

CHAPTER 4

Trade and Industry Department

Four small and medium enterprise funding schemes

**Audit Commission
Hong Kong
23 October 2006**

This audit review was carried out under a set of guidelines tabled in the Provisional Legislative Council by the Chairman of the Public Accounts Committee on 11 February 1998. The guidelines were agreed between the Public Accounts Committee and the Director of Audit and accepted by the Government of the Hong Kong Special Administrative Region.

Report No. 47 of the Director of Audit contains 11 Chapters which are available on our website at <http://www.aud.gov.hk>.

Audit Commission
26th floor, Immigration Tower
7 Gloucester Road
Wan Chai
Hong Kong

Tel : (852) 2829 4210
Fax : (852) 2824 2087
E-mail : enquiry@aud.gov.hk

FOUR SMALL AND MEDIUM ENTERPRISE FUNDING SCHEMES

Contents

	Paragraph
PART 1: INTRODUCTION	1.1
Background	1.2
Setting up of four SME funding schemes	1.3 – 1.4
Additional funding approvals in 2003 and 2005	1.5 – 1.7
Administration and utilisation of the four SME funding schemes	1.8
Audit review	1.9
General response from the Administration	1.10 – 1.11
Acknowledgement	1.12
PART 2: SME EXPORT MARKETING FUND	2.1
Background	2.2 – 2.3
Conditions for grants	2.4
Processing of EMF applications and relating controls	2.5 – 2.8
Need to build up a robust system to guard against potential abuses	2.9 – 2.17
<i>Audit observations</i>	2.18 – 2.20
Need to enhance the computer system supporting the operation of the EMF	2.21 – 2.22
<i>Audit observations</i>	2.23 – 2.24
Need to set up a mechanism to assess the effectiveness of the EMF	2.25

	Paragraph
<i>Audit observations</i>	2.26 – 2.29
<i>Audit recommendations</i>	2.30
Response from the Administration	2.31 – 2.32
PART 3: SME TRAINING FUND	3.1
Background	3.2 – 3.4
Conditions for grants	3.5
Inadequate checking to guard against potential abuses	3.6 – 3.18
<i>Audit observations</i>	3.19 – 3.21
<i>Audit recommendations</i>	3.22
Response from the Administration	3.23
PART 4: SME LOAN GUARANTEE SCHEME	4.1
Background	4.2 – 4.3
Operation of the SGS	4.4 – 4.6
Management of default risk	4.7 – 4.8
<i>Audit observations</i>	4.9 – 4.15
Vetting of default claims	4.16
<i>Audit observations</i>	4.17
Enhancing the impact of the SGS on the local economy	4.18
<i>Audit observations</i>	4.19 – 4.25
Assessing the effectiveness of the SGS	4.26

	Paragraph
<i>Audit observations</i>	4.27
<i>Audit recommendations</i>	4.28
Response from the Administration	4.29 – 4.30
PART 5: SME DEVELOPMENT FUND	5.1
Background	5.2 – 5.5
Processing of SDF applications	5.6
Need to keep in view the SMEs’ needs for support	5.7
<i>Audit observations</i>	5.8 – 5.9
Need to monitor the SMEs’ adoption of the results of funded projects	5.10
<i>Audit observations</i>	5.11 – 5.12
Need to disseminate the results of funded projects more widely to more SMEs	5.13 – 5.14
<i>Audit observations</i>	5.15
Need to set up a mechanism to assess the effectiveness of the SDF	5.16
<i>Audit observations</i>	5.17 – 5.18
<i>Audit recommendations</i>	5.19
Response from the Administration	5.20

	Page
Appendices	
A : Case study A	45
B : Case study B	46
C : Case study C	47
D : Performance measures in the Controlling Officer's Report for 2006-07	48 – 49
E : Case study D	50
F : Case study E	51
G : Details of government guarantees available to SMEs under the BIG and the SGS	52
H : Details of approved government guarantees (31 March 2006)	53
I : Case study F	54
J : Case study G	55 – 56
K : Case study H	57
L : Case study I	58
M : Case study J	59
N : Case study K	60
O : Acronyms and abbreviations	61

PART 1: INTRODUCTION

1.1 This PART describes the background to the audit and outlines its objectives and scope.

Background

1.2 In his 2001 Policy Address, the Chief Executive stated that small and medium enterprises (SMEs) played an important role in the process of economic restructuring. He announced various initiatives to help SMEs raise their competitiveness, including the implementation of 30 proposals put forward by the Small and Medium Enterprises Committee (SMEC – Note 1).

Setting up of four SME funding schemes

1.3 In November 2001, the Finance Committee (FC) of the Legislative Council (LegCo) approved the setting up of four SME funding schemes as recommended by the SMEC. These four schemes are as follows:

- (a) an **SME Business Installations and Equipment Loan Guarantee Scheme (BIG)** to provide guarantees up to an amount of \$6.6 billion with an expected maximum expenditure of \$1 billion;
- (b) an **SME Training Fund (STF)** with a commitment of \$400 million;
- (c) an **SME Export Marketing Fund (EMF)** with a commitment of \$300 million; and
- (d) an **SME Development Fund (SDF)** with a commitment of \$200 million.

The expected maximum expenditure of the four funding schemes was \$1.9 billion.

1.4 The Government defined SMEs as any manufacturing firms or any non-manufacturing firms which employed fewer than 100 persons or 50 persons respectively in Hong Kong. According to the FC paper of November 2001, SMEs

Note 1: *The SMEC comprises a chairman and 25 members which include SMEs operators, businessmen, bankers, academics, representatives from organisations which provide support services to SMEs, the Director-General of Trade and Industry and the Deputy Secretary for Commerce, Industry and Technology (Commerce and Industry). The SMEC is tasked with advising the Chief Executive on issues affecting the development of SMEs in Hong Kong and making suggestions on measures to support and facilitate their development and growth.*

constituted over 98% of the business establishments and provided about 60% of the total employment in Hong Kong (excluding the civil service). They were a major driving force of the Hong Kong economy. The Administration considered that the four funding schemes would help SMEs build on their strengths and redress their weaknesses in various areas (such as business environment, financing and human resources), and would be conducive to improving their long-term competitiveness.

Additional funding approvals in 2003 and 2005

1.5 Between December 2001 and January 2002, the four funding schemes were launched. In January 2003, the FC approved various changes to the BIG, STF and EMF in order to strengthen the Government's support for SMEs. To reflect the expanded scope of government's loan guarantee under the BIG, the BIG was renamed "SME Loan Guarantee Scheme" (SGS).

1.6 Owing to the Severe Acute Respiratory Syndrome (SARS) outbreak in 2003, which had hit the business of many SMEs and affected their competitiveness, the FC approved in June that year the merger of the STF, EMF and SDF through pooling the resources available for the three funding schemes and removing their respective commitment ceilings. The Administration considered that this would enable resources to be deployed flexibly, having regard to SMEs' actual needs.

1.7 In May 2005, the FC approved another increase in the loan guarantee commitment for the SGS by \$4 billion to \$10.6 billion, while the expected maximum expenditure was reduced to \$800 million. The FC also approved the Administration's proposal of allowing the STF to lapse and increasing the commitment for the EMF and SDF by \$500 million to \$1.4 billion (which includes the commitment for the STF).

Administration and utilisation of the four SME funding schemes

1.8 The four SME funding schemes fall under the policy responsibility of the Commerce, Industry and Technology Bureau (CITB) and are administered by the Trade and Industry Department (TID). Up to the end of March 2006, the Government had spent \$935 million on the four SME funding schemes. Table 1 provides a summary of the funding and utilisation position of the four SME funding schemes as at the end of March 2006.

Table 1
Funding and utilisation of the four SME funding schemes
(31 March 2006)

Scheme	Approved commitment (\$ million) (a)	Amount of guarantees approved (as a % of (a)) (\$ million) (b)	Amount of grants approved (as a % of (a)) (\$ million) (c)	Amount spent (\$ million) (d)
SGS	10,600 (expected maximum expenditure: 800)	7,300 (69%)	N.A.	45
EMF STF (Note) SDF	} 1,400	N.A.	} 1,000 (71%)	577 227 86 } 890
Total				935

Source: TID records

Note: The TID ceased to accept new applications for the STF with effect from 1 July 2005.

Audit review

1.9 The Audit Commission (Audit) has recently conducted a review of the efficiency and effectiveness of the four SME funding schemes, as follows:

- (a) SME Export Marketing Fund (PART 2);
- (b) SME Training Fund (PART 3);
- (c) SME Loan Guarantee Scheme (PART 4); and
- (d) SME Development Fund (PART 5).

Audit has identified room for improvement in the management of the above schemes.

General response from the Administration

1.10 The **Director-General of Trade and Industry** generally agrees with the audit recommendations. He has said that:

- (a) the four SME funding schemes were implemented after the Chief Executive accepted the SMEC's recommendations of June 2001 on support measures for SMEs (Note 2). The policy objectives of the four funding schemes are to assist SMEs (including newly established ones) to secure loans for acquiring business installations and equipment, meet working capital needs, expand overseas markets, upgrade human resources, and enhance overall competitiveness. There is general recognition within the SMEC and the business sector that SMEs, especially new SMEs, need greater support to rise to new challenges and capitalise on new business opportunities because of their limited size, scale, experience and resources. Newly established SMEs are particularly vulnerable to economic shocks and cycles (e.g. the Asian financial turmoil and SARS). There is no intention to apply more restrictive measures against new SMEs, otherwise the policy objectives of the schemes will be defeated; and
- (b) in evaluating the effectiveness of the four funding schemes, the TID needs to strike a good balance among the needs to safeguard public expenditure, to develop a user-friendly application procedure, to reduce bureaucracy and the administrative burden of SMEs, as well as the availability of resources to handle the funding applications.

1.11 The **Permanent Secretary for Commerce, Industry and Technology (Commerce and Industry)** has said that, overall, the CITB supports the audit recommendations. The CITB thanks Audit for the audit recommendations and assures Audit that it will continue to work with the TID to improve upon the control mechanism and ensure that the SME funding schemes will effectively achieve the Government's policy objectives. In addition, he has said that:

- (a) as pointed out by the Director-General of Trade and Industry in paragraph 1.10(a), the SME funding schemes were introduced in 2001 with aims to help SMEs to start, build and expand a business. There is general recognition within the SMEC and the business sector that SMEs, especially the new ones, need greater support to respond to the ever-changing economic environment, to

Note 2: *In 2000, the Chief Executive tasked the SMEC to explore practical measures to further support the development of SMEs under the themes of helping to start, build and expand a business. In June 2001, the SMEC submitted to the Chief Executive a report that contained 30 proposals to support SMEs (see para. 1.2).*

develop new business ventures and to enhance their competitiveness. The funding schemes have been designed to meet their needs with a degree of flexibility; and

- (b) the CITB has therefore attempted to strike a balance between prudent management of public resources and the need to ensure user-friendly access of the schemes to the SMEs. As in all schemes but especially new ones, some abuses will occur as no designs could be fool-proof. Having said that, the CITB fully agrees that the Administration should seek to reduce potential abuses through more vigorous risk management and closer monitoring of the schemes.

Acknowledgement

1.12 Audit would like to acknowledge with gratitude the full cooperation of the staff of the TID during the course of the audit.

PART 2: SME EXPORT MARKETING FUND

2.1 This PART examines the operation of the EMF and its effectiveness.

Background

2.2 The EMF was launched in December 2001. Details of the EMF are as follows:

Objective	The EMF aims at helping SMEs expand their businesses through active participation in export marketing activities, such as local and overseas trade fairs and study missions.
Eligible applicants	All locally registered SMEs are eligible (subject to meeting the conditions for grants described in para. 2.4).
Assessment criteria and vetting process	The promotion activities should be organised by experienced and reputable organisers and directly relevant to the business of the SMEs. SMEs have to provide information on details of the promotion activities and the company profile of the organisers. They are required to submit brochures or pamphlets to substantiate the declared information of the export promotion activity and to provide the name of the organiser, activity name and details, date of the activity, etc.
Funds approved	In November 2001, the FC approved funds of \$300 million for setting up the EMF. In June 2003 and May 2005, the FC further approved the merger of the funds for the STF/EMF/SDF and the injection of funds into the pool (see paras. 1.3, 1.6 and 1.7).
Maximum amount of grant per SME	The overall grant ceiling is \$80,000 (\$10,000 before February 2003 and \$40,000 from February 2003 to May 2003) per SME. The sub-ceiling per application is \$30,000 (\$10,000 before February 2003 and \$20,000 from February 2003 to May 2003) or 50% of the total expenditure on fundable items, whichever is the less.
Eligible expenditure	Expenditure on various spending items in relation to the participation in marketing activities is eligible, e.g. participation fees charged by the organiser, travelling expenses and hotel accommodation expenses.

2.3 Up to 31 March 2006, the TID had approved 35,000 applications from 15,000 SMEs involving EMF grants of \$615 million. The average grant per SME was \$41,000. As at 31 March 2006, the TID spent \$577 million on EMF grant payments.

Conditions for grants

2.4 According to the Guide to Application, to be eligible for the EMF grants, SMEs have to meet the following conditions:

- (a) the SMEs must be registered in Hong Kong under the Business Registration Ordinance (BRO – Cap. 310) and fulfilled the Government’s definition of SMEs (see para. 1.4);
- (b) since October 2004, the SMEs must have substantive business operations in Hong Kong (Note 3);
- (c) the export promotion activities must be organised by experienced and reputable organisations/companies and directly relevant to the business of the SMEs;
- (d) the form of the SMEs’ participation must be exhibitors of the trade fairs/exhibitions or as delegation members of the study missions. SMEs must be directly represented by their employers and/or local employees in the name of the SMEs. Participation through any other means including third party commission is not allowed; and
- (e) the SMEs should not be subsidised by any other local and/or overseas public funding schemes (whether provided by the Government or not) in respect of the same export promotion activity.

To apply for the EMF grants, an SME has to submit an Application Form for Grant signed by an authorised person (i.e. the applicant) who is normally the owner (a sole proprietor, a partner or a major shareholder) or a senior staff (e.g. a director) of the SME.

Note 3: *In a Supplementary Note issued on 7 October 2004, the TID stated that, as a condition for grants, the SMEs must have active business operations in Hong Kong. On 1 July 2005, the condition that SMEs must have substantive business operations in Hong Kong was incorporated into the Guide to Application.*

Processing of EMF applications and relating controls

2.5 ***Normal vetting and approval procedures.*** Upon receipt of EMF grant applications, the clerical staff check the eligibility of the applicants and the propriety of the supporting documents. Trade Assistants (TAs) review the applications and approve the issue of grant. For applications which do not meet the conditions for grants, TAs refer them to a Trade Officer (TO) for deliberation. As part of the processing procedures, a Principal Trade Officer (PTO) and the TO conduct supervisory checks on approved grant applications.

2.6 ***TID intensified its checking since October 2004.*** Since October 2004, the TID has strengthened its supervisory check on EMF applications. Daily, the PTO reviews a sample of grant applications. Monthly, the PTO and the TO check selected applications submitted for reimbursement in detail. The checking includes seeking confirmation from organisers on SMEs' participation in the export marketing activities, and confirmation from the trustees of the Mandatory Provident Fund (MPF) to verify the SMEs' employment of the staff members participating in the activities. Since July 2005, controls have been strengthened to require the TO's approval in exceptional cases (e.g. cases involving SMEs that have been created for a short period of time). In such cases, the TID may ask the applicants to provide additional information, e.g. evidence of business activities for the SMEs (business proof).

2.7 ***Approval-in-principle was required before July 2005.*** Before July 2005, an SME wishing to apply EMF grant had to obtain approval-in-principle from the TID before participating in the promotion activities. The approved amount would be reimbursed to the SME upon the submission of an Application for Reimbursement. In July 2005, the TID removed the requirement and has since allowed SMEs to apply for EMF grants after their participation in the promotion activities.

2.8 ***Additional information to be furnished by SMEs after July 2005.*** In July 2005, the TID simplified the application procedures and revised the Application Form for Grant to require applicants to provide additional information, as shown in Table 2.

Table 2

Additional information required to be furnished by SMEs

Before July 2005	Since July 2005
<p>(a) Particulars of ownership not required. No information was collected from SMEs on details of the owners/partners/major shareholders of the SMEs.</p>	<p>Particulars of ownership (e.g. owners/partners/major shareholders) required. Applicants have to indicate in the Application Form for Grant the names and Hong Kong Identity Card (HKID)/Passport numbers of the owners/partners/major shareholders (with individual holding equal to or over 30%) and to furnish certified extract of information on the Business Register (as kept by the Business Registration (BR) Office of the Inland Revenue Department — IRD) and/or Annual Return filed with the Companies Registry.</p>
<p>(b) Particulars of representatives not required. Applicants stated the number of locally employed persons representing the SMEs to participate in the export promotion activity. They were not required to provide employment proof for the representatives.</p>	<p>Names of representatives and evidence to support their employment with the SMEs required. The applicants have to provide names of the representatives attending the export promotion activities and evidence showing that these representatives are employers and/or local employees of the SMEs (Note).</p>
<p>(c) Submission of evidence to support only the expenditure incurred. Applicants had to provide supporting documents (such as receipts) to substantiate the approved expenditures incurred.</p>	<p>Submission of evidence to support complete participation of the activity. In addition to submitting invoices/receipts for expenditure incurred, the applicants have to provide evidence to substantiate the applicant's complete participation of the activity (e.g. delegation list, fair directory with exhibitor's information, photograph of booth showing the exhibitor name and booth number, exhibitor badge and travelling and accommodation proof of employers/local employees participating in the activity).</p>

Source: TID records

Note: Examples of such documentary proof include owners' particulars as recorded in the Business Register of the BR Office of the IRD and MPF records issued by the trustees.

Need to build up a robust system to guard against potential abuses

SMEs with short business life

2.9 The Administration has informed LegCo on various occasions that the EMF is aimed at helping SMEs expand their businesses. Audit however found that it was not until October 2004 that the TID stipulated as a condition for grants that an SME must have active/substantive business operations in Hong Kong (see para. 2.4(b)). Although the requirement has been stated as a condition for grants since October 2004, the TID does not require SMEs to submit documentary evidence at the time of application to prove that they are in active/substantive business operations. Instead, the TID would only ask SMEs to provide business proof in some selected cases (see para. 2.6).

2.10 Audit analysed the period of time from business commencement date to the date the SMEs submitted their first grant applications under the EMF. The analysis revealed that, among the 15,000 SMEs receiving EMF grants since the inception of the EMF up to the end of March 2006, 7% (1,026 SMEs) had commenced business for less than six months at the time of application. An analysis of these SMEs is shown in Table 3.

Table 3

Analysis of 1,026 SMEs

Period of time from business commencement date to date of first EMF grant application	No. of SMEs (Note)	Total grants obtained up to 31.3.2006 (S'000)
Same day	2	44
1 to 7 day(s)	28	918
8 days to less than 1 month	108	4,113
1 to less than 2 months	155	5,910
2 to less than 3 months	168	6,593
3 to less than 6 months	565	20,049
Total	<u>1,026</u>	<u>37,627</u>

Source: Audit analysis of TID records

Note: These SMEs submitted their grant applications within six months after commencing business.

2.11 Table 3 shows that 138 SMEs had only commenced business for less than one month when they submitted their first grant applications. A BR search in April 2006 further revealed that, of the said 138 SMEs, 30% (41 SMEs) had ceased business before April 2006 (Note 4), including 16% (22 SMEs) which had a business life of less than one year. Of these 41 SMEs, 12% (5 SMEs) had ceased business before they received the last grant payments, 20% (8 SMEs) had ceased business in less than three months after the last grant payments were received and 49% (20 SMEs) in less than one year.

2.12 As mentioned in paragraph 2.11, there were SMEs which had commenced business only for a short period of time when they applied for EMF grants and they ceased business shortly after they had received the last grant payments. It is not known why these SMEs ceased operations shortly after they obtained the grants. In this connection, Audit noted that in June 2003, at a meeting of the LegCo Panel on Commerce and Industry when considering the proposal of pooling the resources available for the EMF, STF and SDF together, a LegCo Member expressed his concern that such an arrangement would cause “undesirable elements” to set up shell companies and apply for the funds, resulting in the waste of government resources. He suggested the Administration to conduct regular reviews of the maximum amount of grant of the three funding schemes as well as the provision arrangement, in order to plug the potential loopholes.

SMEs were not required to provide details of their representatives before July 2005

2.13 It is a condition for grants that the SMEs must have participated in the export promotion activities through the employers and/or local employees under the name of the SMEs (see para. 2.4(d)). Audit however noted that before July 2005, SMEs were not required to provide details of the person(s) representing the SMEs who would participate in the activities (e.g. their names), and evidence to substantiate that they were the employers or their local employees (employment proof). An improvement was made in July 2005 by revising the Application Form for Grant to require SMEs to state the names of the representatives and to provide employment proof (see item (b) of Table 2 under para. 2.8).

Claiming EMF grants by SME groups

2.14 Some applicants of business groups obtained grants exceeding the ceiling of \$80,000 per SME by submitting applications under different SMEs. The analysis in

Note 4: *SMEs which had ceased business refers to those which had informed the BR Office under section 8(2) of the BRO that they had ceased business.*

Table 4 shows that, as at 31 March 2006, some 1,800 SME groups (Note 5), involving 4,198 SMEs (28% of 15,000 SMEs which obtained EMF grants), had obtained EMF grants this way.

Table 4
EMF grants obtained by SME groups
(31 March 2006)

No. of related SMEs in a group	No. of SME groups obtaining grants	Total EMF grants obtained by the SME groups concerned (\$'000)
8	5	1,443
7	3	434
6	17	3,809
5	19	4,433
4	59	10,944
3	276	35,890
2	1,438	120,929
Total	<u>1,817</u>	<u>177,882</u>

Source: Audit analysis of TID records

2.15 Of these 1,817 SME groups, 379 had each obtained grants under three or more SMEs. The total amount of grants paid to these 379 SME groups amounted to \$57 million (see Table 4). An analysis of the amount of EMF grants obtained by the SME groups further indicated that some of these 379 SME groups had obtained grants of substantial amounts. For example, 8 SME groups had each obtained grants of over \$320,000 (Note 6), and 26 SME groups had each obtained grants ranging from \$240,001 to \$320,000.

Note 5: *In the analysis, an SME group refers to SMEs which were largely owned or managed by the same group of people (i.e. shareholders/owners/partners/authorised persons of the SMEs), and all or a great majority of the SMEs in the same group used the same business address and conducted similar business.*

Note 6: *One SME group had obtained grants of \$580,000 (see Case study A at Appendix A); another had obtained \$469,000, and the remaining six had obtained \$320,001 to \$400,000.*

2.16 Audit examined the 379 SME groups which comprised 1,300 SMEs. It was noted that 173 SMEs (13%) had submitted grant applications within six months after commencing business. A further examination of these 173 SMEs revealed the following:

- (a) 47 (27%) had already ceased business before April 2006;
- (b) 34 (20%) submitted grant applications **in the first month** after commencing business, with 16 (47%) of them having already ceased business before April 2006;
- (c) of the 16 SMEs in item (b) above, 8 (50%) had a business life of less than one year. Three of these 16 SMEs ceased business **before** receiving the last grant payments and 6 ceased business **within** three months after receiving the last grant payments.

There was a high risk that the 34 SMEs (item (b) above) which submitted grant applications in the first month after commencing business did not have substantive business operations. Yet in most cases, the TID had not verified the business activities of the SMEs.

2.17 The audit analysis of the 379 SME groups mentioned in paragraph 2.16 indicates that there might have been dubious cases of claims. However, Audit observed that the TID had not carried out adequate checking and verification on many of these cases. **Case studies A, B and C** (at Appendices A, B and C respectively) are examples of suspected abuse cases.

Audit observations

2.18 The TID did not have a robust system to guard against abuse of the EMF and there were cases of dubious claims. In November 2004, the TID reported to the SMEC that there were abuse cases which involved claims under several SMEs. It was only since October 2004 that the TID has stepped up its efforts to enhance the controls, including stipulating the condition that SMEs should have active/substantive business operations in Hong Kong, requiring SMEs to furnish additional information when applying for grants and intensifying the checking and verification procedures (see paras. 2.4(b), 2.6 and 2.8).

2.19 **Audit recognises the efforts made since October 2004 and considers that the TID should continue to improve its system and monitor the situation. In particular, it should assess the risk of abuse and, if necessary, take appropriate action to further strengthen the system (for example, ensuring that SMEs indeed have substantive business operations when they apply for EMF grants).**

2.20 **Also, the TID needs to re-examine some of the paid claims (e.g. SMEs submitting grant applications on the date on which they commenced business) to identify obvious non-compliance cases and take action to recover the grants paid.**

Need to enhance the computer system supporting the operation of the EMF

2.21 The operation of the EMF is supported by a computer system. The system has provided for various validation checks on data provided by SMEs. One of the system functions checks the adequacy of balance of fund in the SME account.

2.22 An audit test check of EMF data kept in the computer system identified a number of irregularities. For example:

- (a) the system had accepted 145 application records that contained incorrect HKID/passport numbers;
- (b) the system did not reject an application record without a BR number and nine others with incorrect BR numbers; and
- (c) the system did not reject a grant application from one SME although the total grants obtained by the SME had exceeded the grant ceiling of \$80,000.

Incomplete and incorrect data affect the system's checking on the applications (e.g. the number of SMEs under which an applicant had claimed EMF grants – Note 7). Arising from these irregularities, Audit also noted a few cases where the SMEs had been paid excess EMF grants.

Audit observations

2.23 Audit observed that there were irregularities in the computer system supporting the operation of the EMF and had brought them to the attention of the TID. In August 2006, towards the end of the audit, the TID was taking action to rectify the various deficiencies in the computer system and to recover the excess grants paid to the SMEs.

Note 7: *The computer system captures the names and HKID/passport numbers of the persons who submit the applications on behalf of the SMEs. Since July 2005, the TID has further required SMEs to provide in their applications the names and HKID/passport numbers of their owners/partners/major shareholders (see item (a) of Table 2 in para. 2.8). This enables the system to identify applicants who have cumulatively obtained substantial EMF grants.*

2.24 **Audit considers that the TID should regularly extract exceptional cases from the computer system for follow-up review.** The information in Tables 3 and 4 (in paras. 2.10 and 2.14 respectively) was extracted from the computer system. Such information should be regularly produced for review and follow-up.

Need to set up a mechanism to assess the effectiveness of the EMF

2.25 In November 2001, when approving the initial funds of \$300 million for setting up the EMF, the FC was informed that, based on the maximum grant of \$10,000 per SME, a minimum of 30,000 SMEs would likely be benefited by the scheme. With improvement measures being introduced in February and June 2003, the ceiling amount of grant for an SME has been raised from \$10,000 to \$80,000. Up to March 2006, 15,000 SMEs had been benefited (see para. 2.3).

Audit observations

Need to set additional performance measures

2.26 In the Controlling Officer's Report (COR) for 2006-07, the TID reported three performance targets and one indicator on the EMF (see Appendix D). The results only focused on reporting workload and quality of services, but did not indicate the outcome of the EMF. According to the guidelines issued by the Financial Services and the Treasury Bureau (FSTB) in October 2005, targets should preferably measure outcome. Audit considers that, in the absence of any outcome targets and indicators, the TID cannot measure the efficiency and effectiveness of the EMF. **Audit considers that the TID should, in line with the FSTB's guidelines, develop additional performance targets and indicators to help measure the extent to which the EMF has achieved its objectives.** The number of SMEs benefited by the EMF (see para. 2.25) is a performance indicator which can be considered for reporting in the CORs.

2.27 Audit has found that, for example, in Australia the additional exports and jobs generated by the Export Market Development Grants scheme are used to measure the success of the scheme.

Need to set up a mechanism to monitor benefits

2.28 **To help ascertain the additional impacts, Audit considers that the TID should set up a mechanism for collecting information from SMEs on the benefits they expect to gain from participating in the export promotion activities, and for monitoring the actual benefits they have gained.** Since February 2003, the TID has collected, through the Application Forms for Grant, information on additional staff the SMEs planned

to employ for business development in relation to the export promotion activities. This is a step in the right direction.

2.29 As at 31 March 2006, \$510 million (\$1,400 million less \$890 million) was still available in the EMF/SDF pool (see Table 1 in para. 1.8). As pointed out in paragraph 2.25, up to March 2006, the EMF had benefited 15,000 SMEs, versus 30,000 SMEs as estimated in the FC paper of November 2001. **With the setting up of the monitoring mechanism and the collection of cumulative performance data since February 2003 (see para. 2.28), the TID should conduct, at an opportune time, an effectiveness review of the EMF to assess the extent to which it has met its objectives.**

Audit recommendations

2.30 **Audit has recommended that the Director-General of Trade and Industry should:**

- (a) **continue to improve the TID system and monitor the situation. The TID should assess the risk of abuse and, if necessary, take appropriate action to further strengthen the system (see para. 2.19);**
- (b) **re-examine some of the claims to identify obvious non-compliance cases and take action to recover the grants paid (see para. 2.20);**
- (c) **rectify the deficiencies of the TID computer system as soon as possible (see para. 2.23);**
- (d) **regularly extract exceptional cases from the computer system for follow-up review (see para. 2.24);**
- (e) **develop additional performance targets and indicators to help measure the extent to which the EMF has met its objectives (see para. 2.26);**
- (f) **set up a mechanism for collecting information from SMEs on the benefits they expect to gain from participating in the export promotion activities, and for monitoring the actual benefits gained (see para. 2.28); and**
- (g) **conduct at an opportune time an effectiveness review of the EMF (see para. 2.29).**

Response from the Administration

2.31 The **Director-General of Trade and Industry** has said that:

General

- (a) when the EMF was launched in December 2001, an SME was allowed to obtain a one-off grant up to \$10,000. Following approvals by the FC in February 2003 and June 2003, the cumulative ceiling was raised to \$40,000 and then to \$80,000 respectively. There was a significant increase in the number of applications thereafter. Based on actual experience of handling the applications, the TID has taken its own initiative to strengthen its control mechanism, enhance its risk management strategy and intensify its checking procedures to guard against potential abuses. These measures had been put in place before this audit and were recognised in this Audit Report (see paras. 2.6 to 2.8, 2.18 and 2.19);

Audit recommendations in paragraph 2.30

- (b) the TID accepts the audit recommendation in paragraph 2.30(a) and in fact, has been keeping its control system under constant review. The TID will continue to make vigorous efforts to guard against potential abuses. To protect public expenditure, the TID has been improving its risk management and targeting approach over the years, as illustrated below:
- (i) the TID notes the concern that the requirement for an SME to have substantive business was not specified as a condition of approval before October 2004. When formulating the EMF at the time of launch, the TID considered that participation in an export marketing activity would involve considerable preparatory and follow-up work (e.g. setting up display booths, assigning staff to man the booths and to take orders from buyers, travelling if a trade fair or exhibition takes place outside Hong Kong, and subsequent order fulfilment). These activities already constitute substantive evidence of an active business;
- (ii) the TID is aware that, with the raising of the grant ceiling in February and June 2003, some applicants might inflate their claims or set up new companies for the purpose of circumventing the grant ceiling. Starting from late 2003, the TID has requested additional documentary proof in suspicious cases. A Supplementary Note was issued in October 2004, stating that applicants must have active business operation as a condition for grants (see Note 3 to para. 2.4(b)). Starting from January 2005, the computer system was upgraded to enable the matching of previous applications having the same particulars (e.g. authorised persons' HKID number, address, telephone no./fax no./e-mail address). Applicants so identified are required to submit business/employment proof to substantiate their applications; and

- (iii) the TID reckons that there are legitimate commercial reasons for SMEs to start or cease operation, and it is not uncommon for individuals to set up different companies for different business purposes. Nevertheless, starting from July 2005, the TID has further introduced a major control measure by requiring all applicants to provide full HKID details of the owners/directors of the SME (see item (a) of Table 2 in para. 2.8). With the data collected, the TID is able to identify individuals making applications under different SMEs. The TID has been rejecting applications from SMEs which it believes to have been set up for the purpose of circumventing the grant ceiling;
- (c) the TID agrees with the audit recommendation in paragraph 2.30(b). It has started re-examining those cases where SMEs had submitted applications within one month of their business registration, with a view to ascertaining whether abuses were involved and, if so, to take action to recover improper claims;
- (d) regarding the audit recommendation in paragraph 2.30(c), the TID has made programme enhancements to the computer system to address the deficiencies identified; and
- (e) the TID generally agrees with the audit recommendations in paragraph 2.30(d) to (g).

2.32 The **Secretary for Financial Services and the Treasury** has said that he noted the audit recommendation in paragraph 2.30(e) that additional performance targets and indicators should be developed to help measure the extent to which the SME funding schemes have met their objectives. In this respect, as pointed out in paragraph 2.26, the FSTB has issued a circular memorandum to Directors of Bureaux and Controlling Officers in October 2005, reminding them, inter alia, of the need to focus on “targets” measured in terms of outcome (as opposed to output or input). The circular memorandum has also set out guidelines to facilitate Controlling Officers to draw up suitable performance targets and indicators in their CORs.

PART 3: SME TRAINING FUND

3.1 This PART examines the operation of the STF and its effectiveness.

Background

3.2 The STF was launched in January 2002. Details of the STF are as follows:

Objective	The STF aimed at upgrading the human resources of SMEs through providing financial assistance to their employers and employees to attend training courses relevant to their business operation. The primary aim was to help improve the capabilities and competitiveness of SMEs.
Eligible applicants	All locally registered SMEs were eligible (subject to meeting the conditions described in para. 3.5). Trainees must be Hong Kong residents and should be the employers or local employees of the SMEs.
Funds approved	In November 2001, the FC approved funds of \$400 million for setting up the STF. In June 2003, the FC further approved the merger of the funds for the STF/EMF/SDF (see paras. 1.3 and 1.6).
Scope	The STF covered training courses provided by local or overseas professional training organisations (including distant learning and online learning) and training courses commissioned by SMEs to suit their particular needs, and were conducted by local or overseas professional training organisations or individual instructors.
Maximum amount of grant per SME	Successful applications were reimbursed 70% of the training expenses (50% before July 2003), subject to the ceilings of \$10,000 (\$5,000 before March 2003) for employers' training and \$20,000 (\$10,000 before March 2003) for employees' training per SME.
Eligible expenditure	Fees of training courses which are directly relevant to the business operation of the SMEs.

3.3 ***Discontinuation of STF.*** In May 2005, due to the significant duplication between the STF and other training-related initiatives under which employers and employees of SMEs could obtain Government support to enhance their skills, with the agreement of the SMEC and the FC, the Administration decided to discontinue the STF. The TID ceased to accept new applications for the STF with effect from 1 July 2005.

3.4 **Usage.** Up to 31 March 2006, the Government had approved 73,000 applications from 32,000 SMEs involving grants of \$271 million. On average, each SME obtained grants of \$8,500. Some 56,000 employers/employees had benefited from the STF. As at 31 March 2006, the TID had spent \$227 million on grant payments under the STF.

Conditions for grants

3.5 According to the Guide to Application, to be eligible for the STF grants, SMEs had to meet the following conditions:

- (a) the SMEs must be registered in Hong Kong under the BRO and fulfilled the Government's definition of SMEs (see para. 1.4);
- (b) since December 2004, the SMEs must have business operations. Applicants must actively participate in their business operations and the training courses concerned had to be directly relevant to their business operations (Note 8);
- (c) the persons receiving training must be Hong Kong residents. For **employers**, the persons receiving training must be the proprietors, partners or shareholders actively engaged in the operation of the SMEs. For **employees**, the persons receiving training must be the salaried employees of SMEs. The trainee could either be an employer trainee or an employee trainee of an SME, but not both;
- (d) the SME must ensure that its businesses and trainees meet the respective eligibility criteria for the whole duration of the training course concerned and throughout the application process; and
- (e) successful SMEs or trainees could not obtain grant and loan from any other public funding schemes, whether or not provided by the Government in respect of the same training course.

Inadequate checking to guard against potential abuses

SMEs with short business life

3.6 Similar to the EMF, it should have been a prerequisite for an SME applying for STF grants to have substantive business operations. Audit however found that it was not until December 2004 that the TID stipulated as a condition for grants that an SME must

Note 8: *In a Supplementary Note issued on 15 December 2004, the TID stated the condition for grants that businesses with no operation were not eligible for applying the STF and that, if necessary, the TID might ask applicants to provide additional documentary evidence to prove their business operations.*

have business operations (see para. 3.5(b)). Although the requirement that SMEs must have business operations when applying for STF grants had been stated as a condition for grants since December 2004, the TID did not require SMEs to submit business proof at the time of application. Instead, the TID asked SMEs for business proof in some selected cases (e.g. when the data in an application form hit one or more of the TID's "alert parameters" – Note 9).

3.7 Audit analysed the period of time from business commencement date to the date the SMEs submitted their first grant applications under the STF. The analysis revealed that, among 28,200 SMEs which had received STF grants since the inception of the STF up to the end of March 2006, 8% (2,315 SMEs) had submitted their first grant applications within six months after commencing business. Details are shown in Table 5.

Table 5

Analysis of 2,315 SMEs

Period of time from business commencement date to date of first STF grant application	No. of SMEs (Note)	Total grants obtained up to 31.3.2006 (\$'000)
Same day	5	25
1 to 7 day(s)	97	1,073
8 days to less than 1 month	389	4,033
1 to less than 2 months	486	4,964
2 to less than 3 months	350	3,219
3 to less than 6 months	988	8,662
Total	2,315	21,976

Source: Audit analysis of TID records

Note: These SMEs submitted their grant applications within six months of commencing business.

Note 9: Applications which hit the "alert parameters" included those submitted within a short period of time after the SMEs had commenced business, from SMEs using residential addresses for BR, and which would exhaust the SME's grant entitlement of \$10,000/\$20,000 for employer/employee training in one go.

3.8 Table 5 shows that 491 SMEs had only commenced business for less than one month when they submitted their first applications. A BR search in April 2006 further revealed that 56% (275 SMEs) had ceased business before April 2006, including 38% (188 SMEs) which had a business life of less than one year. Of these 275 SMEs, 14% (38 SMEs) had ceased business on or before they received the last grant payments, 25% (70 SMEs) ceased business in less than three months after the last grant payments and 49% (135 SMEs) in less than one year. Similar to the EMF, some SMEs had only commenced business for a short period of time when they applied for the STF grants and ceased business shortly after receiving the last grant payments.

3.9 **Case study D** (at Appendix E) is an example of a company which claimed the maximum STF grants in one go shortly after commencing business and ceased business 18 months after obtaining the grants. There was however no documented evidence to show that the TID had taken action to verify whether the company had business operations at the time of application.

3.10 After the TID stipulated the requirement for SMEs to have business operations as a condition for grants in December 2004 and asked for business proof in selected cases (see para. 3.6), there was a significant drop in the number of newly established SMEs (commencing business for less than one month) which obtained STF grants. Audit noted that, in respect of the 491 newly established SMEs (see Table 5) which had obtained STF grants, 72 SMEs (15%) pertained to applications made after December 2004.

Insufficient checking of details of trainees

3.11 As mentioned in paragraph 3.5(c), an employer trainee had to be actively engaged in the operation of the SME whereas an employee trainee had to be a salaried employee of the SME at the time of submitting grant applications under the STF. It was also a condition for grants that a trainee could either be categorised as an “employer” or “employee” of the SME, but not both.

3.12 Audit noted that, similar to the EMF before July 2005, the TID did not require SMEs to submit documentary proof to substantiate the owner status of the employer trainees and the employment status of the employee trainees. Instead, the trainees and the applicant were required to sign declarations in the Application Forms for Grant to confirm their position as the employers/employees of the SMEs. The TID would only request the SMEs to submit documentary proof in some selected cases (e.g. for applications that met the TID’s “alert parameters” – see Note 9 to para. 3.6).

3.13 There were no control measures to prevent the same trainee from claiming STF grants both as an “employer” and as an “employee” of the same SME. An audit analysis of the STF grant payments up to the end of March 2006 identified 144 trainees who had obtained STF grants both as an “employer” and as an “employee” of the same SME. Grants of \$1 million were paid to these trainees. In one case, the trainee used up the entire STF grant entitlement of \$30,000 for the SME.

Individuals might claim excess STF grants through different SMEs

3.14 An audit of the STF grant payments revealed that, as at the end of March 2006, some 2,000 trainees had applied for reimbursement of training fees amounting to \$25.7 million from the STF under more than one SME, as shown in Table 6.

Table 6

**Trainees obtained STF grants from more than one SME
(31 March 2006)**

No. of SMEs under which a trainee obtained STF grant	No. of trainees involved	Total STF grants obtained (S'000)
6	4	244
5	20	702
4	28	919
3	167	3,652
2	<u>1,715</u>	<u>20,177</u>
Total	<u>1,934</u>	<u>25,694</u>

} 219

} 5,517

Source: Audit analysis of TID records

Table 6 shows that 219 trainees had obtained grant payments under three or more SMEs. They had obtained grant payments totalling \$5.5 million (see Table 6). It was also found that some trainees had obtained grants of substantial amounts, e.g. three had obtained grants of over \$70,000 each, and 13 had obtained grants of \$50,001 to \$60,000 each. Details are shown in Table 7.

Table 7
Analysis of STF grants made to 219 trainees
(31 March 2006)

Amount of grants obtained	No. of trainees	Total grants obtained (\$'000)
Over \$70,000	3	229
\$50,001 to \$70,000	13	709
\$30,001 to \$50,000	58	2,207
\$30,000 or below	145	2,372
Total	219	5,517

Source: Audit analysis of TID records

- 3.15 Audit's examination of the grant payments to 219 trainees revealed that:
- (a) many of the SMEs under which the trainees applied for STF grants used the same business address, indicating that the SMEs were related;
 - (b) of the 693 SMEs under which grants were claimed by the 219 trainees, 170 SMEs (25%) submitted grant applications within six months after commencing business;
 - (c) of these 170 SMEs, 42 SMEs (25%) submitted grant applications **in the first month** after commencing business. Audit found that of the 42 SMEs, 34 (81%) had ceased business before April 2006, including 27 which had a business life of less than one year; and
 - (d) there was a risk that these 42 SMEs, which submitted grant applications in the first month after commencing business, did not have substantive business operations. In most cases, the TID had not verified the business activities of the SMEs.

3.16 **The audit analysis of the claims made by the 219 trainees in paragraph 3.15 indicated that there might have been dubious cases of claim. However, the TID had not carried out sufficient checking and verification on many of these dubious cases. Case study E (at Appendix F) is an example of these cases.**

3.17 Audit found that there was no robust system to guard against potential abuses in the STF. However, upon identifying a number of suspected abuse cases in June 2004, the TID had intensified its checking and verification work. In December 2004, it further stipulated the condition for STF grants that the SMEs must have business operations before they could apply for STF grants (see para. 3.5(b)).

TID was aware of potential abuses

3.18 In January 2005, the TID proposed to discontinue the STF. The TID advised the SMEC that, apart from the significant overlaps between the STF and the Government's other training-related initiatives (see para. 3.3), about 1% of the STF applications involved suspected abuses. The TID further pointed out that there were suspected abuses which included claims under multiple SMEs, shell companies, using both employer and employee status, and about 8% of the applications came from newly established SMEs (set up for less than six months). In view of the heavy workload of handling voluminous applications a month, many of which were low-valued (with 30% applying for grants under \$1,000 each), and the fact that 15% of the applications hit the TID's "alert parameters" (see Note 9 to para. 3.6), the TID had to deploy extensive manpower resources to operate the STF. The SMEC agreed to discontinue the STF.

Audit observations

3.19 Audit noted that, once the announcement for cessation of the STF in accepting new applications (as from 1 July 2005) was made in May 2005, there was an upsurge in the number of grant applications. Over 15,000 applications were received in June 2005, an increase of 600% from the average number of applications of the previous five months (i.e. January to May 2005).

3.20 Upon Audit's enquiries in July 2006, TID officers advised that, as at 25 July 2006, the TID had still in hand some 2,600 grant applications which had been approved but awaiting the trainees to complete the training courses and to submit claims for reimbursement. They involved claims for training grants of \$20 million. In addition, for 500 grant applications, the provision of additional information by the trainees was still pending. They involved claims of \$4.5 million.

3.21 Up to 31 March 2006, the TID had paid out STF grants of \$227 million (see para. 3.4). Audit considers that the TID should re-examine these paid claims to identify obvious non-compliance cases (e.g. trainees claiming STF grants both as the employers and employees of the same SME) and take action to recover, if possible, any improper claims. Audit also considers that the TID should re-examine those 3,100 (2,600 + 500) outstanding grant applications mentioned in paragraph 3.20 to confirm that they are proper claims for STF grants.

Audit recommendations

3.22 Audit has *recommended* that the Director-General of Trade and Industry should:

- (a) re-examine the paid claims under the STF to identify any obvious non-compliance cases (e.g. trainees claiming STF grants both as the employers and employees of the same SME) and take action to recover, if possible, any grants improperly obtained (see para. 3.21); and
- (b) thoroughly examine the 3,100 outstanding grant applications as at the end of July 2006 to confirm that the claims for grants are proper (see para. 3.21).

Response from the Administration

3.23 The Director-General of Trade and Industry has said that:

General

- (a) the improvement measures introduced in February 2003 and June 2003 (i.e. raising the grant ceiling from \$15,000 to \$30,000 and increasing the subsidy level from 50% to 70%) had brought about a significant increase in the number of applications. Based on actual experience of handling the applications, the TID has intensified the checking/verification work and strengthened its risk management mechanism;
- (b) in June 2004, the TID adopted a new control mechanism whereby SMEs would be asked to produce documentary proof to substantiate their applications which hit one or more of the TID's "alert parameters". In December 2004, the condition that an SME must have active/substantive business operations was spelt out in the Guide to Application. The TID considered this targeted approach effective given the large number of applications received (2,000 to 3,500 per month). Since then, over 10,000 applications were "captured" by these parameters (about 20% of applications received), out of which some 200 were rejected as the SMEs concerned were unable to provide satisfactory proof

to substantiate their applications. The TID considers this mechanism very effective in guarding against abuses;

- (c) the TID has taken note of the audit observations. It does not have any plan for implementing any SME funding schemes similar to STF;

Audit recommendations in paragraph 3.22

- (d) regarding the audit recommendation in paragraph 3.22(a), the TID will re-examine the paid claims involving trainees claiming STF grants both as employers and employees of the same SME and take action to recover, if possible, any improper claims; and
- (e) regarding the audit recommendation in paragraph 3.22(b), the TID will re-examine the outstanding grant applications. Since applications processed after June 2004 had already been subjected to scrutiny under the “alert parameters” mechanism, the TID will focus on cases processed before June 2004 but pending re-imburement payments.

PART 4: SME LOAN GUARANTEE SCHEME

4.1 This PART examines the operation of the SGS and its effectiveness.

Background

4.2 In December 2001, the Government set up the BIG to help SMEs purchase business installations and equipment relating to their business operations. The scheme allowed locally registered SMEs to apply for loans from participating lending institutions (PLIs) to purchase business installations and equipment. As at 31 March 2006, there were 43 PLIs. The Government would guarantee up to 50% of the loan repayment.

4.3 In March 2003, the Government renamed the BIG as the SGS and expanded the scope of government guarantee to cover the following types of loans:

Business installations and equipment loan	Similar to the BIG, an SME may use this loan to purchase business installations and equipment relating to its business operations.
Associated working capital loan	An SME that has obtained a business installations and equipment loan from a PLI may apply for an associated working capital loan from the same PLI, for financing additional operational expenses arising from the acquisition of business installations and equipment under the SGS.
Accounts receivable loan	An SME with accounts receivable in hand may apply for loans from PLIs to meet their working capital needs.

The Government continues to honour its responsibilities and obligations for the outstanding guarantees previously given under the BIG. Appendix G shows details of government guarantees available to SMEs under the BIG and the SGS.

Operation of the SGS

4.4 In the FC paper of January 2003 (see para. 1.5), the Administration advised the FC that the SGS should primarily follow the arrangement of the BIG and would operate on the principles of market-driven, risk-sharing, risk-capping and administrative simplicity. In the FC paper, it is stated that target beneficiaries are SMEs which are creditworthy, have a good track record and are able to demonstrate business prospects.

4.5 The TID relies on the PLIs to exercise their usual prudent professional judgement in assessing the SMEs' creditworthiness. The SMEs deal directly with the PLIs. The PLIs assess the SMEs' creditworthiness, arrange the terms of the loans, and apply for government guarantees from the TID. Upon the TID's approval of an application, the PLI will advance the loan to the SME and follow through with its repayments. In case the SME defaults on repayments, the PLI may claim compensation against the Government.

4.6 As at 31 March 2006, the TID had received 17,641 applications for government guarantees under the SGS. The TID approved 16,075 applications and issued guarantees amounting to \$7.3 billion. Some 8,400 SMEs had benefited from the SGS. Details of the approved government guarantees are summarised at Appendix H.

Management of default risk

4.7 In November 2001, the FC approved an allocation of \$1 billion as maximum expenditure arising from default loans under the then BIG and an assumed overall default rate (Note 10) of 15% for calculating the maximum loan guarantee that the Government might commit under the scheme. On this basis, the maximum loan guarantee under the then BIG was \$6.6 billion. In May 2005, the FC was informed that the loan default rate for the SGS as at the end of March 2005 was 1.6%, which was not representative of the likely default rate because most of the repayments of the SGS-guaranteed loans were not yet due. The FC was also informed that the actual loan default rate as at 31 March 2005 for the then Special Finance Scheme for SMEs (SFS – Note 11) was 6.4%. The FC approved the lowering of the assumed loan default rate of the SGS from 15% to 7.5%.

4.8 As at 31 March 2006, the default rate had increased to 2%. The TID had received a total of 568 claims from PLIs requesting payment of compensation for default repayment of loans. As at 31 March 2006, the net expenditure incurred by the TID on default claims amounted to \$45 million (Note 12).

Note 10: *The loan default rate is equal to the amount of claims received from PLIs for loan default, divided by the total amount of approved government guarantees.*

Note 11: *The SFS was launched in August 1998. Similar to the SGS, the Government acted as the guarantor for SMEs under the scheme. Following a review of the SFS, the Administration decided to stop receiving new applications with effect from 8 April 2000.*

Note 12: *As at 31 March 2006, the TID had made compensation payment of \$48 million and recovered \$3 million from the borrowers through the PLIs. The net expenditure was \$45 million.*

Audit observations

Need for regular compilation of information for risk management

4.9 The TID does not regularly compile analyses of the loan default rates by parameters such as the size, the age and the business nature of the SMEs. **Audit considers that these analyses provide useful information for risk management. For example, such information may help the TID assess whether the current assumed default rate for the SGS is still appropriate as the scheme matures.** In this connection, Audit has analysed the default rates of loans advanced by PLIs as at 31 March 2006.

4.10 Table 8 shows the loan default rates as at 31 March 2006. Although a large proportion of the guaranteed loans were still at their early stage of loan repayment under the SGS, it can be seen that there were three PLIs whose loans had default rates of over 15%, well exceeding the assumed default rate of 7.5%, indicating that the TID needs to keep a close watch on the situation.

Table 8
Default rates of loans advanced by PLIs
(31 March 2006)

Default rate	No. of PLIs	Percentage
0%	14	33%
0.1 – 5%	21	50%
5.1 – 10%	4	10%
10.1 – 15%	Nil	Nil
Over 15%	3	7%
Total	42 (Note)	100%

Source: Audit analysis of TID records

Note: Under the SGS, there were 43 PLIs. One PLI had not made any guaranteed loans under the scheme.

Risks relating to guarantees given to related SMEs

4.11 The Government imposes a ceiling on the maximum amount of guarantees available to each SME (see Appendix G). However, a person can obtain several government guarantees under the SGS through different SMEs registered by him, as long as the guarantee for each SME does not exceed the ceiling.

4.12 Under the present procedures, the TID does not require SMEs applying for guaranteed loans to provide details about their owners (e.g. personal data of the major owners and each owner's share in the business). Therefore, the TID does not have detailed information about the total amount of government guarantees given to related SMEs owned by the same major owners.

4.13 Audit reviewed 100 default cases and noted that in 17 cases, the major owners owned more than one company in the same trade and had obtained several government guarantees through different SMEs. Since the related SMEs were in the same trade and were under the management and control of the same major owners, any downturn in the trade, or any poor management practices of the owners would affect all these related SMEs. **Therefore, Audit considers that granting government guarantees to related SMEs owned by the same major owners may increase the overall default risk. The TID needs to assess the risks relating to guarantees given to related SMEs owned by the same major owners and take effective measures to address such risks.**

4.14 **Case studies F and G** (at Appendices I and J respectively) are examples of related SMEs which obtained total government guarantees exceeding the ceiling set for an SME. It transpired that the related SMEs defaulted on loan repayments and the TID had to pay compensation to the PLIs concerned.

4.15 Audit notes that, since July 2005, the TID has required applicants for EMF grants to disclose, at the time of submitting their grant applications, details of major owners of the SMEs. The information so collected is used for identifying multiple claims under different SMEs owned by major owners (see item (a) in Table 2 under para. 2.8). **Audit considers that the TID should implement similar checking procedures in the SGS.**

Vetting of default claims

4.16 All authorised institutions under the Banking Ordinance (Cap. 155) are eligible to participate in the SGS. Each of the 43 PLIs entered into an agreement with the Government. The Government relies on the PLIs to assess the creditworthiness of SMEs (see para. 4.5). When SMEs default on repayment of the guaranteed loans, the TID will conduct a vetting to check whether the PLIs have exercised due diligence, professional

judgement and prudence in approving the loans. The TID will generally request the PLIs to provide information relating to the credit assessment of the SMEs (e.g. credit assessment reports and audited financial statements) for vetting. The vetting will also include other assessments such as reviewing the actions taken by the PLIs in relation to the realisation of collateral.

Audit observations

4.17 An analysis of default claims under the SGS as at 31 March 2006 is shown in Table 9.

Table 9

**Analysis of default claims under the SGS
(31 March 2006)**

Stage of loan repayment at which default occurred	No. of cases	Percentage	
Within the first 6 months	110	19%	} 54%
After 6 months but within 1 year	197	35%	
After 1 year but within 2 years	204	36%	
After 2 years	57	10%	
Total	568	100%	

Source: Audit analysis of TID records

Table 9 shows that 54% of the default occurred within one year after the SMEs had commenced loan repayment. This indicates that the financial position of the SMEs concerned might have been weak at the time of loan commitment. **For these cases, Audit considers it necessary for the TID to conduct thorough vetting of the default claims to check whether the PLIs concerned had properly assessed the creditworthiness of the SMEs.** However, the TID had not always obtained adequate information from the PLIs to conduct vetting of the default cases. As a result, there were cases for which it remained uncertain whether the PLIs concerned had properly established the SMEs' creditworthiness before approving the loans. **Case studies H and I** (at Appendices K and L respectively) show that the TID might not have obtained adequate evidence to ascertain whether the PLIs concerned had exercised due care in establishing the SMEs' creditworthiness.

Enhancing the impact of the SGS on the local economy

4.18 The SMEs receiving assistance under the SGS need to be operating concerns based in Hong Kong. The Government expects that these SMEs are generally planning to expand their operations and production facilities. Even if they set up the production facilities outside Hong Kong, the fact that these SMEs are locally based means that they will still need to conduct many supporting business transactions in Hong Kong. The Government believes that this will benefit Hong Kong's economy.

Audit observations

SMEs in the service sector

4.19 An audit analysis of the SGS loan guarantees indicated that, as at 31 March 2006, the SMEs in the manufacturing sector had obtained guarantees amounting to \$5.9 billion. This represented 81% of the total guarantees of \$7.3 billion under the SGS.

4.20 Because most of the guaranteed loans were used by SMEs to finance the acquisitions of capital installations and equipment, the majority of the government guarantees had been given to SMEs in the manufacturing sector. However, the Hong Kong economy today mainly relies on the service sector. The manufacturing sector in Hong Kong accounts for less than 10% of the number of establishments and of the number of persons employed in Hong Kong. **Audit considers that the TID should review, in consultation with the CITB, whether more resources from the SGS ought to be devoted to helping SMEs in the service sector.**

Substantive business operations in Hong Kong

4.21 Audit has found that, although SMEs receiving assistance under the SGS need to be operating concerns based in Hong Kong, the TID does not require eligible SMEs to demonstrate that they have substantive business operations in Hong Kong. Consequently, it is doubtful whether some SMEs receiving government guarantees were Hong Kong operating concerns, and whether they could benefit Hong Kong's economy as the Government had intended. **In order for the SGS to benefit the local economy, Audit considers that there is a need for the TID to take measures to ensure that only those SMEs with substantive business operations in Hong Kong will receive assistance under the SGS.**

4.22 **Case studies J and K** (at Appendices M and N respectively) show the inadequacies of TID's measures in ensuring that the SMEs applying for guarantees under the SGS have substantive business operations in Hong Kong. In both cases, the TID had given government guarantees to SMEs which did not appear to be SMEs with substantive

business operations in Hong Kong. The prospect of such SMEs benefiting Hong Kong's economy was questionable.

Number of additional jobs created

4.23 SMEs are not required to create additional jobs after obtaining government guarantees under the SGS. Nevertheless, with effect from 31 March 2003, the TID has collected information on the additional jobs in Hong Kong brought about by the government guarantees. When applying for government guarantees, SMEs are required to state in the applications the number of additional staff they will employ in the following six months to cope with any consequential business development. Audit reviewed 12,006 successful applications which the TID approved during the period from 31 March 2003 to 31 March 2006. Audit noted that in 893 applications, the SMEs claimed that they would employ a total of 3,700 additional staff in six months' time. In other words, about 7% of the successful applications would create additional local jobs. Table 10 shows the distribution of the additional jobs among the successful applications for government guarantees.

Table 10

**Estimated additional local jobs created by SMEs
(31 March 2003 to 31 March 2006)**

No. of additional jobs	No. of successful applications		Total no. of additional jobs
None	11,113		–
1 to 5	738	} 893	1,698
6 to 10	104		838
11 or more	51		1,128
Total	12,006		3,664 (say 3,700)

Source: Audit analysis of TID records

4.24 The fact that most of the government guarantees did not result in creating additional jobs in Hong Kong is a cause for concern. The small number of new jobs created by some SMEs bring to question whether they have substantive business operations in Hong Kong.

4.25 The TID had attempted to measure additional jobs created by requiring SMEs to state the number of additional staff they intended to recruit after obtaining the government guarantees. As mentioned in paragraph 4.23, 3,700 additional local jobs were expected to be created. However, the TID had not followed up on the actual number of new jobs created. **Audit considers that the TID should follow up on the outcome (e.g. the actual number of additional local jobs created) to assess whether the targets set on additional impacts of the SGS are achieved.**

Assessing the effectiveness of the SGS

4.26 The SGS has an objective of helping SMEs enhance their competitiveness and rise to new challenges. As at the end of March 2006, some 8,400 SMEs had benefited from the SGS, and the total amount of guaranteed loans granted by PLIs was \$16 billion. In the COR for 2006-07, the TID reported the results for 2004 and 2005 against one performance target of “processing applications for guarantee within three working days” and one indicator of “amount of government guarantees issued”, both of which focused on the TID’s workload and quality of services (see Appendix D).

Audit observations

4.27 **In the absence of any outcome targets and indicators, Audit considers that the above performance results cannot adequately help stakeholders assess the efficiency, and especially the effectiveness, of the SGS.** Governments of advanced countries have well-defined targets of additional impacts in various aspects to assess the success of similar schemes. Such targets include the number of additional jobs created, the proportion of guaranteed loans which would not have been made without the schemes, the survival rates of SMEs, and the impact on the local gross domestic product. **Similar to the EMF (see para. 2.26), Audit considers that the TID needs to develop additional performance targets and indicators to help measure the extent to which the SGS has achieved its objectives.**

Audit recommendations

4.28 **Audit has recommended that the Director-General of Trade and Industry should:**

Management of default risk

- (a) **regularly compile analyses of the loan default rates by various parameters (e.g. size, age and business nature of the SMEs), in order to obtain relevant information for risk management purpose (see para. 4.9);**

- (b) **monitor closely the default rates of loans advanced by PLIs (see para. 4.10);**
- (c) **assess the risks faced by the Government relating to the provision of loan guarantees to SMEs owned by the same major owners, and take effective measures to address such risks (see para. 4.13);**
- (d) **collect information on details of the major owners of SMEs at the time of guarantee application, and implement checking procedures to help identify multiple government guarantees to be given to related SMEs owned by the same major owners (see para. 4.15);**

Vetting of default claims

- (e) **conduct thorough vetting of the default claims before making compensation payments to PLIs. In particular, the TID should ensure that it has obtained adequate evidence to ascertain that the PLIs have carefully assessed the creditworthiness of the SMEs concerned (see para. 4.17);**

Enhancing the impact of the SGS on the local economy

- (f) **in consultation with the Secretary for Commerce, Industry and Technology:**
 - (i) **review whether the Government should devote more resources from the SGS to help SMEs in the service sector (see para. 4.20); and**
 - (ii) **take measures to ensure that only SMEs with substantive business operations in Hong Kong will receive assistance under the SGS (see para. 4.21);**
- (g) **follow up on the outcome of the implementation of the SGS (e.g. the number of additional local jobs created) to assess whether the targets on additional impacts are achieved (see para. 4.25);**

Assessing the effectiveness of the SGS

- (h) **develop additional performance targets and indicators, including outcome targets, that can adequately help stakeholders assess the efficiency and effectiveness of the SGS in meeting its objectives (see para. 4.27); and**
- (i) **draw on overseas experiences in the performance measurement and reporting of similar schemes, with a view to setting targets on additional impacts of the SGS (see para. 4.27).**

Response from the Administration

4.29 The **Director-General of Trade and Industry** has said that:

General

- (a) The policy objective of the SGS is to assist SMEs obtain financing for business installations/equipment and working capital. Since a significant number of our SMEs have relocated their manufacturing operations away from Hong Kong while keeping their headquarters functions in Hong Kong, their success or otherwise would have a major impact on Hong Kong's employment and economic well being;
- (b) the major principles underlying the operation of the SGS are market-driven, risk-sharing, risk-capping and administrative simplicity. Under the terms of the Deed for the SGS, the Government requires the PLIs to exercise due diligence and professional judgement in accordance with good banking practice in processing the loan applications. The TID notes that the current default rate of 2% is well below the assumed default rate of 7.5% as set out in the government submission to the FC (see para. 4.7);
- (c) like the EMF and the STF, the TID does not impose more restrictive measures against newly established SMEs since they normally face greater difficulty in securing loans from lending institutions;

Management of default risk

- (d) the TID shares the views of Audit. For further enhancement on risk management, the TID agrees to the audit recommendation in paragraph 4.28(a) and will compile regular analyses of default rates by parameters like size and age of SMEs, nature of business and industries;
- (e) regarding the audit recommendation in paragraph 4.28(b), the TID now monitors the default rates by PLIs on a weekly basis. The TID agrees that closer monitoring will contribute to better risk control. The TID will compile more detailed management reports to keep a close watch on default rates;
- (f) regarding the audit recommendations in paragraph 4.28(c) and (d), according to the Supervisory Policy Manual issued by the Hong Kong Monetary Authority, PLIs should make cross-reference to related borrowers/guarantors to facilitate the assessment and approval of credit facilities on a group basis. The TID believes that, in most cases, PLIs will have considered relevant data on related borrowers/guarantors when assessing the loans. Nevertheless, the TID agrees to follow the EMF's practice of collecting information of the major owners of SMEs at the time of guarantee application. This will help safeguard from potential abuse by individuals circumventing the guarantee ceiling;

Vetting of default claims

- (g) regarding the audit recommendation in paragraph 4.28(e), the TID has developed a comprehensive action checklist (including reviewing the PLIs' credit assessment reports) for processing claims to make sure that PLIs have exercised prudence and due diligence in granting the loans. In cases of doubt, the TID will seek clarifications from PLIs. The TID will request access to PLIs' loan files if necessary. The TID will not proceed with the compensation claim unless the PLIs have provided the TID with full explanations;

Enhancing the impact of the SGS on the local economy

- (h) regarding the audit recommendation in paragraph 4.28(f), the TID will review, in consultation with the SMEC and the CITB, whether more resources should be devoted to helping SMEs in the service sector. The survival, growth and development of SMEs benefiting from the SGS has a multiplier effect on employment in sectors providing the related support services, which are key drivers of Hong Kong's economic growth; and

Assessing the effectiveness of the SGS

- (i) the TID generally agrees with the audit recommendations in paragraph 4.28(g) to (i).

4.30 The **Secretary for Financial Services and the Treasury** has said that he noted the audit recommendation in paragraph 4.28(h). His comments in paragraph 2.32 are relevant.

PART 5: SME DEVELOPMENT FUND

5.1 This PART examines the operation of the SDF and its effectiveness.

Background

5.2 The SDF was launched in December 2001. Details of the SDF are as follows:

Objective	The SDF aims at subsidising projects to be carried out by eligible organisations to enhance the competitiveness of SMEs in general or SMEs in specific sectors.
Eligible applicants	All non-profit-distributing support organisations, trade and industrial organisations, professional bodies, and research institutes, which may be statutory organisations or organisations registered under local laws, are eligible. Projects in receipt of other public funding will however not be funded.
Funds approved	In November 2001, the FC approved funds of \$200 million for setting up the SDF. In June 2003 and May 2005, the FC further approved the merger of the funds for the STF/EMF/SDF and the injection of funds into the pool (see paras. 1.3, 1.6 and 1.7).
Project scope	Proposed projects should be conducive to the competitiveness of SMEs in general or SMEs in specific sectors and may include, for example, research studies, award schemes, codes of best practice, databases, conferences, and support facilities and services.
Maximum amount of grant receivable	The maximum amount of funding support for an approved project is \$2 million, or 90% of the total project cost, whichever is less.
Eligible expenses	Manpower, equipment and other costs directly arising from an approved project (e.g. expenses for consumables, audit fees and consultant fees) are fundable, but not for overhead expenses, such as rental.

5.3 **Usage.** Up to the end of March 2006, the TID approved 87 SDF projects involving total grants of \$99 million. Of the 87 approved projects, 28 (32%) belonged to the general SME sector and 59 (68%) belonged to specific sectors, including 14 belonging to the IT sector. As at 31 March 2006, the TID spent \$86 million on the SDF.

5.4 **Application procedures.** Before January 2006, applications for funding support were normally invited twice a year. Since January 2006, the TID has revised its procedures to accept applications all year round.

5.5 **Assessment of applications.** All applications are examined by an SDF Vetting Committee (VC). The VC, chaired by the Director-General of Trade and Industry, comprises SMEC members and representatives from the manufacturing and service sectors, academics and professionals. The VC assesses the applications and monitors the cost-effectiveness of funded projects.

Processing of SDF applications

5.6 The TID is responsible for the preliminary vetting of the applications. Upon receipt of an application, the TID officers check the supporting documents and complete an assessment of the proposal and submit the application with the assessment report to the VC, including outside expert comments if appropriate. The VC will assess the application and advise the TID whether the application should be approved.

Need to keep in view the SMEs' needs for support

5.7 When the SDF was set up in December 2001, funds of \$200 million were approved for subsidising projects. Up to 31 March 2006, 87 projects and total grants of \$99 million, representing 50% of \$200 million, were approved.

Audit observations

5.8 There has been a decrease in the number of applications the TID received over the years 2002 to 2006, as shown in Table 11.

Table 11

**SDF applications received by the TID
(since the inception of SDF to 30 June 2006)**

Particulars	No. of applications received
1st Tranche (14.12.2001 – 18.2.2002)	291
2nd Tranche (9.9.2002 – 11.11.2002)	109
3rd Tranche (1.9.2003 – 31.10.2003)	72
4th Tranche (1.12.2004 – 28.1.2005)	76
5th Tranche (11.7.2005 – 31.8.2005)	58
First six months of 2006	17
Total	623

Source: Audit analysis of TID records

5.9 In the COR for 2006-07, the TID estimated that it would receive 150 SDF applications in 2006. Up to the end of June 2006, the TID received only 17 applications. **Audit considers that the TID needs to monitor the number of applications received closely, assess whether the SMEs' needs for support under the SDF have diminished and whether it needs to take a more proactive approach to help support organisations identify potential projects.**

Need to monitor the SMEs' adoption of the results of funded projects

5.10 According to the Guide to Application, within six months after project completion, an applicant has to submit a Post-Project Evaluation Report for reporting the efforts made in publicising the project deliverables and providing quantitative measurement on the adoption of the project results by the industry.

Audit observations

5.11 From a test examination of Post-Project Evaluation Reports, Audit has found that applicants did not always provide quantitative measurement on the adoption of the project results by the industry, as required by the Guide to Application. For example, it

was not uncommon that the applicants only reported the number of SMEs which had attended the seminars or had been provided with the manuals or reports as a result of the projects. They rarely reported the number of SMEs which had adopted the project results.

5.12 **Audit considers that the TID should take measures to ensure that applicants will always provide quantitative measurement on the adoption of their project results by the industry.**

Need to disseminate the results of funded projects more widely to more SMEs

5.13 The TID maintains at its SME website a register of all SDF funded projects. Information on each funded project such as title, target sector, deliverables, duration, applicant particulars and funds approved is maintained in the register. Such a register has formed a focal point for reference by applicants and SMEs.

5.14 The development of multifarious funded projects under the SDF has also produced many valuable and useful products. Such products included the setting up of websites, production of guides and manuals, holding of seminars, and distribution of reference materials which are beneficial to SMEs.

Audit observations

5.15 For better information and experience sharing, it would appear desirable for the TID to help disseminate the results of funded projects more widely by providing suitable hyperlinks, through its SME website, to the other relevant websites, and disseminating relevant guides/research materials, with information on the contact persons, in its register of funded projects. **Audit considers that the building up of such a central pool of useful information on the SME website of the TID can help further publicise the results of the funded projects.**

Need to set up a mechanism to assess the effectiveness of the SDF

5.16 The SDF was established to help SMEs in Hong Kong build up their strength, redress their weaknesses and face prevailing challenges. At the time when the SDF was to be launched, it was estimated that the SDF, with initial funding of \$200 million, could provide funding support for at least 100 projects. On the assumption that a funded project would on average benefit 200 SMEs, 20,000 SMEs would benefit from the scheme. As at March 2006, 87 projects had been approved involving funds of \$99 million. There was however no indication of the actual number of SMEs that had been benefited.

Audit observations

5.17 In the COR for 2006-07, the TID reported the results on the SDF against one performance target and one indicator (see Appendix D), which focused on reporting on workload and quality of services. The TID did not measure the outcome. Audit considers that, in the absence of any outcome targets and indicators, the TID cannot measure the efficiency and effectiveness of the SDF. **In line with the FSTB's guidelines that targets should preferably measure outcome (see para. 2.26), Audit considers that the TID should develop additional targets and indicators to help measure the extent to which the SDF has met its objectives.** For example, the TID may consider using the number of SMEs benefited by the SDF (see para. 5.16) as a target for reporting in the CORs.

5.18 **The TID should also set up a proper mechanism to monitor the achievements of the additional targets and indicators and conduct at an opportune time an effectiveness review of the SDF to assess the extent to which it has met its objectives.**

Audit recommendations

5.19 **Audit has recommended that the Director-General of Trade and Industry should:**

- (a) **monitor the number of applications received closely, assess whether the SMEs' needs for support under the SDF have diminished and whether the TID needs to take a more proactive approach to help support organisations identify potential projects (see para. 5.9);**
- (b) **take measures to ensure that applicants always provide quantitative measurement on the adoption of their project results by the industry, as required by the Guide to Application (see para. 5.12);**
- (c) **consider further publicising the results of funded projects through building up a central pool of useful information on the SME website of the TID (see para. 5.15);**
- (d) **develop additional targets and indicators to help measure the extent to which the SDF has met its objectives (see para. 5.17); and**
- (e) **set up a proper mechanism to monitor the achievements of the additional targets and indicators and conduct at an opportune time an effectiveness review of the SDF to assess the extent to which it has met its objectives (see para. 5.18).**

Response from the Administration

5.20 The **Director-General of Trade and Industry** generally agrees with the audit recommendations. He has said that:

- (a) the TID has been taking a proactive approach to discuss with prospective applicants on the scope of their projects. If necessary, the TID will give them appropriate advice to fine tune their applications to avoid duplication with other similar projects; and
- (b) as to the audit observation in paragraph 5.11 that applicants had not always provided quantitative measurement on the adoption of project results by the industry, the TID acknowledges that such a quantitative measurement would be desirable in assessing a project. However, in some cases, the project deliverables are reference books or websites providing information and it would not be practicable to quantify the “adoption” of project results.

Case study A

Eight related SMEs obtained 23 EMF grants of \$580,000

Case particulars

Eight SMEs (SME-A1 to SME-A8) were owned largely by the same group of shareholders. All were engaged in garment manufacturing, import and export trading activities. Three had very similar names and the names of another two were very much alike. Four of the eight SMEs used the same business address.

Audit findings

Over a period of 3.5 years from November 2002 to March 2006, the eight related SMEs had submitted 26 grant applications, 23 of which were approved. The eight SMEs had obtained total EMF grants of \$580,000, with six fully claimed the maximum grant entitlement per SME of \$80,000.

Three SMEs (SME-A6 to SME-A8) commenced business in 2004. All of them submitted grant applications shortly after commencing business. SME-A6 and SME-A7 submitted their first grant applications within one month and four months respectively after commencing business. Both of them obtained the maximum grants of \$80,000 by submitting three grant applications about six months after commencing business. In processing their applications, the TID only asked for business proof once. In the case of SME-A8, it submitted its first grant application in the same month as it commenced business. When the TID asked for business and employment proof, the company withdrew the grant application.

Of the 23 approved grant applications, 16 applications were submitted from November 2002 to October 2004. In processing these 16 applications, the TID did not request for business and employment proof. As a result, it was not known in most cases if, at the time of application, the SMEs had substantive business operations in Hong Kong and if the representatives attending the export promotion activities really worked for the SMEs. In processing the remaining 7 applications (23 less 16) which were submitted after October 2004, the TID did not request business and employment proof in every case.

In December 2005, when processing SME-A8's third application, the TID issued a letter to the company noting that its owner was also the person mainly responsible for SME-A1, SME-A2 and SME-A4 and had obtained total grants of up to \$260,000. In the letter, the TID asked SME-A8 to show evidence that the company had substantive business operation in Hong Kong and its operation was entirely different from and independent of the other three SMEs. According to the TID's records, up to the end of September 2006, SME-A8 had not replied to the TID's letter.

Source: TID records and Audit research

Case study B

One owner obtained 12 EMF grants of \$221,000 under three SMEs

Case particulars

- (a) According to the TID's records, Owner 1 owned three SMEs (SME-B1 to SME-B3). All three SMEs were engaged in import and export trading activities. They all operated their business using the same business address. All three SMEs had very similar names. Over a period of less than three years (November 2002 to June 2005), Owner 1 had submitted 12 grant applications under the three SMEs and, by September 2005, had obtained total EMF grants of \$221,000.
- (b) SME-B1, a limited company with Owner 1 holding a 99% shareholding, commenced business in 1987. By December 2004, it had obtained maximum grants of \$80,000 from the EMF.
- (c) SME-B2, with Owner 1 as the sole owner, commenced business in September 2003. In the same month, Owner 1 submitted a grant application. In October 2003 and April 2004, he submitted the second and the third grant applications respectively. SME-B2 ceased business in August 2004. The TID approved all three grant applications without asking for business proof. Owner 1 had obtained total EMF grants of \$69,000 under SME-B2.
- (d) SME-B3, jointly owned by Owner 1 and his daughter, commenced business in November 2004, less than three months after SME-B2 had ceased business. In December 2004, two weeks after commencing business, Owner 1 submitted the first grant application. He submitted the second and third EMF grant applications in April 2005 and June 2005 respectively. Owner 1 had obtained total EMF grants of \$72,000 under SME-B3. In November 2005, SME-B3 ceased business.

Audit findings

SME-B2 ceased business before receiving the last grant payment. SME-B3 ceased business in less than two months after receiving the last grant payment. Both SME-B2 and SME-B3 had a business life of one year. Although SME-B2 submitted its first grant application in less than one month after commencing business, the TID had not asked for business proof.

The fact that both SME-B2 and SME-B3 had a short business life of one year and each of them had almost claimed in full the maximum grants of \$80,000 casts doubt on whether the two SMEs had substantive business operations in Hong Kong at the time of submitting the grant applications.

Source: TID records and Audit research

Case study C

One owner obtained 14 EMF grants of \$344,000 under five SMEs

Case particulars

Owner 2 had five SMEs (SME-C1 to SME-C5). All five SMEs were engaged in trading houseware products. Four SMEs used the same business address for operating their business whereas the remaining SME operated its business using a residential address. The name of SME-C3 was the same as that of SME-C1.

Audit findings

Over a period of less than two years (September 2003 to January 2005), Owner 2 submitted 15 EMF applications under the five SMEs and obtained total EMF grants of \$344,000 for 14 applications.

Three SMEs (SME-C3 to SME-C5) commenced business in 2004. For each of these SMEs, Owner 2 submitted three grant applications within six months after commencing business. In the case of SME-C5, all three grant applications were submitted in less than one month after commencing business.

Of the 14 approved grant applications, in eight cases (mostly related to those submitted before October 2004), the TID had neither checked if the SMEs had substantive business operations in Hong Kong nor verified if the representatives attending the export promotion activities were genuine employees of the SMEs.

As regards business proof, the fact that SME-C3 submitted three grant applications within six months after commencing business and ceased business in two years' time casts doubt on whether it had substantive business operations at the time of submitting the three grant applications. Besides, as the name of SME-C3 was the same as that of SME-C1, it was difficult to distinguish between business proof for SME-C1 and that for SME-C3. In case of SME-C4, on the TID's request for tax returns, Owner 2 said that tax returns were not available as the SME was newly set up.

As regards employment proof, Owner 2 advised the TID that the required MPF records were not available as the SMEs were newly set up and its representatives worked on temporary and voluntary basis for the SMEs. In essence, although Owner 2 had obtained 14 EMF grants, he did not provide any employment proof to support his claims.

Although the TID raised its concern in January 2006 on the excess EMF grants claimed by Owner 2 under different SMEs, it still approved the grant application submitted by him under SME-C4. On Audit's enquiries in July 2006, the TID advised that the application was approved because it was submitted in December 2004 which was just two months after the condition for grants that SMEs must have substantive business operations in Hong Kong was made explicit to all applicants (see para. 2.4(b)).

Source: TID records and Audit research

Performance measures in the Controlling Officer's Report for 2006-07

Performance Target	Target	2004 (Actual)	2005 (Actual)
<i>SME Export Marketing Fund</i>			
• processing applications for grant within seven working days (%)	100	91	92 (Note 1)
• reimbursement of grant within 30 working days (%)	100	90	91 (Note 1)
• processing applications for grant within 30 working days (%)	100	N.A.	98 (Note 2)
<i>SME Training Fund</i>			
• processing applications for grant within 12 working days (%)	100	71	N.A. (Note 3)
• reimbursement of grant within 30 working days (%)	100	63	N.A. (Note 3)
<i>SME Loan Guarantee Scheme</i>			
• processing applications for guarantee within three working days (after receipt of complete applications from participating lending institutions) (%)	100	99.6	99.5
<i>SME Development Fund</i>			
• processing applications for grant within 70 working days (after closing date for submission of applications) (%)	100	100	100

Appendix D
(Cont'd)
(paras. 2.26, 4.26
and 5.17 refer)

Indicator	2004 (Actual)	2005 (Actual)
<i>SME Export Marketing Fund</i>		
• applications received and processed	15,075	10,110 (Note 4)
<i>SME Training Fund</i>		
• applications received and processed	33,149	27,194 (Note 3)
<i>SME Loan Guarantee Scheme</i>		
• amount of government guarantees issued (\$ million)	2,153	1,908
<i>SME Development Fund</i>		
• applications received and processed	74	134

Source: COR for 2006-07

Note 1: Figures were calculated up to 30 June 2005 only. Simplified application procedure took effect on 1 July 2005 whereby SMEs need only to submit single applications for grant within 60 calendar days after their participation in export promotion activities.

Note 2: Figures were calculated since 1 July 2005 upon implementation of the simplified application procedure.

Note 3: The STF has ceased accepting applications as from 1 July 2005. Over 15,000 applications were received in June 2005, representing a drastic increase of 600% against the average figure in the previous five months. The TID had notified concerned applicants that a much longer processing time is required for this last batch of applications. It also expected that all applications would be processed by first quarter of 2006.

Note 4: There was a decrease in the number of applications in 2005 due to the introduction of simplified application procedure on 1 July 2005, whereby application seeking prior in-principle funding approval for future events was no longer accepted.

Case study D

**One SME claimed the maximum STF grant
in one go shortly after commencing business**

Case particulars

- (a) SME-D1 commenced business on 26 August 2003. A residential address in a public housing estate was registered as the business address.
- (b) On 3 September 2003, SME-D1 submitted two applications for claiming employer/employee training grants of \$10,000 and \$20,000 respectively for its manager as the employer and its salesman and clerk as two employees to attend a course entitled “Entrepreneurship & Small Enterprise Management”. The course fee was \$15,000 per trainee. It submitted a copy of the course brochure with the application forms.
- (c) On 17 September 2003, the TID issued its notice of approval-in-principle to SME-D1 for the STF grants.
- (d) On 27 November 2003, SME-D1 submitted two applications for reimbursement of grants, together with original copies of receipts for the three trainees and proof of attendance for the employer and one employee.
- (e) On 26 January 2004, SME-D1 was reimbursed with STF grants of \$10,000 and \$20,000 for employer and employee training respectively.
- (f) On 20 July 2005, SME-D1 ceased business.

Audit findings

Audit is concerned about the submission by SME-D1 of the grant applications shortly after commencing business, the claiming of the maximum grant entitlements in one go, and the cessation of business 18 months after obtaining the grants.

Although SME-D1 submitted its grant applications a few days after it commenced business, there was no evidence that the TID had verified the propriety of the claim, including verifying whether SME-D1 was in substantive business operations in Hong Kong at the time of application and whether the trainees were the employer and employee of SME-D1.

Source: TID records and Audit research

Case study E

Training grants claimed under six SMEs, all of which had a short operating period

Case particulars

Owner 3 had six SMEs (SME-E1 to SME-E6), all of which used the same residential address for business. Three of the SMEs were engaged in beauty service business and all the grant applications were for training attended by Owner 3 as an employer. The other three SMEs were engaged in engineering business and all the grant applications were for the same employee to attend courses in a Master Degree Programme.

Audit findings

Owner 3 submitted 12 applications under SME-E1 to SME-E3 and 8 applications under SME-E4 to SME-E6. **Of the 20 applications, 4 and 11 applications were submitted in less than one month and within six months respectively after commencing business. All six SMEs ceased business within one year after commencing business.** Owner 3 had obtained employer training grants of \$28,590 and employee training grants of \$54,475.

As most of the grant applications were submitted before December 2004, the TID had asked for business proof and/or employment proof on three occasions only. In the case of SME-E5, Owner 3 joined an MPF scheme subsequent to the TID's request for employment proof. In the case of SME-E6, the SME produced copies of eight printed quotations (all without customers' acceptance) as business proof.

Source: TID records and Audit research

**Details of government guarantees
available to SMEs under the BIG and the SGS**

Type	Government guarantees available to each SME	
	Under the BIG (from 14 December 2001 to 30 March 2003)	Under the SGS (from 31 March 2003 onwards)
Business installations and equipment loan guarantee	\$1 million or 50% of the loan offered by the PLI, whichever is less; and maximum guarantee period of 3 years.	\$2 million or 50% of the loan offered by the PLI, whichever is less; and maximum guarantee period of 5 years.
Associated working capital loan guarantee	–	\$1 million or 50% of the lesser of the associated business installations and equipment loan guarantee or the associated working capital loans offered by the PLI, whichever is less; and maximum guarantee period of 2 years.
Accounts receivable loan guarantee	–	\$1 million or 50% of the accounts receivable loans offered by the PLI, whichever is less; and maximum guarantee period of 2 years.

Source: FC papers

**Details of approved government guarantees
(31 March 2006)**

Type	No.	Amount (\$ billion)	Average duration
Business installations and equipment loan guarantee	13,779 (86%)	6.3 (86%)	2.8 years
Associated working capital loan guarantee	1,098 (7%)	0.2 (3%)	2 years
Accounts receivable loan guarantee	1,198 (7%)	0.8 (11%)	2 years
Overall	16,075 (100%)	7.3 (100%)	2.6 years

Source: TID records

Case study F

Guaranteed loans advanced to two related SMEs

Case particulars

- (a) SME-F1 and SME-F2 were limited companies. The SMEs were in the business of manufacturing and trading of garments. Owner 4 and his sister-in-law, Owner 5, together held all the shares of the SMEs. The two owners acted as directors of the SMEs.
- (b) In May 2003, SME-F1 obtained from PLI-1 a guaranteed loan to acquire sewing machinery. The Government guaranteed \$1.28 million.
- (c) In July 2003, SME-F2 obtained from PLI-2 a guaranteed loan for acquiring sewing machinery and another guaranteed loan for financing the additional operational expenses arising from the acquisition. The Government guaranteed \$0.88 million and \$0.44 million for the two loans respectively.
- (d) Owner 4, Owner 5 and her husband had also given personal guarantees for each of the guaranteed loans. SME-F1 and SME-F2 had further given corporate guarantees for each other's guaranteed loans. With the approval of the TID, the SMEs placed the acquired machinery in two limited companies in the Mainland, with one wholly owned by SME-F1.
- (e) On 17 February 2004, SME-F2 defaulted on repayment of its guaranteed loans. On 16 March 2004, SME-F1 also defaulted on repayment of its guaranteed loan. The PLIs could not locate the guarantors.
- (f) In June 2005, the TID paid PLI-1 \$1 million as compensation. In October 2005, the TID paid PLI-2 \$1.1 million as compensation.

Audit findings

SME-F1 and SME-F2 were related companies. Both SMEs were engaged in the same business and were under the management and control of the same owners.

Audit noted that the TID was not aware of the relationship between the SMEs when it gave the government guarantees. The SMEs had in total obtained government guarantees of \$2.16 million (i.e. \$1.28 million plus \$0.88 million) for acquiring sewing machinery, which exceeded the guarantee ceiling of \$2 million for an SME.

Audit further noted that PLI-2 had evaluated the financial stability of SME-F1 when assessing the creditworthiness of SME-F2. However, PLI-2 did not mention in the credit assessment report the corporate guarantee which SME-F2 had given for SME-F1, and the guaranteed loan received by SME-F1. It was unclear whether PLI-2 was aware of these facts in considering SME-F2's loan application.

Source: TID records and Audit research

Case study G

Guaranteed loans advanced to two related SMEs

Case particulars

- (a) An owner wholly owned a group of enterprises in the business of trading and manufacturing of yarn. The group comprised two SMEs in Hong Kong, namely, SME-G1 and SME-G2, and a limited company in the Mainland.
- (b) The owner was a director of SME-G2 and the Mainland company. The two SMEs employed some 10 staff.
- (c) In May 2002, SME-G1 obtained from PLI-3 a guaranteed loan to acquire machinery for processing the yarn. The Government guaranteed \$0.91 million.
- (d) In February 2003, SME-G2 obtained from PLI-4 a guaranteed loan to acquire a set of generator. The Government guaranteed \$0.75 million.
- (e) In July 2003, SME-G1 obtained from PLI-5 a guaranteed loan to acquire another set of generator. The Government guaranteed \$1.09 million which was 45% of the loan. SME-G1 obtained a total of \$2 million (i.e. \$0.91 million plus \$1.09 million) government guarantees, which was equal to the guarantee ceiling.
- (f) The owner and his son had also given personal guarantee for the guaranteed loans advanced by PLI-4 and PLI-5 respectively. A limited company outside the group, which was wholly owned by the owner and his wife, had also given corporate guarantee for the loan advanced by PLI-4.
- (g) On 17 April 2005, SME-G1 defaulted on making repayment to PLI-5. On 3 May 2005, SME-G1 repaid the final instalment of PLI-3's guaranteed loan. Eventually, on 7 May 2005, SME-G2 defaulted on making repayment to PLI-4. The owner then went bankrupt. The limited company which gave the corporate guarantee was also wound up. PLI-4 and PLI-5 could not locate the remaining guarantor.
- (h) In November 2005, the TID paid PLI-4 \$0.22 million as compensation. In December 2005, the TID paid PLI-5 \$0.58 million as compensation.
- (i) In January 2006, SME-G1 ceased business.

Audit findings

SME-G1 and SME-G2 were the purchasing arms of the business which the owner had sole ownership and control. The SMEs were subject to similar business risks.

Audit noted that the TID was not aware of the relationship between the SMEs when it approved the government guarantee to SME-G1 in July 2003. The SMEs had in total obtained government guarantees of \$2.75 million (i.e. \$2 million for SME-G1 plus \$0.75 million for SME-G2), which exceeded the guarantee ceiling of \$2 million for an SME.

Audit further noted from PLI-5's credit assessment report that PLI-5 had evaluated the financial stability of other enterprises owned by the owner when assessing the creditworthiness of SME-G1. Such enterprises included the production arm in the Mainland and the limited company that the owner owned with his wife. However, PLI-5 had not included SME-G2 in the evaluation, nor had PLI-5 mentioned about SME-G2 in the credit assessment report. It was not sure whether PLI-5 was aware of the existence of SME-G2 and of the guaranteed loan it had raised.

Source: TID records and Audit research

Case study H

Guaranteed loan given to an SME with doubtful creditworthiness

Case particulars

- (a) The SME was a limited company. In January 2004, the SME obtained two guaranteed loans from PLI-6 for acquiring business installations and equipment, and for financing the additional operational expenses arising from the acquisition. The amount of Government guarantee was \$810,000. The two loans were defaulted in November and December 2004.
- (b) The TID examined PLI-6's credit assessment of the SME. The TID noted that the auditor of the SME had expressed a qualified opinion on the financial statements used for the credit assessment. The auditor was unable to verify the stock figure of \$1.74 million.
- (c) Upon the TID's inquiry, PLI-6 remarked that, given that the turnover was \$12.5 million, the stock was not material to the financial status of the SME. PLI-6 further stated that there was no significant variance in the stock level comparing with that of the previous year, and the impact of inaccuracy in the stock figure on the profit of the SME was small.
- (d) In July 2005, the TID paid \$0.63 million to PLI-6 as compensation. PLI-6 subsequently recovered \$0.9 million from the director of the SME, and refunded \$0.45 million to the TID. The Government's net loss was therefore \$0.18 million.

Audit findings

PLI-6's explanations were not entirely reasonable because the stock figure of \$1.74 million was not insignificant, given that the net profit before tax was only \$0.2 million and the shareholders' funds was only \$1.2 million. Any misstatement of the stock figure could have a material effect on the overall financial position of the SME.

Despite the auditor's qualified opinion (see (b) above), before making compensation payment to PLI-6, the TID did not require any further explanations from PLI-6, nor did the TID request access to the PLI's loan file to determine whether PLI-6 had exercised due diligence in approving the loan.

Source: TID records and Audit research

Case study I

Guaranteed loan given to an SME with doubtful creditworthiness

Case particulars

- (a) The SME was a limited company. During the period March 2003 to June 2004, the SME obtained nine guaranteed loans from PLI-7 for acquiring business installations and equipment, and for financing the additional operational expenses arising from the acquisition. The Government guaranteed \$1.44 million in total. The SME's director (who was the major shareholder owning 99.9% of the SME's shares) also gave personal guarantee for the loans. After obtaining the last loan on 11 June 2004, the SME defaulted on the repayment of all the nine loans. The director went bankrupt in July 2004.
- (b) The TID examined PLI-7's credit assessment of the SME. The TID noted that the SME's audited financial statements used for the credit assessment indicated that there was fundamental uncertainty about the SME as a going concern, and that the financial support of the shareholders and related company was necessary for the SME to meet its liability and continue operation in the foreseeable future.
- (c) Upon the TID's inquiry, PLI-7 informed the TID that it had noticed the fundamental uncertainty. PLI-7 claimed that it had also considered such other factors as the SME's increase in turnover and net profit in recent years, the low utilisation of bank overdraft facility, and the punctual repayment records.
- (d) In December 2005, the TID paid PLI-7 \$1.05 million as compensation. PLI-7 subsequently recovered \$0.14 million from selling the pledged machinery and refunded \$0.07 million to the TID. The Government's net loss was \$0.98 million.

Audit findings

The SME started to default on repayment almost immediately after obtaining the last loan. PLI-7 should have noted from the SME's audited financial statements that the support of the shareholders and the related company of the SME was crucial for meeting its immediate financial obligations. However, the TID had not required PLI-7 to clarify whether it had ascertained the financial status of the SME's shareholders and the identity and strength of the related company. The TID had not requested access to PLI-7's loan files to verify if PLI-7 had taken any action in this regard.

Source: TID records and Audit research

Case study J

Establishing a new SME to obtain a guaranteed loan

Case particulars

- (a) In January 2003, a sole owner set up a factory in the Mainland. On 20 August 2005, the factory entered into a contract with a supplier to purchase machinery.
- (b) On 12 October 2005, the owner established an SME in Hong Kong with another partner. The SME had two staff.
- (c) On 14 October 2005, two days after its establishment, the SME in Hong Kong applied for a guaranteed loan to pay for the machinery under the aforementioned contract of 20 August 2005, which the SME claimed to have been arranged on its behalf by the factory in the Mainland before the SME's establishment. The SME further stated in its guarantee application that it would not employ any additional staff in Hong Kong in the next six months.
- (d) The SME obtained a guaranteed loan of \$4.8 million (Government guaranteed \$2 million) to pay for the machinery. With the approval of the TID, the machinery was delivered to the factory in the Mainland.

Audit findings

The SME only commenced operation two days before it applied for the government guarantee. It was doubtful whether the SME had any substantive operations in Hong Kong at that time. The fact that the SME employed only two staff in Hong Kong, and that it did not plan to employ additional staff suggested that the SME was not prepared to expand its operations in Hong Kong.

The sole owner of the factory may actually set up the SME as a vehicle for financing the factory's machinery in the Mainland since the purchase of the machinery had been arranged before the SME's establishment. Given that the SME was only a vehicle to raise fund and the SME was not prepared to expand its operations in Hong Kong, Audit considers that giving government guarantee to this SME may not have benefited the Hong Kong economy.

Source: TID records and Audit research

Case study K

Establishing a new SME to obtain an additional guaranteed loan

Case particulars

- (a) In March 2004, Owner 6 and Owner 7 established an SME (SME-K1) in Hong Kong in the form of a partnership. SME-K1, which had three staff in Hong Kong, was in the textile and clothing industry.
- (b) On 16 April 2004, SME-K1 contracted with a supplier for six sets of weaving machinery. SME-K1 obtained two guaranteed loans amounting to \$5.1 million in June 2004 and September 2004 to pay for the machinery. The amount of government guarantees totalled \$2 million, which was the maximum amount available to an SME for purchasing business installations and equipment. With the approval of the TID, the acquired machinery was delivered to SME-K1's production arm in the Mainland. The production arm was a separate enterprise belonged to Owner 6.
- (c) On 20 April 2005, SME-K1 contracted with the same supplier for three more sets of weaving machinery. Since SME-K1 had already obtained the maximum guarantee of \$2 million, it could not obtain further government guarantee for acquiring the machinery.
- (d) On 27 July 2005, Owner 6 registered a new SME (SME-K2) which he solely owned. SME-K2 shared the same address with SME-K1, and claimed to be in the textile and clothing industry with two staff in Hong Kong.
- (e) On 28 July 2005, one day after its establishment, SME-K2 sought a government guarantee for a loan to settle the aforementioned contract of 20 April 2005, which SME-K2 claimed to have been arranged on its behalf by SME-K1 before its establishment. SME-K2 stated in its guarantee application that it would not employ any additional staff in Hong Kong in the next six months.
- (f) In November 2005, SME-K2 obtained a guaranteed loan of \$3.6 million (Government guaranteed \$1.8 million) to settle the aforementioned contract. With the approval of the TID, the acquired machinery was delivered to the same production arm owned by Owner 6.

Audit findings

SME-K2 applied for the government guarantee on the next day after its establishment. It was doubtful whether it had any substantive operations in Hong Kong at that time.

SME-K1 and SME-K2 were parts of the same business. It appears that SME-K2 had served as a vehicle to enable the business of Owner 6 and Owner 7 to obtain government guarantees that exceeded ceiling. As a result, the business obtained government guarantees of \$3.8 million in total, which exceeded the ceiling of \$2 million for an SME.

Source: TID records and Audit research

Acronyms and abbreviations

Audit	Audit Commission
BIG	SME Business Installations and Equipment Loan Guarantee Scheme
BR	Business registration
BRO	Business Registration Ordinance
CITB	Commerce, Industry and Technology Bureau
COR	Controlling Officer's Report
EMF	SME Export Marketing Fund
FC	Finance Committee
FSTB	Financial Services and the Treasury Bureau
HKID	Hong Kong Identity Card
IRD	Inland Revenue Department
LegCo	Legislative Council
MPF	Mandatory Provident Fund
PLIs	Participating Lending Institutions
PTO	Principal Trade Officer
SARS	Severe Acute Respiratory Syndrome
SDF	SME Development Fund
SFS	Special Finance Scheme
SGS	SME Loan Guarantee Scheme
SMEC	Small and Medium Enterprises Committee
SMEs	Small and medium enterprises
STF	SME Training Fund
TAs	Trade Assistants
TID	Trade and Industry Department
TO	Trade Officer
VC	SDF Vetting Committee