

CHAPTER 3

**THE GOVERNMENT OF THE
HONG KONG SPECIAL ADMINISTRATIVE REGION**

CAPITAL WORKS RESERVE FUND

GOVERNMENT SECRETARIAT

Works Bureau

GOVERNMENT DEPARTMENTS

Architectural Services Department

Drainage Services Department

Review of defaulted contracts

REVIEW OF DEFAULTED CONTRACTS

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REVIEW OF DEFAULTED CONTRACTS

Summary and key findings

A. **Introduction.** To implement the Public Works Programme, the Government invites competitive tenders from eligible works contractors on the List of Approved Contractors for Public Works. The Works Bureau (WB) has laid down rules and criteria for assessing the financial, technical and management capability of works contractors. The Government may re-enter a works contract if the contractor is persistently in breach of any of the contractual obligations. From April 1997 to September 2000, the Government re-entered 36 contracts involving 17 defaulting contractors. Almost all of the defaulting contractors went into liquidation (paras. 1.2, 1.3, 1.7 and 1.8).

B. **Audit review.** Audit has recently conducted a review of the defaulted contracts to examine the adequacy and effectiveness of the existing administrative arrangements for financial vetting and monitoring of works contractors, and to review the administrative arrangements for dealing with defaulting contractors (para. 1.9). The audit findings are summarised in paragraphs C to G below.

C. **Improvements needed for assessment of financial capability of works contractors.** The Finance Unit of the WB assesses the financial capability of works contractors for admission to and retention on the List of Approved Contractors, and for tendering for new contracts. The WB has recently completed a review of the financial assessment system for assessing works contractors. The recommendations, which have recently been approved by the Secretary for the Treasury, will help reduce the risk of works contractors failing to meet the required standard of performance due to cashflow problems or heavy financial losses (paras. 1.5 and 2.2).

D. In Audit's review of the defaulted contracts, Audit noted two cases in which the liquidity problems of the contractors were not revealed by the Finance Unit's financial assessment, notwithstanding that there were indications that the contractors might have financial problems. Audit considers that there is scope for improvement in this regard. The Finance Unit should have adopted special and proactive procedures to enable it to effectively assess the contractors' financial position, such as requesting the senior management of the contractors to provide the most up-to-date financial information (para. 2.18).

E. **The need to introduce precautionary measures before relaxing contractors' liability as an alternative to re-entry.** In early 1997, the Architectural Services Department (ArchSD), as an alternative to re-entry of a contract, released the liquidated damages deducted and paid prolongation costs to a contractor under a supplementary agreement to ensure the continuation and completion of

the contract as soon as possible. However, two months after entering into the supplementary agreement, the ArchSD re-entered the contract. Audit considers that, before entering into the supplementary agreement, the works department concerned should have coordinated with the WB to assess whether the contractor could continue with the contract. Audit considers that there is merit for the works department concerned to introduce precautionary measures in the supplementary agreement, such as making payments by instalments, so as to safeguard the interests of the Government (paras. 3.10, 3.14 and 3.17).

F. **The need to monitor novation of contracts.** In the event of re-entry of contracts, money due to the Government pending recovery from a defaulting contractor may be set off against money due to the defaulting contractor under any of his other contracts with the Government. In late 1994, the parent company of a contractor applied to the WB for the transfer of listing on the List of Approved Contractors of its two subsidiary companies to its newly established company (referred to in the Report as Contractor A). In the application, the companies concerned had agreed that, if the WB approved the transfer of the listing, they would accept novation of the 16 outstanding contracts of the two subsidiaries to Contractor A. However, the WB did not monitor closely the progress of the novation of the contracts. Eight of the contracts were not novated. Between late 1998 and early 1999, the Government re-entered three defaulted contracts with Contractor A. If all the 16 contracts had been novated as agreed by the parties concerned, the Government could have been able to set off an additional sum of \$3.35 million (paras. 4.3 to 4.5, 4.7, 4.8, 4.14 and 4.15).

G. **Unauthorised removal of constructional plant and materials.** In the event of re-entry of a contract, the constructional plant and materials on site owned by the contractor would become the property of the Government and the Government may use them for the completion of the contract. In Audit's review of the defaulted contracts, Audit noted two cases in which constructional plant and materials, including high value items such as barges, dredgers and tugboats, were removed from the sites by the defaulting contractors despite the fact that letters had been sent to the contractors prohibiting them from doing so. Audit considers that the works departments should have taken more effective measures to reduce the chances of a defaulting contractor removing the constructional plant and materials from the site (para. 5.12).

H. **Audit recommendations.** Audit has made the following main recommendations:

— the Secretary for Works should:

- (a) closely monitor the financial position of a contractor when there are indications that the contractor may have financial problems (para. 2.22(a));

- (b) where there are indications that a contractor may be in financial difficulties, require the contractor to submit more frequently the most up-to-date financial information (para. 2.22(b));
 - (c) notify in writing all works departments that, before taking remedial measures under a supplementary agreement as an alternative to re-entry of a contract, they should:
 - (i) in consultation with the WB, assess the contractor's ability to meet his obligations under the supplementary agreement, taking into account all relevant factors, such as the financial position and all the other outstanding works commitments of the contractor (para. 3.18(a)); and
 - (ii) if it is necessary to make substantial payments to the contractor, consider making the payments by instalments, and requiring the contractor to ask his parent company and/or a financial institution to provide a third party guarantee (para. 3.18(b)); and
 - (d) in approving applications from contractors for transfer of listing on the List of Approved Contractors, closely monitor the progress of novation of the contracts (para. 4.17(c)); and
- the Director of Drainage Services and the Director of Architectural Services should take effective measures to safeguard the Government's interests, such as valuable constructional plant and materials, having regard to the cost-effectiveness of such measures (para. 5.13).

I. **Response from the Administration.** The Secretary for Works has generally agreed with the audit recommendations and has agreed to draw the attention of the works departments to the audit recommendations.

PART 1: INTRODUCTION

Public Works Programme

1.1 The Public Works Programme (PWP) is a programme of public works projects through which the Government constructs new infrastructure and brings about improvements to Hong Kong's publicly owned facilities. The PWP includes road construction, drainage works, waterworks, land reclamation and building construction. The Works Bureau (WB) is responsible for managing the PWP as a whole, while the works departments are responsible for the implementation of the individual projects.

1.2 To implement the PWP, the Government invites competitive tenders from eligible works contractors on the List of Approved Contractors for Public Works. The List comprises contractors who have been approved to carry out one or more categories of public works, namely Buildings, Port Works, Roads and Drainage, Site Formation and Waterworks. From 1997-1998 to 1999-2000, the Government awarded about 450 public works contracts at a total sum of about \$60 billion, i.e. about \$20 billion a year.

Rules for administration of public works contractors

1.3 Works Bureau Technical Circular (WBTC) No. 9/97 (Note 1) on "Rules for the Administration of the List of Approved Contractors for Public Works" of May 1997 lays down the rules and criteria for assessing the financial, technical and management capability of works contractors. The approved contractors within each category (see paragraph 1.2 above) are further divided into Groups A, B or C according to the value of contracts for which they are normally eligible to tender, as shown in Table 1 below.

Note 1: *WBTC No. 9/97 of May 1997, which is still in force, replaces WBTC Nos. 2/90, 20/93 and 37/93.*

Table 1

Tender limits and financial criteria for admission to and retention on the List of Approved Contractors

Classification of contractor	Tender limit (contract value)	Minimum employed capital (Note 1)	Minimum working capital (Note 2)
	(\$ million)	(\$ million)	(\$ million)
Group A	up to 20	2.1	2.1
Group B	up to 50	5.3	5.3
Group C (Note 3)	exceeding 50	9.0	9.0

Source: WBTC No. 9/97

Note 1: Employed capital refers to the shareholders' funds. It basically comprises capital, reserves and retained profits of a company.

Note 2: Working capital refers to the net current asset position (current assets minus current liabilities) of a contractor. It serves as an indicator of the contractor's liquidity position.

Note 3: Group C contractors are normally not allowed to tender for contracts intended for Groups A and B contractors, unless the works department concerned considers that there may be an inadequate number of tenders as a result of the restriction.

1.4 Admission to and retention on the List of Approved Contractors for a particular group is subject to the contractor meeting the financial criteria, having the appropriate technical and management capabilities and in all other ways being considered suitable for inclusion in the List. In particular, the contractor is expected to employ a certain minimum number of full time management and technical staff who have relevant experience in engineering and project management in Hong Kong.

1.5 In accordance with WBTC No. 9/97, the Finance Unit of the WB (hereinafter referred to as the Finance Unit) assesses the financial capability of contractors (in terms of employed capital and working capital) for admission to and retention on the List of Approved Contractors, and for tendering for new contracts. In this connection, all approved works contractors are required to

submit a copy of their annual audited accounts to the Secretary for Works to show that they meet the financial criteria applicable to the particular group. In addition, in order to enable the Finance Unit to make a more up-to-date financial appraisal, all Group C contractors are also required to submit half-yearly accounts. The half-yearly accounts of the Group C contractors should be certified by their auditors or, if this is not feasible, by the directors, partners or the sole proprietor of the company. All approved works contractors are required to submit the required accounts within six months after the end of the accounting period. Regulatory actions (including suspension from tendering, demotion to a lower group, or deletion from the List of Approved Contractors) will be taken against those contractors who fail to submit the accounts within the specified time.

1.6 For admission to and retention on the List of Approved Contractors, the contractors are required to maintain not less than the minimum levels of employed capital and working capital applicable to their group as shown in Table 1 in paragraph 1.3 above. However, in order to be recommended for the award of a contract of any value in a category of works, a contractor's working capital (as shown by his latest submitted accounts) should be at least:

- the minimum working capital for retention on the Approved List; or
- a required percentage of the total annualised value of the new contract and uncompleted works on current government works contracts held by the contractor (Note 2),

whichever is the higher. Regulatory actions will be taken against contractors who fail to rectify the shortfall, if any, in employed capital and/or working capital within the time specified by the Finance Unit.

Defaulted contracts

1.7 According to Clause 81(1) of the General Conditions of Contract (GCC) for Civil Engineering and Building Works, the Government may re-enter a works contract if, for example, despite repeated warnings, the contractor fails to proceed with the works with due diligence or is persistently in breach of any of the contractual obligations. The Government should normally be entitled to recover the following costs from the defaulting contractor:

- expenses properly incurred by the Government;

Note 2: *The required percentages for Groups A, B and C contractors are 20%, 10% and 6% respectively. However, for a Group C contractor, the uncompleted works include those under Housing Authority contracts and contracts with the private sector.*

- extra cost in completion of the works; and

- damages for delay in completion.

However, the Government was usually unable to recover the full amount as most of the defaulting contractors had become bankrupt or gone into liquidation.

1.8 According to the statistics compiled by the Finance Unit, from April 1997 to September 2000, the Government re-entered 36 contracts involving 17 defaulting contractors (Note 3). Almost all of the defaulting contractors went into liquidation and, as at January 2001, they owed the Government about \$716 million (see Note 4 and Appendix A).

Audit review

1.9 Audit has recently conducted a review of the defaulted contracts:

- (a) to examine the adequacy and effectiveness of the existing administrative arrangements for financial vetting and monitoring of works contractors; and

- (b) to review the administrative arrangements for dealing with defaulting contractors.

1.10 Audit reviewed 19 contracts (i.e. 53% of the 36 contracts re-entered over the period April 1997 to September 2000) involving five defaulting contractors (see Appendix A). As at January 2001, the five defaulting contractors owed the Government an estimated amount of \$607 million (85% of the total of about \$716 million mentioned in paragraph 1.8 above). The audit has revealed that there is room for improvement in the financial vetting and the monitoring of works contractors, and in the administrative arrangements for dealing with the defaulting contractors.

Note 3: *Due mainly to the Asian financial turmoil in 1997, there was a larger number of defaulted contracts in 1997 and 1998 compared with previous years.*

Note 4: *The actual amounts owed by the defaulting contractors, including liquidated damages, are subject to any extra cost in completion of the works and further claims.*

PART 2: ASSESSMENT OF FINANCIAL CAPABILITY OF WORKS CONTRACTORS

2.1 This part examines the system of financial assessment of works contractors. The audit has revealed that there is room for improvement in assessing the financial capability of contractors.

WB's review of the financial assessment system

2.2 The existing system of assessing the financial capability of works contractors has been used since the 1970s without major changes in the basic control features. In mid-1997, in the light of the spate of Group C contractors having financial problems, the WB started a review of the financial assessment system. In October 1999, a working group comprising representatives of the works departments and the WB was set up to examine what measures could be adopted for improving the financial vetting of works contractors. The objective was to reduce the risk of works contractors failing to meet the required standard of performance due to cashflow problems or heavy financial losses. In August 2000, the working group finalised its review report. In February 2001, the Secretary for the Treasury approved the working group's proposed revisions to the existing financial criteria for assessing the works contractors.

2.3 The approved revisions and the related changes that will be made to the existing financial assessment criteria and procedures include the following:

- (a) ***Increasing the employed capital and working capital to the present cost level.*** The present level of employed capital and working capital required for admission to or retention on the List of Approved Contractors will be increased by 44%, e.g. from \$9 million to \$13 million for Group C contractors (see Table 1 in paragraph 1.3 above). The increase will restore the required levels of capital to the same real value as those in the last revision in 1994 (Note 5);
- (b) ***Increasing the minimum working capital requirement for Group C contractors from 6% (see Note 2 to paragraph 1.6 above) to 8%.*** The working group considers that a minimum of 8% of the total annualised value of the outstanding works as working capital, which is equivalent to one-month's working capital, is appropriate for Group C contractors. In works contracts, it is reasonable to expect a contractor to have a minimum of one-month's working capital in hand because the cost of works done is usually reimbursed at least one month in arrears;
- (c) ***Higher employed capital and working capital requirements where the total annualised outstanding workload for public and private sector contracts exceeds \$800 million.*** The default of a works contract with a high value of outstanding works is more

Note 5: *This is based on the weighted average rate of increase in various construction cost indices.*

undesirable than that with a low value of outstanding works in terms of works progress and potential financial loss to the Government. Therefore, contractors have to meet higher employed capital and working capital requirements for periodic financial assessment, pre-qualification and tender assessment, if the value of the total annualised outstanding workload for public and private sector works exceeds \$800 million, as follows:

- their minimum employed capital should be \$13 million (see item (a) above) plus \$2 million for every \$100 million of the total annualised value of the outstanding works or part thereof above \$800 million; and
 - their minimum working capital should be 8% (see item (b) above) on the first \$800 million of the total annualised value of the outstanding works and 10% on the remaining amount;
- (d) ***Introducing profitability trend analysis.*** Financial problems caused by continued heavy losses in operations was one of the main reasons for the failure of contractors. A 30% loss rate (Note 6) will be adopted as a threshold for action in the annual financial assessment of contractors. If a contractor suffers from a loss rate worse than 30%, he will be subject to regulatory actions, including downgrading;
- (e) ***Taking outstanding workload into account in financial assessment for retention on the Approved List.*** This will ensure that the works contractors possess sufficient working capital to complete government contracts during the contracting period and not only at the time of tendering;
- (f) ***Obtaining additional financial information from contractors as and when required.*** The working group considers that, from time to time, ad hoc financial assessment may be necessary, for example, if there is news or information that a contractor is undergoing restructuring or if the main debtor of a contractor is being wound up; and
- (g) ***Removing contractors automatically from the Approved List for failure to submit two consecutive audited accounts within the prescribed period.*** The working group considers that it is not advisable for the WB to exercise undue effort in listing those contractors who cannot prove that they possess the necessary financial capability to tender for government contracts.

Note 6: *The loss rate is defined as the weighted average of the operating loss as a percentage of the opening balance of the shareholders' funds over the past three consecutive years.*

2.4 The implementation of the changes to the existing financial assessment criteria and procedures will help reduce the risk of works contractors failing to meet the required standard of performance due to cashflow problems or heavy financial losses. Nevertheless, in Audit's view, there is room for improvement in the financial assessment of works contractors. The audit findings and recommendations are described in paragraphs 2.5 to 2.22 below.

Assessment of financial capability of works contractors

2.5 As mentioned in paragraph 1.5 above, all works contractors are required to submit a copy of their annual audited accounts to the WB for assessment. Group C contractors are required to submit annual audited accounts and half-yearly accounts. The accounts are required to be submitted within six months after the end of the accounting period. **Accordingly, for assessment purposes the WB considers that, for Groups A and B contractors, their annual audited accounts are valid for 18 months after the balance sheet date** (i.e. six months for the submission of the accounts, and 12 months before the submission of the next audited accounts). **For Group C contractors, the WB considers that their annual audited accounts and half-yearly accounts are valid for 12 months after the balance sheet date** (i.e. six months for the submission of the accounts, and six months before the submission of the next annual audited accounts or half-yearly accounts).

2.6 As it takes time for the contractors to prepare their accounts and arrange for audits, the accounts are usually out-of-date when they are received by the Finance Unit. In view of this, the Finance Unit also takes into account subsequent material events and transactions after the balance sheet date in assessing the capital requirements. For assessment purposes, contractors are required to provide supplementary information which will affect the employed capital and working capital significantly.

2.7 The Finance Unit also regularly reviews information from various independent sources, such as the Gazette, newspapers and business magazines, to trace any signs of financial problems of contractors. The Finance Unit will ask for updated information from the contractors if there are signs of financial problems. The information obtained, if found relevant and valid, will be provided to the works departments.

2.8 In reviewing the defaulted contract cases, Audit noted two cases in which the liquidity problems of the contractors were not revealed by the Finance Unit's financial assessment, notwithstanding that there were indications that the contractors might have financial problems. The audit has revealed that there are lessons to be learnt from such cases.

Case studies of liquidity problems of works contractors not revealed by financial assessment

2.9 Audit examined in detail the two cases in which the liquidity problems of the works contractors were not revealed by the Finance Unit's financial assessment (see paragraphs 2.10 to 2.17 below). The defaulting contractors involved are hereinafter referred to as Contractor A and Contractor B. Table 2 below gives a summary of the two cases.

Table 2

Summary of two case studies of liquidity problems of contractors not revealed by financial assessment

	Case 1 — Contractor A	Case 2 — Contractor B
Works department	Water Supplies Department (WSD)	Architectural Services Department (ArchSD)
Request for financial assessment	On 12.3.1998 , the WSD requested the Finance Unit to assess the financial capability of a joint venture, of which Contractor A was a partner, for acceptance of its lowest tender for a new contract (hereinafter referred to as Contract WSD1).	On 20.4.1999 , the ArchSD requested the Finance Unit to assess the financial capability of Contractor B because of his poor performance in a contract (hereinafter referred to as Contract ArchSD1).
Financial assessment	On 19.3.1998 , the Finance Unit assessed Contractor A's audited accounts for the year ended 31.3.1997 (i.e. the financial information used for the assessment was more than 11 months after the end of the accounting period).	On 29.4.1999 , the Finance Unit assessed Contractor B's half-yearly accounts for the period ended 30.9.1998 (i.e. the financial information used for the assessment was about 7 months after the end of the accounting period).
Finance Unit's comments	On 20.3.1998 , the Finance Unit advised the WSD that Contractor A met the financial criteria for acceptance of the new tender.	On 30.4.1999 , the Finance Unit advised the ArchSD that Contractor B met the financial criteria for retention on the List of Approved Contractors.
Indications of financial problems	On 26.3.1998 , Contractor A's parent company announced that it had liquidity problems. On 7.4.1998 , creditors of Contractor A discussed about Contractor A's debt moratorium and restructuring (Note).	On 14.5.1999 , Contractor B advised the ArchSD that the slow progress of works was due to his cashflow problems.
Contract re-entered	Between December 1998 and January 1999 , the Government re-entered three Contractor A's contracts (one Civil Engineering Department — CED contract and two WSD contracts).	In August 1999 , the Government re-entered three Contractor B's ArchSD contracts (one of the contracts was Contract ArchSD1).

Source: WB's records

Note: On 9 April 1998, the WSD requested the Finance Unit to reconsider Contractor A's financial situation in view of the development. In May 1998, Contract WSD1 was awarded to the second lowest tenderer instead of to the joint venture, of which Contractor A was a partner.

Case 1 — Contractor A

2.10 **Background.** In January 1998, the WSD invited tenders for a waterworks contract, Contract WSD1, from approved Group C contractors under the Waterworks category. In March 1998, in accordance with WBTC No. 9/97, the WSD asked the Finance Unit for advice on the financial capability of the three lowest tenderers. The lowest tender was from a joint venture, of which Contractor A was a partner. On 19 March 1998, the Finance Unit assessed the financial capability of Contractor A based on the latest annual audited accounts for the year ended 31 March 1997. **On 20 March 1998, the Finance Unit advised the WSD that the joint venture was able to meet the laid-down financial criteria for acceptance of its tender (Note 7).**

Liquidity problems of Contractor A and his parent company

2.11 Soon after the financial assessment, the Finance Unit noted that Contractor A's parent company made a press announcement on 26 March 1998 stating that it had liquidity problems and that various measures were being taken to improve its working capital. On 30 March 1998, the Finance Unit asked Contractor A's parent company:

- to advise on whether its subsidiaries, including Contractor A, had similar problems in working capital; and
- to submit the latest accounts of its subsidiaries for review by 9 April 1998.

2.12 After attending a creditors' meeting on 7 April 1998 at which a moratorium on Contractor A's debts and a restructuring of loan payments were discussed, on 9 April 1998, the WSD's consultant informed the WSD that:

- Contractor A was having financial problems; and
- the WSD should take into account the adverse financial situation of Contractor A when making its recommendation to the Central Tender Board for the award of Contract WSD1.

Note 7: *Each partner of the joint venture was required to meet individually the financial criteria for acceptance of the tender, having regard to the proportion of the partner's share in the joint venture.*

On 9 April 1998, the WSD informed the Finance Unit of the consultant's comments on Contractor A's financial position. The WSD requested the Finance Unit to reassess Contractor A's financial capability and to reconsider whether the Finance Unit's earlier advice that the joint venture had met the financial criteria for acceptance of its tender (see paragraph 2.10 above) needed to be changed.

Liquidity problems not revealed by financial assessment

2.13 On 16 April 1998, the Finance Unit informed the WSD that:

- in the light of the liquidity problems faced by Contractor A's parent company as announced on 26 March 1998 (see paragraph 2.11 above), the Finance Unit had requested Contractor A's parent company to submit Contractor A's latest accounts to enable the Finance Unit to carry out a special assessment;
- Contractor A's parent company subsequently submitted to the Finance Unit a set of Contractor A's unaudited accounts for the 10-month period ended 31 January 1998. The Finance Unit had further requested supplementary information to enable it to perform the assessment;
- the Finance Unit might take some time to complete the assessment. The assessment results, if available, could only reflect Contractor A's financial performance up to 31 January 1998. The results might not be able to indicate Contractor A's liquidity problems, which had earlier been revealed by Contractor A's parent company on 26 March 1998 and at Contractor A's creditors' meeting on 7 April 1998; and
- unless there were further developments which clearly indicated that Contractor A's liquidity problems had been resolved, from the financial viewpoint, the Finance Unit had reservations to recommend the joint venture, of which Contractor A was a partner, to undertake Contract WSD1.

In May 1998, Contract WSD1 was awarded to the second lowest tenderer instead of to the joint venture because the Finance Unit was unable to confirm that the joint venture was financially capable of undertaking the contract.

2.14 *Contractor A's contracts re-entered.* Between December 1998 and January 1999, the Government re-entered three Contractor A's contracts, one CED contract (hereinafter referred to as Contract CED1) and two WSD contracts (hereinafter referred to as Contract WSD2 and Contract WSD3), because of the slow progress of works.

Case 2 — Contractor B

2.15 **Background.** In this case, on 20 April 1999, the ArchSD requested the Finance Unit to assess the financial capability of Contractor B because of his poor performance in Contract ArchSD1.

2.16 **Financial problems of Contractor B.** In March 1999, the WB noted that there were two writs filed in the High Court against Contractor B, a Group C contractor. The WB informed the works departments of Contractor B's possible financial problems. The WB asked the works departments to monitor closely the progress of Contractor B's works contracts and put up recommendations to the WB for regulatory actions if warranted. On 20 April 1999, the ArchSD asked the Finance Unit to assess Contractor B's financial position, and expressed concern that Contractor B might have financial problems because of his continued slow progress in carrying out the works of Contract ArchSD1. **On 30 April 1999, the Finance Unit advised the ArchSD that, on the basis of Contractor B's half-yearly unaudited accounts for the period ended 30 September 1998, Contractor B was able to meet the laid-down financial criteria for retention on the List of Approved Contractors.** However, the Finance Unit cautioned that, due to the lead time for the preparation and the submission of the accounts, it was unable to ascertain Contractor B's financial position up to the date of assessment. At a meeting held on 14 May 1999, Contractor B informed the ArchSD that the slow progress of works and lack of labour resources in Contract ArchSD1 were due to his continued financial and cashflow problems. On 27 July 1999, the ArchSD was informed that Contractor B had ceased trading.

2.17 **Contractor B's contracts re-entered.** In August 1999, the Government re-entered three Contractor B's ArchSD contracts, namely Contract ArchSD1 and two other ArchSD contracts (hereinafter referred to as Contract ArchSD2 and Contract ArchSD3).

Audit observations on assessment of financial capability of works contractors

2.18 **The two cases mentioned in paragraphs 2.10 to 2.17 above illustrate that the liquidity problems of the contractors were not revealed by the Finance Unit's assessment of the accounts submitted, notwithstanding that there were indications that the contractors might have financial problems. In Audit's view, there is scope for improvement in this regard. The Finance Unit should have adopted special and proactive procedures to enable it to effectively assess the contractors' financial position, such as requesting the senior management of the contractors to provide the most up-to-date financial information.**

2.19 **Contractor A's Case.** In Contractor A's case, there were indications that Contractor A had been in financial difficulties since mid-1997. Between March 1997 and February 1998, Contractor A received a total of five adverse performance reports in a civil engineering works contract, Contract CED1. The performance of Contractor A in Contract CED1 was rated poor,

particularly on works progress and provision of resources, which indicated that Contractor A might have financial problems. In view of the poor performance in Contract CED1, Contractor A had agreed to voluntary suspension under the Port Works category as from 21 March 1998.

2.20 *Contractor B's case.* In Contractor B's case, between April 1998 and February 1999, Contractor B received seven consecutive adverse performance reports in a building works contract (hereinafter referred to as Contract ArchSD4). Contractor B's performance in Contract ArchSD4 was rated poor, particularly on works progress, organisation and provision of resources, which indicated that Contractor B might have financial problems. These were indications that Contractor B had been in financial difficulties since mid-1998. In view of the poor performance in Contract ArchSD4, Contractor B had agreed to voluntary suspension under the Buildings category as from 21 September 1998.

2.21 **The Finance Unit has access to the contractors' performance reports through the Contractor Management Information System maintained by the WB. In Audit's view, in contracts where a contractor has received several consecutive adverse performance reports or has repeatedly received a number of adverse performance reports, particularly on works progress and provision of resources, the Finance Unit should take prompt and proactive action to obtain more frequently the most up-to-date financial information from the contractor so as to monitor his financial position more closely.**

Audit recommendations on assessment of financial capability of works contractors

2.22 **Audit has noted that the Works Bureau will soon implement the changes to the existing financial assessment criteria and procedures as mentioned in paragraph 2.3 above. To further improve the financial assessment system, Audit has *recommended* that the Secretary for Works should:**

- (a) **closely monitor the financial position of a contractor when there are indications that the contractor may have financial problems, or when the contractor has received many adverse performance reports from any works department (e.g. three consecutive or a number of adverse performance reports on works progress and provision of resources); and**
- (b) **where there are indications that a contractor may be in financial difficulties, require the contractor to submit more frequently the most up-to-date financial information (including bank statements/references and the most recent financial statements, audited or duly certified by the directors of the company) so as to enable the WB to effectively assess and closely monitor his financial position.**

Response from the Administration

2.23 The **Secretary for Works** has said that:

- (a) implementation of the working group's recommendations to improve the financial assessment system (see paragraph 2.3 above) will strengthen the financial control on the contractors and reduce the risk of contractors failing to meet the standard of performance due to cashflow problems or heavy financial losses. As regards the request for further information from the management where there are indications that a contractor may be in financial difficulties, it may be difficult to obtain the most up-to-date financial information from the contractor as he usually has reservations to submit the most up-to-date financial information, which may need quite some time to prepare;
- (b) the WB has recently reviewed the guidelines and procedures for the administration and monitoring of the performance of contractors. The financial requirements of contractors will be raised so that contracts will be awarded to contractors with sound financial position. The monitoring of performance of contractors will also be tightened so that contractors who have received two consecutive adverse reports on performance, instead of three, will be suspended from tendering for works contracts; and
- (c) all the new initiatives will be incorporated into a new Contractor Management Handbook to be promulgated in early 2001.

2.24 The **Secretary for the Treasury** has said that the changes to the existing financial assessment criteria will take effect immediately after promulgation of the revisions in the Contractor Management Handbook for new applicants to the List of Approved Contractors. Existing contractors will be allowed a grace period of 18 months to meet the revised financial assessment criteria.

PART 3: RELAXATION OF CONTRACTORS' LIABILITY AS AN ALTERNATIVE TO RE-ENTRY

3.1 This part examines the actions taken by the Government to help a contractor to complete his works as an alternative to re-entry of the contract due to unsatisfactory progress of works. The audit has revealed that there are lessons to be learnt from such cases if the Government enters into a supplementary agreement with a works contractor.

Relaxation of contractors' liability to liquidated damages as an alternative to re-entry

3.2 Under Clause 81(1) of the GCC, the Government can re-enter a works contract if, despite previous written warnings, the contractor fails to proceed with the works with due diligence or is persistently in breach of his obligations under the contract. The defaulting contractor is liable to pay for any extra cost, including general damages, incurred by the Government in completing the works. However, it is often difficult to fully recover the extra cost from the defaulting contractor as most of the defaulting contractors may become bankrupt or have gone into liquidation. According to WBTC No. 16/99 of June 1999 (Note 8), the procedures for the re-entry of public works contracts include the following:

- **before giving the notice of re-entry, consideration should be given to other courses of action, such as relaxing the contractor's liability to liquidated damages (LD) by fixing a new date for completion by way of a supplementary agreement, if this proves less expensive in the long run in terms of cost and/or time;**
- before deciding on such a course of action, full consideration should be given to the pros and cons and all relevant matters;
- if any alternative courses of action or other extra-contractual actions are to be explored, both the Finance Bureau of the Government Secretariat and the Legal Advisory Division of the WB should be closely involved; and
- any agreement involving the contractor must be confirmed by way of a supplementary agreement made under seal. In most of the cases, the prior approval of the Secretary for the Treasury is required.

Note 8: *WBTC No. 16/99 of June 1999, which is still in force, replaces WBTC No. 19/94. There are no major differences in the procedures for re-entry of works contracts between the two WBTCs.*

Release of LD and payment of prolongation costs as an alternative to re-entry

3.3 In late 1994, an ArchSD Contract (hereinafter referred to as Contract ArchSD5) under the then Regional Council (RC — Note 9) Capital Works Programme was awarded to the lowest tenderer (hereinafter referred to as Contractor C). The ArchSD was responsible for the implementation of the project. A consultant was appointed by the ArchSD as the Architect's Representative to undertake the day-to-day administration of the contract.

3.4 *Slow progress of works.* The project was behind schedule soon after the commencement of the works. The ArchSD closely monitored the performance of Contractor C and took various regulatory actions, such as interviewing Contractor C and issuing warning letters. The Capital Works Select Committee (CWSC) and a Steering Committee (Note 10) of the RC for the project (hereinafter referred to as the Steering Committee) also closely monitored the situation through monthly progress reports prepared by the ArchSD. In March 1996, in view of the unsatisfactory progress of the works, the Steering Committee requested the ArchSD to submit bi-weekly progress reports.

Disputes over deduction of LD

3.5 In mid-1996, Contractor C lodged a number of claims for extension of time for the completion of the contract. The ArchSD granted extension of time to Contractor C for the delay due to inclement weather. However, for the other claims, the Architect's Representative said that the contractor's submissions had not been adequately substantiated. Subsequently, a dispute arose between the Government and Contractor C over the deduction of LD.

3.6 In late 1996, after considering the information submitted by Contractor C, the ArchSD informed Contractor C that LD were due. The ArchSD deducted the LD from payments due to Contractor C by withholding an interim payment.

Settlement of the dispute

3.7 Thereafter, the ArchSD observed a sudden drop in the size of Contractor C's labour force on site. At a special meeting held in early 1997, the Steering Committee requested the ArchSD to provide an assessment of Contractor C's ability to continue with the contract. In response, the ArchSD reported to the Steering Committee and the CWSC that Contractor C had

Note 9: *The Regional Council was dissolved on 31 December 1999.*

Note 10: *The terms of reference of the Steering Committee were to monitor the progress of the works, and to put up recommendations to the CWSC with a view to enabling the contract to be completed on time and up to the required standard.*

shown an interest in completing the remaining works of the contract and that the ArchSD was negotiating a supplementary agreement with Contractor C to enable the completion of the contract as soon as possible.

3.8 The ArchSD then recommended to the RC a commercial settlement which would be implemented as a supplementary agreement with Contractor C. The ArchSD informed the RC that:

- (a) the supplementary agreement would commit Contractor C to a realistic and firm completion date. There would be a small additional cost which could be absorbed within the Approved Project Estimate;
- (b) while Contractor C might still fail to meet his obligations under the supplementary agreement, this was a risk that was worth taking in the circumstances; and
- (c) other courses of action would result in substantial time delay, incur additional costs and run the risk of litigation initiated by Contractor C.

The RC reluctantly supported the proposed supplementary agreement in the hope that the project would be completed as soon as possible.

3.9 In January 1997, the ArchSD sought approval from the Finance Bureau to enter into a supplementary agreement with Contractor C. The ArchSD informed the Secretary for the Treasury that, without the commercial settlement, the following two alternative courses of action were available:

- (a) ***Initiating re-entry action with a view to re-tendering the remaining works.*** Under this course of action, the estimated completion date of the contract would be deferred and additional costs would be incurred. Since there had been improvements in the progress of the works from mid-September to mid-December 1996, Contractor C might be able to contest the Government's entitlement to invoke the re-entry provisions of the contract. In case of litigation, there would be greater uncertainty as to when the remaining works might be completed; or
- (b) ***Allowing Contractor C to continue with the project but imposing LD from the revised contract completion date.*** Under this course of action, the imposition of LD would exacerbate the cashflow problems of Contractor C, who might find it financially impossible to continue with the project.

The ArchSD considered that the commercial settlement was the most expedient way to complete the remaining works.

3.10 In late January 1997, after obtaining the Finance Bureau's approval, the ArchSD entered into a supplementary agreement with Contractor C and released the LD (see paragraph 3.6 above) to Contractor C. In February 1997, a sum of prolongation costs was also paid to Contractor C.

Re-entry of the contract

3.11 After entering into the supplementary agreement in late January 1997, there was no obvious improvement in the progress of works. As there had been rumours that Contractor C was about to go into liquidation, in March 1997, the WB requested the works departments to be on the alert about Contractor C. In mid-March 1997, in view of the poor performance and the lack of improvement, the ArchSD requested, unsuccessfully, for an urgent meeting with Contractor C. The ArchSD then served upon Contractor C a written notice requiring him to take all necessary steps within 14 days to expedite the completion of the works. At the end of the 14-day period, Contractor C failed to expedite the works. In April 1997, the ArchSD re-entered the site.

RC's enquiry

3.12 In April 1997, the CWSC set up an Ad Hoc Committee to study the circumstances leading to re-entry of the contract. The Ad Hoc Committee concluded that:

- (a) the ArchSD should have checked with the WB about the financial position of Contractor C before recommending the supplementary agreement; and
- (b) the ArchSD had failed to obtain adequate relevant background information to ascertain the intention and ability of the contractor to complete the project, and to provide in-depth analyses of the possible consequences and potential pitfalls.

3.13 In response to the RC's enquiry, the ArchSD admitted that it had not requested the WB to assess the latest financial situation of Contractor C before signing the supplementary agreement in January 1997. However, the ArchSD said that:

- (a) based on the substantially improved progress of the contract made by Contractor C during the period September and mid-December 1996 and the quantity of building materials on site, the ArchSD's assessment of Contractor C's ability and intention to complete the project at that time could not be considered an oversight;

- (b) the proposal to enter into a supplementary agreement with Contractor C was considered at that time the most cost-effective solution to facilitate completion of the project within the shortest possible time;
- (c) at that time, the ArchSD could not have predicted that Contractor C would default after the execution of the supplementary agreement. This was Contractor C's commercial decision; and
- (d) the WB would only be able to make a quick assessment based on Contractor C's audited accounts up to June 1996, which would be deemed by the WB as meeting the financial criteria for retention on the Approved List. Although the WB could seek clarification from Contractor C on his latest financial situation, this process would take time to complete depending on the time taken by Contractor C to respond.

Audit observations on release of LD and payment of prolongation costs as an alternative to re-entry

3.14 According to the ArchSD, the primary objective of the supplementary agreement signed in January 1997 was to ensure the continuation and completion of the contract by Contractor C as soon as possible without an increase in the Approved Project Estimate. **However, the ArchSD re-entered the contract in April 1997, i.e. two months after entering into the supplementary agreement (see paragraph 3.11 above).**

3.15 **According to the financial information submitted regularly by Contractor C to the Finance Unit between 1994 and 1996, Contractor C had incurred losses which had accumulated significantly since 1994.** As a Group C contractor, Contractor C was required to maintain minimum employed capital of \$9 million and minimum working capital of \$9 million for retention on the Approved List (see Table 1 in paragraph 1.3 above). For most of the time since 1994, the employed capital and working capital of Contractor C, as periodically assessed by the Finance Unit, were below the minimum level of requirement. **To enable Contractor C to meet the minimum level of requirement, on several occasions, the parent company of Contractor C agreed with the Government and Contractor C that it would not require Contractor C to repay the sums Contractor C owed to the parent company. However, in late March 1997, the parent company of Contractor C, on disposal of its entire shareholding interest in Contractor C, revoked the agreements. This resulted in a substantial decrease in the working capital of Contractor C.**

3.16 Audit noted that, at the time of entering into the supplementary agreement, Contractor C had eight other public works contracts with the Government. The estimated outstanding value of the works of the contracts, including Contract ArchSD5, was about \$419 million. In April and May 1997, the eight other contracts with Contractor C were re-entered (see Appendix B).

3.17 In Audit's view, before entering into the supplementary agreement, the works department concerned should have coordinated with the WB to assess whether the contractor could continue with the contract, taking into account the contractor's financial position and all other outstanding works commitments. There is also merit for the works department concerned to introduce precautionary measures in the supplementary agreement, such as making payments by instalments, so as to safeguard the interests of the Government.

Audit recommendations on release of LD and payment of prolongation costs as an alternative to re-entry

3.18 Audit has *recommended* that the Secretary for Works should notify in writing all works departments that, before taking remedial measures under a supplementary agreement as an alternative to re-entry of a contract, they should:

- (a) in consultation with the WB, assess the contractor's ability to meet his obligations under the supplementary agreement, taking into account all relevant factors, such as the financial position and all the other outstanding works commitments of the contractor; and
- (b) if it is necessary to make substantial payments to the contractor under the supplementary agreement, consider:
 - (i) making the payments by instalments, the timing of the instalments being based on an agreed schedule of works with the contractor; and
 - (ii) requiring the contractor to ask his parent company and/or a financial institution to provide a third party guarantee to safeguard against the possibility of his being unable to meet his obligations under the supplementary agreement.

Response from the Administration

3.19 The Secretary for Works agrees that all works departments should be notified in writing of the audit recommendations, made in paragraph 3.18 above, in order to avoid occurrence of similar cases in future.

PART 4: NOVATION OF CONTRACTS AND SET-OFF AGAINST MONEY DUE TO DEFAULTING CONTRACTORS

4.1 This part examines the novation of contracts (Note 11) and its implications to the setting off against money due to the defaulting contractors. The audit has revealed that there are lessons to be learnt from such cases.

Novation of contracts

4.2 Occasionally, contractors may wish to transfer their benefits and obligations, under their contracts with the Government, to other companies. This may be necessary when a contractor changes his corporate structure from a partnership or sole proprietor to a limited company; or where a parent company wishes to transfer its benefits and obligations to a subsidiary with a separate legal status. In such cases, a novation agreement is required. **For works contracts, a novation agreement is a tripartite agreement between the Government, the works contractor and a third party, whereby the contractor is released from the original contract and the third party assumes the contractor's obligations and rights under the contract.** According to WBTC No. 7/96 (Note 12) on "Change of Company Name of a Contractor and Transfer of Benefits and Obligations of Contracts by Contractors (Novation)" of March 1996, a proposal for a novation agreement needs not be resisted, but the circumstances must be checked for any implications on other contracts which the contractor has had with the Government, and the third party must be checked to ensure that it is a suitable substitute for the contractor.

4.3 ***Set-off against money due to defaulting contractors.*** According to Clause 83 of GCC, **in the event of re-entry of contracts, money due to the Government pending recovery from a defaulting contractor may be set off against money due to the defaulting contractor under any of his other contracts with the Government.** In the review of the defaulted contract cases, Audit noted a case in which the works departments concerned did not take necessary action to novate all the contracts between the Government and two contractors to a third party, despite the fact that the third party had assumed all the rights and benefits of the two contractors through the transfer of listing on the List of Approved Contractors. Subsequently, when the third party defaulted the contracts, for those contracts which had not been novated, the Government was unable to set off the money due to the Government against the money due to the two contractors. If all the contracts with the two contractors had been novated to the third party as had originally been agreed by all parties concerned, the Government would have been able to set off an additional sum of \$3.35 million from the money due to the third party. Details of the case are reported in paragraphs 4.4 to 4.15 below.

Note 11: *The novation of a contract involves a tripartite agreement whereby the contract between the two original contractual parties is rescinded in consideration of a new contract being entered into on the same terms between one of the original parties and a third party. The contractual obligations and rights are thereby "novated to" the third party.*

Note 12: *WBTC No. 7/96 of March 1996, which is still in force, replaces WBTCs No. 9/91, 9/91A, 30/93 and 30/93A.*

Transfer of listing on the List of Approved Contractors

4.4 In December 1994, the parent company of Contractor A (a newly established company) applied to the WB for the transfer of listing on the List of Approved Contractors of its two subsidiary companies (hereinafter referred to as Contractor F and Contractor G) to Contractor A.

4.5 **In the application for the transfer of the listing, the parent company of Contractor A attached copies of the minutes of meetings of the Board of Directors of the three companies (Contractor F, Contractor G and Contractor A) stating that the companies concerned had agreed that, if the WB approved the transfer of the listing, they would accept novation, as required by the WB, of all the contracts of Contractor F and Contractor G to Contractor A.**

4.6 In January 1995, the WB requested the CED, the Territory Development Department (TDD), the Highways Department (HyD) and the WSD to provide the particulars of the outstanding contracts held by Contractor F and Contractor G. In response, these departments said that the transfer of the listing requested by Contractor A's parent company was agreeable to them and submitted lists of the outstanding contracts to the WB.

4.7 In a letter dated 16 March 1995, the WB informed Contractor A that:

- Contractor A had been included on the List of Approved Contractors, as a Group C contractor, under the Roads and Drainage and Waterworks categories in substitution of Contractor F, and under the Port Works and Site Formation categories in substitution of Contractor G; and
- the works departments responsible for the contracts would write to Contractor A separately concerning the novation of all outstanding contracts from Contractor F and Contractor G to Contractor A.

Copies of the WB's letter dated 16 March 1995 to Contractor A were also sent to the seven works departments (i.e. the ArchSD, the CED, the Drainage Services Department — DSD, the Electrical and Mechanical Services Department — EMSD, the HyD, the TDD and the WSD). **However, Audit noted that the WB did not write directly to the works departments advising them to proceed with the novation of the contracts with Contractor F and Contractor G to Contractor A (Note 13). The WB did not set a deadline requiring the works departments to**

Note 13: *According to the WB, since August 1999, the WB has alerted the works departments to proceed with the novation arrangements by adding a note to the copies of the approval letter (issued to the contractor) sent to the works departments. In the note, the WB has specified the outstanding contract(s) that will require novation by the works departments concerned.*

complete the novation of the contracts and did not monitor closely the progress of the novation of the contracts.

Eight contracts not novated

4.8 The Government had 16 outstanding contracts with Contractor F and Contractor G (Note 14) at the time when the parent company of Contractor A applied for the transfer of the listing. **Of the 16 contracts, only eight contracts were novated to Contractor A. The other eight contracts were not novated to Contractor A.**

4.9 Table 3 below shows the eight contracts which were not novated to Contractor A, their final payment certificate dates, and the number of months between the date of the transfer of the listing and the date of the final payment certificate.

Table 3
Eight contracts not novated to Contractor A

Works department	Contract	Date of transfer of listing (a)	Date of final payment certificate (b)	No. of months between (a) and (b)
CED	Contract CED3	16.3.1995	8.8.1996	17
	Contract CED4	16.3.1995	10.9.1996	18
DSD	Contract DSD3	16.3.1995	4.8.1998	41
TDD	Contract TDD3	16.3.1995	28.6.1996	15
	Contract TDD4	16.3.1995	24.8.1998	41
HyD	Contract HyD2	16.3.1995	16.12.1998	45
WSD	Contract WSD6	16.3.1995	8.8.1995	5
	Contract WSD7	16.3.1995	25.7.1995	4

Source: WB's records

Note 14: *Of the 16 contracts, four were awarded to joint ventures of which Contractor F and/or Contractor G was a partner.*

4.10 Regarding Contract WSD6 and Contract WSD7, in September 1995, the WSD informed the Secretary for Works that the two contracts were not novated to Contractor A because of the short duration between the date of transfer of listing to Contractor A and the date of the final payment certificate of the two contracts (see Table 3 above). **However, for the six other contracts, Audit noted that there was a long lapse of time (from 15 to 45 months) between the date on which the WB approved the application for the transfer of the listing and the date of the final payment certificate of the contracts (see Table 3 above). The works departments concerned did not take any action to novate these contracts to Contractor A, despite the fact that they had been informed by the WB, by copy of the letter dated 16 March 1995 to Contractor A, of the need to novate the contracts upon the transfer of the listing, from Contractor F and Contractor G to Contractor A (see paragraph 4.7 above).**

Eight other contracts novated

4.11 Table 4 below shows the eight contracts which were novated to Contractor A, the date of the novation agreement, and the number of months between the date of the transfer of the listing and the date of the novation agreement.

Table 4

Eight contracts novated to Contractor A

Works department	Contract	Date of transfer of listing (a)	Date of novation agreement (b)	No. of months between (a) and (b)
CED	Contract CED5	16.3.1995	30.10.1997	31
TDD	Contract TDD5	16.3.1995	22.7.1996	16
DSD	Contract DSD4	16.3.1995	8.3.1996	12
WSD	Contract WSD2 (Note)	16.3.1995	26.9.1995	6
	Contract WSD8	16.3.1995	26.9.1995	6
	Contract WSD9	16.3.1995	26.9.1995	6
	Contract WSD10	16.3.1995	26.9.1995	6
	Contract WSD11	16.3.1995	26.9.1995	6

Source: WB's records

Note: Contract WSD2 was re-entered in January 1999.

4.12 As shown in Table 4 above, although these eight contracts were novated to Contractor A, some contracts took a long time to complete novation after the date of the transfer of the listing (i.e. Contract CED5, Contract TDD5 and Contract DSD4 took a year or more).

4.13 The sequence of events and reasons for the delay in novation of the three contracts, mentioned in paragraph 4.12 above, were as follows:

- **Contract CED5.** The CED commenced the novation process on 7 November 1996. In February 1997, Contractor G acknowledged the necessary novation of the contract. The novation agreement was signed on 30 October 1997 upon the WB's approval (i.e. about 31 months after the transfer of the listing);
- **Contract TDD5.** The TDD was aware of the need for the novation of the contract in early 1995. However, Contractor F had not positively responded to the proposed novation. In March 1996, the TDD discussed with Contractor F the need to novate the contract. In May 1996, Contractor F acknowledged the necessary novation of the contract. The novation agreement was signed on 22 July 1996 upon the WB's approval (i.e. about 16 months after the transfer of the listing); and
- **Contract DSD4.** The DSD was aware of the need for the novation of the contract in early 1995. In November 1995, the DSD discussed with Contractor F the need to novate the contract. In December 1995, Contractor F acknowledged the necessary novation of the contract. The novation agreement was signed on 8 March 1996 upon the WB's approval (i.e. about 12 months after the transfer of the listing).

In Audit's view, the WB should have monitored closely the progress of novation of the contracts to Contractor A made by the works departments concerned, after the WB had approved the transfer of the listing, so as to ensure that all necessary actions were completed without undue delay.

Re-entry of contracts

4.14 Between late December 1998 and January 1999, the Government re-entered three defaulted contracts with Contractor A, of which:

- one was a novated contract (Contract WSD2 — see Note in Table 4 in paragraph 4.11 above); and
- two were new contracts (Contract CED1 and Contract WSD3) which were awarded to Contractor A, subsequent to the WB's approval of the transfer of listing.

According to Clause 83 of GCC, as mentioned in paragraph 4.3 above, in the event of re-entry of contracts, money due to the Government pending recovery from the defaulting contractor may be set off against money due to the defaulting contractor under any of his other contracts with the Government. As shown in Table 5 below, up to December 2000, the Government was able to set off against \$9.5 million due to Contractor A under four of his seven novated contracts with the Government (one of the novated contracts was re-entered — see Note in Table 4 in paragraph 4.11 above). This was possible because the payments for these contracts had not yet been finalised at the time the Government re-entered the three defaulted contracts. For the other three novated contracts, no set-off could be made because all the payments had been finalised.

Table 5
Amounts withheld from contracts novated to Contractor A
(position as at December 2000)

Works department	Contract	Amount withheld for set-off (\$ million)
WSD	Contract WSD10	6.11
	Contract WSD11	2.31
	Contract WSD8	0.03
CED	Contract CED5	1.05
Total		<u>9.50</u>

Source: WB's records

4.15 As mentioned in Table 3 in paragraph 4.9 above, there were eight contracts which were not novated to Contractor A. **If these eight contracts had been novated to Contractor A, the Government could have been able to set off an additional sum of \$3.35 million from one of these eight contracts, i.e. Contract TDD3 (Note 15).** This sum was paid by the Government to Contractor G in February 1999, after the Government had re-entered the three defaulted contracts with Contractor A (see paragraph 4.14 above).

Note 15: *For the other seven contracts mentioned in Table 3 in paragraph 4.9 above, even if they had been novated to Contractor A, the Government could not have been able to set off against money due to Contractor A. This was because the payments of five of these contracts had been settled before the Government re-entered the three defaulted contracts with Contractor A. For the remaining two contracts, there might be problems in invoking the set-off provisions.*

Audit observations on novation of contracts and set-off against money due to defaulting contractors

4.16 In March 1995, the WB approved the transfer of the listing on the List of Approved Contractors from Contractor F and Contractor G to Contractor A. In Audit's view, the WB should have monitored closely the progress of the novation of the contracts to Contractor A upon the approval of the transfer of the listing. This would have provided the Government with a safeguard by way of invoking the set-off provisions if Contractor A's contracts had to be re-entered at a later date. As mentioned in paragraph 4.15 above, if all the contracts with Contractor F and Contractor G had been novated to Contractor A, the Government could have been able to set off an additional sum of \$3.35 million.

Audit recommendations on novation of contracts and set-off against money due to defaulting contractors

4.17 **Audit has recommended that in approving applications from contractors for transfer of listing on the List of Approved Contractors, the Secretary for Works should:**

- (a) **write directly to the works departments concerned to advise them to proceed with the necessary novation of the contracts without delay;**
- (b) **ask the works departments concerned to report to the WB the time required (setting a deadline if necessary) for the completion of novation of the contracts; and**
- (c) **closely monitor the progress of novation of the contracts to ensure that the process is completed without undue delay.**

Response from the Administration

4.18 The **Secretary for Works** agrees with the audit recommendations made in paragraph 4.17 above. He has said that:

- (a) when approving the transfer of listing from one contractor to another on the List of Approved Contractors, he will write directly to the works departments concerned to advise them to proceed with the novation arrangement; and
- (b) he has included the monitoring mechanism and detailed guidelines regarding the novation arrangement in the Contractor Management Handbook, mentioned in paragraph 2.23(c) above, which will be promulgated in early 2001.

PART 5: UNAUTHORISED REMOVAL OF CONSTRUCTIONAL PLANT AND MATERIALS

5.1 This part examines the procedures for prohibiting the removal of constructional plant and materials from a site in the event of re-entry of contracts. The audit has revealed that there is room for improvement in the procedures for safeguarding the Government's interests.

Vesting of constructional plant and materials in the Government

5.2 Clauses 71 and 72 of the GCC state that:

- all constructional plant and temporary buildings owned by the contractor shall, when brought onto the site, be and become the property of the employer (i.e. the Government), but may be removed from the site by the contractor at any time unless removal is expressly prohibited by the Engineer/Architect in writing; and
- all materials owned by the contractor for incorporation in the works shall be and become the property of the Government upon delivery to the site, and shall not be removed without an instruction or the prior written consent of the Engineer/Architect.

5.3 Pursuant to Clause 81(1) of the GCC, in the event of re-entry of a contract, the Government may use, for the completion of the contract, the constructional plant, temporary buildings and materials which become the property of the Government under Clauses 71 and 72 of the GCC as the Government may think proper. The Government may also at any time sell any of the said constructional plant, temporary buildings and unused materials and apply the proceeds of sale towards the satisfaction of any sum due, or which may become due, to the Government from the contractor under the contract.

Prohibition of unauthorised removal of constructional plant and materials

5.4 WBTC No. 19/94 (Note 16) on "Contractual Procedures for Re-entry (Forfeiture) of Public Works Contracts" of August 1994 promulgated the following guidelines about the prohibition of the unauthorised removal of constructional plant, temporary buildings and materials in the event of re-entry of a contract:

- (a) ***Action before serving the notice of re-entry.*** If the contractor was not performing satisfactorily and was not responding to warnings, the site staff should increase their general vigilance and, in particular, should:
 - (i) **try to prevent any wrongful removal of constructional plant and materials on the site; and**

Note 16: *In June 1999, WBTC No. 19/94 was replaced by WBTC No. 16/99 which is still in force. There are no major changes in the procedures for re-entry of contracts.*

- (ii) enhance record keeping, both documentary and photographic, particularly of constructional plant and materials on the site;
- (b) ***Action upon serving the notice of re-entry.*** The following actions should be taken:
- (i) at the same time as the notice of re-entry was issued, the Engineer/Architect should give written notice to the defaulting contractor prohibiting the removal from the site of any constructional plant, temporary buildings and materials owned by the contractor;
 - (ii) the Engineer/Architect should make a complete record of the constructional plant, temporary buildings and materials on the site and keep a record of any attempts to remove them;
 - (iii) **any person attempting to remove any of the items should be advised that, under the contract, these items were the Government's property and should not be removed until acceptable proof could be provided to show that the items belonged to another person. In such an event, the details of this person and the items removed should be recorded. Any document submitted to support a claim of ownership should be sent to the Legal Adviser of the WB for advice before permission was given to remove the item concerned;**
 - (iv) the works department should inform the Police if a person physically removed items from the site against the advice of the staff of the works department; and
 - (v) the works department should provide additional security for the site, where necessary; and
- (c) ***Action upon re-entry.*** The following actions should be taken:
- (i) in addition to securing the site and valuing the constructional plant on the site, a complete photographic record of the site, the works and all items on the site should be made as soon as possible; and
 - (ii) it was important to record the quantities of unused or partially used materials on the site and list any constructional plant and temporary buildings which had become the property of the Government under the contract.

Unauthorised removal of constructional plant and materials

5.5 In reviewing the defaulted contracts, Audit noted and examined two cases of unauthorised removal of constructional plant and materials. Table 6 below gives a summary of the two cases. The defaulting contractors involved were Contractor C and another contractor (hereinafter referred to as Contractor D).

Table 6

Unauthorised removal of constructional plant and materials from sites

	Case 1 — Contractor C	Case 2 — Contractor D
Works department	DSD	ArchSD
Contract	Contract DSD1	Contract ArchSD6
Notice of Corrective Action	On 20.3.1997 , the DSD issued a Notice of Corrective Action to the contractor.	From April to December 1997 , the ArchSD issued 5 Notices of Corrective Action to the contractor. The last Notice of Corrective Action was issued on 1.12.1997 . On 2.12.1997 , the WB informed the ArchSD that petitions had been filed to the Official Receiver's Office to compulsorily wind up Contractor D.
Security measures	On 27.3.1997 , the DSD posted two security guards on site on a 24-hour basis, secured all gates and doors by new padlocks, and placed concrete blocks at the entry roads to the site.	On 12.12.1997 , the ArchSD posted two security guards on site on a 24-hour basis.
Letter prohibiting unauthorised removal	On 7.3.1997 and 4.4.1997 , the DSD issued letters to the contractor prohibiting unauthorised removal of plant and materials.	On 18.12.1997 , the ArchSD issued a letter to the contractor prohibiting unauthorised removal of plant and materials.
Unauthorised removal	Unauthorised removal occurred on 2, 3 and 4 April 1997 .	—
Notice of Re-entry	On 16.4.1997 , the DSD issued a Notice of Re-entry to the contractor and on 24.4.1997 re-entered the site.	On 19.12.1997 , the ArchSD issued a Notice of Re-entry to the contractor and on 30.12.1997 re-entered the site.
Unauthorised removal	Unauthorised removal occurred on 23.4.1997 .	Unauthorised removal occurred on 23.12.1997 and 24.12.1997 .

Source: DSD's and ArchSD's records

Case 1 — Contractor C

5.6 In August 1993, a civil engineering contract, Contract DSD1, was awarded to Contractor C. From early 1997, the performance of Contractor C under the contract was extremely poor. Most of the major construction activities had slowed down and the number of essential plant had decreased to an unreasonable level. **On 7 March 1997, the Engineer notified the contractor that the removal of any plant was not permitted without his written permission.** On 8 March 1997, the Secretary for Works requested the works departments to watch out for any possible liquidation action of Contractor C.

5.7 On 13 March 1997, the contractor virtually stopped all the works on site. On 20 March 1997, the DSD issued a Notice of Corrective Action to Contractor C requiring him to take immediately all necessary steps to expedite the completion of the works. In the Notice of Corrective Action, the DSD also warned Contractor C that, if no improvements were made after 14 days from the date of the Notice, the Government would re-enter the contract.

5.8 *Unauthorised removal of constructional plant and materials.* On 27 March 1997, the DSD employed two security guards to prevent the contractor from removing constructional plant and materials from the site. All gates and doors giving access to any part of the site were reportedly secured by new padlocks, and concrete blocks were placed at different entry roads to the site. **However, despite the security measures, on 2, 3 and 4 April 1997, some constructional plant and materials, including high value items such as barges, dredgers and tugboats, were removed from the site (see Appendix C). On 4 April 1997, the DSD warned Contractor C that the removal of the plant from the site disregarding the DSD's objection was unacceptable.** On 16 April 1997, the DSD issued a Notice of Re-entry to Contractor C informing him that the Government would re-enter the site on 24 April 1997. **On 23 April 1997, some more items of constructional plant were removed from the site without permission (see Appendix C).**

Case 2 — Contractor D

5.9 In July 1996, the ArchSD awarded Contract ArchSD6 to Contractor D. The performance of Contractor D was poor and the progress of works was unsatisfactory. Subsequently, in December 1997, the ArchSD re-entered the contract.

5.10 As shown in Table 6 in paragraph 5.5 above, from April to December 1997, before the contract was re-entered on 30 December 1997, the ArchSD issued five Notices of Corrective Action to Contractor D requiring him to take immediately all necessary steps to expedite completion of the works. The last Notice was issued on 1 December 1997. In the Notices of Corrective Action, the ArchSD warned Contractor D that if no improvements were made after 14 days from the date of the Notice, the Government would re-enter the contract.

5.11 ***Unauthorised removal of constructional plant and materials.*** On 2 December 1997, the WB informed the ArchSD that petitions had been filed to the Official Receiver's Office to compulsorily wind up Contractor D. On 12 December 1997, the ArchSD employed two security guards to prevent the removal of the constructional plant and materials from the site. **On 18 December 1997, the ArchSD sent a letter to Contractor D prohibiting him from removing constructional plant and materials from the site.** On 19 December 1997, the ArchSD issued a Notice of Re-entry to Contractor D informing him that the Government would re-enter the site on 30 December 1997. **However, despite these letters from the ArchSD to Contractor D, on 23 and 24 December 1997, some items of constructional plant were removed from the site without permission (see Appendix D).**

Audit observations on unauthorised removal of constructional plant and materials

5.12 As mentioned in paragraph 5.3 above, in the event of re-entry of a contract, the Government may use, for the completion of the contract, the constructional plant, temporary buildings and materials which become the property of the Government under Clauses 71 and 72 of the GCC. The Government may also at any time sell any of these items and apply the proceeds of sale towards the satisfaction of any sum due, or which may become due, to the Government from the contractor. In the two cases mentioned in paragraphs 5.6 to 5.11 above, constructional plant and materials, including valuable items such as barges, dredgers and tugboats, were removed from the sites by the defaulting contractors, despite letters were sent by the DSD and the ArchSD to Contractor C and Contractor D respectively to prohibit them from doing so. **In Audit's view, the works departments should have taken more effective measures in order to reduce the chances of a defaulting contractor removing the constructional plant and materials from a works site.**

Audit recommendations on unauthorised removal of constructional plant and materials

5.13 **To ensure that sufficient safeguard is provided to prohibit defaulting contractors from removing constructional plant and materials from a site, in particular valuable items, Audit has recommended that the Director of Drainage Services and the Director of Architectural Services should take effective measures to safeguard the Government's interests, having regard to the cost-effectiveness of such measures.**

5.14 **Audit has also recommended that the Secretary for Works should consider notifying in writing all other works departments of the audit recommendation in paragraph 5.13 above in order to avoid the occurrence of similar cases in future.**

Response from the Administration

5.15 The **Secretary for Works** has noted the audit recommendation made to the Director of Drainage Services and Director of Architectural Services in paragraph 5.13 above. He agrees that all other works departments should be notified in writing of the audit recommendation in order to avoid occurrence of similar cases in future.

5.16 The **Director of Drainage Services** has said that:

- (a) according to past experience, in practice it was difficult to identify the ownership of constructional plant and materials, because the contractor could sell or transfer their ownership before the re-entry of the contract without informing the Government. As a result, it is difficult to prove that the Government contractually owns the plant and materials under Clauses 71 and 72 of the GCC;
- (b) practically speaking, measures to prevent removal of marine plant (e.g. a barge) by, for instance, securing them are difficult if not impossible; and
- (c) where someone claims ownership and attempts to remove constructional plant or materials from the site, reporting to the Police is ineffective because the Police will not act pursuant to contractual provisions between two parties and could only record the case for follow-up action where necessary.

5.17 The **Director of Architectural Services** has said that:

- (a) serving a Notice of Re-entry does not mean that the Government has taken over the control of the site. The site is still contractually under the control of the contractor who is proceeding with the contract; and
- (b) until the site is re-entered, it is not possible to effect any security measures to safeguard the Government's interests other than to provide surveillance on constructional plant and materials on site.

Appendix A
(paragraphs 1.8 and
1.10 refer)

**Defaulted works contracts
from April 1997 to September 2000**

Contractor	Number of contracts	Period during which contracts were re-entered	Estimated amount due to the Government as at January 2001 (Note)
			(\$ million)
Contractor A	3	December 1998 — January 1999	168.1
Contractor B	3	August 1999	80.0
Contractor C	9	April 1997 — May 1997	215.2
Contractor D	1	December 1997	31.1
Contractor E	3	August 1997 — January 1998	112.3
	<u>19</u>		<u>606.7</u>
			(say \$607 million)
Other (12) defaulting contractors	17	January 1998 — August 2000	109.1
Total	<u><u>36</u></u>		<u><u>715.8</u></u>
			(say \$716 million)

Source: WB's records

Note: The actual amounts owed by the defaulting contractors, including liquidated damages, are subject to any extra cost in completion of the works and further claims.

Appendix B
(paragraph 3.16 refers)

Contractor C's defaulted contracts

Works department	Contract	Month in which contract was re-entered	Estimated value of the outstanding works (\$ million)
ArchSD	Contract ArchSD5	April 1997	77.0
CED	Contract CED2	May 1997	18.2
DSD	Contract DSD1	April 1997	49.0
	Contract DSD2	May 1997	4.0
HyD	Contract HyD1	May 1997	0.7
TDD	Contract TDD1	April 1997	25.0
	Contract TDD2	May 1997	153.0
WSD	Contract WSD4	April 1997	67.0
	Contract WSD5	April 1997	25.0
		Total	<u>418.9</u>

(say \$419 million)

Source: WB's records

Appendix C
(paragraph 5.8 refers)

Unauthorised removal of constructional plant and materials in Contract DSD1

Date of unauthorised removal	Description	Quantity removed
2.4.1997	Constructional plant (Note)	
	<ul style="list-style-type: none"> • Hopper barge • Derrick barge • Grab dredger • Tugboat 	<ul style="list-style-type: none"> 4 nos. 1 no. 1 no. 2 nos.
3.4.1997	Constructional plant (Note)	
	<ul style="list-style-type: none"> • Hopper barge • Derrick barge • Grab dredger • Suction dredger • Tugboat 	<ul style="list-style-type: none"> 1 no. 2 nos. 1 no. 1 no. 2 nos.
4.4.1997	Materials	
	<ul style="list-style-type: none"> • Reinforcement fabric • Primer • Joint filler • Joint sealant 	<ul style="list-style-type: none"> 2 rolls 12 cans 45 pieces 32 cans
23.4.1997	Constructional plant	
	<ul style="list-style-type: none"> • Office equipment and survey instrument 	

Source: DSD's records

Note: According to the information obtained from the Marine Department, Audit estimated that the total value of the barges, dredgers and tugboats could amount to about \$16 million.

Appendix D
(paragraph 5.11 refers)

Unauthorised removal of constructional plant in Contract ArchSD6

Date of unauthorised removal	Description	Quantity removed
23.12.1997	Constructional plant	
	<ul style="list-style-type: none">• Excavator• Concrete vibrator	2 nos. 2 nos.
24.12.1997	Constructional plant	
	<ul style="list-style-type: none">• Concrete vibrator• Water pump• Soil compactor	4 nos. 6 nos. 2 nos.

Source: ArchSD's records

Appendix E

Summary of contractors mentioned in the Report

Mentioned in the following Parts of the Report

Contractor A	1, 2 and 4
Contractor B	1 and 2
Contractor C	1, 3 and 5
Contractor D	1 and 5
Contractor E	1
Contractor F	4
Contractor G	4

Appendix F

Acronyms and abbreviations

ArchSD	Architectural Services Department
CED	Civil Engineering Department
CWSC	Capital Works Select Committee of the Regional Council
DSD	Drainage Services Department
EMSD	Electrical and Mechanical Services Department
GCC	General Conditions of Contract
HyD	Highways Department
LD	Liquidated damages
PWP	Public Works Programme
RC	Regional Council
TDD	Territory Development Department
WB	Works Bureau
WBTC	Works Bureau Technical Circular
WSD	Water Supplies Department