Internal Controls and Risk Management Report

Responsibility

Our Board of Directors has the overall responsibility to ensure that sound and effective internal controls are maintained, while management is charged with the responsibility to design and implement an internal controls system to manage risks. A sound system of internal controls is designed to manage rather than eliminate the risk of failure to achieve business objectives, and can only provide reasonable but not absolute assurance.

Our Risk Management Framework

The Board is responsible for the Group’s system of internal controls and for reviewing its effectiveness. The Audit Committee supports the Board in monitoring our risk exposures, the design and operating effectiveness of the underlying risk management and internal controls systems. Management assesses and presents regular reports to the Audit Committee on its own assessments of key risks, the strengths and weaknesses of the overall internal controls systems, with action plans to address the weaknesses. Internal Audit regularly reports on reviews of the business processes and activities, including action plans to address any identified control weaknesses. External auditors also report on any control issues identified in the course of their work. Taking these into consideration, the Audit Committee reviews the effectiveness of the Group’s system of internal controls and reports to the Board on such reviews. Work and findings of the Committee are considered by the Board in forming its own view on the effectiveness of the system.

(Please also see “Audit Committee Report” on page 113 regarding the Committee’s detailed review work, including the forms of “assurance” received from management, external auditor, and internal auditor).

Hysan Risk Management Framework Diagram
2014 Review of Internal Controls Effectiveness

In respect of the year ended 31 December 2014, the Board considered the internal controls system effective and adequate. No significant areas of concern that might affect the financial, operational, compliance controls, and risk management functions of the Group were identified. The scope of this review covers the adequacy of resources, qualification/experience of staff of the Group’s accounting and financial reporting function, and their training and budget.

Hysan’s Internal Controls Model and Continuous Improvement in our System

Our internal controls model is based on that set down by the Committee of Sponsoring Organisations of the U.S. Treadway Commission (“COSO”) for internal controls, and has five components, namely Control Environment; Risk Assessment; Control Activities; Information and Communication; and Monitoring Activities. In developing our internal controls model based on the COSO principles, we have taken into consideration our organisational structure and the nature of our business activities.

Since 2012, we have put in place a phased improvement plan and progressed to further enhance our internal controls and risk management system. The initial phase of the plan focused on adopting a more risk-based (instead of process-based) approach in risk identification and assessment. This 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.

In the current phase, we aim to further integrate internal controls and risk management into our business processes, including in annual budgeting and planning. The COSO framework has been revised, effective December 2013. Instead of treating this as a framework-update exercise, a holistic approach has been adopted, taking into consideration the Company’s circumstances, including its ongoing internal controls and risk management improvement plan as well as other strategic initiatives. (e.g. corporate social responsibility strategy and reporting). All these further our ultimate objective to make our risk management system a “live” one that is practised on a day-to-day basis by operating units.
• **Control Environment** – this is very important as it sets the tone for internal controls in a company. Hysan is a tightly-knit organisation with around 600 staff members. The actions of management and its demonstrated commitment to effective governance and control are therefore very transparent to all.

We have a strong tradition of good corporate governance and a corporate culture based on good business ethics and accountability. We have in place a formal Code of Ethics that is communicated to all staff (including new recruits). Our “whistle-blowing” system is monitored by an independent third party service provider with direct reporting to the Audit Committee Chairman. We aim to build risk awareness and control responsibility into our culture and regard them as the foundation of our internal controls system.

• **Risk Assessment** – we continue to drive improvements to our risk management process and the quality of risk information generated, while at the same time maintaining a simple and practical approach. Instead of setting up a separate risk management department, we instead seek to have risk management features embedded within our operations (leasing, property management, and project) as well as functional areas (including finance, human resources, IT, and legal). We aim to have a “live” risk management system that is practised on a day-to-day basis by our operating units.

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

Management also forms a risk management committee (headed by the Chief Executive Officer) which sets the relevant policies and monitors potential weaknesses and action items regularly. It 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 the “bottom-up” aspects and the involvement of operating unit heads in identifying operational risks. These together determine the Group’s top risks. Discussion sessions with all department heads led by the Chief Executive Officer were held, with the view to further enhancing the “participatory” aspect of the overall risk assessment process.
• **Control Activities; Information and Communication** – 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. Over the past few years, we have been formalising and documenting the control processes in policies and procedures. Written policies and procedures with defined limits of delegated authority are in place, which facilitate effective segregation of duties and controls. A greater use of automation (information processing) is also being implemented.

The annual budgeting and planning process is one of our key control activities, which has been refined to take into consideration risk factors. All operating units prepare their respective operating plans pursuant to corporate objectives for consideration. In this process, they are required to identify material risks that may impact the achievement of their business objectives. Action items to mitigate the identified risks are developed for implementation as well as for finalising the budget and business objectives. An annual budget with financial targets, as approved by the Board, provides the foundation for the allocation of resources. Variance analyses are regularly performed, and reported to management and the Board. These help identify deficiencies and enable timely remedial actions to be taken.

Capital expenditures monitoring is also significant given the capital-intensive nature of our property business. Depending on strategic importance, cost / benefit and the size of the projects, detailed analysis of expected risks and returns is submitted to operating unit heads, Executive Directors or the Board for consideration and approval. The criteria for assessment of financial feasibility are generally based on net present value, payback period and internal rate of return from projected cash flow.

• **Monitoring Activities** – the Board and Audit Committee oversee the process, assisted by our Internal Audit team. Management has enhanced its update reports to the Audit Committee on movements of top risks and appropriate mitigating measures. There are three Audit Committee meetings annually, with one meeting substantially devoted to special risks items.
## Further Strengthening of Our Underlying Systems

We have made further progress in strengthening our internal controls and risk management systems, highlighted as follows:

### Risk Assessment – enhanced monitoring of “emerging risks”

- Further strengthened the monitoring of “emerging risks” (i.e. risks that are new or evolving, which have potentially significant impact even though the likelihood of their happening may not be certain). Management’s Risk Management Committee takes a key role in identifying and tracking these risks. The Chief Executive Officer also led further discussions with all department heads. Examples include political / socio risks, hazards / catastrophic loss (for example, natural disasters).

Crucial in the context of a fast changing global as well as local environment.

### Risk Assessment – strengthening fraud risks assessment

- Refined our Fraud Handling Policy, including providing for periodic fraud risk assessments.
- Fraud risk assessment performed, by a combined “top-down” (by management) and “bottom-up” (by departments) process. Improvement areas identified and completed include the performance by Human Resources Department of credit check for promotions and transfers to critical positions of responsibility, and the refinement of the exit interview process for leaving staff to identify potential fraud opportunities.

Further strengthened the anti-fraud aspects of our Code of Ethics, which is particularly important as the Group evolves and looks into other growth opportunities.

### Risk Assessment – strengthening non-financial reporting objective

- Introduced independent third-party verification (HKQAA) for our corporate social responsibility report in March 2014

Reflected our commitment to being a responsible business, stressing financial performance as well as the manner of achieving such financial results.

### Control Activities – policies and procedures

- Identified and in the process of implementing new policies to address cross-departmental issues. For instance, corporate policies relating to privacy, in addition to departmental policies and procedures already in place. This ensures that a more holistic approach is taken. It also signifies the importance we place on the subject, which has become more important in light of fast-changing regulatory requirements and heightened stakeholder expectations.

Continual review and refinement of policies and procedures in light of the changing external and internal environment.

### Monitoring – enhanced “management assurance” to the Audit Committee and the Board in their respective reviews

- To further strengthen management’s “assurance” to Audit Committee and the Board, control self-assessment questionnaires were rolled out across all departments. Department heads were required to certify their departmental controls effectiveness including identifying any control issues. This in turn backs up management’s certification to Audit Committee and the Board.

Facilitates and enhances the work of the Audit Committee and the Board in monitoring our risk exposure.

## Way Forward

In the context of a fast-changing global and local environment, the monitoring of “emerging risks” will be a focus. In general, achieving a “live” risk management system practised on a day-to-day basis by our operating units is a continuous journey. We shall continue this path, with further integration of internal controls and risk management into our business processes.
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 some of our principal risks, although it does not represent an exhaustive list of the risks we face. 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 2014</th>
<th>Description of risk change</th>
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<tbody>
<tr>
<td>Impact of Hong Kong and global macroeconomic developments on:</td>
<td></td>
<td>Considering the impact of changes in demand and competition on the three leasing units, which continued to be challenging during the year. When compared with good growth over the past few years, Hong Kong retail sales declined slightly during the year. New supply remains, however, tight for all three units. For Hysan, a relatively small portion of commercial leases were due for renewal or rent review during the year.</td>
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<tr>
<td>1. Office leasing operations</td>
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<td>2. Retail leasing operations</td>
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<tr>
<td>3. Residential leasing operations</td>
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<td>4. Projects (including combined Sunning site redevelopment)</td>
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<td>Asset enhancement at Lee Gardens Two shopping centre completed. Demolition work for the Sunning buildings completed in Q3 2014. Excavation and other foundation works had commenced. The project is on schedule for its anticipated completion around 2018.</td>
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<td>5. Human resources</td>
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<td>Greater competition for skilled personnel, and labour shortage for front-line staff, to support the Group’s growth strategy.</td>
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<td>6. Emerging risks including political risks / hazards / catastrophic loss (health epidemics, natural disasters, man-made hazards like fire, flooding)</td>
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<td>We maintain comprehensive emergency handling procedures covering all our properties. Their effectiveness were demonstrated during Q4 2014, when some main roads in Hong Kong (including Causeway Bay) were blocked by the “Occupy Central” protests. Our Property Services team implemented special measures and successfully mitigated their adverse impact on our tenants, visitors and shoppers.</td>
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Note:
- ↑ where “inherent risks” (i.e. before taking into consideration mitigating activities) increased
- ↓ where “inherent risks” remain broadly the same