a policy not to provide for deferred taxation on timing differences unless they are expected to crystallise in the foreseeable future. Adoption of the new SSAP 12 therefore constituted a change in accounting policy and pursuant to SSAP 2 (which outlines the disclosure requirements when a change in accounting policy has a material effect on the current or prior periods presented), the Group has retrospectively restated the opening balances of the retained profits as at 1 January 2002 and 2003. The previously reported net profit for the six-month ended 30 June 2002 and for the year ended 31 December 2002 have also been adjusted to reflect movements in the deferred income taxes account during the period. These effects are summarised as follows:

		Net movements in deferred income taxes		
in HK$ million	Balance as at 1 January 2002	6 months ended 30 June 2002	6 months ended 31 December 2002	Balance as at 1 January 2003
Retained profit as previously reported	14,407			16,487
Prior period adjustments in respect of:				
Deferred tax	(2,622)	(251)	(379)	(3,252)
Share of non-controlled subsidiary's deferred tax	2	(2)	(1)	(1)
Retained profit as restated	11,787			13,234

B Lease out and lease back transactions

In March 2003, the Group entered into a series of structured transactions with unrelated third parties to lease out and lease back certain of its passenger cars (Lease Transaction) involving a total original cost of HK$2,562 million and a total net book value of HK$1,674 million as at 31 March 2003. Under the Lease Transaction, the Group has leased the assets to institutional investors in the United States (the "Investors"), who have prepaid all the rentals in relation to the lease agreement. Simultaneously, the Group has leased the assets back from the Investors and will pay rentals in accordance with a pre-determined payment schedule. The Group has an option to purchase the Investors' leasehold interest in the assets at a pre-determined dates for fixed amounts. Part of the rental prepayments received from the Investors has been placed in debt securities which will be sufficient to meet the Group's rental obligations and the amount payable for exercising the purchase option under the Lease Transaction. Subject to certain events of default under the Lease Transaction, the Group retains legal title to the assets, and there are no restrictions on the Group's ability to utilise these assets in the operation of the railway business.

As a result of the Lease Transaction, the Group received total cash of approximately HK$3,688 million and committed to long-term lease payments with an estimated net present value of approximately HK$3,533 million, which have been defeased by purchase of debt securities to meet the payment obligations. The Group received net cash amount of HK$141 million from the Lease Transaction.

As the long-term lease obligations have been defeased by the placement of securities, the transactions are not accounted for as leases and those liabilities and investments in debt securities are not recognised as obligations and assets of the Group. The net amount of cash received by the Group has been accounted for as deferred income and is being amortised to the Group's profit and loss account over the terms of the respective leases.

17 Post balance sheet event

On 15 July 2003, the practical completion certificate in respect of the property which represents the Company's share of profit in kind in Two International Finance Centre was issued. According to the Company's accounting policy, this represents the official handover of the property to the Company and the related property development profit is required to be recognised in its profit and loss account on that date. The receipt is expected to generate a net profit of approximately HK$3 billion, which will be reflected in the Company's accounts in the second half of 2003.

18 Comparative figures

Comparative figures have been restated and reclassified based on the requirement of the new accounting standard as set out in note 16 in the interim financial report.

19 Approval of interim financial report

The interim financial report was approved by the Board on 31 July 2003.