

Report No. 42 of the Director of Audit — Chapter 2

FUNDING OF PROJECTS UNDER THE APPLIED RESEARCH FUND

Summary

1. The Applied Research Fund (ARF), with a start-up capital of \$750 million, funds technology ventures and research and development activities that have the potential to yield commercially exploitable results in Hong Kong. It is administered by the Applied Research Council (ARC), a private company formed in August 1992 and wholly owned by the Government. The Innovation and Technology Commission acts as the Secretariat of the ARF and represents the ARC in its day-to-day activities. Since November 1998, venture capital firms have been engaged as fund managers of the ARF to make investment decisions. The Audit Commission (Audit) has recently reviewed the performance of the ARF, focusing on those financial aspects which can be measured objectively.

Financial performance of the Applied Research Fund

2. *Financial return of invested projects.* The Government expected a financial return on ARF investments. This was originally set at “at least 5% per annum on the sum advanced”. It was revised in March 1998 to “the best return rate achievable”. Up to November 2003, the ARF had invested \$461 million in 50 projects. Based on the latest valuation, the ARF investments overall incurred a capital loss of \$247 million, with many projects suffering a near total loss.

3. *Cost of operating the ARF.* Audit found that, up to November 2003, the total operating costs of the ARF (i.e. staff costs of the Secretariat, management fees paid to fund managers, and other administration and operating expenses) amounted to \$127 million. This represented 28% of the \$461 million investments made so far.

4. *Utilisation of available funds.* As at November 2003, the ARF had a large cash balance of \$434 million available for new investments. Audit findings indicate that there has been difficulty in identifying worthwhile projects for ARF investment. Only five new investments have been made since April 2001. Furthermore, no new investment has been approved since May 2003.

5. *Need for a comprehensive review.* In January 2003, the ARC noted that if the modus operandi of the ARF was to continue, the ARF would unlikely bring about local technology development opportunities with visibility or impact. After considering various options on the future positioning of the ARF, the ARC agreed that it would continue to review the ARF in the run-up to November 2004 in the light of the Government's overall strategy in supporting technology development. *As an overall review of the ARF would go beyond the ARC's purview, Audit has recommended that the Secretary for Commerce, Industry and Technology should take the lead to critically review the role of the ARF in the context of the Government's overall strategy in supporting innovation and technology development.*

Audit case studies on disposal of investments by fund managers

6. Audit conducted case studies on two investments made by the fund managers which were sold at either a nominal or substantially write-down value. Audit has found that the ARC could lose control of the disposal of ARF investments because fund managers are given absolute discretion on matters concerning the disposal of ARF investments. The case studies have also highlighted the need for more frequent progress reporting by fund managers because the market in which investee companies operate is very volatile. *Audit has recommended that the ARC and the Commissioner for Innovation and Technology should take vigorous actions to strengthen control over the disposal of ARF investments and consider requiring more frequent progress reporting by fund managers.*

Response from the Administration

7. The Administration has generally agreed with the audit recommendations.

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