



***Audit Commission
Hong Kong***

**Corporate Governance for
Subvented Organisations:
The Audit Commission's
Perspective**

**Benjamin Tang
Director of Audit
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Part 1

Corporate governance of subvented organisations

What is corporate governance?

- There is no single universally accepted definition
- Corporate governance generally refers to the processes by which organisations are directed, controlled and held to account
- It encompasses authority, accountability, stewardship, leadership, direction and control exercised in the organisation

Governance and accountability

- It is important that those who govern need to be held accountable to the stakeholders
- The concepts of governance and accountability are very much related

Development of the concept of corporate governance

- The concept of corporate governance originated in the **private sector**
- It was derived primarily from a desire to improve the **transparency and accountability of financial reporting** by listed companies to their shareholders

Increasing importance of corporate governance

- Following the **collapse of large corporations** like Enron and WorldCom at the beginning of the 21st century, issues about corporate governance have become increasingly topical
- More recently, the series of **corporate failures** of major international brand names, notably Lehman Brothers, have once again highlighted the importance of corporate governance

Corporate governance in the public sector

- In the past decade, the concept of corporate governance has developed very quickly, extending from the private sector to the public sector
- In the public sector, the concept of governance has a clear focus on **performance and accountability**
- Public sector governance primarily originated from a desire for greater **effectiveness, efficiency and economy** in the use of public resources, as well as a higher expectation for **openness and accountability**

Fundamental principles of good corporate governance

- *The 1992 UK Report of the Committee on the Financial Aspects of Corporate Governance (the Cadbury Report)* identified three fundamental principles of good corporate governance:
 - **Openness**
 - **Integrity**
 - **Accountability**
- These principles are also relevant in the public sector

Principles of good public governance

- ***Openness***: Ensures that stakeholders have confidence in the decision-making processes and actions of public sector entities
- ***Integrity***: Based on honesty and objectivity, and high standards of propriety and probity in the stewardship of public resources
- ***Accountability***: Process whereby public sector entities, and the individuals within them, are responsible for their decisions and actions, and submit themselves to appropriate external scrutiny

Provision of public services by subvented organisations

- Subvented organisations have played an important role in the provision of public services in Hong Kong, particularly in:
 - education
 - healthcare
 - social welfare
- Subventions to these organisations accounted for some **40% of Government spending**

Public concern about corporate governance issues

- Subvented organisations are accountable for the use of public resources in their provision of services
- The public is concerned about whether good value is obtained for the public money entrusted to these organisations
- In recent years, the Public Accounts Committee (PAC) of the Legislative Council (LegCo), has expressed **concern about subvented organisations' corporate governance issues**

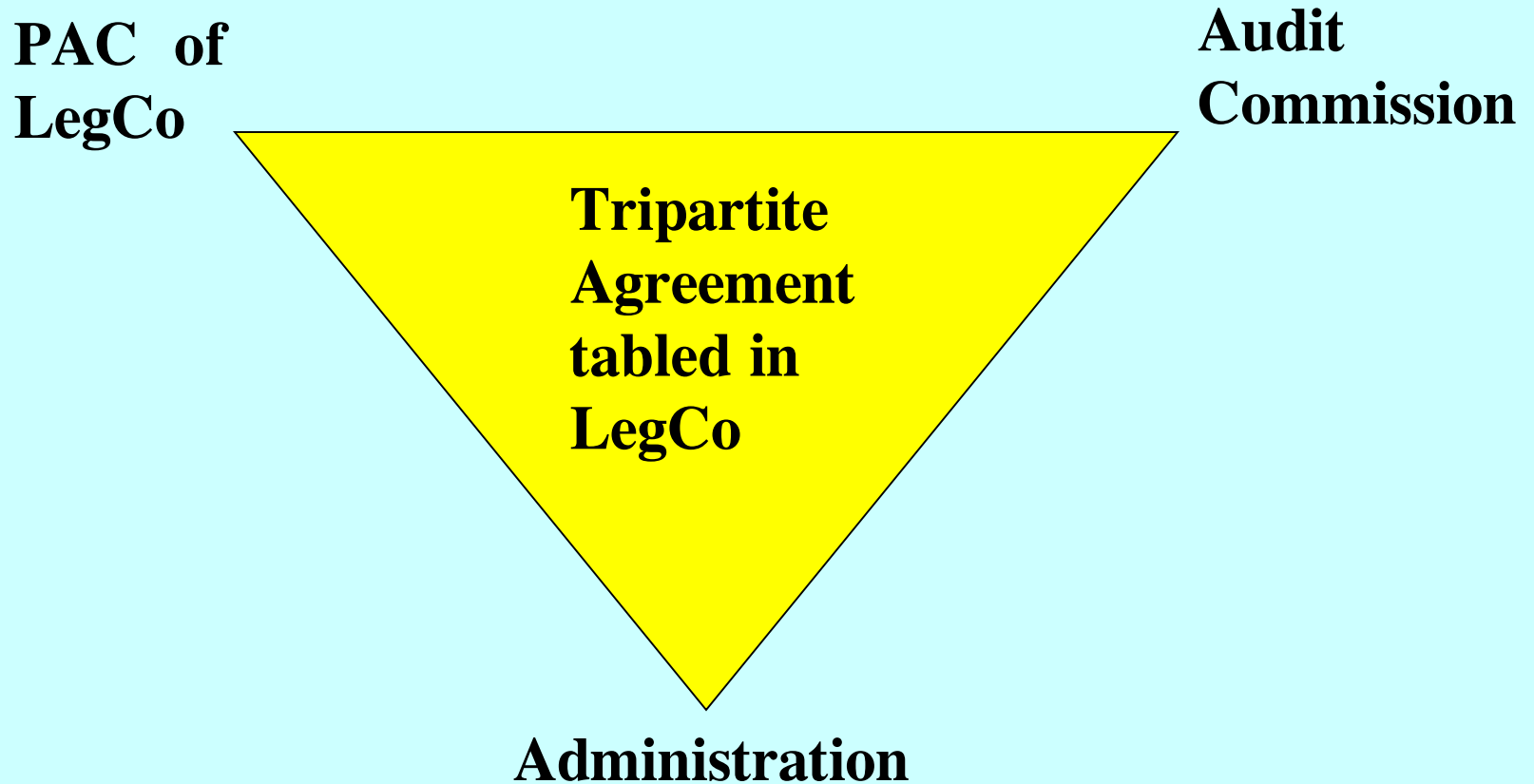
Part 2

Audit approach to the review of subvented organisations

Mission of Audit Commission

- To provide independent, professional and quality audit services, in order to help the Government enhance public sector **performance and accountability**
- In particular, **value for money (VFM) audit** provides independent information, advice and assurance about the **economy, efficiency and effectiveness** with which the Government has discharged its functions

VFM Audit Guidelines



Organisations subject to VFM audit

- Under the VFM Audit Guidelines, an **“audited organisation”** shall include any organisation:
 - whose accounts the Director of Audit is empowered under any **Ordinance** to audit (or an **agreement** for audit made as a condition of subvention);
 - which receives **more than half its income from public moneys**; and
 - the accounts of which the Director is **authorised in writing to audit by the Chief Executive** in the public interest under section 15 of Audit Ordinance.

Criteria for selecting subjects for VFM audit

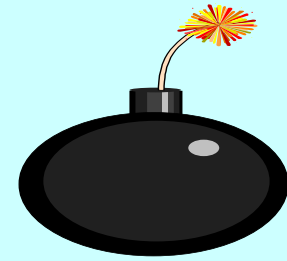
- 1. Materiality** (重要性)
- 2. Risk** (風險)
- 3. Timeliness** (時間性)
- 4. Value-added** (增值性)
- 5. Auditability** (審核工作的可行性)

1. *Materiality* (重要性)



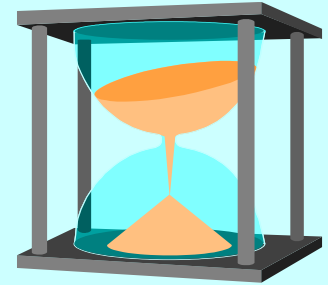
- A matter is material if its disclosure is likely to be of interest to, or influence, the report users
- A matter may be material by:
 - **amount**
 - **nature**
- As mentioned above, subventions are material, accounting for some **40% of Government spending**

2. Risk (風險)



- The risk that an audited body is not achieving good VFM, resulting in:
 - **wastage of public resources**
 - **objectives not achieved**
- Subvented organisations enjoy **a high degree of independence**, and may not be subject to government rules and regulations. Their **governance arrangements** also vary markedly - hence higher VFM risk

3. *Timeliness* (時間性)



- It affects the setting of **priority**.
For example, **urgent issues** should be addressed first
- There are subvented organisations which have not been subject to VFM audit for quite some time
- Some of them have not yet been subject to any VFM audit since their establishment

4. *Value-added* (增值性)



- Likely **benefits** of the audit
- Potential for generating **constructive recommendations** which will lead to increased economy, efficiency and accountability in the use of public resources
- Recent VFM audits on subvented organisations had made **constructive recommendations** for improvement, especially in corporate governance

5. *Auditability*

(審核工作的可行性)



- Audits must be **evidence-based** (i.e. sufficient evidence to support the audit conclusions)
- **Qualitative/unquantifiable** aspects are less auditable
- Subvented organisations that are “audited organisations” under the VFM Audit Guidelines are auditable
- Audit has already reviewed quite a large number of such organisations in recent years

“Health checks” of subvented organisations

- In the past few years, Audit conducted a series of VFM audits of subvented organisations, highlighting problems of corporate governance and making recommendations for improvement
- VFM audits of subvented organisations may be likened to **“health checks”**, which are aimed at helping the organisations **“prevent long-term illness through early diagnosis and treatment”**

Part 3

Corporate governance issues in recent audits of subvented organisations

Recent audit cases on governance of subvented organisations

- *Hong Kong Applied Science and Technology Research Institute Co. Ltd.*
香港應用科技研究院 (ASTRI)
(March 2007)
- *Hong Kong Tourism Board* 香港旅遊發展局 (HKTB) (October 2007)
- *Equal Opportunities Commission* 平等機會委員會 (EOC) (March 2009)



VFM audit : ASTRI



- A limited company incorporated by the Government
- Mission: To perform research and development to enhance Hong Kong's competitiveness in technology-based industries
- Government subvention in 2006-07 amounted to \$120 million

VFM audit: ASTRI

Corporate governance

- Low attendance rate of some Directors at Board meetings
- Incomplete/inaccurate documentation of committee proceedings



VFM audit: ASTRI

Management of conflicts of interest

- Register of Directors' interest forms were lost
- Non-disclosure agreements were not signed as required



VFM audit: ASTRI

Remuneration and recruitment

- Staff receiving salaries higher than maximum of respective pay bands
- Improper staff recruitment procedures



VFM audit: ASTRI

Project management

- Risk analysis not conducted
- No computerised project management information system
- Reporting requirements in relevant guidelines not followed



VFM audit: ASTRI

Expenditure control

- Entertainment expenses exceeded annual budget
- No prior approval for overseas duty visits
- “Fung Shui” (風水) consultancy fees of some \$181,000 paid



VFM audit : HKTb



- A Government-subsidized body founded on 1 April 2001 under the HKTb Ordinance (Cap. 302). Government subvention in 2006-07 amounted to \$466 million
- Objectives:
 - to market and promote Hong Kong as a destination worldwide; and
 - to enhance the experiences of its visitors once they have arrived

VFM audit : HKTB

Corporate governance

- Draft business plans and budgets were approved after commencement of relevant financial years
- Attendance of some members at Board meetings was low
- Declaration of interest forms were not submitted



VFM audit : HKTB

Performance measurement and reporting

- No direct measurement of HKTB's performance in its marketing activities
- Annual reports were tabled one year after year-end dates



VFM audit : HKTB

Remuneration and recruitment

- Staff received salary higher than maximum of respective salary range
- **Medical insurance plan (total premium: \$177,000) for the CEO** did not have proper approval
- Staff recruitment procedures were not adhered to

VFM audit : HKTB

Financial controls

- Entertainment expenses exceeded cost-per-head spending limits
- Commenced business travel before obtaining approval



VFM audit : EOC



- A statutory body established in 1996 under the Sex Discrimination Ordinance (Cap. 480)
- Mission: To eliminate discrimination and promote equal opportunities
- Funded mainly by recurrent government subventions (\$76.5 million in 2008-09)

VFM audit : EOC

Corporate governance

- **The posts of the Chairperson and the CEO are not separated** to provide checks and balances
- Low attendance of some Members at Board/Committee meetings
- At some meetings, the EOC had not ensured a quorum was present throughout the meetings

VFM audit : EOC

Duty visits outside Hong Kong

- Expenditure incurred by a public entity on duty visits can be a **sensitive** issue:
 - **Ambassador Suite hotel accommodation** for the Chairperson during a duty visit
 - No documentation on the number of guests and their identities for a dinner (amounting to \$15,200) attended by 28 persons
 - Cost of a lunch before a duty visit commenced was reimbursed as expenses of the duty visit

VFM audit : EOC

Procurement

- Procurement procedures not always followed
- In some purchases, the need for an item was not clearly established before expenditure was incurred, including:
 - Environmental bags (in large quantity)
 - Video conferencing system
 - Air purifiers
 - Staplers (in large quantity)
 - Extension sockets

VFM audit : EOC

Management of stores

- Disposal of surplus assets not properly carried out and documented, including:
 - Conference table
 - Air-conditioner
 - Clock (at a cost of \$7,200) which was described by EOC staff as “classic and accurate”
 - Computer equipment (e.g. LCD monitors)
- Shortcomings in control of library materials

VFM audit : EOC

Life insurance coverage for the Chairperson

- In 1997, the EOC Board endorsed a proposal for the provision of life insurance to the EOC staff and its Chairperson (premium paid for the period August 2008 to July 2009 was \$245,000)
- However, the Chairperson's remuneration shall be **determined by the Chief Executive** under the Sex Discrimination Ordinance
- There was **no specific approval** from the Administration for the provision of life insurance coverage for the Chairperson

Good practices recommended

- Expedite action to consider separating the posts of the Chairperson and the CEO to provide an **effective system of checks and balances**
- Adopt high standards of corporate governance, including improving the attendance of Members at meetings and ensuring the quorum requirement is met throughout the meetings
- Strictly apply the **“moderate and conservative” principle (適度和保守原則)** in making expenditure decisions on duty visits (and also other **“sensitive expenditure”**)



Good practices recommended (Cont'd)



- Ensure compliance with the procurement procedures
- Ensure that the need for an item is clearly established before expenditure is incurred
- Draw up guidelines to ensure proper disposal of assets
- Seek specific approval from the Administration for the provision of life insurance coverage for the Chairperson

Common governance issues identified in previous audits

- **Low attendance rates** of governing board and committee meetings
- **Reappointment** of board/committee members with poor attendance records
- **Quorum requirements** not met at meetings
- Inadequacies in management of **conflicts of interest**
- Lack of a strong **internal audit** function (including audit committee)

Common governance issues identified (Cont'd)

- **Poor record keeping** in recruitment and procurement matters
- Inadequacies in **strategic management**
- Room for improvement in **performance management**
- Problems in managing **sensitive expenditure**

Strategic management

- In nearly every audit, we examine whether an effective strategic planning framework is in place in the audited organisation
- But very often, we found that strategic plans were not properly devised
- In some cases, these plans were not regularly updated

Performance management

- Performance management is another area that we will address in nearly every audit
- Common observations include:
 - **Inadequate disclosure** of key performance information
 - Lack of **outcome performance indicators**, particularly effectiveness indicators

Audit issues about strategic and performance management

- Issues about strategic and performance management are well received by the audited organisations
- Audit recommendations to address these issues are generally **constructive and forward-looking**
- They are however not really “sexy” issues in the eyes of the public (compared with cases of non-compliance and wastage)
- In Audit’s view, they are very important issues that help the audited organisations **manage risks at a strategic level**

Management of sensitive expenditure

- Many subvented organisations have common problems in managing **sensitive expenditure**
- Sensitive expenditure generally refers to expenditure by a public entity that could be seen as giving some private benefit to an individual staff that is additional to the business benefit to the entity
- Examples include:
 - **official entertainment**
 - **overseas business trips**
 - **fringe benefits of CEOs**

Management of sensitive expenditure (Cont'd)

- While the amount of money spent on an item of sensitive expenditure may be small in the context of an entity's total expenditure, each sensitive expenditure decision is important
- It is because improper expenditure could harm the reputation of, and trust in, the entity (i.e. **reputational risk** 聲譽風險)
- Even if such expenditure may be fully justified, its potential sensitivity means that careful decision making is needed to decide whether:
 - there is **a justifiable business purpose** for the expenditure
 - the expenditure decision is **moderate and conservative** (適度和保守)

Management of sensitive expenditure (Cont'd)

- Examples of audit observations on sensitive expenditure that attracted much public concern in recent audits include:
 - *Audit of ASTRI 香港應用科技研究院 (Mar 2007):*
“**Fung Shui**” (風水) consultancy fees of some \$181,000 paid by ASTRI which is supposed to be a centre of excellence in research of applied science and technology
 - *Audit of HKTB 香港旅遊發展局 (Oct 2007):*
Medical insurance plan for the CEO of HKTB **without proper approval** (total premium amounting to \$177,000), which gave rise to a public outcry over such excessive and unauthorised insurance package for the CEO of a statutory body

Management of sensitive expenditure (Cont'd)

- *Audit of EOC 平等機會委員會 (Mar 2009):*
Extravagant and inappropriate expenditure of the EOC that failed the test of **moderate and conservative principle (適度和保守原則)** in the use of public funds, e.g.:
 - Ambassador Suite (大使套房) hotel accommodation for the EOC Chairperson (who is also the CEO) during a duty visit; and
 - Chairperson's life insurance coverage which did not have proper approval

Final tips on achieving good corporate governance

- ***Guide to Corporate Governance for Subvented Organisations (May 2010), Efficiency Unit:***
 - It provides a lot of good guidance and advice
 - Good practices should be followed as far as possible – ***the “comply or explain” principle***
- **Fostering a compliance culture:**
 - Many of the good corporate governance practices are just basic management principles
 - There is also no lack of procedures and guidelines in most public-sector organisations
 - **Very often, poor corporate governance is mainly a result of non-compliance**

Final tips (Cont'd)

- **Director of Audit's Reports:**
 - Recent audits on corporate governance of subvented organisations, e.g.:
 - ◆ **2007:** ASTRI and HKTB
 - ◆ **2008:** SARDA, Hong Kong Design Centre, Consumer Council, and Prince Philip Dental Hospital
 - ◆ **2009:** EOC, HK Arts Development Council, HK Productivity Council, and Office of the Privacy Commissioner for Personal Data
 - ◆ **2010:** HK Chinese Orchestra Ltd
 - **Lessons should be learnt from past audit findings**

“I will not say I failed 1000 times, I will say that I discovered there are 1000 ways that can cause failure”

Thomas Edison

Concluding remarks

- **“Immune system” (免疫系統)** refers to all the organs and processes in your body which protect you from illness and infection
- **Government audit is expected to function as the “immune system” that safeguards national interests, security and sustainability (免疫系統功能)**
- **“Corporate governance” of an organisation may also be likened to the “immune system” of a human being**
- **“Corporate governance” functions as an organisation’s “immune system” that safeguards stakeholders’ interests, prevents corporate failures, and ensures long-term corporate health and sustainability**

Concluding remarks

- Having a good immune system does not guarantee perfect health and longevity. However, it does a great job in preventing infections and protecting us from illnesses
- Problems with the immune system will inevitably lead to infections and illnesses. A collapse of the immune system is very often fatal
- **Similarly, for an organisation, while achieving good corporate governance may not guarantee success, without it, failure is almost certain**

Thank you



End of Presentation