

CHAPTER 5

Create Hong Kong

<p>Government's financial support to film industry</p>

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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.

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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

GOVERNMENT'S FINANCIAL SUPPORT TO FILM INDUSTRY

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GOVERNMENT'S FINANCIAL SUPPORT TO FILM INDUSTRY

Executive Summary

1. The film industry is a flagship of the creative industries in Hong Kong. It is the Government's objective to provide a favourable environment conducive to the long-term and healthy development of the film industry. The Government provides financial support to the film industry through:

- (a) the Film Development Fund (FDF);
- (b) the Film Guarantee Fund (FGF); and
- (c) funding for the Hong Kong International Film Festival (HKIFF) Society.

The Film Services Office (FSO) of Create Hong Kong is responsible for administering the financial support. The Audit Commission (Audit) has recently conducted a review of such support.

Strategic review

2. *Strategic review of FDF.* The FDF funds film-production projects and film-related projects to help develop the film industry. As at July 2007, the FDF had an approved funding of \$320 million. The FDF has since financed 22 film-production projects and 79 film-related projects. The FDF incurred expenditure of roughly \$38 million per year, and would be depleted by mid-2015. As the Government considers its next step, it is opportune to conduct a review of the future funding strategy and direction of the FDF and take into consideration the following observations:

- (a) *Use of FDF funds.* The FDF has a primary objective of financing film productions. However, from April 2005 to June 2012, \$148.2 million (72%) was spent on film-related projects while only \$58.1 million (28%) was on film-production projects. The Government needs to review the

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appropriateness of the funding distribution between the two types of projects;

- (b) ***Funding of film events.*** Four film events were annually funded by the FDF. They rely largely on FDF funding. From January 2008 to June 2012, FDF funding for these four film events amounted to \$88.8 million, which was 49% of total funding of \$180.4 million spent on film-related and film-production projects by the FDF. The significant amount of funds provided for these four film events reduced the FDF funds available for other film activities. The Government needs to review the extent to which these four film events should continue to be funded by the FDF and motivate the organisers to expand their sources of funding and income; and
- (c) ***Review of the current mode of financing film-production projects.*** Audit noted that in 10 films financed by the FDF and theatrically released before 2012, the Government could not recover part or all of its contributions, with very low recovery for some of the films. The overall recovery rate was 44.2%. Audit recognises the high investment risk that may be faced by the Government for financing film production. However, because public funds are involved, the Government needs to evaluate the acceptability of the low overall recovery rate, review the current mode of financing film-production projects, and assess the effectiveness of the safeguards in ensuring their commercial viability.

3. ***Strategic review of FGF.*** The FGF was established in 2003 to provide guarantee to local film production companies for obtaining loans from lending institutions for financing film production. It received and approved 12 applications between April 2003 and June 2007. However, since the FDF (see para. 2 above) started to finance film production in July 2007, up to July 2012, the FGF had received no applications. It is unlikely that the FGF will attract many applications as long as funding is available from the FDF, as the terms and conditions of the FDF are more favourable. The Government needs to review whether the FGF meets the needs of the film industry.

4. ***Strategic review of provision of funding for HKIFF Society.*** Create Hong Kong provides annual funding of some \$11 million to the Society for organising mainly the HKIFF. The Society also receives funding under the FDF for organising the Asian Film Awards and the Hong Kong-Asia Film Financing Forum. Given the different sources of funding, the FSO needs to review the funding arrangement for the Society.

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Administration of FDF film-production projects

5. *Securing third-party financing.* To substantiate the commercial viability of a proposed film, the applicant has to secure financing from a third-party. Audit examination of 15 applications revealed that in 6 applications, the applicant was the third-party financier and in 5 applications, a related company of the applicant was the financier. As such, the objective of having a third party evaluate and affirm the commercial viability of a proposed film might have been compromised.

6. *Film promotion and distribution expenses.* Sales agents and distributors (SA&Ds) are engaged for film promotion and distribution. Their expenses and commissions are payable from the revenue of the film. The FSO has imposed caps on SA&D expenses and commissions. If the caps are likely to be exceeded, film production companies have to seek prior endorsement from the Film Development Council and the Film Vetting Committee. Audit examination revealed that in 3 of the 5 cases examined, the caps were exceeded but prior endorsements were not obtained.

7. *Collection of film revenues.* A collection agent is appointed to manage the revenue collection under a collection account management agreement. The agent needs to issue to the FSO and the third-party financier collection statements on a regular basis. The FSO and the third-party financier will check the statements and give approval to the agent to distribute the net film revenue to them. Audit noted that in 2 of the 5 films examined, the collection agents did not issue collection statements to the FSO on a regular basis, and they had distributed net film revenues without obtaining prior approvals of the FSO.

Income of FDF film-related projects

8. The organiser of a FDF film-related project has to include a budget in its application form, comprising all anticipated project expenditure, all anticipated project incomes and FDF funding required to meet the project deficit. For three film events held in 2009 to 2011, Audit found that: (a) no anticipated project incomes were stated in the application forms; and (b) for one film event, project

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incomes were also not reported in the project completion reports and the audited accounts. The FSO contacted the organisers of these projects in June 2012 and was informed that these projects had received incomes of \$13.4 million in total for the three years.

Audit recommendations

9. **Audit recommendations are made in the respective sections of this Audit Report. Only the key ones are highlighted in this Executive Summary. Audit has *recommended* that the Head of Create Hong Kong should:**

Strategic review

- (a) **conduct a strategic review of the use of FDF funds to support the film industry in future, taking into consideration Audit's observations on the FDF;**
- (b) **critically examine whether the FGF meets the needs of the film industry and whether all or part of the FGF's commitment can be deployed to other uses (e.g. transferring to the FDF);**
- (c) **review the funding arrangement for the HKIFF Society;**

Administration of FDF film-production projects

- (d) **critically review the existing practice of using the applicant's ability to secure third-party financing as a measure of the commercial viability of a film;**
- (e) **take measures to ensure that film production companies always seek prior endorsements in cases where the caps on SA&D expenses and commissions are likely to be exceeded;**
- (f) **take adequate and prompt actions to follow up with the collection agents on all irregularities found (e.g. failure in issuing collection statements, and distribution of film revenues without the FSO's approvals);**

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Income of FDF film-related projects

- (g) ensure that project organisers provide details of anticipated project incomes in their applications, and include actual project incomes in their project completion reports and audited accounts; and
- (h) follow up with project organisers after the completion of their projects to ascertain the actual project incomes and determine whether there are any surpluses that need to be refunded to the Government.

Response from the Administration

10. The Head of Create Hong Kong agrees with the audit recommendations. He has said that Create Hong Kong will conduct, among others, a review of the usage of the FDF.

PART 1: INTRODUCTION

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

Background

1.2 The film industry is a flagship of the creative industries in Hong Kong. It contributes significantly to the development of Hong Kong's service industries as well as tourism, and enhances the international and cultural image of Hong Kong. It is the Government's objective to provide a favourable environment conducive to the long-term and healthy development of the film industry. The Secretary for Commerce and Economic Development formulates policies for the development of the film industry. The Film Development Council (FDC) is a non-statutory advisory committee which advises the Secretary on matters relating to the film industry. The Government provides financial support to the film industry through:

- (a) the Film Development Fund (FDF — see para. 1.4);
- (b) the Film Guarantee Fund (FGF — see para. 1.6); and
- (c) funding the Hong Kong International Film Festival (HKIFF) Society (see para. 1.8).

The Permanent Secretary for Commerce and Economic Development (Communications and Technology) (hereinafter referred to as the Permanent Secretary), as the Controlling Officer of the above financial support, is responsible for approving funding applications.

Film Development Council

1.3 The FDC advises the Secretary for Commerce and Economic Development on the policy, strategy and institutional arrangement for the promotion and development of the film industry as well as the use and allocation of public funds in support of the film industry. As at 30 June 2012, the FDC had 24 council members including a non-official Chairman and two Vice Chairmen, one of whom was the Permanent Secretary. The members came mainly from the film industry. To help discharge its functions, the FDC had set up three committees, namely the

Introduction

Fund Vetting Committee (FVC), the Market Development Committee and the Support Services Committee. Most of the members of the committees were drawn from the FDC, while the remaining were co-opted members.

Film Development Fund

1.4 In April 1999, to fund projects that contribute towards the development of the film industry, the Government established the FDF with a financial commitment of \$100 million for a period of five years from 1999-2000 to 2003-04. In April 2004, the FDF ceased operation. In March 2005, the Government deployed \$20 million from the FGF to revive the FDF to sustain the momentum of promoting the film industry. In July 2007, the Government injected \$300 million to the FDF, thereby bringing the approved funding to \$320 million. The purpose was to overcome the problems of shrinking film market, decreasing number of local productions (particularly small-to-medium budget films) and talent drought.

1.5 The FDF funds two types of projects:

- (a) ***Film-production projects.*** Since 2008, the FDF has funded production of small-to-medium budget films. Each film's production budget must not exceed \$15 million. The Government's maximum contribution is 40% of the production budget (i.e. \$6 million for each film). The films must be produced for commercial theatrical release in Hong Kong and must fulfil the requirement on the employment of Hong Kong permanent residents in their main film crew and cast; and
- (b) ***Film-related projects.*** The FDF also funds film-related projects. The objectives are to help enhance efforts to promote Hong Kong films in the Mainland and overseas, train talents in various aspects of the film production and distribution, and enhance the interest and appreciation of Hong Kong films by the local audience.

Project applications are approved by the Permanent Secretary based on the recommendations of the FVC (Note 1). In the period July 2007 to June 2012,

Note 1: *For film-related projects, recommendations of the FVC have to be endorsed by the FDC before submitting to the Permanent Secretary for consideration and approval.*

22 film-production projects and 79 film-related projects were approved (Note 2). As at 30 June 2012, the FDF had a balance of \$113.7 million, after excluding \$27.1 million of fund for approved projects not yet paid to the applicants.

Film Guarantee Fund

1.6 In April 2003, the Government established the FGF to provide guarantee to local film production companies for obtaining loans from lending institutions for financing film production.

1.7 The FGF operates on a revolving basis. Upon the discharge by lending institutions, guaranteed amounts will be ploughed back for providing guarantee to other projects. Projects are approved by the Permanent Secretary. Up to 30 June 2012, the FGF had provided guarantees totalling \$24 million for 11 projects. The guarantees had all been discharged. The fund balance as at 30 June 2012 was \$29 million.

Funding for Hong Kong International Film Festival Society

1.8 The HKIFF Society was established in 2004. It is a non-governmental organisation set up to promote film culture in Hong Kong. The Government provides annual funding to the HKIFF Society to organise mainly the HKIFF held usually in March and April each year. The HKIFF's programmes include premieres, exhibitions, networking events, competition and awards, seminars, courses and forums. In the period 2009-10 to 2011-12, funding was approximately \$11 million a year and was paid from the departmental expenditure of Create Hong Kong (Note 3).

Note 2: *The number of approved projects did not include those subsequently withdrawn by applicants.*

Note 3: *Create Hong Kong co-ordinates government policy and effort regarding creative industries, focuses government resources catering for the promotion and speeding up of the development of creative industries, and works closely with the trade to boost the development of creative industries.*

Film Services Office

1.9 The Film Services Office (FSO) was set up under Create Hong Kong of the Commerce and Economic Development Bureau to promote the development of the film industry in Hong Kong. In addition to administering the various funding sources (i.e. the FDF, the FGF and the funding for the HKIFF Society), the FSO provides other support services to the film industry such as facilitating location filming, maintaining a resource centre of information about film production, and helping the industry to publish trade promotion materials. As the secretariat of the FDC, the FSO also provides support to the FDC and its committees.

1.10 The FSO is headed by the Secretary-General of the FDC. The Secretary-General is not a council member and is a non-civil service contract staff with experience in the film industry. As at 30 June 2012, the FSO had 16 staff (comprising 10 civil servants and 6 non-civil service contract staff) responsible for administering the funding sources (see para. 1.9) and providing other support services. In 2011-12, the FSO incurred a staff cost of about \$6 million for administering the funding sources. An extract of the organisation chart relating to the FSO is shown at Appendix A.

Audit review

1.11 The Audit Commission (Audit) has recently conducted a review of the Government's financial support to the film industry, focusing on the following areas:

- (a) strategic review (PART 2);
- (b) administration of FDF film-production projects (PART 3);
- (c) income of FDF film-related projects (PART 4); and
- (d) monitoring of FDF projects (PART 5).

1.12 Audit has found that there is room for improvement in the above areas and has made a number of recommendations to address the issues.

Acknowledgement

1.13 Audit would like to acknowledge with gratitude the full cooperation of the staff of the FSO during the course of the audit review.

PART 2: STRATEGIC REVIEW

- 2.1 This PART discusses the need for a strategic review of:
- (a) the FDF, which provides the largest amount of financial support to the film industry (see paras. 2.2 to 2.16);
 - (b) the FGF, which has not received any applications since mid-2007 (see paras. 2.17 to 2.22); and
 - (c) the provision of funding for the HKIFF Society (see paras. 2.23 to 2.31).

Strategic review of FDF

2.2 In the period January 2008 to June 2012, with an approved commitment of \$320 million, the FDF financed 22 film-production projects and 79 film-related projects (see para. 1.5). Achievements of the FDF include:

- (a) *Local and international film awards.* Seven films won 11 local awards and 24 international awards. In particular, the film “Echoes of the Rainbow” (see Figure 1) won five local awards and six international awards, including the Crystal Bear for the Best Feature Film awarded by the 60th Berlinale 2010’s Generation Section. The film “McDull Kungfu Ding Ding Dong” (see Figure 2) is also an example of a popular film;

Figure 1

Poster of the film
“Echoes of the Rainbow”



Figure 2

Poster of the film
“McDull Kungfu Ding Ding Dong”



Source: Pictures supplied by FSO

- (b) **Nurturing producers and directors.** Five producers and 11 directors were engaged to produce commercial films for the first time. A film directed by one of these directors was nominated to participate in the Hong Kong Film Awards Presentation Ceremony, the Asian Film Awards and overseas film festivals;
- (c) **Training film talents.** There were some training programmes on, for example, film production and special effects;
- (d) **Promoting Hong Kong films.** Over 30 local films were sponsored by the FDF to participate in overseas film festivals, such as the Festival De Cannes, the Berlin International Film Festival and the Venice International Film Festival. The presentation ceremonies of the Hong

Kong Film Awards were broadcast to millions of households in Hong Kong and abroad; and

- (e) *Funding of last resort.* In December 2011, the Information Services Department arranged interviews with some directors of the new generation. These directors were appreciative of the financial support provided by the FDF. They said that the FDF invested in film productions which traditional investors would often refuse to invest because they considered the productions too risky or were not optimistic about the financial return.

2.3 Audit appreciates the achievements of the FDF. Nevertheless, Audit considers that it is opportune for the Government to conduct a review of the future funding strategy and direction of the FDF for the reasons detailed in paragraphs 2.4 to 2.14.

Balance of FDF

2.4 As at 30 June 2012, the FDF had an available balance of \$113.7 million. In the period 2008-09 to 2011-12 (Note 4), the FDF incurred an average expenditure of \$37.6 million a year (see Table 1). Given this spending rate, the FDF could be used up by mid-2015.

Note 4: *In January 2008, the FDF started approving applications for film-production projects.*

Table 1

**FDF actual expenditure
(2008-09 to 2011-12)**

Year	Amount (\$ million)
2008-09	31.4
2009-10	48.1
2010-11	33.1
2011-12	37.9
Average	37.6

} \$150.5 million

Source: FSO records

Number of local films produced

2.5 The FDF aims to overcome the problems of shrinking film market and decreasing number of local film productions (see para. 1.4). With FDF funding, the overall production of films has increased (see Table 2). However, as the Government has not set a target number of films to be produced through FDF funding, it is uncertain whether, and the extent to which, the results shown in Table 2 have met the Government's expectations.

Table 2**Number of local films theatrically released in Hong Kong
(2006 to 2011)**

Year	Privately financed	With FDF funding	Total
2006	51	Nil (Note)	51
2007	50		50
2008	53		53
2009	48	3	51
2010	51	3	54
2011	51	5	56

Source: Audit's research and analysis of FSO records

Note: The films financed by the FDF were first theatrically released in 2009.

Operational review of FDF

2.6 In mid-2009, the Government conducted a review of the FDF. However, this review only covered the operational aspects of funding for film-production projects. For example, in response to the film industry's concerns about the cumbersome application procedures and limited funding support, the FSO streamlined the application process, and raised the upper limit of production budget from \$12 million to \$15 million and the Government's contribution from 30% of the production budget to 40%.

Funding of film events

2.7 The following four film-related projects apply for funding from the FDF annually:

- (a) Asian Film Awards;
- (b) Entertainment Expo Hong Kong;

- (c) Hong Kong-Asia Film Financing Forum; and
- (d) Hong Kong Film Awards Presentation Ceremony.

In the period January 2008 to June 2012, funding for these four film events amounted to \$88.8 million (about \$18 million each year). This was 73% of the total funding of \$122.3 million for all the film-related projects, or 49% of the total funding of \$180.4 million for both film-related and film-production projects in the same period.

2.8 *Reliance of film events on FDF.* Audit noted that these events rely largely on FDF funding (see Table 3).

Table 3
Expenditure of four film events financed by the FDF
(2008 to 2012)

Year	Amount (percentage) financed by FDF			
	Asian Film Awards (\$ million)	Entertainment Expo Hong Kong (\$ million)	Hong Kong-Asia Film Financing Forum (\$ million)	Hong Kong Film Awards Presentation Ceremony (\$ million)
2008	6.3 (74.1%)	1.5 (54.0%)	3.4 (86.1%)	2.9 (100.0%)
2009	7.2 (72.0%)	1.8 (69.7%)	3.8 (96.0%)	5.4 (100.0%)
2010	7.6 (76.3%)	2.4 (75.2%)	4.0 (87.8%)	5.0 (100.0%)
2011	7.6 (69.1%)	1.8 (71.6%)	4.1 (88.4%)	5.3 (100.0%)
2012 (up to June)	7.4 (57.8%)	1.7 (67.6%)	3.9 (88.2%)	5.7 (Note)

Source: Audit analysis of FSO records

Note: The audited account of the Hong Kong Film Awards Presentation Ceremony for 2012 had not been received by the FSO. The amount of \$5.7 million was the approved funding.

Strategic review

The significant amount of funds provided for these four film events reduced the FDF funds available for other film activities, such as film production and training of manpower for the film industry. In 2010, in the funding offer letters sent to the organisers of three of the four film events, the Government reminded them that:

- (a) FDF funding for the events was generally on a one-off basis;
- (b) they should not expect recurrent funding from the FDF; and
- (c) they should make their best endeavours to search for other sources of finance (such as sponsorship and donations).

Audit considers that the Government needs to review the contributions of these film events and the extent to which they should continue to be funded by the FDF. To ensure that the organisers will not overly rely on FDF funding, the Government also needs to motivate the organisers to expand their sources of funding and income. For example, in the case of the Asian Film Awards, according to the organiser, promotion trailers and events such as the presentation ceremony and “Red Carpet” were broadcast to over 300 million households around the world through over 20 broadcasting channels including an online video streaming website. However, unlike the Hong Kong Film Awards Presentation Ceremony, the Asian Film Awards did not charge any broadcasting fees. The FSO could have encouraged the organiser to negotiate with the broadcasting channels for broadcasting fees so as to reduce the amount of funding from the FDF.

2.9 ***Project effectiveness.*** Since 2000, the FDF has provided funding of about \$4 million a year to the Hong Kong-Asia Film Financing Forum. The Forum is a three-day event held in March every year in Hong Kong. It provides a platform for filmmakers in Asia (including Hong Kong) to present their films to potential investors (e.g. fund managers and sales agents) from around the world. Around 30 films are presented at the Forum each year, of which about 5 are Hong Kong films. Audit noted that in the period January 2008 to June 2012, only one Hong Kong film received investment in 2009 as a result of participating in the Forum. Audit considers that the Government needs to ascertain the reasons for the low success rate of Hong Kong films in receiving investment and to identify measures to support Hong Kong filmmakers. It also needs to assess whether it is justified to continue funding the Forum.

Use of FDF funds

2.10 In the years 2005-06 to 2012-13 (up to 30 June 2012), the FDF amount spent on film-production projects and film-related projects, together with the film revenues received by the Government, are shown in Table 4.

Table 4
Payments of FDF and film revenues received by Government
(April 2005 to June 2012)

	Amount (\$ million)							
	2005-06 to 2007-08	2008-09	2009-10	2010-11	2011-12	2012-13 (up to 30 June 2012)	Approved but not yet paid as at 30 June 2012	Total
Payments on film-production projects	—	9.6	14.4	3.4	13.1	2.1	15.5	58.1
Payments on film-related projects	25.9	21.8	33.7	29.7	24.8	0.7	11.6	148.2
Total	25.9	31.4	48.1	33.1	37.9	2.8	27.1	206.3
Film revenues received by the Government	—	—	0.8	5.2	5.5	1.0	N/A	12.5

Source: Audit analysis of FSO records

Table 4 shows that from April 2005 to June 2012, the total FDF funding was \$206.3 million, \$148.2 million (72%) of which was for film-related projects and \$58.1 million (28%) for film-production projects.

2.11 According to the FSO, the amounts of funding sought for film-production projects and film-related projects are driven by the market. The Government has not set any demarcation of the use of the FDF. The fact that the proportion of funding committed to film-related projects exceeds that of film-production projects

merely reflects a greater demand of funding for film-related projects and the individual merits of the applications under these two types of projects.

2.12 Audit noted that although the FDF was established to fund both film-production and film-related projects (see para. 1.5), a primary objective of the injection of \$300 million to the FDF in July 2007 was to fund film-production projects as reflected by the following:

- (a) the decision to fund film-production projects was based on the recommendation of a consultancy study on the development of the Hong Kong film industry commissioned by the then Film Development Committee (replaced by the FDC in April 2007). The consultancy report published in January 2007 recommended the setting up of a fund to support film production;
- (b) in the 2007-08 budget, \$300 million were earmarked “*to help finance film production and overcome the shortage of talent*”; and
- (c) in March 2009, the Secretary for Commerce and Economic Development informed the Legislative Council (LegCo) that the Government’s injection of \$300 million to the FDF was “*to support small-to-medium budget film productions*” and “*to provide funding support to encourage commercial investment in film productions, create employment opportunities, and nurture new directors and other industry talent in order to revitalise Hong Kong’s film industry*”.

The current mode of financing film-production projects

2.13 In July 2007, when seeking the approval of the LegCo Finance Committee for injection of the \$300 million to the FDF, the Government informed the Committee that there was a chance of the Government not recouping part or all of the contribution of a film if the Government’s share of the revenues (e.g. from box office and sale of copyrights for producing DVDs) could not cover the contribution. The Government had also implemented various safeguard measures to protect the investment, such as:

- (a) ensuring the commercial viability of film-production projects by requiring the applicants to secure third-party financing (see para. 3.2(e)); and

- (b) assessing the reasonableness of the production budget and estimated net income of the proposed film production (see para. 3.4).

2.14 Audit reviewed the records of 10 films which were theatrically released before 2012. In these 10 films, Audit found that the Government could not recover part or all of its contributions, with very low recovery for some of the films (see Table 5). Audit recognises that the Government may face a high investment risk for financing film production. However, because public funds are involved, the Government needs to evaluate the acceptability of the low overall recovery rate, review the current mode of financing film-production projects, and assess the effectiveness of the safeguards in ensuring their commercial viability.

Table 5
Recovery of the Government's contributions to film-production projects
(up to 31 August 2012)

Film	Month of theatrical release (Note 1)	Government's contribution (a) (\$)	Net film revenue shared by Government (Note 2) (b) (\$)	Recovery rate (b) ÷ (a) × 100%
A	February 2009	1,618,255	792,251	49.0%
B	February 2009	2,419,674	1,598,400	66.1%
C	May 2009	2,993,179	0	0%
D	July 2009	3,598,800	2,107,194	58.6%
E	March 2010	3,598,274	2,955,000	82.1%
F	June 2010	1,759,500	1,422,000	80.8%
G	July 2010	2,520,000	968,100	38.4%
H	January 2011	1,855,297	1,048,367	56.5%
I	July 2011	2,799,836	687,261	24.5%
J	December 2011	3,017,435	1,769	0.1% (Note 3)
Overall		26,180,250	11,580,342	44.2%

Source: Audit analysis of FSO records

Note 1: Film revenue is gradually received after a film has been theatrically released. Therefore, Audit selected the films released in or before 2011 for examination to ensure that these films had already received most of their revenues.

Note 2: The Government's share of net film revenue (i.e. after deducting production expenses and promotion and distribution expenses) is based on its contribution to a film production. For example, if the Government has contributed 30%, it will receive 30% share of net film revenue.

Note 3: The FSO considered that as Film J had been theatrically released for nine months only, the recovery rate of 0.1% might not be final. In this regard, Audit noted that the sales agent had commented that the film was not successful and was unable to provide sales estimates for the film. Up to August 2012, a distribution right of the film in the Mainland was still under negotiation. If successful, the Government might receive an amount of \$300,000 and the recovery rate would be 10%.

Audit recommendation

2.15 Audit has *recommended* that the Head of Create Hong Kong should conduct a strategic review of the use of FDF funds to support the film industry in future, taking into consideration Audit's observations in paragraphs 2.4 to 2.14.

Response from the Administration

2.16 The Head of Create Hong Kong agrees with the audit recommendation. He has said that:

- (a) Create Hong Kong will conduct a review of the need for replenishing the FDF next year and has plans to conduct a review on the usage of the FDF;
- (b) the number of films financed by the FDF in any particular year depends on a number of factors, some of which are beyond the Government's control. These include the individual merits of applications received, the market situation and the risk level individual private investors are prepared to take. The FSO takes into account relevant indicators in assessing whether the FDF meets the policy objectives of facilitating the healthy development of Hong Kong's film industry. For example, 13 out of 22 approved applications are submitted by small-scale film production companies (i.e. independent companies without their own distribution network). Eleven directors and five producers have been engaged to produce commercial films for the first time. These indicators show that the FDF has been successful in facilitating small-scale film productions and up-and-coming directors/producers in producing films, thereby helping to create a larger mass of film activities for the local film industry and nurturing film talents; and
- (c) the main objectives of the Hong Kong-Asia Film Financing Forum are to establish Hong Kong as a film financing centre in Asia, and to attract film financing capital and film projects from non-Hong Kong sources. From

Strategic review

January 2008 to June 2012, the Forum succeeded in raising capital for 22 films, including one Hong Kong film. The Forum has played an important role in raising capital for non-Hong Kong film projects, thereby raising the profile of Hong Kong as a film financing centre in Asia. The low success rate of Hong Kong films in receiving investment through the Forum is attributed to Hong Kong films' preference to secure financing from traditional Hong Kong and Mainland sources, which are largely absent at the Forum.

Strategic review of Film Guarantee Fund

2.17 To apply for funding from the FGF for a film-production project (see paras. 1.6 and 1.7), an applicant, normally a registered company, has to secure from a lending institution an approval-in-principle loan. For each project, the Fund will guarantee 50% of the loan amount up to a maximum of \$2.625 million.

2.18 In the period April 2003 to June 2007, the FGF received and approved 12 applications. However, since the FDF started to finance film production in July 2007, up to July 2012, the FGF had not received any applications. According to the Government, the possible causes for the lack of response to the FGF were:

- (a) cumbersome application procedures in the view of some members of the film industry;
- (b) the lending institutions' cautiousness in granting loans for filmmaking because of the poor economic climate and relatively high risk involved; and
- (c) the fact that lending institutions wanted to ascertain whether the Government was willing to provide guarantee before offering loans.

2.19 In September 2010, the FSO conducted a review of the operation of the FGF. During the review, the FSO consulted the film industry. As the industry had no objection to the retention of the Fund, the FSO decided to keep the FGF as a funding option.

2.20 In Audit's view, it is unlikely that the FGF will attract many applications as long as funding is available from the FDF. Since a film-production project is not allowed to apply for funding support under both the FDF and the FGF, the applicant would more likely choose the FDF as its terms and conditions are more favourable than those of the FGF. For example:

- (a) the Government's maximum contribution under the FDF is \$6 million, whereas the maximum guarantee under the FGF is \$2.625 million; and

Strategic review

- (b) the applicant is not required to pay interest on Government's contribution under the FDF, but is required to pay interest to the lending institution under the FGF.

Audit recommendations

2.21 **Audit has *recommended* that the Head of Create Hong Kong should critically examine whether:**

- (a) **the FGF meets the needs of the film industry; and**
- (b) **all or part of the FGF's commitment can be deployed to other uses (e.g. transferring to the FDF).**

Response from the Administration

2.22 The Head of Create Hong Kong agrees with the audit recommendations and will conduct a review in consultation with the FDC.

Strategic review of provision of funding for HKIFF Society

2.23 As mentioned in paragraph 1.8, funding for the HKIFF Society is paid annually from the departmental expenditure of Create Hong Kong to organise mainly the HKIFF. The annual funding application of the HKIFF Society is assessed by the FSO and approved by the Permanent Secretary.

Use of accumulated fund

2.24 In addition to Government's funding, the HKIFF Society derives revenue from various sources such as donations, sponsorship and ticket sales of activities other than the HKIFF. According to the funding agreement signed between the Government and the HKIFF Society in October 2009, if the total revenue exceeds the total expenditure at the end of each grant year (May to April of the following year), the HKIFF Society may keep and carry forward a surplus of not more than 25% of the total expenditure of that grant year. The surplus may be used for purposes relating to the development of film industry.

2.25 The HKIFF Society had net surpluses (generated from the HKIFF and offset the deficits of some other film activities) of \$0.03 million, \$3.7 million and \$0.4 million in the grant years 2008-09, 2009-10 and 2010-11 respectively. The net surplus of each grant year had been accrued to the accumulated fund of the HKIFF Society. Table 6 shows the accumulated fund balances of the HKIFF Society as at the end of the grant years 2008-09 to 2010-11.

Table 6

**Accumulated fund balance of the HKIFF Society
(2008-09 to 2010-11)**

Grant year	Balance as at 30 April (\$ million)
2008-09	5.8
2009-10	9.5
2010-11	9.9

Source: The HKIFF Society's audited accounts

Remarks: The HKIFF Society's audited account for 2011-12 was not yet available at the time of audit.

2.26 Audit noted that during the grant years 2008-09 to 2010-11, the revenue and expenditure of the HKIFF Society were generally stable and were in the range of \$34 million to \$38 million, with the Government's funding (Note 5) constituted about two-thirds of the HKIFF Society's revenue. Given the stability of the revenue and expenditure, and the fact that the Society had accumulated a substantial balance of \$9.9 million as at 30 April 2011, the FSO needs to consider setting a ceiling on the accumulated fund balance held by the Society. When the ceiling is exceeded, annual funding from the Government should be adjusted.

Funding for HKIFF Society

2.27 Table 7 provides a historical background of funding the HKIFF Society by departmental expenditure.

Note 5: *The Government's funding includes funds provided to the HKIFF Society through Create Hong Kong's departmental expenditure for organising mainly the HKIFF. It also includes FDF funds provided for the Asian Film Awards and the Hong Kong-Asia Film Financing Forum organised annually by the HKIFF Society (see also para. 2.28).*

Table 7

Historical background of funding the HKIFF Society

Year	Funding history
1977	The HKIFF Society was not yet established. The then Hong Kong Urban Council funded the first HKIFF.
2000	The Leisure and Cultural Services Department started to fund the HKIFF.
2002	The Hong Kong Arts Development Council (subvented by the Home Affairs Bureau) started to fund the HKIFF.
2004	The HKIFF Society was established to organise the HKIFF. The Hong Kong Arts Development Council started to fund the HKIFF Society.
2009	The Commerce and Economic Development Bureau took over the funding responsibility for the HKIFF Society.

Source: FSO records

2.28 In addition to the funding provided by Create Hong Kong, the HKIFF Society sought funding support from the FDF annually for organising two other major projects, namely the Asian Film Awards and the Hong Kong-Asia Film Financing Forum (see para. 2.7). The funding applications were considered by the FDC and recommended to the Permanent Secretary for approval.

2.29 Given the different sources of funding, Audit considers that the Government needs to review whether it would be desirable to consolidate the funding for the HKIFF Society under the FDF. The FDC is tasked to advise the Government on the use and allocation of public funds to support the film industry (see para. 1.3). Consolidating the funding for the HKIFF Society under the FDF would enable the FDC to determine more effectively how best to provide financial support to the film industry.

Audit recommendations

- 2.30 **Audit has *recommended* that the Head of Create Hong Kong should:**
- (a) **consider the need to set a ceiling on the accumulated fund of the HKIFF Society, and to adjust the Government's annual funding if the ceiling is exceeded; and**
 - (b) **review the funding arrangement for the HKIFF Society.**

Response from the Administration

2.31 The Head of Create Hong Kong agrees with the audit recommendations and will conduct a review of the funding arrangement for the HKIFF Society.

PART 3: ADMINISTRATION OF FDF FILM-PRODUCTION PROJECTS

3.1 This PART examines the following issues relating to the administration of FDF film-production projects:

- (a) application for FDF funding (paras. 3.2 to 3.16);
- (b) film promotion and distribution expenses (paras. 3.17 to 3.22);
- (c) collection of film revenues (paras. 3.23 to 3.27); and
- (d) selling back copyrights on films (paras. 3.28 to 3.31).

Application for FDF funding

Application requirements

3.2 An applicant for FDF funding for a film-production project must meet all the following major requirements before its application will be considered:

- (a) the applicant is a company formed and registered under the Companies Ordinance (Cap. 32);
- (b) the proposed film is a drama feature film produced for commercial theatrical release in Hong Kong;
- (c) among the applicant, the film producer and the film director, at least one must have produced not less than two released films before the date of application;
- (d) the film-production budget does not exceed \$15 million;
- (e) the project is shown to be commercially viable. A project is regarded as commercially viable if the applicant has secured third-party financing to the satisfaction of the Government; and

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- (f) there is at least one Hong Kong permanent resident in each of any three of the five categories of main film crew and cast (i.e. film producer, film director, scriptwriter, leading actor and leading actress).

Processing of applications

3.3 ***Checking by FSO.*** The FSO has promulgated a set of guidelines for processing applications. According to the guidelines, the FSO will check:

- (a) whether the applicant has fulfilled all the application requirements in paragraph 3.2;
- (b) whether the applicant has submitted the required supporting documents such as certified true copies of its certificate of incorporation and audited accounts, statutory declarations of directors and shareholders about their criminal records, and the cash flow schedule of the film-production project; and
- (c) the directorship of the applicant by conducting company search.

If the checking result is satisfactory, the FSO will inform the applicant in writing that the application has been accepted.

3.4 ***Assessment by FVC.*** The application will be assessed by six examiners drawn from the Panel of Examiners. Members of the Panel are experienced practitioners in film production, marketing and distribution. The examiners will assess the reasonableness of the production budget and estimated net income of the proposed film. Each of the examiners will provide comments on an assessment form. The FSO will summarise the examiners' assessments and submit them together with its views on the assessments to the FVC for consideration.

3.5 ***Approval by Permanent Secretary.*** The FVC will put forward its recommendation for the application to the Permanent Secretary for consideration and approval. If the application is approved, a production finance agreement will be signed between the Government and a new film production company formed by the applicant for receiving FDF funding. Funds will be disbursed in accordance with the milestones of the film production.

Approved applications

3.6 In October 2007, the FSO started to receive applications for FDF funding for film-production projects. Up to 30 June 2012, it had processed 52 applications (see Table 8), of which 22 were approved.

Table 8

**Film-production project applications
(October 2007 to June 2012)**

Result	Number of applications
Approved	22 (42%)
Withdrawn by applicants (before/after approval)	19 (37%)
Rejected	11 (21%)
Total	52 (100%)

Source: FSO records

Remarks: The 52 applications did not include 4 applications which were being processed as at 30 June 2012.

Checking of applications

3.7 Audit examined 15 of the 52 applications for FDF funding (Note 6) to ascertain the adequacy of the FSO's work in processing the applications. Audit examination revealed that:

- (a) in 5 applications, not all the required supporting documents had been submitted; and

Note 6: *Of the 15 applications, 11 were approved (including 4 which were withdrawn by applicants after approval) and 4 were rejected.*

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- (b) in 1 application, there was no documentary evidence showing that the FSO had verified the required film production experience (see para. 3.2(c)).

Securing third-party financing

3.8 As mentioned in paragraph 3.2(e), to substantiate the commercial viability of a proposed film, an applicant has to secure financing from a third-party (i.e. other than the applicant and the Government). When seeking the LegCo Finance Committee's approval for the injection of the \$300 million to the FDF in July 2007, the Government informed the Committee of the requirement of third-party financier. According to the Finance Committee paper, the assessment criteria of commercial viability included the requirement for the film project to have secured third-party financing (e.g. 50% undertaking of the production budget). According to the FSO's application guidelines, the applicant is required to submit documentary evidence proving that it has secured third-party financing for the film project.

3.9 Audit examination of the 15 applications revealed that in 6 applications, the applicant itself was the third-party financier and in another 5 applications, a related company of the applicant was the third-party financier. As such, the objective of having a third party evaluate and affirm the commercial viability of a proposed film might have been compromised. Notwithstanding this, 10 of these 11 applications were approved.

3.10 In response to Audit's enquiry, the FSO informed Audit that:

- (a) the term "third-party financier" should be interpreted to mean non-government private investor, including the applicant. The paper submitted to the Finance Committee in July 2007 did not preclude the applicant from acting as the financier;
- (b) it was practically difficult, if not impossible, to ascertain the real identity of a third-party financier as it could be any company formed as a "single-purpose vehicle" which was related or unrelated to the applicant; and

- (c) in reality, potential investors would require the applicant to obtain the approval from the Government to finance the film-production project before committing themselves to the film project.

3.11 In the light of the above, the Government needs to critically review the existing practice of using the applicant's ability to secure third-party financing as a measure of the commercial viability of a film.

Creation of employment opportunities

3.12 One of the aims of the FDF is to create employment opportunities for film industry practitioners. This aim is considered achieved if an applicant has met the requirement of employing at least one Hong Kong permanent resident in each of any three of the five categories of main film crew and cast (see para. 3.2(f)). As the FDF aims to create employment opportunities, the FSO should accord more favourable treatment to those applications that employ more than the minimum required number of Hong Kong permanent residents.

Film for mass appeal

3.13 At a meeting of the LegCo Panel on Information Technology and Broadcasting held in April 2008, the Government informed the Panel that a factor for evaluating an application for FDF funding is whether the film is for mass appeal rather than niche market only. Audit noted that there was no evidence showing that this factor had been taken into account in the 15 applications examined (see para. 3.7). In response to Audit's enquiry, the FSO informed Audit that in examining the production budget and estimated net income of the applications, the examiners had assessed whether the proposed films were for mass appeal or for niche market only, though the assessments had not be separately spelt out.

Marking scheme for evaluating applications

3.14 In administering government funds, government departments usually make use of a marking scheme, which consists of relevant assessment factors (including past performance) with individually assigned weightings, to evaluate

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funding applications. An application will only be approved if a pre-determined overall mark has been achieved. However, the FSO has not adopted a marking scheme for evaluating applications for FDF funding. There is a risk that an assessment factor which is:

- (a) relevant to an application but has not been properly dealt with; or
- (b) not pre-determined but has been used in evaluating an application.

To standardise the assessment factors and to use it as a reminder checklist for the evaluation of applications for FDF funding, Audit considers that the FSO needs to establish a marking scheme incorporating all relevant assessment factors.

Audit recommendations

3.15 **Audit has *recommended* that the Head of Create Hong Kong should:**

- (a) **ensure that all supporting documents are submitted by applicants for FDF funding;**
- (b) **always verify that among the applicant, the film producer and the film director, at least one has produced not less than two released films before the date of application for FDF funding;**
- (c) **critically review the existing practice of using the applicant's ability to secure third-party financing as a measure of the commercial viability of a film; and**
- (d) **establish a marking scheme incorporating all relevant assessment factors for the evaluation of FDF funding applications.**

Response from the Administration

3.16 The Head of Create Hong Kong agrees with the audit recommendations. He has said that:

Administration of FDF film-production projects

- (a) as a matter of rule, the FSO had verified the required film production experience of the applicants before the applications concerned were formally accepted for further processing. For the case mentioned in paragraph 3.7(b), the record of the checking conducted could not be located; and

- (b) the FSO has already put in place a mechanism to ensure that all the required and applicable documents are submitted and properly filed.

Film promotion and distribution expenses

3.17 After the production of a film has been completed, the film production company will arrange the film to be theatrically released. This will involve film promotion (e.g. advertising and public relations functions) and distribution (e.g. showing the film in a cinema). The company will engage sales agents for the promotion work. The sales agents will find distributors, on behalf of the company, for the distribution work. Expenses spent by sales agents and distributors (SA&Ds) for their work, together with SA&D commissions, are payable from the revenue of the film.

Caps on SA&D expenses and commissions

3.18 As films financed by the FDF are small-to-medium budget productions, to avoid incurring excessive and unreasonable promotion and distribution costs, the FSO has imposed caps on SA&D expenses and commissions. In cases where the caps are likely to be exceeded, film production companies have to seek endorsements of both the FVC and the FDC. The caps and the need for endorsements are essential controls for safeguarding the recovery of the Government's contributions to film-production projects, given that the greater the expenses and commissions incurred for a film, the lesser will be the film revenue shared by the Government.

3.19 From time to time, the FSO reviews the appropriateness of the caps. In its latest review in 2010, it decided that with effect from December 2010, SA&D expenses and SA&D commissions would be subject to caps at 15% of production budget and gross film revenue respectively. However, Audit noted that no record was available showing that the FVC and the FDC had been consulted about the decision.

SA&D expenses and commissions exceeding caps

3.20 Prior to the theatrical release of a film, a meeting will be held between the film production company and the FSO to discuss matters relating to the promotion and distribution of the film. At the meeting, the FSO will remind the company to seek prior approvals if the SA&D expenses and commissions are likely to exceed the caps. The FSO will also emphasise to the company that the Government reserves the right to disclaim responsibility for any excessive SA&D expenses and commissions for which no prior approval has been granted. However, Audit's examination of the SA&D expenses and commissions incurred for 5 of the 10 theatrically released films (see para. 2.14) revealed that:

- (a) in 3 films, the cap on the SA&D expenses had been exceeded. Of these films:
 - (i) in 1 film, endorsements of the FVC and the FDC were not obtained for expenses, which exceeded the cap by \$4.4 million (or 362%);
 - (ii) in 2 films, prior endorsements of the FVC and the FDC had not been obtained and the covering endorsements were obtained 10 and 17 months respectively after the theatrical release of the films; and
 - (iii) in 1 of the 2 films in (a)(ii), although covering endorsements of the FVC and the FDC had been obtained, the expenses still exceeded the endorsed amount by \$5.4 million (or 200% of the endorsed amount — see Case 1); and

Case 1

1. In June 2011, 15 months after the theatrical release of the film, the film production company confirmed that the SA&D expenses incurred amounted to \$2.7 million, i.e. exceeding the cap by 50%. In August 2011, the FVC and the FDC endorsed the excess as they considered that the extra expenses were reasonable, given the film's successful box office.

2. Audit examined the records of the film-production project and noted that the SA&D expenses amounted to \$8.1 million, i.e. \$5.4 million or 200% higher than the endorsed amount of \$2.7 million. This was because the endorsed expenses only included those spent for the Hong Kong market but not the expenses incurred for markets outside Hong Kong.

Audit comments

3. In approving cases of excess of SA&D expenses, the FSO needs to ensure that all such expenses incurred for both the Hong Kong and overseas markets are accounted for.

Source: Audit analysis of FSO records

- (b) in 1 of the above 3 films, the cap on the SA&D commissions was exceeded, but endorsements of the FVC and the FDC had not been obtained.

Audit recommendations

3.21 **Audit has recommended that the Head of Create Hong Kong should:**

- (a) **always consult the FVC and the FDC about setting caps of SA&D expenses and commissions;**
- (b) **seek the endorsements of the FVC and the FDC for the cases with caps exceeded in paragraphs 3.20 (a)(i) and (iii), and (b);**

- (c) **in cases where the caps on SA&D expenses and commissions are likely to be exceeded, take measures to ensure that film production companies always seek prior endorsements from the FVC and the FDC. Such measures may include:**
 - (i) **liaising regularly with the companies to ascertain the actual SA&D expenses and commissions incurred to date; and**
 - (ii) **exercising the right to disclaim responsibility for any excessive SA&D expenses and commissions for which no prior approval has been obtained; and**
- (d) **in approving cases of excess of SA&D expenses or commissions, ensure that all such expenses or commissions are accounted for.**

Response from the Administration

3.22 The Head of Create Hong Kong agrees with the audit recommendations. He has said that:

- (a) the FSO will seek covering endorsements of the FVC and the FDC for the excessive SA&D expenses and commissions in the cases quoted by Audit; and
- (b) the FSO will devise clearer guidelines on the cap of SA&D expenses spent for the films within and outside Hong Kong.

Collection of film revenues

3.23 To ensure proper sharing of film revenue by the third-party financier and the Government, a bank account is set up for each film-production project. All revenues received (e.g. from box office) are deposited into the account. A collection agent (usually a practising Certified Public Accountant) is appointed to manage the revenue collection.

3.24 The collection agent needs to sign a collection account management agreement (Note 7). Under the Agreement, the agent needs to issue to the FSO and the third-party financier collection statements detailing the film revenues received, the expenditure spent (e.g. SA&D expenses and commissions) and the net film revenues on a regular basis (usually once revenues are deposited into the bank account). The FSO and the third-party financier will check the statements and afterwards give approval to the agent to distribute the net film revenue to them. The service of an agent with unsatisfactory performance may be terminated.

3.25 Audit examined the records of the five films which had been theatrically released (see para. 3.20) and noted that in two films, the collection agents did not issue collection statements to the FSO on a regular basis. The agents had also distributed net film revenues without obtaining prior approvals of the FSO. The FSO had followed up the irregularities with the third-party financiers. However, Audit considers that there is still room for improving the follow-up action. Case 2 is an example.

Note 7: *The collection account management agreement is signed by all parties involved in a film-production project, i.e. the collection agent, the production company, the third-party financier, the sales agents and the Government. This is to ensure that the parties who receive film revenues would deposit the revenues into the bank account set up for the film-production project.*

Case 2

1. In January 2011, the film was theatrically released. In March 2011, a collection agent was appointed. According to the collection account management agreement, the agent should issue monthly collection statements to the FSO and the third-party financier. Furthermore, the agent should only distribute the net film revenues after approvals had been given by the FSO and the third-party financier.

2. Audit found that the agent had not issued any collection statements to the FSO. The agent also distributed revenues of some \$1 million (by 11 instalments) from April 2011 to June 2012 without the FSO's approvals.

3. The FSO followed up with the third-party financier in May and June 2011 to find out if the latter had received any collection statements. Upon request, the financier furnished to the FSO two statements prepared by the agent. The FSO reviewed the statements and considered that they did not provide adequate information on the revenues collected. It thus asked the agent to provide revised statements based on a sample collection statement prepared by the FSO. Despite repeated reminders, up to 30 June 2012, the agent had not provided any such statements.

Audit comments

4. The FSO should have instructed the agent to stop distributing revenues after the FSO had received the first payment in April 2011, and to submit collection statements on a monthly basis to the FSO and the third-party financier for approval.

Source: Audit analysis of FSO records

Audit recommendations

- 3.26 **Audit has recommended that the Head of Create Hong Kong should:**
- (a) **ensure that collection agents issue collection statements and distribute film revenues in accordance with the terms and conditions of the collection account management agreements;**

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- (b) **take adequate and prompt actions to follow up with the collection agents on all irregularities found (e.g. failure in issuing collection statements, and distribution of film revenues without the FSO's approvals); and**
- (c) **consider terminating the services of collection agents with unsatisfactory performance.**

Response from the Administration

3.27 The Head of Create Hong Kong agrees with the audit recommendations.

Selling back copyrights on films

3.28 The Government has copyrights on films funded by the FDF. It also has the discretion to relinquish the copyrights. In the paper submitted to the LegCo Finance Committee in July 2007 for approving the \$300 million injection to the FDF, it was stated that relinquishing copyrights by, for example, selling them back to the film production companies, might be the best option where:

- (a) there was no real prospect of recouping the Government's contribution to a film-production project; or
- (b) where further proceeds to be attained from the copyrights were envisaged to be very small and would not justify the administrative costs entailed by continuing to hold on to the copyrights.

In December 2009, after consulting the FDC, the Government informed the LegCo Panel on Information Technology and Broadcasting that when the improvement measures were implemented (see para. 2.6), it would promulgate clear guidelines for selling back copyrights to the film industry. It would also start to sell back the copyright of a film five years after the film had been theatrically released.

3.29 Audit noted that:

- (a) the improvement measures had been implemented since early 2010. However, the FSO had not worked out the mechanism for selling back film copyrights (e.g. drafting the selling back procedures, working out the copyright valuation methodology and consulting the film industry); and
- (b) despite the fact that some films were theatrically released some years ago and that the prospect of further recouping the Government's contributions seemed limited (such as Film C in Table 5 of para. 2.14), the FSO had not considered whether the films' copyrights could be relinquished earlier.

Audit recommendation

3.30 **Audit has recommended that the Head of Create Hong Kong should finalise the administrative procedures for selling back copyrights of films.**

Response from the Administration

3.31 The Head of Create Hong Kong agrees with the audit recommendation. He has said that as the FDF-financed film was first released in February 2009, the first case of film copyrights relinquishment will arise by February 2014 (i.e. five years after the film has been theatrically released — see para. 3.28). The FSO will propose a mechanism for selling back copyrights, in consultation with the Department of Justice where necessary, for consultation with the FDC.

PART 4: INCOME OF FDF FILM-RELATED PROJECTS

4.1 This PART examines issues relating to the income of FDF film-related projects.

Film awards and forums

4.2 From January 2008 to June 2012, FDF funding of some \$80 million was used to support:

- (a) the Hong Kong Film Awards Presentation Ceremony;
- (b) the Asian Film Awards; and
- (c) the Hong Kong-Asia Film Financing Forum.

Anticipated project incomes

4.3 According to the FSO's guidelines, the organiser of a FDF film-related project has to state in the application form the budget of the project, comprising:

- (a) all anticipated project expenditure (i.e. manpower cost, equipment expenses and other expenses);
- (b) all anticipated project incomes (e.g. sponsorship and broadcasting license fee payable by a media company for broadcasting an event); and
- (c) the amount of FDF funding required to finance the project deficit (i.e. the difference between (a) and (b) above).

Once an application has been approved and a funding agreement has been signed between the project organiser and the Government, the project organiser will normally be paid 75% to 85% of the FDF funding amount. The remaining amount will be paid after the completion of the project.

Income of FDF film-related projects

4.4 Audit examined the records of the Hong Kong Film Awards Presentation Ceremony, the Asian Film Awards and the Hong Kong-Asia Film Financing Forum held in 2009 to 2011. Audit found that in all the three years, no anticipated project incomes were stated in the nine application forms of these projects. However, upon Audit's enquiries in June 2012, the FSO contacted the organisers of the projects and was informed that the projects had received incomes, on a regular basis, in these three years (see Table 9).

Table 9

**Project incomes of film award events and financing forums
(2009 to 2011)**

Project	Year	Broadcasting fee (\$)	Submission fee (Note) (\$)	Income from advertisements and sale of publications (\$)	Sponsorship (\$)	Others (\$)	Total (\$)
Hong Kong Film Awards Presentation Ceremony	2009	1,687,419	Nil	167,534	600,000	6,000	2,460,953
	2010	2,262,229		185,446	819,595	30,395	3,297,665
	2011	2,398,865		189,820	1,131,851	8,598	3,729,134
Asian Film Awards	2009	Nil	Nil	Nil	587,000	Nil	587,000
	2010				2,085,819		2,085,819
	2011				737,529		737,529
Hong Kong-Asia Film Financing Forum	2009	Nil	85,860	Nil	Nil	Nil	85,860
	2010		55,257		140,950		196,207
	2011		67,406		141,667		209,073
Total							13,389,240

Source: Audit analysis of FSO records

Note: Submission fee was paid by film production companies to the organiser of the Hong Kong-Asia Film Financing Forum for participation in the event.

4.5 Given the significance of the project incomes, Audit considers that the FSO needs to ensure that the project organisers provide details of anticipated project incomes in their application forms for FDF funding. This would help ensure that the FDF does not overly finance the deficits of projects.

Actual project incomes

4.6 The FDF funding agreement signed between the project organiser and the Government requires the organiser to observe the following conditions after the completion of the project:

- (a) submission of a project completion report within 90 days to the Government on the achievements of the project. The report should include a summary of project incomes, FDF funding and project expenditure;
- (b) submission of an audited account containing project incomes, FDF funding and project expenditure within 90 days; and
- (c) refund of any surplus (i.e. project incomes and FDF funding over expenditure) to the Government.

4.7 Audit examination of the records of the film award events and financing forums held from 2009 to 2011 revealed that:

- (a) in all the three years, while there were project incomes (see Table 9 in para. 4.4), such incomes were not included in the project completion reports and audited accounts of the Hong Kong Film Awards Presentation Ceremony; and
- (b) submission fee income of \$85,860 and \$67,406 received in 2009 and 2011 respectively (see Table 9 in para. 4.4) were also not included in the audited accounts of the Hong Kong-Asia Film Financing Forum.

4.8 With regard to the project incomes received by the organiser (see para. 4.7(a)), the FSO informed Audit that, when assessing the funding applications, it was aware of such project incomes, and the fact that these incomes were not included in the applications, assessment reports, completion reports and auditor's

Income of FDF film-related projects

reports. The FSO did not follow up with the organiser because it understood that the incomes had been/would be used to cover the operation of the organisation not related to the presentation ceremony (as the organiser had done so in the past). Audit considers that the FSO needs to review the propriety of such practice. Net surplus of the Hong Kong Film Awards Presentation Ceremony for the years 2009 to 2011 after taking into account the project incomes amounted to \$2.5 million, \$3.3 million and \$3.7 million respectively.

Audit recommendations

4.9 **Audit has *recommended* that the Head of Create Hong Kong should:**

- (a) **ensure that project organisers:**
 - (i) **provide details of anticipated project incomes in their applications for FDF funding; and**
 - (ii) **include actual project incomes in their project completion reports and audited accounts submitted to the FSO after completion of the projects; and**
- (b) **follow up with project organisers after the completion of their projects to ascertain the actual project incomes and determine whether there are any surpluses that need to be refunded to the Government.**

Response from the Administration

4.10 The Head of Create Hong Kong agrees with the audit recommendations and will review the propriety of the practice mentioned in paragraph 4.8.

PART 5: MONITORING OF FDF PROJECTS

5.1 This PART examines the following issues relating to the monitoring of film-production and film-related projects funded by the FDF:

- (a) execution of agreements (see paras. 5.2 to 5.9);
- (b) submission of documents (see paras. 5.10 to 5.14); and
- (c) audit of books and records of distributors (see paras. 5.15 to 5.18).

Execution of agreements

5.2 If an application for FDF funding is approved, the FSO will send an offer letter to the successful applicant. Upon acceptance of the offer, the applicant is required to set up a film production company for the film-production project, which will execute a production finance agreement with the Government. Similarly, the applicant of a film-related project is required to enter into a funding agreement with the Government. These agreements include terms and conditions which enable the FSO to monitor the progress and propriety of the projects.

5.3 Film production is generally divided into three stages, namely pre-production, principal photography and post-production (Note 8). Of the 22 approved film-production projects in the period July 2007 to June 2012 (see para. 1.5), Audit examined 14 projects. The films of these 14 projects had been theatrically released as at 30 June 2012. Audit noted that in 11 (79%) projects, the production finance agreements were executed at a late stage — either during or after the post-production stage.

Note 8: *Pre-production refers to the tasks that have to be completed before filming begins, such as hiring main crew and cast, and budgeting. Principal photography refers to the filming of the movie. Post-production refers to the work performed on a film after the end of principal photography, such as video editing and addition of sound/visual effects.*

Monitoring of FDF projects

5.4 For film-related projects, Audit examined 20 of the 79 projects approved in the period July 2007 to June 2012 (see para. 1.5). Audit noted that in 13 (65%) of the 20 projects, the funding agreements were signed after the projects had started. The average delay was about five months.

5.5 Since the terms and conditions of the agreements will not come into effect until the agreements are duly signed, late execution of agreements affect the FSO's efficiency and effectiveness in monitoring the projects. For example, in cases of the production finance agreement, the FSO:

- (a) might not be able to conduct inspections during the principal photography of film productions, though film production companies have always been cooperative and have allowed the FSO to carry out inspections before the signing of agreements; and
- (b) would not be able to ensure that purchases made by the film production companies comply with the procurement requirements (Note 9). For instance, Audit noted that in one film-production project, purchases not complying with the procurement requirements had been made before the production finance agreement was signed.

5.6 According to the FSO, the long time taken by the film production company to sign supplementary agreements with members of the 12 categories of a film's main crew and cast accounted for the delay in executing the production finance agreements. The Intellectual Property Department and the Department of Justice had advised the FSO that, before signing the production finance agreement, each member had to sign a supplementary agreement with the film production company. By signing the supplementary agreement, each member acknowledged that the film production company would be the sole owner of the intellectual property of any components of the film. Upon execution of the production finance agreement, the film production company would assign all intellectual property rights of the film to the Government and the third-party financier. As a large group of people were involved in signing the supplementary agreements, with the

Note 9: *According to the production finance agreement, quotations should be obtained in writing from at least two suppliers for every procurement of value more than \$50,000 but not exceeding \$500,000. For procurement of value exceeding \$500,000, tender exercise is required.*

complication that they would consult their individual lawyers, the supplementary agreements took a long time to get executed.

5.7 The FSO had also informed Audit that film production was a dynamic and fast-paced business. Filming would proceed once a decision to produce a film was made, and the third-party financier often wanted a film to be shot as soon as possible. Therefore, it would not be practicable to delay the filming until all supplementary agreements were signed. As for film-related projects, Audit noted that the delays were mainly due to slippages.

Audit recommendations

5.8 **Audit has *recommended* that the Head of Create Hong Kong should:**

- (a) **implement measures for proper monitoring of the project progress prior to the signing of production finance agreements. Such measures may include, for example, specifying in the offer letters (see para. 5.2) that the FSO may conduct inspections; and**
- (b) **take measures to expedite the execution of agreements, including urging the successful applicants of film-related projects to sign and return the funding agreements as soon as possible, and following up with those delayed cases in a timely manner.**

Response from the Administration

5.9 The Head of Create Hong Kong agrees with the audit recommendations.

Submission of documents

5.10 For monitoring purposes, the following documents are required to be submitted by film production companies or project organisers to the FSO in accordance with the production finance agreements or funding agreements:

- (a) *For film-production projects:* agreements for film distribution, cost/progress reports and other materials (e.g. final shooting script and publicity materials);
- (b) *For film-related projects:* final completion reports; and
- (c) *For both projects:* audited accounts.

Late submission of documents

5.11 Audit examination revealed that there were cases of late submission of the required documents (see Appendix B).

5.12 In response to Audit's enquiry, the FSO said that the required documents were not submitted in a timely manner because:

- (a) the distribution agreements could only be executed after the distributors had viewed the completed films, but the films were usually available for viewing only after the deadlines for submission of distribution agreements as set out in the production finance agreements; and
- (b) it was difficult for the film production companies to submit the cost/progress reports on a monthly basis, and such reports were not critical as long as the final cost reports had been incorporated in the audited accounts.

Audit recommendations

- 5.13 **Audit has *recommended* that the Head of Create Hong Kong should:**
- (a) **review the existing requirements on submission of documents stipulated in the production finance agreement and funding agreement; and**
 - (b) **in the light of the results of the review, rationalise the requirements for submission of documents.**

Response from the Administration

- 5.14 **The Head of Create Hong Kong agrees with the audit recommendations.**

Audit of books and records of distributors

5.15 It is required under the production finance agreement signed between the Government and the film production company that each distribution agreement entered into by the sales agent with the distributor should contain a right for the film production company and/or its designees, including the Government and the collection agent, to audit the books and records of the distributor (see paras. 3.17, 3.23 and 3.24). This requirement help ensure the accuracy of the film revenues reported by the distributors.

5.16 Audit examined the distribution agreements of the 10 film-production projects and noted that in all the projects, the distribution agreements did not contain the right to audit the books and records of distributors. In response to Audit's enquiry, the FSO said that, as advised by the Department of Justice, since it was not feasible to require all distributors to sign the collection account management agreement, the sales agents should take up the duty to audit the books and records of distributors. As such, in consultation with the Department of Justice, the FSO had revised the collection account management agreement. Under the revised agreement, the sales agents are responsible for auditing the books and records of distributors. Nevertheless, Audit noted that the relevant clause in the production finance agreement had not been revised accordingly.

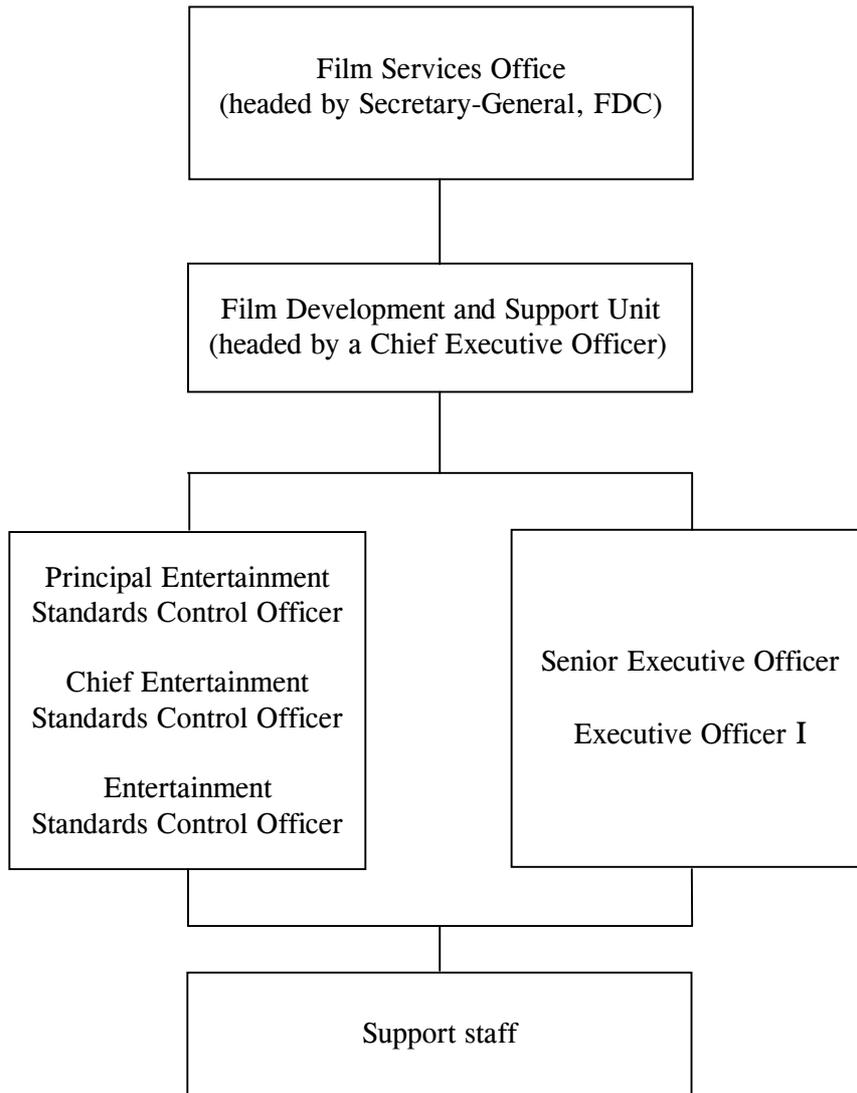
Audit recommendation

5.17 **Audit has *recommended* that the Head of Create Hong Kong should, in consultation with the Department of Justice, review and revise the terms of the production finance agreement pertaining to the rights to audit the books and records of distributors.**

Response from the Administration

5.18 The Head of Create Hong Kong agrees with the audit recommendation.

**Film Services Office
Organisation chart (extract)
(30 June 2012)**



Source: FSO records

Late submission of documents by film production companies and project organisers

Document	Submission requirement	Audit sample	Audit finding
Distribution agreements (Note 1)	Should be submitted: (a) within three months after the date of production finance agreement (for projects approved before August 2011); or (b) before the completion date of the “final cut” (i.e. the last editing) of the film (for projects approved in or after August 2011)	 (a) 8 film-production projects approved before August 2011; and (b) 2 film-production projects approved in or after August 2011	 (a) In 6 of the 8 (75%) projects, the distribution agreements were submitted late. Delay range: 1 to 15 months (Average: 9 months) (b) In the 2 projects, the distribution agreements were submitted late. Delay range: 2 to 5 months (Average: 4 months)
Cost/progress reports	Should be submitted: (a) on a fortnightly basis during pre-production, principal photography and post-production, and thereafter on a monthly basis until the submission of the audited account (for projects approved before August 2011); or (b) on a monthly basis (for projects approved in or after August 2011)	 (a) 8 film-production projects approved before August 2011; and (b) 2 film-production projects approved in or after August 2011	Up to 30 June 2012: (a) for the 8 projects, a total of 183 cost/progress reports should have been submitted, but only 32 (17%) were submitted; and (b) for the 2 projects, a total of 7 cost/progress reports should have been submitted, but only 2 (29%) were submitted.

Appendix B
(Cont'd)
(para. 5.11 refers)

Document	Submission requirement	Audit sample	Audit finding
Other materials (e.g. final shooting script and publicity materials)	Should be submitted on or before a date specified in the production finance agreement (the delivery date)	10 film-production projects	In 7 of the 10 (70%) projects, the other materials were submitted late. Delay range: 1 to 30 months (Average: 12 months) In 1 project, up to June 2012, not all other materials had been received, though they were due for submission in February 2012.
Final completion reports	Should be submitted within 90 days after project completion	18 film-related projects (Note 2)	In 7 of the 18 (39%) projects, the final completion reports were submitted late. Delay range: 2 to 13 months (Average: 5 months)
Audited accounts	Should be submitted within 90 days after: (a) the delivery date (for film-production projects); or (b) project completion (for film-related projects)	(a) 7 film-production projects (Note 3); and (b) 18 film-related projects (Note 2)	In 12 of the 25 (48%) projects, the audited accounts were submitted late. Delay range: 2 to 12 months (Average: 4 months)

Source: Audit analysis of FSO records

Note 1: The distribution agreements were signed between the sales agents and the distributors (see para. 3.17).

Note 2: Audit selected 20 film-related projects for examination, but 2 of them had not yet been completed at the time of audit.

Note 3: The audited accounts of 3 of the 10 film-production projects were not yet due for submission.

Acronyms and abbreviations

Audit	Audit Commission
FDC	Film Development Council
FDF	Film Development Fund
FGF	Film Guarantee Fund
FSO	Film Services Office
FVC	Fund Vetting Committee
HKIFF	Hong Kong International Film Festival
LegCo	Legislative Council
Permanent Secretary	Permanent Secretary for Commerce and Economic Development (Communications and Technology)
SA&D	Sales agent and distributor