

# Corporate governance report

## Corporate Governance Practices

The Company is committed to ensuring high standards of corporate governance in the interests of shareholders and devotes considerable effort to identifying and formalising best practices. This Report describes how the Company has applied the principles of the Code on Corporate Governance Practices (the "Code") contained in Appendix 14 of the Listing Rules.

The Company has complied throughout the year ended 31 December 2005 with the Code Provisions except that, with respect to Code Provision A.4.1, non-executive Directors of the Company are not appointed for a specific term but are subject (save for those appointed pursuant to Section 8 of the MTR Ordinance) to retirement by rotation and re-election at the Company's annual general meetings in accordance with Articles 87 and 88 of the Company's Articles of Association. As there are currently nine Directors subject to the requirement to retire by rotation, and one-third of them shall retire at each annual general meeting of the Company (subject to re-election by the shareholders), each of these Directors is effectively appointed for a term of approximately three years.

## The Board of Directors

The overall management of the Company's business is vested in the Board. Pursuant to the Articles of Association and the Protocol adopted by the Board, the Board has delegated the day-to-day management of the Company's business to the Executive Directorate, and focuses its attention on matters affecting the Company's overall strategic policies, finances and shareholders. These include financial statements, dividend policy, significant changes in accounting policy, annual operating budget, certain material contracts, strategies for future growth, major financing arrangements and major investments, risk management strategies, treasury policies and fare structures.

The Board comprises 11 members, consisting of one executive Director (the Chief Executive Officer) and ten non-executive Directors, of whom six are independent non-executive Directors. In this regard, the Company exceeds the requirement of the Listing Rules which requires every board of directors of a listed issuer to have at least three independent non-executive directors. Following the Board's decision to split the roles of Chairman and Chief Executive Officer, Dr. Raymond Ch'ien Kuo-fung, already a Member of the Board, was appointed non-executive Chairman for three years with effect from 21 July 2003, and Mr. Chow Chung-kong was appointed Chief Executive Officer and a Member of the Board on

1 December 2003. Two of the other non-executive Directors (being the Secretary for the Environment, Transport and Works and the Commissioner for Transport) are appointed by the Chief Executive of the HKSAR. Another non-executive Director, Mr. Frederick Ma Si-hang, is the Secretary for Financial Services and the Treasury of the Government of the HKSAR. The Government of the HKSAR through The Financial Secretary Incorporated, holds approximately 76% of the issued share capital of the Company.

Coming from diverse business and professional backgrounds, the non-executive Directors actively bring their valuable experience to the Board for promoting the best interests of the Company and its shareholders. On the other hand, the independent non-executive Directors contribute to ensuring that the interests of all shareholders of the Company are taken into account by the Board and that relevant issues are subjected to objective and dispassionate consideration by the Board. The Company has received confirmation from each independent non-executive Director about his/her independence under the Listing Rules, and continues to consider each of them to be independent.

Each Director ensures that he/she can give sufficient time and attention to the affairs of the Company. They are requested to disclose the number and nature of offices held in public companies or organisations and other significant commitments as well as their identity to the Company twice a year.

Biographies of the Members of the Board and Executive Directorate are set out on pages 66 to 70. None of the Members of the Board and Executive Directorate has any relationship (including financial, business, family or other material or relevant relationships) between each other, although Commissioner for Transport (Mr. Alan Wong Chi-kong) and Secretary for the Environment, Transport and Works (Dr. Sarah Liao Sau-tung) were appointed by the Chief Executive of HKSAR, and Mr. Frederick Ma Si-hang was appointed by The Financial Secretary Incorporated, and Ms. Christine Fang Meng-sang sits on various government advisory committees.

As permitted under its Articles of Association, the Company has arranged Directors' and Officers' Liability Insurance for which Members of the Board and officers of the Company do not have to bear any excess.

## Chairman and Chief Executive Officer

The posts of Chairman and Chief Executive Officer are distinct and separate. The non-executive Chairman is responsible for chairing and managing the operations of the Board, as well as monitoring

the performance of the Chief Executive Officer and Members of the Executive Directorate. Apart from ensuring that adequate information about the Company's business is provided to the Board on a timely basis, the Chairman also ensures that the non-executive Directors make an effective contribution at Board meetings. As head of the Executive Directorate, the Chief Executive Officer is responsible to the Board for managing the business of the Company.

The Chairman held a meeting on 12 April 2005 with all of the non-executive directors without the presence of Members of Executive Directorate (including the Chief Executive Officer) to discuss the responsibilities of the Board, proceedings at Board Meetings and the performance of Members of the Executive Directorate. Another meeting was held by the Chairman on 7 March 2006.

### Board Proceedings

The Board meets in person regularly, and all Members of the Board have full and timely access to relevant information and may take independent professional advice at the Company's expense, if necessary, in accordance with the approved procedures. The draft agenda for regular Board meetings is prepared by the Legal Director & Secretary and approved by the Chairman of the Company. Members of the Board are advised to inform the Chairman or the Legal Director & Secretary not less than one week before the relevant Board meeting if they wish to include a matter in the agenda of the meeting. The date of the Board meetings for the following year is usually fixed by the Legal Director & Secretary and agreed by the Chairman some time in the third quarter of each year.

At each regular Board meeting, Members of the Executive Directorate together with senior managers report to the Board on their business, including the operations, project progress, financial performance, corporate governance and outlook. The Chief Executive Officer also submits his Executive Summary, which focuses on the overall strategies and principal issues of the Company, to the Board. These reports, together with the discussions at Board meetings, provide information to enable all Members of the Board to make informed decisions for the benefit of the Company. The agenda together with board papers is sent in full at least 3 days before the intended date of the Board Meeting.

All Members of the Board have access to the advice and services of the Legal Director & Secretary, who is responsible for ensuring that the correct Board procedures are followed and advises the Board on all corporate governance matters. The Members of the Board also have full access to all Members of Executive Directorate as and when they consider necessary.

In 2005, the Board held eight meetings. The possible merger between the Company and Kowloon-Canton Railway Corporation ("KCRC") was discussed at all eight meetings by the Members of the

Board who did not have conflicts of interest. The attendance record of each Member of the Board is set out below:

Directors	Attendance of Board meetings in 2005	Attendance rate
<b>Non-executive Directors</b>		
Dr. Raymond Ch'ien Kuo-fung (Chairman)	8/8	100%
Commissioner for Transport (Robert Charles Law Footman, ceased to be the Commissioner for Transport with effect from 18 June 2005)	3/3	100%
(Alan Wong Chi-kong, appointed Commissioner for Transport with effect from 18 June 2005)	4/5*	80%
* 1 meeting was attended by the alternate director		
Secretary for the Environment, Transport and Works (Dr. Sarah Liao Sau-tung)	8/8*	100%
* 6 meetings were attended by the alternate directors		
Frederick Ma Si-hang	8/8†	100%
† 4 meetings were attended by his alternate director		
<b>Independent Non-executive Directors</b>		
Professor Cheung Yau-kai	8/8	100%
David Gordon Eldon	2/8	25%
Christine Fang Meng-sang	7/8	88%
Edward Ho Sing-tin	8/8	100%
Lo Chung-hing	8/8	100%
T. Brian Stevenson	8/8	100%
<b>Executive Director</b>		
Chow Chung-kong (Chief Executive Officer)	8/8	100%

The minutes of Board meetings are prepared by the Secretary of the meeting with details of the matters considered by the Board and decisions reached, including any concerns raised by the Members of the Board or dissenting views expressed. The draft minutes are circulated to all Members of the Board for their comment within a reasonable time after the meeting. The approved procedure is that the Board formally adopts the draft minutes at the subsequent meeting. If Members of the Board have any comment on the draft minutes, they will discuss it at that meeting, followed by a report on what has been agreed in the minutes of that meeting. Minutes of Board Meetings are kept by the Legal Director & Secretary and open for inspection by all Members of the Board at the Company's registered office.

### Appointment, re-election and removal of Members of the Board

A person may be appointed as a Member of the Board at any time either by the shareholders in general meeting or by the Board upon recommendation by the Nominations Committee of the Company. Directors who are appointed by the Board must retire at the first annual general meeting after their appointment. A Director who

retires in this way is eligible for election at that annual general meeting, but is not taken into account when deciding which and how many Directors should retire by rotation. In either case, the Directors so elected and appointed are eligible for re-election and re-appointment. At each annual general meeting of the Company, one third of the Directors (or, if the number of Directors is not divisible by three, such number as is nearest to and less than one third) must retire as Directors by rotation.

The Chief Executive of the HKSAR may, pursuant to Section 8 of the MTR Ordinance, appoint up to three persons as "additional directors". Directors appointed in this way may not be removed from office except by the Chief Executive of the HKSAR. These Directors are not subject to any requirement to retire by rotation nor will they be counted in the calculation of the number of Directors who must retire by rotation. In all other respects, the "additional directors" are treated for all purposes in the same way as other Directors. The Chief Executive has appointed the Office for the Secretary for Environment, Transport and Works and the Office for Commissioner for Transport as "additional directors". As there are currently nine Directors subject to the requirement to retire by rotation, and one-third of them shall retire at each annual general meeting of the Company (subject to re-election by the shareholders), each of these Directors is effectively appointed for a term of approximately three years.

Each of the Directors, on appointment to the Board, is given a comprehensive induction programme on key areas of business operations and practices of the Company, as well as a Directors' Manual. Amongst other things, the Manual not only sets out the general and specific duties of the Directors under general law (common law and legislation) and the Listing Rules, but also includes the Terms of Reference of the Board Committees. The Directors' Manual is updated from time to time to reflect developments in those areas.

To assist their continuous professional development, the Legal Director & Secretary recommends Directors to attend relevant seminars and courses. The costs for such training are borne by the Company.

## Accountability

The Members of the Board are responsible for preparing the accounts of the Company and of the Group. The accounts are prepared on a going concern basis and give a true and fair view of the state of affairs of the Company and of the Group as at 31 December 2005, and of the Group's profit and cash flow for the year then ended. In preparing the accounts for the year ended 31 December 2005, the Members of the Board have selected appropriate accounting policies and, apart from those new and amended accounting policies as disclosed in the notes to the accounts ended 31 December 2005, have applied them consistently with previous financial periods. Judgments and estimates have been made that are prudent and reasonable. The reporting responsibilities of the External Auditor are set out on page 82.

In support of the above, the accounts presented to the Board have been reviewed by the Members of Executive Directorate. For both the annual and interim reports and accounts, the Finance Division is responsible for clearing them with the External Auditor and then the Audit Committee. In addition, all new accounting standards and requirements adopted by the Company have been discussed and approved at the Audit Committee before adoption by the Company.

## Board Committees

As an integral part of good corporate governance, the Board has established the following Board Committees to oversee particular aspects of the Company's affairs. Each of these Committees comprises non-executive Directors who have been invited to serve as members. Each of the Audit, Remuneration and Nominations Committee is governed by its respective Terms of Reference, which are available on the Company's website: [www.mtr.com.hk](http://www.mtr.com.hk). All Committees are provided with sufficient resources to discharge their duties.

### Audit Committee

The Audit Committee consists of three non-executive Directors, two of whom are independent non-executive Directors. The Members of the Committee are T. Brian Stevenson (chairman), Professor Cheung Yau-kai and the Commissioner for Transport (Robert Charles Law Footman who ceased to be the Commissioner for Transport and Alan Wong Chi-kong who was appointed Commissioner for Transport, both with effect from 18 June 2005). None of the Committee Members is a partner or former partner of KPMG, the Company's External Auditor. The Finance Director, the Head of Internal Audit Department and representatives of the External Auditor of the Company are expected to attend meetings of the Committee. At the discretion of the Committee, others may also be invited to attend meetings. The Committee normally meets four times a year, and the External Auditor or the Finance Director may request a meeting if they consider it necessary.

Under its Terms of Reference, the duties of the Audit Committee include financial and efficiency aspects. Amongst other things, the Committee is required to oversee the relationship with the Company's External Auditor, to review the financial information of the Company, and to oversee the Company's financial reporting system and internal procedures. The Committee discusses with the External Auditor the nature and scope of audit and reporting obligations before the audit commences. Apart from giving pre-approval of all audit services, the Committee also pre-approves any non-audit services for complying with relevant legal requirements. The Committee is primarily responsible for making recommendations to the Board on the appointment and removal of the External Auditor, and approving the remuneration and terms of such engagement. With respect to financial information of the Company, the Committee monitors the integrity of financial statements, annual and interim reports and accounts, together with the preliminary announcement of results and other announcements

regarding the Company's financial information to be made public. In dealing with the financial information, the Committee liaises with the Board and the Executive Directorate (including the Finance Director), and further meets with both the External Auditor and the Head of Internal Audit. Apart from considering issues arising from the audit, the Committee discusses any matters that auditor(s) may wish to raise either privately or together with executive director and any other person. The Committee is required to review, at least annually, the effectiveness of the Company's financial controls, internal control and risk management systems and to report to the Board that such a review has been carried out. These controls and systems allow the Board to monitor the Company's overall financial position and to protect its assets. In addition, the Committee reviews periodic reports from the Head of Internal Audit and the follow-up of major action plans recommended. The Committee selects, in consultation with the Chairman and the Chief Executive Officer (or otherwise approves) any topic to be the subject of an audit into the efficiency, effectiveness or value for money of any of the activities or operations of the Company. It then reviews reports of such audit and puts forward recommendations to the Board.

The Chairman of the Committee summarises activities of the Committee and highlights issues arising therefrom by a report to the Board after each Audit Committee meeting.

The minutes of the Audit Committee meetings are prepared by the secretary of the meeting with details of the matters considered by the Committee Members and decisions reached, including any concerns raised by the Committee Members and dissenting views expressed. The draft minutes are circulated to the Committee Members for comments and the final version of the minutes is sent to the Committee Members for their records within a reasonable time after the meeting and the minutes are open for inspection by the Committee Members at the Company's registered office. A framework of the agenda items for the meetings for the following year is set out for the Committee Members' reference and comment in the last quarter of each year. The chairman of the Committee makes the final determination on the agenda for the regular Committee meetings.

In 2005, the Audit Committee held four meetings. The major work performed by the Committee in 2005 included:

- Reviewing and recommending for the Board's approval the draft 2004 Annual Report and Accounts and 2005 Interim Report and Accounts;
- Reviewing 2005 Revised Accounting Standards;
- Reviewing the Company's internal control systems;
- Approving the 2005 Audit Plan and reviewing the periodic report prepared by the Internal Audit Department;
- Pre-approving the audit and non-audit services provided by KPMG, External Auditor, for 2005;
- Reviewing and recommending for the Board's approval the revision of the Terms of Reference of the Audit Committee to comply with amendments to the Listing Rules.

The attendance record of each Audit Committee Member is set out below. Representatives of the External Auditor, the Finance Director and the Head of Internal Audit Department attended all those meetings for reporting and answering questions about their work. Further to that and by invitation, the then Managing Director – Operations and Business Development (or his representative), and Property Director had respectively provided an overview of the Company's railway operations and property business to the Members at their meetings.

Directors	Attendance of Audit Committee meetings in 2005	Attendance rate
T. Brian Stevenson (chairman)	4/4	100%
Professor Cheung Yau-kai	4/4	100%
Commissioner for Transport (Robert Charles Law Footman, ceased to be the Commissioner for Transport with effect from 18 June 2005)	2/2	100%
(Alan Wong Chi-kong, appointed Commissioner for Transport with effect from 18 June 2005)	2/2	100%

### Remuneration Committee

The Remuneration Committee consists of three non-executive Directors, two of whom are independent non-executive Directors. The Members of the Remuneration Committee are Edward Ho Sing-tin (chairman), T. Brian Stevenson and Frederick Ma Si-hang.

The principal responsibilities of Remuneration Committee include formulating a remuneration policy and practices that facilitate the employment of top quality personnel, recommending to the Board the remuneration of Members of the Board who are non-executive Directors, determining the remuneration packages of the Members of the Board who are executive Directors and the Members of the Executive Directorate, and reviewing and approving performance-based remuneration by reference to the Company's goals and objectives.

In 2005, the Remuneration Committee held two meetings. In accordance with its Terms of Reference, the Committee performed the following work during the year:

- Reviewed and approved payouts under the Company's performance-based variable incentive scheme for the 2004 performance period;
- Reviewed and recommended for the Board's approval the revision of the Terms of Reference of the Remuneration Committee to comply with amendments to the Listing Rules;

- Conducted an annual review of remuneration packages for the Chief Executive Officer and Executive Directorate for effect in 2005;
- Reviewed and approved the remuneration packages of new Members of the Executive Directorate and Senior Management.

The attendance record of each Committee Member is set out below:

Directors	Attendance of Remuneration Committee meetings in 2005	Attendance rate
Edward Ho Sing-tin (chairman)	2/2	100%
T. Brian Stevenson	2/2	100%
Frederick Ma Si-hang	2/2	100%

The Remuneration Committee also met on 7 March 2006 to approve the 2005 Remuneration Report. This report is set out on pages 63 to 65 and includes a description of the remuneration policy of the Company.

#### Nominations Committee

The Nominations Committee consists of three non-executive Directors, two of whom are independent non-executive Directors. The Members of the Nominations Committee are David Gordon Eldon (chairman), Lo Chung-hing and the Secretary for the Environment, Transport and Works (Dr. Sarah Liao Sau-tung). The Nominations Committee nominates and recommends to the Board candidates for filling vacancies on the Board.

Since there were no new Board appointments in 2005, the Committee did not convene any meeting during the year.

#### Independent Committee

The Board is committed to looking after the interests of independent shareholders of the Company and, for this purpose, an independent committee of the Board (the "Independent Committee"), chaired by Edward Ho Sing-tin, together with Professor Cheung Yau-kai, Christine Fang Meng-sang, Lo Chung-hing and T. Brian Stevenson, has been established to consider and review the terms of any possible merger between the Company and KCRC, and to advise independent shareholders whether they are fair and reasonable. At the Board Meeting on 7 March 2006, the Board approved Mr. David Gordon Eldon rejoining the Independent Committee. All Members of the Independent Committee are independent non-executive Directors of the Company.

#### Internal Controls

The Board is responsible for ensuring that there is in place a satisfactory system of internal control. The main objectives are to ensure adherence to management policies, compliance with applicable laws and regulations, the safeguarding of assets, the efficiency and effectiveness of operation, the prevention and detection of fraud and error, the accuracy and completeness of the accounting records, and the timely preparation of reliable financial information.

The Company has adopted the internal control systems including following:

- The Board has delegated to the Executive Directorate all decision-making powers to run the business on a day to day basis subject to the terms of the "Protocol: Matters reserved to the Board".
- Various risk management strategies have been established by the Board to identify, assess and reduce risks including construction and insurance, finance, treasury, safety, security and environmental. The relevant Member of the Executive Directorate is responsible for managing the risks under his areas of business.
- The Company is developing a formal Enterprise Risk Management framework (the "Framework"). The Framework aims to standardise and extend the risk management practices that are already present in some key functions of the Company, to provide an overall view of key risks at a corporate level, and to enhance common understanding of how individual business areas can support the control of such risks. An Enterprise Risk Manager has been appointed to lead this effort.
- The Company respects investors' rights to information that is necessary for evaluating their investments in the Company. Directors and employees are required to be familiar with and comply with the Company's disclosure controls and procedures so that the Company's public reports and documents that the Company is required to disclose publicly comply in all material respects with the applicable regulatory regimes.
- Members of the Board and Executive Directorate, and other nominated managers who have access to price-sensitive and/or specific information are bound by the Model Code for Securities Transactions by Directors of the Company (see below). In addition, every employee is also bound by the Code of Conduct issued by the Company, amongst other things, to keep unpublished price-sensitive information in strict confidence.
- All Department Heads, including the responsible Business and Project Managers for overseas projects, are asked to identify any new or updated statutes, to assess the risk of such statutes/regulations and their impact on the Company's operations, and to review at least once every year to ensure that relevant statutes/regulations are complied with. Any non-compliance that is detrimental to the Company is reported to the respective Divisional Heads who would then report it to the Executive Directorate.
- The Internal Audit Department carries out audits on systems, financial controls, and compliance with statutes/regulations according to the Audit Plan approved by the Audit Committee.

The Internal Audit Department plays a major role in support of and in collaboration with the Company's management, in monitoring the internal governance of the Company. The Internal Auditor reports directly to the Chief Executive Officer and has direct access



to the Audit Committee. The Department has unrestricted access to information that allows it to review all aspects of the Company's risk management, control and governance processes. On a regular basis, it conducts audits on internal control systems of all business, support units and subsidiaries. As the need arises, it also conducts ad-hoc reviews or investigations. On a half-yearly basis, based on the audit findings and other relevant information that have come to the Internal Audit Department's attention during the course of the audits, the Internal Auditor reports to the Audit Committee his opinion on system of internal controls. In the 2005 reports, it was stated that in general an adequate and effective system of internal controls was in place.

As disclosed before, the Chairman of the Committee summarises activities of the Committee and highlights issues arising therefrom by a report to the Board after each Audit Committee meeting.

### **Model Code for Securities Transactions by Directors of Listed Issuers (the "Model Code")**

The Company has adopted the Model Code and, having made specific enquiry, confirms that Members of the Board and the Executive Directorate complied throughout the year with the Model Code set out in Appendix 10 to the Listing Rules. Senior managers who, because of their office in the Company, are likely to be in possession of unpublished price sensitive information, have been requested to comply with the provisions of the Model Code.

### **Business Ethics**

The Company is committed to a high standard of business ethics and integrity. The content of the Company's Code of Conduct and the Corporate Guidebook for All Staff are reviewed every two years by Human Resource Management Department to ensure appropriateness and compliance with legislation.

In order to extend the ethical culture of the Company to our Mainland subsidiaries, the Induction Programme for the Shenzhen subsidiary company has been reviewed and updated to incorporate a briefing on the Company's Code of Conduct and the Corporate Guidebook for All Staff.

### **US Sarbanes-Oxley Act 2002**

This legislation, which seeks to enhance the transparency and accountability of companies in the areas of corporate governance and financial reporting, was signed into law by the President of the United States on 30 July 2002.

As the Company is an SEC reporting company, it is generally bound by this legislation.

The Company has been, and will continue its process of, reviewing its internal systems and practices and implementing new requirements under this legislation in line with applicable compliance dates.

### **External Auditor**

The Company engages KPMG as its External Auditor. In order to maintain KPMG's independence and objectivity and the effectiveness of the audit process in accordance with applicable standards, the Audit Committee, under its Terms of Reference, pre-approves all audit services to be provided by KPMG and discusses with KPMG the nature and scope of their audit and reporting obligations before the audit commences.

The Audit Committee also reviews and pre-approves the engagement of KPMG to provide any non-audit services for complying with relevant legal requirements and seeks to balance the maintenance of objectivity with value for money.

The nature of audit and non-audit services provided by KPMG and fees paid to KPMG (including any entity that is under common control, ownership or management with the audit firm or any entity that a reasonable and informed third party having knowledge of all relevant information would reasonably conclude as part of the audit firm nationally or internationally) are set out in note 6D to the accounts on page 107.

### **Communication with Shareholders**

The Company's Annual General Meeting ("AGM") is one of the principal channels of communication with its shareholders. It provides an opportunity for shareholders to question Directors about the Company's performance. The Chairman of the Company and the Chairmen of each of the Board Committees were present at the 2005 AGM.

At the 2005 AGM, the Chairman started the formal business by outlining the categories of persons who were entitled to demand a poll in accordance with Article 67 of the Company's Articles of Association on any resolution to be proposed at the AGM. Separate resolutions were proposed for each substantially separate issue at the AGM. Before the resolutions were considered, the Chairman exercised his right as the Chairman of the Meeting under Article 67 of the Company's Articles of Association to call a poll on all resolutions. The poll results were published in an English and a Chinese newspaper and posted on the websites of the Company and HKSE on the day after the AGM. The AGM minutes were also posted on the Company's website within a reasonable time.

Details of other means of communication with shareholders are set out in the section of Investor Relations on pages 54 to 55.