

A. Introduction

The Audit Commission ("Audit") carried out a value for money audit on the corporate governance and administrative issues of the Hong Kong Productivity Council ("HKPC"). The review focused on the following areas:

- corporate governance;
- human resource management;
- administrative issues; and
- performance measurement and reporting.

2. The Committee held two public hearings on 8 and 10 December 2009 respectively to receive evidence on the findings and observations of the Director of Audit's Report ("Audit Report").

3. **Mrs Rita LAU NG Wai-lan, Secretary for Commerce and Economic Development, and Mr Clement CHEN Cheng-jen, Chairman of the HKPC**, respectively made an opening statement at the beginning of the Committee's public hearing on 8 December 2009. The full texts of their statements are in *Appendices 12* and *13* respectively.

4. In gist, the **Chairman of the HKPC** said in his opening statement that:

- regarding the Audit Report which covered the HKPC's corporate governance and administrative issues, the HKPC had already implemented 43 out of the 54 recommendations made by Audit. The HKPC planned to progressively implement the remaining ones, hopefully within six to nine months (i.e. by September 2010);
- he took over the chairmanship of the HKPC in July 2009. He admitted that the HKPC had been slack, negligent and even faulty in some aspects of corporate governance and project management. However, it should be noted that the HKPC had had three new Executive Directors ("EDs") within six years, and there were gaps in the transitional periods;
- as a statutory body with a long history, the HKPC's business model and corporate culture had to be updated from time to time in order to cope with the changing environment. Hence, the HKPC embarked on a corporate reform three years ago to enhance its corporate governance. As stated in paragraph 1.17(b) of the Audit Report, the HKPC carried out two consultancy

studies in early 2006 to comprehensively review and improve its procurement, administration and human resource systems. The consultants made a total of 87 recommendations, of which the HKPC had implemented 64 recommendations, resulting in the amendment of 44 internal guidelines and the formulation of 26 new internal guidelines in the past two years. Of all the reform measures introduced, the most important ones included an improved and more objective performance appraisal system, a new performance-based salary policy, and a reformed medical benefit regime. These reforms not only had modernised the HKPC's management system, but also changed its work culture, hence enhancing the HKPC's efficiency and competitiveness; and

- public sector reform was no easy task. Changing the service culture of an organisation could never be achieved in one go. Reform must take a measured pace. The reform measures introduced by the HKPC since 2006 might not be comprehensive enough. To this end, the recommendations made by the Director of Audit could squarely fill the gaps. He hoped that the Audit Report could drive and consolidate the HKPC's internal reform in an even more solid and comprehensive manner. The HKPC would spare no efforts in implementing the recommendations put forward in the Audit Report with a view to further improving its internal operations and corporate governance.

5. Noting the Chairman's remark that the HKPC had had three new EDs within six years, the Committee asked why the EDs had left the HKPC, and whether the frequent change in management had made the HKPC's internal reform a difficult task.

6. The **Chairman of the HKPC** said that he had not ascertained the reasons for the EDs' departure. He believed that the change of ED did not have a direct correlation with the difficulties encountered during internal reform. However, the gaps during the transitional periods might have resulted in slackness or certain omissions.

7. At the request of the Committee, **Miss Janet W C WONG, Commissioner for Innovation and Technology**, provided information on the departure of two former EDs, namely, Mr Thomas TANG who served from 1 January 1997 to 8 March 2003 and Mr K K YEUNG who served from 1 September 2003 to 31 August 2006, vide her letter of 28 December 2009 (in *Appendix 14*).

8. The Committee also noted from the copy of the opening statement of the Chairman of the HKPC tabled at the public hearing that some hand-written alterations had been made to the original text. Most notably, the Chairman added "I admit that the HKPC had been slack, negligent and even faulty in some aspects of corporate governance and project management". The Committee asked:

- who drafted the opening statement and why the Chairman made the above alterations; and
- since the original text did not contain the above admission by the Chairman, whether the Council and the HKPC management subscribed to the Chairman's admission.

9. The **Chairman of the HKPC** explained that since this was the Chairman's statement, he had the responsibility to add his own comments and make amendments after considering the draft prepared by the management. He had also verbally informed the ED of his alterations. His admission was definitely subscribed to by the HKPC management and staff, as he had made the same remark in front of all the 600 staff at a staff symposium arranged by the ED earlier.

10. **Mr Wilson FUNG Wing-yip, ED of the HKPC**, said that the draft was prepared by the Director (Corporate Services) of the HKPC, and he had personally vetted the draft before it was e-mailed to the Chairman. The remark added was not only the Chairman's personal views, as the Council had thoroughly discussed the Audit Report and was fully aware of the inadequacies of the HKPC. Therefore, when the Chairman mentioned the alterations to him, he considered them a reasonable expression of the Council's sentiment.

B. Internal control and administrative issues

Fixed asset management

11. Paragraph 4.3 of the Audit Report revealed that for the full-scale stocktake carried out by the HKPC from September to December 2005, 8,726 (34%) of the 26,045 items recorded in the Fixed Asset Register could not be located. The total purchase cost of the missing items was \$54.6 million. On the other hand, there were 4,450 items of stock that could not be traced to the Fixed Asset Register. In view of the significant number of loss of items and the high cost involved, the Committee asked:

- whether the HKPC had ascertained the underlying reasons for the loss;
- about the division of the HKPC which was in charge of fixed asset management;

- whether any criminal act was involved and whether the HKPC had reported the loss to the Police; and
- whether any negligence was involved and whether any staff had been held responsible for the lost items.

12. In response, the **ED of the HKPC** said that:

- some items could not be traced due to missing or incorrect affixing of barcode labels. The HKPC had taken further actions to locate the 20 items set out in Appendix C of the Audit Report. The latest matching results were in *Appendix 15*. The HKPC had found 17 of the 20 items after matching the specifications and models of the items. For example, the networking system of the HKPC Building, the network security system and computer servers could all be located and, in fact, they were in use every day;
- in the past, the HKPC had simply adopted an accounting system to record its fixed assets and had not seriously reviewed how fixed assets could be better managed. Items that could not be traced due to loss of barcode labels were regarded as "missing items". He understood that the significant number of loss of items had created a bad public impression of the HKPC and he apologised on behalf of the then management; and
- since he assumed duty, he had encouraged staff to report suspicious loss cases which might involve criminal act to the Police. In 2007, the HKPC had reported two cases of loss to the Police, one for the loss of a notebook computer and another for the loss of a digital camera. The Police had also held crime prevention talks for the HKPC staff to increase staff awareness in this regard. As to why no cases were reported by the then management to the Police in 2005 and 2006, it could be due to the fact that the ownership of fixed assets had not been clearly defined. In the absence of clear ownership, it would be difficult to hold any staff responsible for the loss and investigation by the Police might be in vain.

13. **Mr Sam LAW Hung-wai, General Manager (Finance) of the HKPC**, said that the Finance Division was responsible for maintaining fixed asset inventory records. There were one clerical staff and 0.5 professional staff in the Finance Division for undertaking such tasks. As fixed assets were scattered in various divisions, each division was required to report to the Finance Division the transfer of fixed assets among divisions and disposal of fixed assets. It was noted from the 2005 stocktake that the divisions had not updated the Finance Division of the transfer and disposal of assets, especially during the time when the HKPC underwent organisation restructuring, resulting in discrepancies between the items recorded in the Fixed Asset Register and the items that could be located.

14. The Committee referred to the 109 computers which could not be located in the stocktake in June 2009, as reported in paragraph 4.7 of the Audit Report, and asked whether any of these computers could subsequently be located.

15. The **ED of the HKPC** stated in his letter of 29 December 2009 (in Annex P of *Appendix 16*) that:

- whilst paragraph 4.7(a) of the Audit Report mentioned that 109 computers could not be located, paragraph 4.7(b) also mentioned that 163 computers could not be traced to the Fixed Asset Register because their barcode labels were peeled off or wrongly affixed; and
- the HKPC had subsequently tried to match the specifications (such as type, brand name and model) of the 163 computers with those of the 109 missing computers. 100 could be matched while nine could not. This notwithstanding, there remained 63 computers not recorded in the Fixed Asset Register.

16. To ascertain whether the problems in fixed asset management had been adequately followed up by the HKPC, the Committee asked:

- whether the HKPC's Audit Committee and external auditor had had any findings and put up any recommendations relating to fixed asset management since 2005-2006; and
- about the actions that had been taken by the HKPC to implement the recommendations of the Audit Committee and the external auditor, if any.

17. The **ED of the HKPC** stated in his letter of 29 December 2009 (in Annexes H and I of *Appendix 16*) that:

- there were several occasions on which the Audit Committee deliberated the HKPC's fixed asset management:
 - (a) on 12 October 2006, the Audit Committee noted the completion of the consultancy study, which included recommendations on fixed asset management. The Audit Committee also noted the approach of taking forward the consultant's recommendations (such as according priority to improve fixed asset management and not accepting one of the recommendations, i.e. centralising goods receipt function);

- (b) on 22 June 2007, the Audit Committee was updated on the progress of implementation of the consultant's recommendations, including those on fixed asset management;
 - (c) on 23 March 2009, in the context of a compliance checking report on fixed asset management submitted to the Audit Committee by the internal audit team, the Audit Committee noted the findings of the internal audit team and the actions taken by the HKPC management in respect of two non-compliance cases out of 68 samples surveyed;
 - (d) on 15 July 2009, the HKPC management reported the results of the partial stocktake conducted in April 2009 to the Audit Committee; and
 - (e) on 6 November 2009, in the context of an internal audit report on fixed asset management (relating to barcode label and disposal of fixed assets) submitted to the Audit Committee by the internal audit team, the Audit Committee noted the findings and actions taken by the HKPC management; and
- the external auditor had raised observations on fixed assets on three occasions in the years 2005-2006, 2006-2007 and 2008-2009. In brief, the external auditor's observations and the actions taken by the HKPC were as follows:

2005-2006 and 2006-2007

- (a) for both years, the external auditor expressed the view that no major issues were observed and no significant weaknesses were noted. However, some audit observations on fixed asset management were discussed, including the need to review the useful life estimation and to conduct periodic fixed assets counts. Upon review by the HKPC, the Standard Practices had been revised and issued on 1 January 2008;

2007-2008

- (b) the external auditor did not make any observation on fixed asset management; and

2008-2009

- (c) the external auditor expressed the view that no significant issues were observed or weaknesses noted. The external auditor noted the result of the partial stocktake conducted in April 2009 and that the HKPC management would report the result to the Audit Committee. However, the external auditor did not make any recommendation.

18. According to paragraph 4.9 of the Audit Report, no partial stocktake was conducted from January 2008 to March 2009, although the Standard Practices promulgated in January 2008 required that partial stocktake be conducted annually. In April 2009, the HKPC carried out a partial stocktake. As pointed out in paragraph 4.6 of the Audit Report, 13% of items could not be located. The Committee enquired:

- why partial stocktake had not been carried out as required and whether the stocktake in April 2009 was only conducted in response to the audit review; and
- about the specific actions that had been taken by the HKPC since the full-scale stocktake in 2005 to improve the management of fixed assets.

19. The **ED of the HKPC** said at the public hearing and in his letter of 29 December 2009 (in Annexes L and N of *Appendix 16*) that:

- the HKPC had planned to carry out partial stocktake annually according to the financial year. Hence, a partial stocktake was carried out in April 2009 after the end of the financial year on 31 March 2009. The HKPC also conducted in June 2009 another stocktake at its own initiative to focus on high risk items such as desktop and notebook computers;
- the HKPC did make some improvements in fixed asset management since 2005. The percentages of missing items in the three stocktakes had decreased from 34% in 2005, 13% in April 2009 to 7% in June 2009. Since June 2007, the HKPC had used barcode labels which were scratch-free and more difficult to be peeled off. Also, five sets of internal guidelines on fixed asset management were revised and issued on 1 January 2008 (i.e. Standard Practices A6/1, A6/2, A6/3, A6/4 and A6/5);
- following the recommendations of the consultant on fixed asset management, the following revisions were made to the Standard Practices:
 - (a) a clearer definition of the ownership of fixed assets was provided (see paragraphs 1 and 2 of Standard Practice A6/2). In particular, the General Manager of each division was responsible for the assets under the division's use and control; and
 - (b) improvement was made on stocktake procedures of fixed assets, such as stipulation of an annual cycle for partial stocktake and a five-year cycle for a full-scale stocktake, instead of just requiring partial stocktake and full-scale stocktake to be done on a "regular" basis (see paragraph 8 of Standard Practice A6/3);

- the HKPC management had also taken the opportunity to amend other Standard Practices relating to fixed asset management covering the following aspects:
 - (a) the depreciation life of various fixed assets was stipulated (see Appendix 1 of Standard Practice A6/1);
 - (b) the role for managing disposal and transfer of software and information technology equipment was centralised and vested with the internal Management Information Service Unit (see paragraph 2.3 of Standard Practice A6/4); and
 - (c) a clearer definition was provided in respect of equipment for the purpose of fixed asset management (see paragraph 1 of Standard Practice A6/5);
- furthermore, after the stocktake in June 2009, it was decided that a Fixed Asset Manager be appointed in each division to strengthen the safe custody of fixed assets. The five major duties of the Fixed Asset Manager were:
 - (a) to help ensure compliance of respective divisions with the Standard Practices;
 - (b) to co-ordinate asset stocktake exercises;
 - (c) to ensure the reporting of asset movement and disposal;
 - (d) to clear asset movement and disposal; and
 - (e) to co-ordinate the affixing of barcode labels; and
- despite the adoption of the above measures, it was still necessary to introduce additional measures to further improve and strengthen asset management.

20. At the request of the Committee, the **ED of the HKPC** elaborated the details of the proposed measures that were under consideration by the management to further improve and strengthen fixed asset management. He said at the public hearing and in his letter of 29 December 2009 (in Annex M of *Appendix 16*) that:

- the HKPC management was reviewing its fixed asset management system, and had yet to finalise the measures to be taken. The proposed measures would be submitted to the Council for approval at a later stage;
- subject to the approval of the Council, the HKPC might implement the following measures:

- (a) for equipment of high value or with high risk of loss or theft (such as mobile phones, digital cameras and notebook computers), the HKPC management would consider the feasibility of dispensing with the barcode altogether and linking the asset record to the unique identification number of each of the items, if available;
 - (b) the HKPC would further review and refine the ownership and level of custody responsibility of fixed assets and assign them to the individual staff level as far as practicable;
 - (c) the HKPC would further review if fixtures (e.g. built-in furniture and information technology systems, exhibition display panels) should be included in the fixed asset control list as they had virtually no chance of loss or theft; and
 - (d) the HKPC would further consider how the effectiveness of annual partial stocktake exercise could be enhanced. Enhancement measures might include, for instance, mandatory annual stocktake for high value items beyond a certain threshold and stocktake on certain selected categories of items as opposed to random sampling during the partial stocktake exercise; and
- he had accorded the highest priority to reviewing the fixed asset management system. He held meetings with his management team once a week, and hoped that the above measures could be implemented by March 2010.

Other administrative issues

21. According to paragraph 4.14 of the Audit Report, Audit found that only 43 (2%) of the 2,603 pieces of laboratory equipment were purchased at a cost of \$500,000 or more and hence covered by the inventory control system. The utilisation and disposal of the remaining 2,560 pieces (98%) of equipment at a total purchase cost of \$50.7 million were not covered by the system. The Committee asked whether the HKPC would consider lowering the threshold of the laboratory equipment purchase cost stated in the Standard Practices so that more equipment would be covered by the inventory control system.

22. The **ED of the HKPC** replied that the HKPC had revised its Standard Practices on 7 October 2009. The threshold of the laboratory equipment purchase cost was lowered from \$500,000 to \$100,000 so that 183 pieces (73%) of equipment were covered by the inventory control system.

23. Regarding entertainment expenses, the Committee noted that:

- a new set of spending limits for entertainment expenses was adopted in August 2008. The spending limits were increased substantially, ranging from 14% to 108%, but the justifications for the increase were not documented (paragraph 4.28 and Table 11 of the Audit Report referred); and
- the annual fee for using a private club in Kowloon Tong was \$15,000 in 2008-2009. However, Audit analysis of the entertainment claims made in 2008-2009 revealed that only 29 (7%) of the 408 official entertainments were held at the private club, and the total amount spent was \$16,000 (paragraph 4.30 and Table 12 of the Audit Report referred).

The Committee asked why the HKPC decided to make a substantial increase in the spending limits, especially the limit for breakfast (108% increase for the ED and Branch Directors), and whether the HKPC had considered the use of other more economical dining venues.

24. In response, the **ED of the HKPC** said that:

- he had reviewed the spending limits for breakfast, lunch and dinner by benchmarking with some hotel coffee shops in Central and Admiralty. He had also taken the opportunity to put in place an approval mechanism in case the ED's claim exceeded the limits. The limit of \$250 per head for breakfast for the ED was considered reasonable, beyond which the Chairman of the HKPC's approval would be required;
- since he assumed duty, the entertainment expenses of the HKPC had continued to reduce, from \$298,000 in 2007-2008, \$250,000 in 2008-2009 to \$210,000 in 2009-2010. As for his own entertainment expenses during the two and 11 months' tenure, the average expenses for breakfast, lunch and dinner were \$95, \$186 and \$241 respectively. The HKPC had been prudent when entertainment expenses had to be incurred;
- the number and amount of claims made by the HKPC at the private club were small because most of the dining expenses incurred there had not been claimed. The expenses were often paid for by the Chairman of the HKPC, shared among the participants, or included in the seminar/training fees. In fact, the HKPC had frequently made use of the private club for liaison with trade associations; and
- given that over 200 professional staff could make use of the dining facilities at the private club to facilitate business development, and that it was the only dining venue of this nature in the vicinity, the annual fee was considered

reasonable. Nevertheless, the HKPC would bring up the matter for the Council's consideration in due course.

25. According to paragraph 4.34 of the Audit Report, the HKPC had adopted the practice of selling assets to staff through internal bidding without setting a reserve price. The Committee queried the propriety of the practice, which might create a perception of unduly favouring the staff at the expense of the HKPC.

26. The **ED of the HKPC** responded that according to the then Standard Practices, fixed assets that were surplus to operation might be disposed of through internal bidding, first among interested divisions, then among interested staff and finally, among external parties. If no one was interested, the assets would be donated to charity organisations or disposed of. Since September 2009, the HKPC had dispensed with the arrangement of selling assets to staff through internal bidding.

27. According to paragraphs 4.48 and 4.49 of the Audit Report, the Chairman of the HKPC commented in November 2006 that the expenditure of BMM Limited was on the high side, and doubted whether the HKPC was getting value for money in operating a subsidiary to provide building management services to itself. In response to the Chairman's comments, a review was carried out. The Chairman of the HKPC and Committee Chairmen decided in 2007 to continue the building management services of BMM Limited. The Committee asked:

- whether the HKPC had further reviewed the cost-effectiveness of BMM Limited since 2007; and
- about the respective operating costs of BMM Limited in 2006-2007, 2007-2008 and 2008-2009.

28. The **ED of the HKPC** said at the public hearing and in his letter of 29 December 2009 (in Annex G of **Appendix 16**) that:

- in 2007, the Chairman of the HKPC and Committee Chairmen had fully considered the cost-effectiveness and staff implications of outsourcing the management services of the HKPC Building. They came to the view that maintaining the services of BMM Limited was the most viable option, given that discontinuing its operation would give rise to sensitive staff issues, and the HKPC would have to make severance payment of about \$3 million to BMM Limited staff; and

- the HKPC would invite tender in 2010 for the provision of building management services at the HKPC Building. The operating cost of BMM Limited should be quite competitive as compared to other service providers. In fact, the operating costs of BMM Limited had decreased in the past three years, as shown below:

<i>Year</i>	<i>Operating cost</i>
2006-2007	\$6,234,466
2007-2008	\$6,326,292
2008-2009	\$6,012,712

29. It appeared to the Committee that the various problems in fixed asset management and administrative issues identified by Audit reflected that the HKPC's internal control was lax and ineffective and there was a lack of prudence in the use of public funds. The Committee asked:

- about the HKPC's response to the above observation; and
- whether the HKPC would review the terms of reference of the Finance Committee to see if they should be expanded to include overseeing matters relating to fixed asset management and procurement.

30. The **ED of the HKPC** said that:

- since he assumed duty in December 2006, the HKPC had already implemented many important reforms which were urgently required. For example, the HKPC had implemented most of the recommendations put forward in the two consultancy reports, covering procurement, human resource management, staff termination policy and procedures, etc. A performance pay scheme was also introduced. With the implementation of these reforms and the support of the 600 HKPC staff, the corporate culture of the HKPC had changed a lot;
- as for some minor cases identified by Audit, such as the ordering of newspapers and magazines from a newsagent and the renting of a private post office box at the Tsim Sha Tsui Post Office, there was indeed room for achieving greater economy. The HKPC had already taken swift actions to implement the audit recommendations. Newspapers and magazines were now subscribed directly from the publishers, and the renting of the post office box was discontinued; and

- as matters relating to fixed assets and procurement usually arose from internal audit review, they were discussed at meetings of the Audit Committee. This might not be the most appropriate arrangement. The HKPC would review the terms of reference of the Finance Committee to see if they should be expanded to include overseeing matters relating to fixed asset management and procurement.

C. Human resource management

Performance pay scheme

31. According to paragraph 3.4 of the Audit Report, it was stated in Financial Circular No. 9/2004 "Guidelines on the Management and Control of Government Funding for Subvented Organisations" that Controlling Officer should require the subvented organisation to produce annually a budget for subvented programmes, including a breakdown of staff expenses such as salaries, contract gratuity, bonuses and job-related allowances. However, Audit found that the budgets for 2007-2008 and 2008-2009 submitted by the HKPC to the Innovation and Technology Commission ("ITC") did not include the variable pay. Paragraph 3.13 also revealed that the HKPC had not sought prior approval from the Commissioner for Innovation and Technology for making the variable pay for 2007-2008, despite the requirement in section 6 of the HKPC Ordinance (Cap. 1116) that approval from the Commissioner was required for changes made to its salary scales. Covering approval was only obtained from the Commissioner in April 2009, about two months after the audit review commenced. The Committee asked why the HKPC had paid no regard to the relevant government guidelines and statutory requirement.

32. The **ED of the HKPC** responded that:

- the performance pay system was planned in 2007 and launched in January 2008. Serving staff were given one year to consider opting over to the new pay scheme. During the option period, there was no plan to make the variable pay. However, after noting that the financial performance for that year was good, he recommended to the Council that a pilot scheme be implemented by setting aside a small amount of money, i.e. about \$400,000, as variable pay. The purpose of the pilot scheme was to demonstrate how staff's performance was linked to their pay, and encourage more staff to opt over to the new scheme. Therefore, the item of variable pay was not included in the 2007-2008 budget;
- for 2008-2009, although variable pay was not included in the budget, when the HKPC management made recommendations to the Staffing Committee to set a ceiling of \$5 million for the variable pay, the Staffing Committee also noted that the expected surplus for that year would be at least \$6 million. In response to the audit recommendation, the HKPC had included the estimated

amount of variable pay in the budget for 2010-2011; and

- the HKPC had not sought prior approval from the Commissioner for making the variable pay due to negligence on the part of the management. Nevertheless, the background for introducing the variable pay should be noted. Since the Government had removed the general subvention guideline requiring subvented organisations to offer terms of service not superior to those offered for comparable civil service grade (i.e. the "no better than" guideline) in 2003, the ITC encouraged the HKPC to set a performance-based pay system. During the process of review, the HKPC fully consulted the ITC and the ITC supported the HKPC's proposed pay scheme. The performance pay scheme was subsequently endorsed by the Staffing Committee and approved by the Council. Since the Administration had all along supported the implementation of the pay scheme, the HKPC had overlooked the need to obtain written approval from the ITC.

33. The Committee then sought the views of the Financial Services and the Treasury Bureau on the HKPC's omission to include variable pay in the budgets. **Ms Bernadette LINN, Deputy Secretary for Financial Services and the Treasury (Treasury)**, said that since the budget for 2007-2008 had to be submitted several months before April 2007, it was understandable that the HKPC might not have determined the amount of variable pay at that time. However, for 2008-2009, as the HKPC had already implemented the performance pay scheme, it would be more desirable to specify the approximate amount of variable pay in that year's budget.

34. As mentioned in paragraphs 3.5 to 3.7 and 3.15 of the Audit Report, the variable pay was increased from \$400,000 in 2007-2008 by over 10 times to \$4.9 million in 2008-2009. The HKPC also determined the amount of variable pay for the two years before the actual financial results were available. Audit noted that the actual operating results for each year might differ significantly from the estimated results. The Committee asked:

- about the criteria for determining the level of variable pay for each year;
- why there were significant discrepancies between the actual operating results and the estimated results; and
- whether the HKPC had not been prudent in setting the amount of variable pay.

35. The **ED of the HKPC** responded that:

- in the submission to the Staffing Committee, it was stated that the estimated surplus for 2007-2008 amounting to about \$2.4 million would be sufficient to cover the variable pay. By the end of that year, in view of the larger amount of surplus available as compared to previous years, he decided to increase the expenditure for capital equipment, as such investment was essential for the HKPC's long-term development in providing services and support to Hong Kong's foundation industries. As a result, the actual surplus before deducting the variable pay was \$900,000, which was still sufficient for paying the variable pay of \$400,000. The amount of variable pay for that year was only a nominal pay under a pilot scheme;
- in 2008-2009, the variable pay of \$5 million was determined on the assumption that the most outstanding staff could obtain one month's salary as variable pay, those with good performance could obtain 0.6 to 0.8 month's salary and those with steady performance could receive 0.45 to 0.5 month's salary. It turned out that the actual surplus increased significantly from the estimated \$6 million to \$14.5 million, leaving a surplus of over \$9 million after deducting the variable pay. Given the healthy financial position, the amount of variable pay was considered moderate and reasonable; and
- in future, the HKPC would determine the amount of variable pay after the annual financial results were available.

36. According to paragraphs 3.8 to 3.12 of the Audit Report, in 2007-2008 and 2008-2009, the HKPC had decided the variable pay before the performance appraisal results for the relevant year were available, resulting in inconsistencies between the performance appraisal results and the variable pay awarded to individual staff for 2007-2008. The Committee asked why some of the best performers had not been awarded the highest variable pay, and whether this would cause discontent among the staff.

37. The **ED of the HKPC** explained that:

- the seemingly inconsistent results were due to the fact that the financial year cycle and the staff performance appraisal cycle did not synchronise in respect of the determination of variable pay for individual staff. The HKPC had used the performance appraisal results for 2006-2007 to determine the variable pay for 2007-2008. A diagram showing the cycles of performance appraisal and the financial year for the determination of variable pay was in *Appendix 17*;

- taking 2007-2008 as an example, if the performance appraisal cycle were to be aligned with the financial year cycle, the appraisal results could only be available in September 2008 taking into account the time required for writing the reports and holding promotion board meetings. By the time variable pay was made, the 2007-2008 financial year had already ended, and there might be technical difficulty in including the variable pay in the accounts of the 2007-2008 financial year; and
- notwithstanding the above difficulty, the HKPC had considered the audit recommendation and planned to synchronise the financial year cycle and the staff performance appraisal cycle from 2009-2010 onwards by compressing the appraisal process. By so doing, the HKPC would be able to make reference to the performance appraisal results in the same year in determining the variable pay.

Recruitment of staff

38. According to paragraph 3.19 of the Audit Report, in a recruitment exercise conducted in December 2006, the HKPC changed the appointment terms of the post from contract terms as advertised to permanent terms because the selected candidate was a serving HKPC permanent staff. The Committee enquired:

- about the justifications for doing so, which might be unfair to other candidates who had been discouraged from applying for the post on contract terms; and
- whether the HKPC had considered conducting another recruitment exercise, given that the appointment terms had changed.

39. The **ED of the HKPC** explained that:

- the selection panel, headed by the Chairman of the Staffing Committee, selected the most suitable candidate among the applicants. The selected candidate happened to be a serving staff on permanent terms. The selection panel then recommended to the Staffing Committee the changing of the post to a permanent one. The Staffing Committee, after discussion, agreed to the selection panel's recommendation; and
- in discussing the above matter, the Staffing Committee considered that flexibility should have been provided for in the recruitment advertisement, i.e. the terms to be offered should depend on the qualifications and experience of the candidate. With hindsight, as the terms of appointment in this case had been stated in the recruitment advertisement, the HKPC should have considered conducting another recruitment exercise when the terms of appointment were changed.

40. According to paragraphs 3.22 and 3.23 of the Audit Report, in a recruitment exercise held in October 2007, only one of the eleven candidates who met all the qualification requirements stated in the recruitment advertisement were invited to attend the selection interview, whereas four candidates who did not meet all the qualification requirements were invited. The Committee enquired about the reasons for inviting the four unqualified candidates and not inviting the 10 qualified candidates to the selection interview, which were not in compliance with the requirements on short-listing of candidates for job interview as stipulated in the Standard Practices.

41. The **ED of the HKPC** provided a summary of the reason why the 10 "qualified" candidates were not invited for interview whereas four "unqualified" candidates were invited (in *Appendix 18*). He also stated that as shown in the summary, although the 10 candidates seemed to have met the requirement of a minimum of 15 years' experience at senior positions, part of their experience was in fact irrelevant. As for the other four candidates invited for interview, their experience was highly relevant and close to meeting the requirement of 15 years' senior management experience.

Non-accountable Cash Allowance ("NCA")

Staff A

42. As stated in paragraph 3.31 of the Audit Report, according to the subvention guidelines in force when Staff A was appointed, subvented organisations were required to offer terms of service not superior to those offered to comparable civil service grade, and to follow the "no double housing benefits" rule in offering housing benefits to their staff. Under the rule, if an officer or his/her spouse had received full housing entitlement from a subvented body, he/she was ineligible for further housing assistance. Since Staff A had already exhausted his housing benefit entitlement under his previous employment with a publicly-funded organisation, the Committee asked:

- why the HKPC still offered him full entitlement to the NCA;
- why details of Staff A's previous and proposed remuneration packages were not provided to the Staffing Committee for consideration; and
- whether remedial action would be taken regarding the NCA offered to Staff A, which was against the "no double housing benefits" rule in force at that time.

43. The **ED of the HKPC** explained that:

- the paper submitted to the Staffing Committee clearly stated that Staff A was previously an employee of a publicly-funded organisation, and that he had exhausted his housing benefit entitlement and was no longer eligible for any housing benefits under that employment. The paper also set out a brief comparison of his previous remuneration package with the one proposed by the HKPC. The Staffing Committee approved the remuneration package with full entitlement to the NCA to Staff A in order to provide a remuneration package comparable to his previous terms;
- the management had no intention to withhold any information from the Staffing Committee. It would certainly be desirable if the paper could include more detailed information. However, the focus at that time was whether the remuneration package was attractive enough to Staff A; and
- the HKPC was seeking legal advice to see if there was sufficient legal ground to pursue remedial action. Personally, he considered it difficult to take further action on this case, given that special approval had been given by the Staffing Committee to offer the NCA to Staff A, and that a contract had been signed with him. After considering the legal advice and other objective facts, he would submit a proposal to the Council for consideration.

Staff B

44. According to paragraph 3.35 of the Audit Report, Staff B previously worked in a publicly-funded organisation and received a non-time-limited cash allowance in lieu of fringe benefits on housing, passage and education. In December 2007, the HKPC sought the Staffing Committee's approval to offer Staff B the full entitlement to the NCA. However, the HKPC informed the Staffing Committee that "it would be difficult to argue that the granting of NCA to Staff B would be in breach of the Standard Practices". The Committee queried why the HKPC management had made such a comment instead of informing the Staffing Committee that granting Staff B the full entitlement to the NCA would be in breach of the Standard Practices, and whether this would have misled the Staffing Committee.

45. The **ED of the HKPC** replied that:

- the comment was only mentioned in an e-mail sent to the Chairman of the Staffing Committee to explain his thoughts. It was not contained in the paper submitted to the Staffing Committee;

- with the promulgation of the government policy in December 2003 to delink the pay structure of subvented organisations from that of the civil service and the removal of the "no better than" and "no double housing benefits" requirements, the HKPC introduced the performance pay scheme in January 2008 to migrate towards a more market-oriented pay structure. Staff B was appointed after the performance pay scheme had taken effect and hence his entitlement to the NCA should not be reduced or limited. However, as the relevant provisions in the Standard Practices had yet to be updated, the HKPC went through the due process by seeking the Staffing Committee's special approval in this regard; and
- with hindsight, the Standard Practices should have been updated sooner. It would be most desirable if the Standard Practices were revised before the appointment was made.

46. The Committee then invited Audit's comments on this case. **Mr Benjamin TANG, Director of Audit**, said that as mentioned in paragraph 3.36 of the Audit Report, the HKPC management should have informed the Staffing Committee that the granting of full entitlement to the NCA to Staff B would be in breach of the Standard Practices.

Staff C

47. According to paragraph 3.37 of the Audit Report, when seeking the Staffing Committee's special approval to deviate from the Standard Practices, the justification provided by the HKPC was that in the absence of the full entitlement to the NCA, the offer was not sufficient to attract Staff C to join the HKPC. However, as revealed in paragraph 3.38(b), another candidate who achieved almost the same high ratings at the second interview had been selected as a reserve appointee. The Committee asked whether the HKPC had considered appointing the reserve appointee, if the offer was not considered to be attractive by Staff C.

48. The **ED of the HKPC** replied that according to normal practice, once the selection panel had decided on the most suitable candidate, the HKPC would negotiate the remuneration package with that candidate. At that stage, the HKPC would not contact any reserve candidate and it had no idea of the reserve candidate's expected remuneration package. It was not until the most suitable candidate had turned down the offer that the HKPC would proceed to negotiate with the reserve candidate.

Revision of the Standard Practices

49. As mentioned by the HKPC in paragraph 3.42(b) of the Audit Report, the relevant provisions regarding the NCA under the Standard Practices should have been revised to reflect the new market-oriented pay policy framework. The Committee enquired about the progress made in revising the Standard Practices.

50. The **ED of the HKPC** stated in his letter of 29 December 2009 (in Annex E of *Appendix 16*) that on 2 November 2009, the Staffing Committee endorsed the general removal of the "no double housing benefits" rule in the context of NCA for new hire. The Council approved the general removal of the rule on 17 November 2009. On 23 November 2009, the HKPC submitted the proposed amendments of the Standard Practices to the ITC for approval.

51. The **Commissioner for Innovation and Technology** said in her letter of 28 December 2009 (in *Appendix 14*) that after seeking legal advice, she approved on 15 December 2009 under delegated authority the submission from the HKPC in accordance with section 6(1) of HKPC Ordinance.

Remuneration package of the ED

52. As pointed out in paragraph 3.45 of the Audit Report, the ITC, when seeking the approval of the Council on the appointment of the ED, had not provided the Council with all relevant information about the eligibility to the allowances included in the remuneration package and the financial implications of encashing the allowances for inclusion in the lump-sum monthly salary. The Committee queried why the ITC had not provided such critical information to the Council to facilitate its making of a fully informed decision.

53. The **Commissioner for Innovation and Technology** said that:

- when seeking the Council's approval of the remuneration package to be offered to the ED, the ITC had not explicitly informed the Council of the information mentioned in paragraph 3.45 of the Audit Report. In the paper presented to the Council, the ITC explained that the negotiated package for the prospective ED followed a modernised and simplified approach, offering one lump-sum monthly remuneration and a gratuity at the end of the contract, instead of following the package for the previous ED. A comparison of the new remuneration package with that of the previous ED was also provided to the Council for reference; and

- it was definitely not the ITC's intention to withhold any information from the Council. The ITC agreed that when seeking the Council's approval, the information provided should be comprehensive and complete. The ITC would draw experience from this case in handling similar situation in future.

54. According to paragraph 3.52(b) of the Audit Report, the ITC concurred with the view of the then Chairman of the HKPC that it was not necessary for a separate submission to the Council for revising the contract term on the ED's salary adjustment mechanism. As the authority for appointing the ED was vested in the Council under the HKPC Ordinance, the Committee asked why prior approval from the Council was not obtained for such change in the terms of appointment.

55. The **Commissioner for Innovation and Technology** and **Mr Andrew LAI Chi-wah, Deputy Commissioner for Innovation and Technology**, said that the proposed change was only a technical amendment to align the ED's salary adjustment mechanism to the newly introduced performance pay scheme, and to demonstrate the ED's support for the scheme. Hence, the Chairman of the HKPC, the Chairman of the Staffing Committee and the ITC had all agreed that it was not necessary to submit a separate paper to the Council seeking its approval for the addendum to the ED's contract. As rightly pointed out by Audit, the ITC would in future obtain approval from the Council for any change in the ED's terms of appointment.

56. Regarding the terms of the new contract with the ED mentioned in paragraphs 3.49 and 3.50 of the Audit Report, the ITC recommended to the Council in June 2009 that the rate for calculating the ED's end-of-contract gratuity should be adjusted from 12.5% to 15% "to align with the provision for other HKPC staff". However, the rationale for offering a reduced gratuity rate in the ED's first contract was not mentioned. The Committee queried why the ITC had not provided the relevant background information to the Council.

57. The **Commissioner for Innovation and Technology** said that in negotiating the terms of the new contract with the ED, it was agreed that whilst the monthly salary would remain unchanged, the contract gratuity rate should be adjusted from 12.5% to 15% to align with the provision for other HKPC staff. The paper which recommended the ED's contract renewal was indeed quite succinct, with no detailed explanation on the background of the rate of gratuity. Having regard to the experience of this case, the ITC would provide more relevant information for the Council's reference in future to avoid recurrence of similar situation.

D. Corporate governance

58. To ascertain the involvement of the Chairman of the HKPC and government officials in the governance of the HKPC, the Committee asked about:

- the time devoted by the Chairman to the HKPC's work;
- the role of the Commissioner for Innovation and Technology and the time devoted by her to matters relating to the HKPC; and
- the role of the Permanent Secretary for Commerce and Economic Development in the Council of the HKPC.

59. The **Chairman of the HKPC** said that apart from attending regular Council meetings, he also actively participated in meetings of other standing committees to gain a better understanding of the operation of the HKPC, as he was newly appointed to the Council. To learn more about the HKPC's management team, he attended the management's working meetings. He also attended two staff symposiums arranged by the ED. Because of this Audit Report, he spent about one and a half to two days per week in the HKPC to discuss various issues with the management.

60. The **Commissioner for Innovation and Technology** said that:

- the Commissioner was one of the public officers appointed to the Council, and also the Controlling Officer of the subvention to the HKPC. The Commissioner was responsible for ensuring that the HKPC's activities accorded with its objectives and relevant public policies and priorities. As the bridge between the HKPC and the Administration, the Commissioner provided policy directives and gave advice on policy matters to the HKPC, and communicated with other government bureaux and departments on other policy areas if necessary;
- the Commissioner also had the responsibility to oversee the administration of the HKPC, although the daily operation should be the responsibility of the ED and his management team. To discharge the oversight responsibility, the Commissioner would attend the HKPC's meetings, examine the Three-year Forecast and Annual Programme and Estimates submitted by the HKPC to the ITC, and discuss the performance indicators with the HKPC. The relationship between the Government and the HKPC and the responsibilities of each party were set out in the Memorandum of Administrative Arrangements;

- after she took up the post as Commissioner in September 2009, she was aware that there would be an Audit Report on this subject, and had spent time in learning more about the matter. She estimated that in the past month, she had discussed the subject matter with her colleagues (e.g. the Deputy Commissioner and Assistant Commissioner) at least three times a week through various channels. She also had frequent communication with the Chairman of the HKPC; and
- the ITC attached importance to the expeditious and full implementation of the audit recommendations and had discussed the issues raised in the Audit Report and their latest progress through the ITC's regular housekeeping meetings with the HKPC.

61. **Mr Duncan Pescod, Permanent Secretary for Commerce and Economic Development (Communications and Technology)**, said that he represented the Bureau and reflected to the HKPC the policy decisions taken by the Government. However, the Bureau would not get involved in the day-to-day management of the HKPC, which was the responsibility of its management.

62. The **Secretary for Commerce and Economic Development** also said that the Council of the HKPC attached importance to the need to improve its governance. Therefore, the HKPC commissioned two consultancy studies in 2006 on its governance and administration. The ITC, through participation in the Council's work, had thoroughly examined the consultants' recommendations and seriously followed up the implementation of those recommendations.

63. The Committee then enquired:

- how the ITC had monitored the HKPC's implementation of the consultants' recommendations, apart from discussing the matter in the Council; and
- about the latest progress of and timetable for implementing the consultants' recommendations, as well as the reasons for not implementing certain recommendations, if any.

64. The **Commissioner for Innovation and Technology** stated in her letter of 28 December 2009 (in *Appendix 14*) that the ITC held regular housekeeping meetings with the HKPC management. At the meetings on 10 January, 6 February, 12 April, 7 June and 11 September 2007, the implementation of the recommendations of the two consultancy studies was discussed.

65. The **ED of the HKPC** provided, vide Annex B of his letter of 29 December 2009 (in *Appendix 16*), a list summarising the major recommendations made by the two consultants, the progress made so far and the timetable for implementing other recommendations. The reasons for not implementing certain recommendations were also provided.

Council and Committee meetings

66. According to paragraph 2.6 of the Audit Report, the attendance rates of six members at the Council/Committee meetings held during the period 2005 to 2008 were low. They attended 33% or less of the Council meetings. Paragraph 2.10 further revealed that two of the abovementioned Council members were reappointed in January 2009. The Committee asked:

- about the measures that would be taken by the HKPC to improve the attendance of members at Council/Committee meetings;
- whether the HKPC would consider publishing the Council members' attendance rates in its annual report; and
- why the two Council members were reappointed by the Government despite their low attendance rates.

67. The **Chairman of the HKPC** and the **ED of the HKPC** said that the Council Secretariat had already taken actions to improve the attendance rates. Apart from drawing up an annual tentative schedule of Council/Committee meetings to facilitate members' planning in advance, the Council Secretariat would also remind members to attend meetings by sending e-mails and short messages via mobile phones. Starting from the last round of meetings, the Council Secretariat had tabled a note at each meeting of the Council/Committees informing members of their up-to-date attendance rates. The HKPC would also publish Council members' attendance rates in its next annual report. The above measures would be conducive to higher attendance rates.

68. Regarding the reappointment of the two Council members with low attendance rates, the **Secretary for Commerce and Economic Development** explained that when considering the ITC's recommendations on the reappointment, apart from the members' attendance records, due consideration had been given to their overall performance and contributions to the Council's work. Besides, their continuous service in the Council would be of particular help at the time of the expected change in the chairmanship of the Council by the end of 2008.

69. The Committee noted from paragraph 2.25(d) of the Audit Report that the HKPC would make the minutes of Council/Committee meetings available on its website as suggested by Audit, and asked whether this had been done.

70. The **ED of the HKPC** said that the Council had decided that the minutes of meetings of the Council and three standing committees (viz. Staffing Committee, Finance Committee and Business Development Committee) would be posted on the HKPC's website, except those of the Audit Committee and discussion items containing commercially sensitive or confidential information. The first batch of minutes had been posted on the website in December 2009.

71. According to paragraph 2.16 of the Audit Report, the joint-meeting arrangement for the Council and Finance Committee was stopped after the then Commissioner for Innovation and Technology raised his concerns over the arrangement with the Chairman of the HKPC in September 2005. However, the arrangement was resumed in November 2007. The Committee asked:

- whether the HKPC had consulted the ITC before the resumption of the arrangement;
- since the ED was not a Council member, whether his participation in the joint meetings would cause any conflict of interest; and
- whether the HKPC would revisit the joint-meeting arrangement, which might have undermined the role of the Finance Committee in the governance of the HKPC.

72. The **ED of the HKPC** responded that:

- according to usual practice, he would discuss with the Chairman of the HKPC and other Committee Chairmen the agenda of upcoming meetings. For the Finance Committee meeting, the major agenda item was the HKPC's Annual Programme and Estimates. Since recommendations on the Annual Programme and Estimates made by the Finance Committee had to be approved by the Council, the Chairman of the HKPC had decided to hold joint meetings of the Council and the Finance Committee for the sake of efficiency. When a joint meeting was held, the HKPC would inform the Council and Finance Committee members of the arrangement. The HKPC had not consulted the ITC in advance, but the Commissioner for Innovation and Technology, as one of the Council members, was aware of the arrangement;

- he attended Council meetings mainly to explain the Three-year Forecast and Annual Programme and Estimates to the Council and answer any queries that Council members might have. If he was not present at the meeting to provide immediate response and information, there might be practical difficulties in the smooth conduct of the meeting. As the ED did not have voting right in the Council, he did not perceive any conflict of interest for his participation in the meetings; and
- the HKPC accepted the audit recommendation. The last Finance Committee meeting was held separately from the Council meeting. If any change of meeting arrangement was warranted in future, the HKPC would consult the whole Council and full documentation of the justifications would be made.

73. The Committee noted that under section 5(1)(i) of the HKPC Ordinance, the Council might "appoint a standing committee (of which the Executive Director shall be an ex officio member) for such general purpose, and from time to time a special committee for such special purpose, as in the opinion of the Council would be better regulated and managed by such a committee". As stated in paragraph 2.21 of the Audit Report, the ED's membership of the Audit Committee was contrary to the good corporate governance practice that an audit committee should be independent of the executive management. The Committee asked:

- whether the ITC considered the Audit Committee a standing committee for general purpose, or a special committee for special purpose, within the meaning of section 5(1)(i) of the Ordinance, and the reason for taking such view;
- whether the ITC considered that the ED was required to be an ex officio member of the Audit Committee by virtue of section 5(1)(i) of the Ordinance, and the reason for taking such view;
- whether the ITC had sought legal advice in respect of the application of section 5(1)(i) of the Ordinance in determining the status of the Audit Committee for the purpose of that section; if it had, what the legal view was; and
- whether the Administration would consider amending the Ordinance to ensure that the ED would cease to be a member of the Audit Committee.

74. The **Commissioner for Innovation and Technology** responded in her letter of 28 December 2009 (in *Appendix 19*) that:

- the formation of an Audit Committee was proposed by the HKPC management in August 2005. This was a follow-up to one of the recommendations made by the consultant SQW which recommended that for effective and transparent corporate governance, the HKPC should establish an Audit Committee with the internal audit function reporting to that committee. The proposal was subsequently approved by the Council of the HKPC on 11 August 2005. At that time, it was a special committee and the ED was not its member. In January 2006, following a review of its committees' composition, the HKPC management proposed to turn the Audit Committee into a standing committee. The proposal was approved by the Council with the ED as a member of the Audit Committee in line with section 5(1)(i) of the HKPC Ordinance. On both occasions, the ITC agreed to the HKPC management's proposals;
- section 5(1)(i) of the HKPC Ordinance stipulated that the Council of the HKPC might appoint a standing committee for such general purpose and the ED shall be an ex officio member. The ITC noted that the Audit Committee had been a standing committee of the Council since January 2006 and the ED should hence be its ex officio member under the Ordinance;
- the ITC had sought legal advice on the ED's membership on the Audit Committee having regard to the provision in section 5(1)(i) of the HKPC Ordinance. The legal view was that there was no provision in the section and in other parts of the Ordinance which provided the flexibility of the ED not taking up membership in a standing committee; and
- having regard to the audit recommendations and after discussion with the Chairman of the HKPC and the Chairman of the Audit Committee, it had been agreed that while the ED should continue to attend the Audit Committee to facilitate the Committee to better understand the governance issues of the HKPC, he would refrain from taking part in the voting of the committee. He should also be excused from the discussion of the sensitive issues if the Chairman of the Audit Committee saw such a need. The new arrangement should be able to address, to a large extent, the governance issue raised by Audit. The ITC, together with the HKPC, would closely monitor the implementation of the new arrangement and carry out review to see if further improvement was required.

75. The Committee also sought the views of the HKPC on:
- how "a standing committee for general purpose" and "a special committee for special purpose" were understood by the Council;
 - the reason for regarding the Audit Committee as a standing committee whereby the ED was required to be its ex officio member; and
 - whether the Council had perceived any problem with the application of section 5(1)(i) of the Ordinance in determining the status of the Audit Committee for the purpose of that section; if it had, whether any advice had been sought from the Administration in this regard.

76. The **ED of the HKPC** stated in his letter of 29 December 2009 (in *Appendix 20*) that:

- "a standing committee for general purpose" was generally taken as a committee which in the opinion of the Council would better regulate and manage matters of general and recurrent nature and the committee was set up on a long-standing basis. "A special committee for the special purpose" was taken as a committee set up for an one-off specific issue and so it was usually task-specific or time-limited;
- the terms of reference of the Audit Committee were of a general nature and they covered issues which were recurrent in nature. On 25 January 2006, a paper was circulated to the Council seeking its approval for the membership of the Audit Committee and the transformation of the Audit Committee into a standing committee. The Council approved the transformation. The Audit Committee was therefore considered a standing committee and the ED an ex officio member thereof; and
- the Council had not perceived any problem with the application of section 5(1)(i) of the Ordinance in determining the status of the Audit Committee for the purpose of that section. The Council also had not separately sought any advice from the Administration as there were five government officials on the Council advising it on government policies and practices.

Strategic planning

77. According to paragraph 2.31 of the Audit Report, the HKPC management had not regularly updated the five-year strategic plan approved by the Council in March 2004, and had not reported the progress of the implementation of the strategic plan to the Council since January 2006. Up to September 2009, no new strategic plan had been prepared for

2009-2010 and beyond. The Committee asked why the HKPC management had not updated the strategic plan and prepared a new strategic plan.

78. The **ED of the HKPC** replied that:

- in 2008-2009, i.e. the last year of the five-year strategic plan made in 2004-2005, the Council reviewed the implementation of the strategic plan and decided that it was not necessary to draw up another five-year strategic plan. This was because the HKPC had all along prepared a rolling Three-year Forecast which mapped out in detail the direction and activities planned over a three-year period. The rapid changes in technology and the operating environment of the industries also rendered a long-term planning difficult, as the HKPC had to respond to external challenges quickly. At present, the HKPC held regular meetings with the ITC and the Chairmen of the Council/Committees to discuss its short to medium term strategies; and
- as Audit had pointed out the importance of having a strategic plan in corporate governance, the Council would revisit the need for a five-year strategic plan and other viable alternatives that would serve the same purpose.

Monitoring of the operation of subsidiaries in the Mainland

79. According to paragraph 2.38 of the Audit Report, in 2003, the HKPC incorporated the Productivity (Holdings) Limited as the vehicle to hold the Wholly Foreign Owned Enterprises ("WFOEs") incorporated in the Pearl River Delta ("PRD"). The objective of setting up the WFOEs was to promote productivity excellence across the value chain of Hong Kong firms operating in the PRD. Table 3 and paragraph 2.40 of the Audit Report showed that about 51% and 22% of the capital of the Productivity (Guangzhou) Consulting Company Limited ("GZ-WFOE") and the Productivity (Dongguan) Consulting Company Limited ("DG-WFOE") were depleted because of the accumulated losses. The Committee asked whether the HKPC had conducted a thorough strategic review of the long-term sustainability and operation of the WFOEs, in particular, the financial viability of the GZ-WFOE and DG-WFOE.

80. The **ED of the HKPC** said that the history of the three WFOEs was short as they were only established in 2003 and 2004. Since he assumed duty, the WFOEs had transformed into a service platform for supporting Hong Kong industries in the Mainland. Although the GZ-WFOE and the DG-WFOE had experienced losses in their initial years of operation, in 2007-2008 and 2008-2009, the GZ-WFOE had accumulated gains and the DG-WFOE started to have surplus in 2008-2009. Hence, there were marked improvements in the financial performance of the WFOEs since the business model had changed. The HKPC would conduct a thorough strategic review on the long-term sustainability and operation of the subsidiaries in the PRD, and would regularly report their operating results to the Council.

81. According to section 4(2)(b) of the HKPC Ordinance, all projects undertaken by the HKPC elsewhere than in Hong Kong should be carried out on a full-cost recovery basis, i.e. the minimum rate charged by the HKPC for the assignment was sufficient to recover all costs incurred in carrying out that assignment, which costs shall include direct costs (recurrent and capital) and overhead costs. However, the Committee noted from paragraph 2.42 of the Audit Report that the HKPC adopted a discount policy for projects undertaken for its Mainland subsidiaries, whereby only 58% of the project staff cost and overheads incurred were recovered from the subsidiaries. The Committee:

- queried why the HKPC had adopted such a discount policy, which was in breach of the statutory requirement; and
- asked whether the Administration would consider amending the relevant provisions in the Ordinance so that the HKPC could charge a lower rate for projects undertaken in the Mainland.

82. The **ED of the HKPC** explained that:

- the rate charged for projects undertaken for the Mainland subsidiaries was determined in 2004 and had been followed since then. The then management might have considered it necessary to provide services to the Hong Kong industries which had relocated to the Mainland on the same subvented basis as those provided for Hong Kong industries, given the important public mission of the HKPC in supporting Hong Kong industries in the Mainland to enhance their productivity;
- according to the latest available figures, as at September 2009, the Mainland subsidiaries had accumulated a surplus of \$110,000. It was estimated that by the end of March 2010, the surplus would reach \$130,000. From this angle, the returns were more than sufficient to cover the total paid up capital; and
- the HKPC did not notice the problem with the rate charged until the audit review. The HKPC accepted that a strict legal interpretation should be adopted regarding the full-cost recovery requirement. Therefore, the HKPC decided at its Council meeting held in November 2009 that a rate set on a full-cost recovery basis would be charged in order to comply with the statutory requirement.

83. The **Chairman of the HKPC** also added that whilst he understood the need to comply with the statutory requirement, Hong Kong industries in the Mainland expected that the service provided by a publicly-funded organisation would be of high quality and reasonable cost. If the HKPC charged them a full rate for the services provided, the industries would consider the cost too high. Such structural problem had put the HKPC in a difficult position.

84. The **Secretary for Commerce and Economic Development** said that:

- the services provided by the HKPC should suit the needs of the industries in view of the rapid changes in the economic environment. Some trade associations and industries had also raised the problem with the Bureau and expressed their concerns about the statutory requirement of full-cost recovery; and
- the HKPC Ordinance had been enacted for over 40 years. In view of changed circumstances, the Administration would consider whether legislative amendment was necessary having regard to other considerations.

85. In view of the various inadequacies in the matter of corporate governance, the Committee asked whether the ITC had not adequately discharged its oversight responsibility over the HKPC, and whether the HKPC was determined to revamp its corporate culture and enhance its governance.

86. The **Commissioner for Innovation and Technology** said that the ITC needed to enhance its oversight over the HKPC. She would accord a high priority to the follow-up of the audit recommendations. The ITC would also set up in December 2009 a financial unit, headed by a government senior accountant, to liaise with the publicly-funded organisations within the ITC's purview, so as to strengthen the ITC's oversight over the governance and financial arrangements of these organisations.

87. The **Chairman of the HKPC** responded that the HKPC attached great importance to the audit recommendations and would make its best endeavours to implement them. The HKPC would draw experience from the inadequacies identified by Audit and make improvements. In fact, he had told all staff at a symposium that he hoped the HKPC would be considered an exemplary publicly-funded organisation by the Director of Audit if Audit conducted another value for money audit.

E. Conclusions and recommendations

88. The Committee:

- expresses grave dismay and alarm at the:
 - (a) manifest lack of compliance culture in the Hong Kong Productivity Council ("HKPC"), whether with regard to relevant statutory requirements, regulations, procedures and guidelines set out in the HKPC Ordinance (Cap. 1116), its own Standard Practices or relevant government guidelines;

- (b) lack of prudence in the use of public funds expected of a publicly-funded organisation; and
- (c) lax and ineffective internal controls of the HKPC;
- considers that while the HKPC has to be flexible and proactive in achieving its objectives and delivering its services, the need for compliance, internal controls and proper documentation should not be compromised for the sake of expediency;
- acknowledges that the Chairman of the HKPC:
 - (a) has admitted that the HKPC had been slack, negligent and even faulty in some aspects of corporate governance and project management; and
 - (b) is hopeful that by the time the HKPC has completed the implementation of all audit recommendations by September 2010, the HKPC would be considered an exemplary publicly-funded organisation by the Director of Audit if he conducts another value for money audit;
- urges the HKPC to foster a corporate culture of compliance and prudent use of public funds, and take measures to ensure that such a culture takes root in the organisation;

Internal control and administrative issues

- expresses alarm and strong resentment, and finds it unacceptable that the HKPC has failed to take effective measures to ensure the proper management of fixed assets and laboratory equipment:
 - (a) a large number of items at the total purchase cost of \$54.6 million, \$1.7 million and \$762,000 were found missing in the three stocktakes conducted in 2005 and 2009. However, there was no record showing that the HKPC had investigated each case of loss and ascertained the causes for the loss and whether any criminal act or negligence was involved;
 - (b) despite the significant number of loss of items identified in the full-scale stocktake conducted from September to December 2005, five sets of Standard Practices were only revised and issued on 1 January 2008 to promulgate measures to strengthen fixed asset management. The effectiveness of these measures was also in doubt, as 13% of items among those selected for checking in the partial stocktake in April 2009 could not be located;

- (c) only 43 (2%) of the 2,603 pieces of laboratory equipment were purchased at a cost of \$500,000 or more and hence covered by the inventory control system. The utilisation and disposal of the remaining 2,560 pieces (98%) of equipment were not covered by the system; and
 - (d) the requirements of the system to control the utilisation and disposal of laboratory equipment as specified in the Standard Practices were not fully complied with;
- finds it unacceptable that the HKPC had adopted the practice of selling assets to staff through internal bidding without setting a reserve price, which demonstrates a lack of sensitivity over the possibility of creating a perception of unduly favouring the staff at the expense of the HKPC;
 - expresses concern that the HKPC has not taken the initiative to explore means to achieve greater economy and ensure the prudent use of public funds:
 - (a) the low utilisation of the dining facilities of the private club near the HKPC Building gave rise to doubt whether the annual fee of \$15,000 paid for it was good value for money;
 - (b) although the Chairman of the HKPC and the Committee Chairmen decided in 2007 to continue the building management services of BMM Limited after noting that its operating expenditure was on the high side, the HKPC management had not further reviewed the feasibility of outsourcing the services;
 - (c) the HKPC had for many years ordered newspapers and magazines from a newsagent instead of directly subscribing from the publishers, which could have achieved savings ranging from 9% to 81%; and
 - (d) the HKPC had rented a private post office box at the Tsim Sha Tsui Post Office for about 20 years without reviewing its cost effectiveness, despite that there is a post office within walking distance from the HKPC Building;
 - acknowledges that:
 - (a) the Executive Director ("ED") of the HKPC has undertaken to accord the highest priority to reviewing the fixed asset management system and will introduce additional improvement measures to the Council for approval;

- (b) with effect from 7 October 2009, the threshold of the laboratory equipment purchase cost was lowered from \$500,000 to \$100,000 so that 183 pieces (73%) of equipment were covered by the inventory control system; and
 - (c) the HKPC has agreed with the audit recommendations in paragraphs 4.10, 4.16, 4.24, 4.31, 4.36, 4.40, 4.45, 4.51, 4.55 and 4.61 of the Director of Audit's Report ("Audit Report");
- urges the HKPC to:
- (a) take effective measures expeditiously to ensure the safe custody and management of fixed assets;
 - (b) review the terms of reference of the Finance Committee to see if they should be expanded to include overseeing matters relating to fixed asset management and procurement; and
 - (c) continue to monitor the operating cost of BMM Limited and periodically assess its cost-effectiveness;

Human resource management

Performance pay scheme

- expresses serious dismay and finds it unacceptable that in administering the performance pay scheme, the HKPC has failed to comply with the relevant statutory requirements and government guidelines, or act prudently in its detailed implementation:
 - (a) the HKPC had not sought prior approval from the Commissioner for Innovation and Technology for making the variable pay for 2007-2008, as required under section 6 of the HKPC Ordinance. Covering approval was only obtained from the Commissioner in April 2009, about two months after the audit review commenced;
 - (b) the budgets for 2007-2008 and 2008-2009 submitted by the HKPC to the Innovation and Technology Commission ("ITC") did not include the variable pay, contrary to the requirement in the Government's Financial Circular No. 9/2004 "Guidelines on the Management and Control of Government Funding for Subvented Organisations";
 - (c) the decisions on variable pay for 2007-2008 and 2008-2009 were made before the actual financial results were available; and

- (d) in 2007-2008 and 2008-2009, the HKPC had decided the variable pay before the performance appraisal results for the year were available, resulting in inconsistencies between the performance appraisal results and the variable pay awarded to individual staff for 2007-2008;
- acknowledges that the HKPC has agreed with the audit recommendations in paragraph 3.16 of the Audit Report;

Recruitment of staff

- expresses serious dismay and finds it unacceptable that notwithstanding the policy of the HKPC to maintain fairness in its recruitment, selection and appointment process, the following irregularities were noted:
 - (a) in a recruitment exercise conducted in 2006 to fill a senior post, the HKPC changed the appointment terms of the post from contract terms as advertised to permanent terms to suit the selected candidate because he was a serving permanent staff, casting doubt on the fairness and openness of the recruitment exercise; and
 - (b) in another recruitment exercise conducted in October 2007, four candidates who did not meet the qualification requirements were invited to attend the selection interview. There was no documentation showing the justifications for inviting the four unqualified candidates and not inviting the other 10 qualified candidates to the interview, contrary to the requirements stipulated in the Standard Practices;
- acknowledges that the HKPC has agreed with the audit recommendations in paragraph 3.24 of the Audit Report;

Non-accountable Cash Allowance ("NCA") and the ED's remuneration package

- finds it appalling and totally unacceptable that the HKPC management and the ITC failed to make full and frank disclosure when seeking exceptional approval for departure from the requirements of the Standard Practices and when seeking approval for important personnel matters. The withholding of relevant information was likely to have misled the approving authorities in making their decisions:
 - (a) the HKPC management, when seeking exceptional approval from the Staffing Committee for offering full entitlement to the NCA to candidates whose entitlement should have been reduced or limited according to the Standard Practices, failed to provide full details (e.g. the candidate's existing remuneration package, his expected salary, and the availability of a reserve appointee) to help the Committee make a fully informed decision;

- (b) since Staff B had previously worked in a publicly-funded organisation receiving cash allowance in lieu of housing, passage and education benefits, his entitlement to the NCA in the HKPC might be reduced according to the Standard Practices. However, instead of informing the Staffing Committee that granting Staff B the full entitlement to the NCA would be in breach of the Standard Practices, the HKPC management informed the Chairman of the Staffing Committee that "it would be difficult to argue that the granting of NCA to Staff B would be in breach of the Standard Practices". This is unacceptable and misleading;
 - (c) the ITC, when seeking the Council's approval of the remuneration package to be offered to the incumbent ED, failed to explicitly inform the Council that:
 - (i) the ED might not be eligible for the NCA or his eligibility had to be reduced; and
 - (ii) the entitlement to the NCA was limited to 10 years under the Standard Practices but the encashed NCA element in the package was not time-limited; and
 - (d) the ITC failed to provide the Council with all the relevant information (such as the financial implications of encashing the allowances for inclusion in the lump-sum monthly salary and the rationale behind reducing the rate of gratuity to 12.5% in the ED's first contract) when seeking its approval for renewal of the ED's contract with an increased rate for contract gratuity;
- expresses serious concern and finds it unacceptable that:
- (a) for three senior staff, despite the fact that they had received housing benefits from the Government or from publicly-funded organisations in their previous employment, their entitlements to the NCA were not reduced or limited as stipulated in the Standard Practices;
 - (b) the HKPC failed to take timely action to amend the relevant provisions in the Standard Practices to reflect the new market-oriented pay policy framework, which included the removal of the "no double housing benefits" rule in the context of the NCA for new hire; and
 - (c) approval from the Council had not been obtained for revising the contract term regarding the ED's salary adjustment mechanism, and that even the ITC concurred that a separate submission to the Council was not necessary on the basis that the revision was a consequential amendment;

- acknowledges that:
 - (a) the HKPC submitted to the ITC for approval on 23 November 2009 the proposed amendments of the Standard Practices regarding the removal of the "no double housing benefits" rule in the context of the NCA for new hire, and the Commissioner for Innovation and Technology approved under delegated authority the HKPC's submission on 15 December 2009 in accordance with section 6(1) of the HKPC Ordinance;
 - (b) the HKPC has agreed with the audit recommendations in paragraph 3.41 of the Audit Report; and
 - (c) the Commissioner for Innovation and Technology has agreed with the audit recommendations in paragraph 3.51 of the Audit Report;
- urges:
 - (a) the HKPC management to strictly comply with the requirements of the Standard Practices and, if exceptional approval from the Staffing Committee is required, make full and frank disclosure by providing detailed and complete information to facilitate the Committee's decision-making; and
 - (b) the Commissioner for Innovation and Technology to provide all relevant information to the Council when seeking its approval on the appointment and terms of appointment of the ED;

Corporate governance

- expresses grave dismay that:
 - (a) contrary to the statutory requirement under section 4(2)(b) of the HKPC Ordinance that all projects undertaken by the HKPC elsewhere than in Hong Kong should be carried out on a full-cost recovery basis, the HKPC had adopted a discount policy for projects undertaken for its Mainland subsidiaries, whereby only 58% of the project staff cost and overheads incurred were recovered; and
 - (b) the Commissioner for Innovation and Technology, as the Controlling Officer of the subvention to the HKPC and one of the public officers appointed to the Council, has not adequately discharged the oversight responsibility over the HKPC, including ensuring the HKPC's compliance with the statutory requirements concerning projects undertaken for its Mainland subsidiaries;

- expresses serious concern that there were the following inadequacies in the matter of corporate governance:
 - (a) the joint-meeting arrangement for the Council and the Finance Committee, which had been resumed since November 2007 on the ground of efficiency, might have undermined the role of the Finance Committee in the governance of the HKPC;
 - (b) the ED of the HKPC has been a member of the Audit Committee since it became a standing committee in January 2006, contrary to the good corporate governance practice that an audit committee should be an oversight committee independent of the executive management;
 - (c) about 51% and 22% of the capital of two of the HKPC's subsidiaries in the Mainland had depleted because of accumulated losses, and the operating results of the Mainland subsidiaries were not regularly reported to the Council;
 - (d) the attendance rates of six Council members at Council/Committee meetings held from 2005 to 2008 were low, but two of them were still reappointed in January 2009;
 - (e) despite the Government Economist's low attendance at Council/Committee meetings during the period 2005 to 2008, the arrangement for appointing an alternate member to ensure higher attendance was not made until April 2009;
 - (f) the HKPC had not set any target to ensure that draft minutes of meetings would be issued in a timely manner;
 - (g) in 2008 and 2009, some Council members had submitted their declarations of interests late; and
 - (h) after the approval of the strategic plan for 2004-2005 to 2008-2009 in March 2004, the management had not regularly updated the plan. Since January 2006, no report on the progress of the implementation of the plan had been made to the Council, and strategic planning was not discussed at Council meetings. Up to September 2009, no new strategic plan had been prepared for 2009-2010 and beyond;
- acknowledges that:
 - (a) the HKPC decided at its Council meeting held in November 2009 that a rate set on a full-cost recovery basis would be charged for projects undertaken for its Mainland subsidiaries in order to comply with the statutory requirement;

- (b) the Secretary for Commerce and Economic Development has undertaken to review whether legislative amendment is necessary regarding the minimum rate charged by the HKPC for projects undertaken elsewhere than in Hong Kong, having regard to changes in circumstances and views of industries;
- (c) the Commissioner for Innovation and Technology:
 - (i) has accepted that the ITC needs to enhance its oversight over the HKPC, and will accord a high priority to the follow-up of the audit recommendations; and
 - (ii) set up in December 2009 a financial unit in the ITC, headed by a government senior accountant, to liaise with the publicly-funded organisations within the ITC's purview, so as to strengthen the ITC's oversight over the governance and financial arrangements of these organisations;
- (d) the HKPC will hold separate meetings of the Council and its Finance Committee. Should any change of meeting arrangement be warranted, thorough discussion of the justifications and the full Council's approval would be required;
- (e) the ED will refrain from taking part in the voting of the Audit Committee, and will be excused from the discussion of sensitive issues if the Chairman of the Audit Committee sees such a need. The ITC and the HKPC will closely monitor the implementation of this new arrangement and carry out review to see if further improvement is required;
- (f) at the Council meeting held on 16 September 2009, the Council decided that:
 - (i) in addition to its regular reminders to members, the Council Secretariat will at each meeting of the Council/Committees provide a note informing all members of their up-to-date attendance rates;
 - (ii) the Council Secretariat will draw up an annual tentative schedule of Council/Committee meetings at the beginning of each year so that members can better plan in advance;
 - (iii) the Council Secretariat will issue draft minutes of meetings of the Council/Committees within three weeks of the meetings and any proposed amendments within two weeks thereafter;

- (iv) the minutes of Council/Committee meetings will be made available on the HKPC's website, except discussion items containing commercially sensitive or confidential information; and
- (v) the Council Secretariat will issue written reminders to members when declarations of interests are due;
- (g) except in very special circumstances, members with low attendance will not be reappointed. Any exceptions will be properly documented and full justifications given;
- (h) all public officers on the Council have made arrangements on the appointment of alternate members to facilitate attendance at Council meetings;
- (i) the HKPC will revisit the need for a five-year strategic plan and other viable alternatives that would serve the same purpose;
- (j) the HKPC has agreed with the audit recommendations in paragraphs 2.23, 2.35 and 2.43 of the Audit Report; and
- (k) the Secretary for Commerce and Economic Development and the Commissioner for Innovation and Technology has agreed with the audit recommendations in paragraph 2.24 of the Audit Report;
- urges that the Secretary for Commerce and Economic Development and the Commissioner for Innovation and Technology should, in consultation with the HKPC, comprehensively review the HKPC Ordinance which was enacted in the 1960s, to ensure that it meets present-day good corporate governance and management principles and practices, and suits the current needs of Hong Kong industries. In particular, the Administration should:
 - (a) consider amending section 5(1)(i) of the HKPC Ordinance to ensure that the ED's membership in a standing committee will not contravene generally accepted good corporate governance practices (e.g. the ED should not be a member of the Audit Committee); and
 - (b) consider amending section 4(2)(b) of the HKPC Ordinance so that Hong Kong industries operating in the Mainland can be provided with support from the HKPC's Mainland subsidiaries on the same subvented basis as those operating in Hong Kong;

Performance measurement and reporting

- expresses concern that:
 - (a) documentation was not available showing that the performance indicators used by the HKPC to report its performance had been approved by the Commissioner for Innovation and Technology in accordance with the Memorandum of Administrative Arrangements;
 - (b) the HKPC had not set performance targets for performance management according to the Memorandum of Administrative Arrangements; and
 - (c) the performance indicators used by the HKPC and the ITC for reporting the performance of the HKPC are mainly output indicators;
- acknowledges that:
 - (a) the HKPC has agreed with the audit recommendations in paragraph 5.11 of the Audit Report; and
 - (b) the Commissioner for Innovation and Technology has agreed with the audit recommendations in paragraph 5.12 of the Audit Report; and

Follow-up actions

- wishes to be kept informed of:
 - (a) the measures taken to foster a corporate culture of compliance and prudent use of public funds, and ensure that such a culture takes root in the organisation;
 - (b) the measures taken to ensure the safe custody and management of fixed assets;
 - (c) the result of the review of the terms of reference of the Finance Committee;
 - (d) any decision made regarding the continuation of building management services provided by BMM Limited;
 - (e) the decision regarding the proposed comprehensive review of the HKPC Ordinance to ensure that it meets present-day good corporate governance and management principles and practices, and suits the current needs of Hong Kong industries. In particular:

- (i) the decision and progress made in amending section 5(1)(i) of the HKPC Ordinance to ensure that the ED's membership in a standing committee will not contravene generally accepted good corporate governance practices; and
 - (ii) the decision and progress made in amending section 4(2)(b) of the HKPC Ordinance regarding the minimum rate charged by the HKPC for projects undertaken elsewhere than in Hong Kong; and
- (f) the progress made in implementing the various audit recommendations.