Risk Management and Internal Control Report

Responsibility

Responsibility for risk management is shared among the Board of Directors and the management of the Group. The Board has the overall responsibility of reviewing and maintaining sound and effective risk management and internal control systems. Management’s role is to design and implement these systems, and report to the Board and Audit Committee on the risks identified and how they are managed which are essential for the Group to achieve its business objectives.

Our Risk Management and Internal Control Framework

The Audit Committee supports the Board in monitoring our risk exposures, the design and operating effectiveness of the underlying risk management, and the internal control systems. Acting on behalf of the Board, it oversees the following process on a regular basis:

(i) Reviewing the principal business risks and control measures in order to mitigate, reduce or transfer such risks, the strengths and weaknesses of the overall risk management and internal control systems, and action plans to address the weaknesses or improve the assessment process;

(ii) Reviewing the business process and operations reported by Internal Audit, including action plans to address the identified control weaknesses, as well as status updates and monitoring the implementation of audit recommendations; and

(iii) Reporting by the external auditor of any control issues identified in the course of their work and discussion with the external auditor of the scope of their respective review and findings.

The Audit Committee will then report its findings to the Board, which then consider these findings in forming its own view on the effectiveness of the Group’s risk management and internal control systems.

Please also see the “Audit Committee Report” from pages 86 to 89 regarding the Committee’s detailed review work, including the forms of assurance received from management, the external auditor and internal auditor.
Hysan’s Top-Down/Bottom-Up Risk Management Framework

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THE BOARD
  • Has overall responsibility for the Group’s risk management and internal control systems
  • Sets strategic objectives
  • Reviews the effectiveness of our risk management and internal control systems
  • Monitors the nature and extent of risk exposure for our major risks
  • Provides direction on the importance of risk management and risk management culture

RISK MANAGEMENT COMMITTEE AND MANAGEMENT
  • Designs, implements, and monitors risk management and internal control systems
  • Assesses our risks and mitigating measures Company-wide

AUDIT COMMITTEE
  • Supports the Board in monitoring risk exposure, design and operational effectiveness of the underlying risk management and internal control systems

INTERNAL AUDIT
  • Supports the Audit Committee in reviewing the effectiveness of our risk management and internal control systems

OPERATIONAL LEVEL
  • Risk identification, assessment and mitigation performed across the business
  • Risk management process and internal controls practised across business operations and functional areas
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2017 Review of Risk Management and Internal Control Effectiveness

In respect of the year ended 31 December 2017, the Board, with confirmation from the Chief Operating Officer, Chief Financial Officer, Head of Internal Audit and Company Secretary, considered the risk management and internal control systems to be effective and adequate. No significant areas of concern that may affect the financial, operational, compliance controls, internal audit, risk management and internal controls functions of the Group were identified. The risk management and internal control systems are designed to manage rather than eliminate the risk of failure to achieve business objectives, and can only provide reasonable, not absolute, assurance against material misstatement or loss.

During the review, the Board also considered the resources, qualifications/experience of staff of the Group’s internal audit, accounting and financial reporting functions and their training and budgets were adequate.

Our Risk Management and Internal Control Model

Our risk management and internal control model is based on that of the Committee of Sponsoring Organisations of the U.S. Treadway Commission (“COSO”) for internal control, but with due consideration given to our organisational structure and business nature.
The COSO model has five components and how the model fit in to our operational and control environment is described as follows:

- **Control Environment** – this sets the tone for risk management and internal control. As Hysan is a tightly-knit organisation, the actions of management and its commitment to effective governance are transparent to all.

  We have a strong tradition of good corporate governance and a corporate culture based on sound business ethics and accountability. We have in place a formal Code of Ethics that is communicated to all staff (including new recruits). In 2016, we adopted a separate Whistleblowing Policy, under which whistle blowers can raise concerns to a designated independent third party who will report to the Audit Committee. Our overall aim is to build risk awareness and control responsibility into our culture, which are the foundation of our risk management and internal control systems.

- **Risk Assessment** – we continue to improve our risk management process and the quality of information generated, while maintaining a simple and practical approach. Instead of setting up a separate risk management department, we seek to embed risk management into our operations (retail, office, residential, property management & technical services, projects, marketing and development & investment) and functional areas (including finance, human resources, IT, legal, secretarial and corporate communications).

  On an annual basis, department heads review and update their risk registers, providing assurances that controls are both embedded and effective.

  Management is part of a risk management committee (consists of Executive Director(s), Chief Operating Officer, Chief Financial Officer, Head of Legal and Head of Internal Audit), which sets relevant policies and monitors potential weaknesses and action items regularly. This committee is also responsible for identifying and assessing risks of a more macro and strategic nature, including emerging risks.

  This top-down approach is complemented by a bottom-up approach in which operating unit heads identify operational risks. Together, these determine the Group’s major risks. Discussion sessions with all department heads further enhance the participatory aspect of the overall risk assessment process.

- **Control Activities and Information and Communicating** – our core property leasing and management business involves well-established business processes. Control activities have traditionally been built on top-level reviews, segregation of duties, and physical controls. These control policies are now formalised as written policies and procedures, with defined limits of delegated authority and segregated duties and controls. A greater use of automation (information processing) is also being implemented.

  The annual budgeting and planning process, one of our key control activities, has been refined to take into consideration risk factors. In preparing their respective plans, all operating units are required to identify material risks that may have an impact on the achievement of their business objectives. Action items to mitigate identified risks are developed for implementation as well as for finalising the budget and business objectives. Variance analyses are regularly performed and reported to management and the Board, which help to identify deficiencies for timely remedial actions to be taken.
Another significant control activity is the monitoring of project expenditures, as they are a particularly capital-intensive aspect of our property business. For each project, a detailed analysis of expected risks and returns is submitted to the operating unit heads, Chief Operating Officer, Chief Financial Officer, Executive Director(s) or the Board for approval. Criteria used to assess financial feasibility are generally based on net present value, payback period and internal rate of return from projected cash flow.

Management also conducts an internal control self-assessment annually. All department/unit heads must complete a relevant control self-assessment questionnaire and confirm with management that appropriate internal control policies and procedures have been established and properly complied with.

- **Monitoring Activities** – the Board and Audit Committee oversee the control process, assisted by our Internal Audit team. Management provides update reports to the Audit Committee on major risks and appropriate mitigating measures. Among the three Audit Committee meetings held annually, one is substantially given over to the risk management and internal control systems.

**Strengthening our Underlying Systems**

Since 2012, we have been progressively making improvements to our risk management and internal control systems. The initial phase focused on adopting a more risk-based — rather than process-based — approach to risk identification and assessment. This new approach enriches our ability to analyse risks and respond to opportunities as we pursue our strategic objectives. Management reporting to the Audit Committee has also been enhanced, including the presentation of special reports on selected risk topics.

Our goal is to further integrate risk management and internal control into our business processes, including annual budgeting and planning. In December 2013, we revised the COSO framework to adopt a holistic approach to risk management, taking into consideration the Company’s circumstances, including its ongoing risk management and internal control improvement plan as well as strategic initiatives such as corporate social responsibility. Ultimately, our objective is to make risk management a “living” process that is practised on a day-to-day basis by operating units.
HYSAN’S “THREE LINES OF DEFENCE” MODEL

Clear responsibilities and robust controls are vital to help manage risks and build trust. During the year 2017, we further reinforced our risk governance structure by adopting a “Three Lines of Defence” model to address how specific duties related to risk and control could be assigned and coordinated within the Group. It reinforces Hysan’s risk management capabilities and compliance culture across all divisions and functions.

The model aims to reinforce Hysan’s risk management capabilities and compliance culture throughout the Group. The responsibilities of each of the defence lines are as follows:

<table>
<thead>
<tr>
<th>Relevant units</th>
<th>Responsibilities</th>
</tr>
</thead>
<tbody>
<tr>
<td>First Line</td>
<td>Business and supporting units</td>
</tr>
<tr>
<td>Second Line</td>
<td>Corporate oversight and control functions</td>
</tr>
<tr>
<td>Third Line</td>
<td>Group internal audit</td>
</tr>
</tbody>
</table>

Risk Management Committee & Senior Management

Board / Audit Committee

1st LINE OF DEFENCE

Management Controls

Internal Control Measures

2nd LINE OF DEFENCE

Financial Control

System of Internal Control & Risk Management

HR Capability

Public Communication

Compliance

Information Security

3rd LINE OF DEFENCE

Internal Audit

RISK OWNERS / MANAGERS

Business divisions & supporting units

RISK CONTROL AND COMPLIANCE

Control functions

RISK ASSURANCE

Internal Audit

Regulator

External audit
HYSAN’S REGULATORY COMPLIANCE AND GOVERNANCE FRAMEWORK

The Board, supported by the Audit Committee, shall have overall regulatory compliance authority in all matters. During the year 2017, we have reviewed our regulatory compliance and governance framework taking the house of governance initiative. This forms a central part of our commitment to high standard of internal control governance.

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**Identify**
- Each Business Unit confirms compliance semi-annually (including compliance with laws affecting operation).
- Compliance/Non-compliance is properly identified and recorded.

**Assess**
- Review and assess the impact. Seek external legal advisors, where necessary.
- Report to Executive Committee.

**Prioritize**
- Prioritize for immediate action, corporate governance/policy planning and follow up.

**Respond**
- Advise Business Unit on appropriate legal steps/actions.
- Assist the department to initiate and follow up on the required action.
- Report to the Executive Committee.

**Monitor**
- Semi-annual compliance reported to the Audit Committee, and the Board.
- Quarterly legal and regulatory updated to the Board.
- Corporate governance policies regularly reviewed by the Board.

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**REGULATORY COMPLIANCE AND GOVERNANCE FRAMEWORK**

Board
Audit Committee
Executive Committee
Control & Business Units
OUR PAST EFFORTS IN ENHANCING THE INTERNAL CONTROL ENVIRONMENT AND ACTIVITIES

In addition to the above major enhancements during the year, the following are examples of the improvements we have made over the past few years to strengthen our risk management and internal control system:

Control Environment – policy of compliance

<table>
<thead>
<tr>
<th>Changes</th>
<th>Ongoing review/refinement of processes and structures to enhance compliance.</th>
</tr>
</thead>
<tbody>
<tr>
<td>• Policy of compliance together with the compliance framework, key owners of compliance and a non-compliance checklist developed and enhanced. General Counsel of the Group presented the “Risk Management and Internal Control Framework” to the senior management and department heads.</td>
<td></td>
</tr>
</tbody>
</table>

Risk Assessment – enhanced monitoring of “emerging risks”

<table>
<thead>
<tr>
<th>Changes</th>
<th>In the context of a fast-changing global and local environment, the monitoring of “emerging risks” will be a focus.</th>
</tr>
</thead>
<tbody>
<tr>
<td>• Strengthened the monitoring of material risks and “emerging risks”, i.e. new or evolving risks with potential significant impact, such as socio-political, economic or cybersecurity risks. The Risk Management Committee plays a key role in identifying and tracking these risks, with top management leading discussions with all department heads.</td>
<td></td>
</tr>
</tbody>
</table>

Control Activities – procedures for monitoring connected transactions

<table>
<thead>
<tr>
<th>Changes</th>
<th>Continual review and refinement of policies and procedures in the changing external and internal environment.</th>
</tr>
</thead>
<tbody>
<tr>
<td>• Automation of exceptional report for monitoring connected transactions has been reviewed and enhanced. Connected transactions seminars had been conducted for all departments by General Counsel.</td>
<td></td>
</tr>
</tbody>
</table>

Control Activities – internal controls and policies

<table>
<thead>
<tr>
<th>Changes</th>
<th>Continual review and refinement of risk management and internal controls for handling concerns raised by whistle blowers.</th>
</tr>
</thead>
<tbody>
<tr>
<td>• Enhanced the procedure for handling and reporting a data breach (jointly developed by legal and IT departments) to support compliance of Personal Data (Privacy) Ordinance.</td>
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<tr>
<td>• A new procurement manual has been developed to tighten the internal controls, in particular, the setup of Tender Committee and the segregation of duties in handling technical and financial matters during tendering.</td>
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<tr>
<td>• Regular trainings and education across the Group during the year, including leasing, intellectual property, etc.</td>
<td></td>
</tr>
</tbody>
</table>

Monitoring Activities – enhanced “management assurance” to Audit Committee and Board

<table>
<thead>
<tr>
<th>Changes</th>
<th>Facilitation and enhancement of the work of the Audit Committee and the Board in monitoring our risk exposure.</th>
</tr>
</thead>
<tbody>
<tr>
<td>• Enhanced management update reports to the Audit Committee and Board on major risks, including deep-dive reports on topics such as risk management in procurement and tender process. To strengthen management’s “assurance” to the Audit Committee and Board, self-assessment questionnaires were rolled out across all departments. Department heads were required to review and certify the effectiveness of their departmental controls, including the identification of any control issues. This backs up management’s certification to the Audit Committee and Board.</td>
<td></td>
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</tbody>
</table>
## Our Risk Profile

Our approach for managing risk is underpinned by our understanding of our current risk exposures, and how our risks are changing over time. The following illustrates the nature of our major risks. Further analysis of our strategies is set out in other sections of the Annual Report as indicated below:

<table>
<thead>
<tr>
<th>Risk</th>
<th>Risk change during 2017</th>
<th>Description of risk change</th>
</tr>
</thead>
<tbody>
<tr>
<td><strong>Impact of macroeconomic developments on:</strong></td>
<td></td>
<td></td>
</tr>
<tr>
<td>1. Office</td>
<td>↑</td>
<td>The office rental market on Hong Kong Island core area benefited from limited new supply and demand from Chinese institutions. However, due to global economic headwinds, there was a drop in the overall demand for office space across the market from multinational companies. Further, new supply from Hong Kong Island East and lower rent in the non-core business areas has driven cost-conscious tenants to move out of core areas. The rise of co-work concept is also a disruptor to traditional office leasing business.</td>
</tr>
<tr>
<td>2. Retail</td>
<td>↑</td>
<td>The retail market was challenging during 2017 as Hong Kong retail sales continue to record a decline during first half 2017, owing to a fall in tourist numbers as well as the downturn in local sentiment. However, the decline trend reversed in later 2017 with some growth in retail sales and tourist numbers. Although early sign of recovery is seen, retail tenants are still cautious in expanding their retail enterprises, shop numbers or footprints. Pressure on rental may continue for a while until a solid growth in retail sales and higher confidence is seen.</td>
</tr>
<tr>
<td>3. Residential</td>
<td>↑</td>
<td>Reduced demand from expatriates and tighter rent budget, higher market vacancy rates and keen competition continued to exert pressure on the luxury residential leasing market leading to higher vacancies at our property.</td>
</tr>
<tr>
<td>&gt; For more analysis and mitigating measures of the above risks, see “The Marketplace” &amp; “Review of Operations”</td>
<td></td>
<td></td>
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<tr>
<td>4. Projects</td>
<td>↔</td>
<td>Lee Garden Three obtained its occupation permit in December 2017 with the first batch of tenants already moved-in. Other tenants are also preparing their premises for occupation. Together with HKR International Limited (&quot;HKR&quot;), the Group acquired two pieces of adjacent land in Tai Po with a view to develop into a low-rise residential development for sale. With the HKR’s and Hysan’s amplified expertise, we believe the project will be executed professionally and meet market demand. The project has been in good progress.</td>
</tr>
<tr>
<td>&gt; For more analysis and mitigating measures of the above risks, see “Review of Operations”</td>
<td></td>
<td></td>
</tr>
<tr>
<td>5. Human Resources</td>
<td>↑</td>
<td>The service industry in Hong Kong continues to experience widespread labour shortages and structural changes in workforce. We are facing increased competition for skilled personnel, especially experienced front-line staff, to provide good services and support the Group’s growth strategy.</td>
</tr>
<tr>
<td>&gt; For more analysis and mitigating measures of the above risks, see “Corporate Responsibility Report 2017” separately available on Hysan’s website: <a href="http://www.hysan.com.hk">www.hysan.com.hk</a></td>
<td></td>
<td></td>
</tr>
</tbody>
</table>

**Notes:**

↑ where “inherent risks” (i.e. before taking into consideration mitigating activities) increased

↔ where “inherent risks” remained broadly the same