



**OFFICE OF THE
CONTROLLER AND AUDITOR-GENERAL**

Te Mana Arotake

29 July 2003

Our Ref: SB08-0202 C

Mr Rodney Hide MP
Parliament Buildings
WELLINGTON 1

Dear Mr Hide

**INDUSTRY NEW ZEALAND – BUSINESS GROWTH FUND GRANT TO THE
WAREHOUSE**

1. You wrote to the Auditor-General on 6 November 2002 regarding a Business Growth Fund (BGF) grant of \$75,000 made by Industry New Zealand to The Warehouse Limited (The Warehouse).
2. You were concerned that The Warehouse does not meet the eligibility criteria for BGF funding, specifically in relation to the size and the growth potential of the recipient of the grant.
3. We apologise for not being able to respond to your concerns earlier, but as you will see from our response, the issues raised by your letter were complex and needed considerable time to work through.
4. We have discussed the grant with Industry New Zealand (INZ) and more recently with New Zealand Trade and Enterprise (NZTE) – the Crown entity formed from 1 July 2003 from the merger of INZ and Trade New Zealand. We set out our findings and conclusions from our review of the grant as well as NZTE's response to the issues we have identified.

Summary

5. We found that The Warehouse was not a direct beneficiary of the BGF grant. The beneficiaries were the ten suppliers of The Warehouse. None of the ten supplier companies are part of The Warehouse group of companies.
6. However, we found that the grant did not meet the size or growth criteria set out by Cabinet for the BGF in Cabinet Economic Development Committee minute (DEV (00) M21/1 dated 13 September 2000). The reasons for our view are explained in paragraphs 22 to 46 of this letter.

7. We have advised NZTE that this represents a breach of the output (contractual) agreement between the Minister for Industry and Regional Development and INZ. We recommended that NZTE take the necessary action to remedy this breach.
8. NZTE has informed us that it has decided to cancel the grant. The Warehouse will repay to NZTE the amount of \$21,090.42 already paid out to the supplier companies under the grant. The contract between The Warehouse and INZ will be dissolved.
9. As part of our review, we identified two areas where BGF processes could be improved. NZTE has also recognized that our review has identified that some aspects of its processes to ensure Cabinet criteria are effectively operationalised could be improved. NZTE is taking the steps necessary to improve its processes. We note that the BGF has now been replaced by the Growth Services Fund, as part of the integration process to form NZTE. However, most of the eligibility criteria, including the size and growth criteria that applied to the BGF, will continue to apply to the Growth Services Fund. The areas for improvement and the steps being taken by NZTE to effect these improvements is discussed further in paragraphs 49 to 56 of this letter.
10. NZTE has examined the extent to which the size and growth eligibility issues raised by The Warehouse grant apply to other BGF grants. It has determined that these issues impact primarily on grants to groups of companies. NZTE has identified that four BGF grants have been made to groups of companies since the scheme's inception. NZTE has reviewed the application of the size and growth eligibility criteria to these grants and advised us that while three of the grants meet the criteria, one does not. Steps are being taken to cancel this grant.
11. We are satisfied that NZTE has responded appropriately and in a pro-active manner to the issues raised by our review of the BGF grant to The Warehouse.

Background

12. INZ approved a BGF grant of up to \$75,000 to The Warehouse (the grant) in May 2002.
13. The Warehouse was to act as an umbrella organisation for a group of its suppliers in relation to this grant. The funding was to be used for an Enviro-Mark project. The project aimed to enable a group of suppliers of The Warehouse to achieve the Enviro-Mark certification for eco-efficiency. Enviro-Mark is an international qualification that has been customised for New Zealand use by the Crown Research Institute, Landcare Research. The suppliers were to be small to medium size enterprises. Ten supplier companies were signed up for the project in April 2003. None of the ten supplier companies are part of The Warehouse group of companies.
14. The grant money was to be used to fund 50% of the costs of the project. Costs arise from the workshops to be held for participating companies, consultancy support, and certification audits etc. Each company was to receive approximately \$6,000, which would then be matched with their own dollar for dollar contribution to the cost of the

project. The Warehouse was to act as sponsor and manager of the programme, assisted by Landcare Research.

15. The payment of the grant was to be on a reimbursement basis, that is, when the services had been delivered.

The Business Growth Fund

16. INZ provided a BGF scheme to help businesses implement strategies for business growth. The funding available under the scheme is primarily for non-capital costs necessary to enable companies to achieve significant growth. The aim is to identify a package of measures that will ensure that the firm's capacity is enhanced to meet designated growth targets. Grants are made on a dollar for dollar basis. They cover 50% of the total cost of the project up to a maximum of \$100,000 (including GST). The applicant covers the remaining 50%.
17. The documents that are central to the issues about eligibility to receive BGF funding are:
 - ◆ the Cabinet Economic Development Committee minute (DEV (00) M21/1 dated 13 September 2000) approving the BGF scheme, and the accompanying Cabinet paper; and
 - ◆ the evaluation criteria used for the BGF scheme, which were approved by the Evaluation and Risk Committee of the Board of INZ on 23 February 2001.
18. The Cabinet minute approving the BGF scheme sets out Cabinet's agreement to the objectives, principles, eligibility criteria, and other details of the scheme. The minute also noted that INZ would develop the precise details of the administration and management of the scheme and would set evaluation criteria in consultation with the relevant departments.
19. Under the output agreement between the Minister for Industry and Regional Development and INZ, INZ is required to ensure that all *access criteria and delivery processes for the programmes defined by Cabinet are followed by Industry New Zealand and any other contracted service provider*. This gives effect to the requirements of the Cabinet minute.
20. INZ developed evaluation criteria for BGF grants as the Cabinet minute noted it would. INZ provided us with documentation relating to these criteria, as follows:
 - ◆ A presentation prepared for the Board of INZ in November 2000. This presentation sets out the key recommendations relating to the criteria that were to be used in implementing the scheme. The Board however delegated approval of the evaluation criteria for the BGF scheme to the Evaluation and Risk Committee on 23 February 2001.

- ◆ A paper presented to the Evaluation and Risk Committee (the Committee) that provides more detailed guidance on the BGF scheme. The Committee approved this paper on 23 February 2001 as being the evaluation criteria for the BGF.
- ◆ The brochures and the promotional material produced by INZ on the BGF, which were also on INZ's website.

21. The evaluation criteria used for the BGF scheme were consistent with the matters specified in the Cabinet minute with one exception (which we discuss in paragraphs 27 to 30), but provide more detail of the criteria that INZ used in some areas, such as project impact.

The Eligibility Criteria for the Business Growth Fund

22. The Cabinet Committee minute notes the following eligibility criteria for the BGF.

i Businesses or groups of businesses must:

A be operating in a commercial environment, resident in New Zealand and registered for GST purposes;

B be financially viable and have a sound track record;

C have clear growth potential and a demonstrated commitment to growth;

D show why they need this funding rather than any alternative funding;

E demonstrate how the funding will add value to existing activities;

F demonstrate a commitment to retain the value of the proposal in New Zealand;

G have proposal and business concepts that are consistent with laws and regulations;

ii indicatively, individual businesses will have less than or equal to 100 full time equivalent employees and/or annual turnover of less than or equal to \$NZ 50 million.

23. A point to note is that, while the size criterion is indicative only, the other eligibility criteria are mandatory. By this, we understand that Cabinet intended there to be some flexibility in the criteria INZ could use in respect of business size.

The Size Criteria

24. It is clear from all the documentation we reviewed that the BGF targets small to medium sized businesses.

25. The BGF brochure states *eligible businesses will have sales of less than \$50 million or no more than 100 full time equivalent staff, and not be a subsidiary of a larger firm.*
26. The BGF promotional material also notes that the INZ criteria are indicative only and there is some flexibility in applying the criteria. For example, firms which have a slightly higher turnover or staff numbers but which would generally be considered medium sized are eligible, as are businesses with sales greater than \$50 million but less than 100 employees.
27. Furthermore, the promotional material also states that if the application is from a network of companies, then at least one of them must meet the eligibility criteria in terms of size, and all must meet the other criteria. This was relevant for The Warehouse grant. However, we note that this network aspect of the criteria is not referred to in the evaluation criteria approved by the Evaluation and Risk Committee. INZ advised us that INZ management subsequently agreed to this additional guidance in relation to the size criterion because of what was considered to be ambiguity about the extent to which each participating company within a group has to meet the eligibility criteria. Management approval for this additional guideline was only given verbally.
28. The network aspect of the size criteria would appear to be inconsistent with the Cabinet minute. Cabinet agreed that:
 - ◆ groups of businesses are eligible for BGF funding; and
 - ◆ indicatively, individual businesses will have less than or equal to 100 full time equivalent employees and/or annual turnover of less than or equal to NZ\$50 million.
29. We interpret the Cabinet minute as requiring all individual businesses, even if they form part of a group, to meet the indicative size criteria. In other words, all individual businesses, even if they form part of a group, should be small to medium sized entities. In our view, the Cabinet minute provides an indication of small to medium business size, but does not give INZ the flexibility to decide that only one business within a group needs to meet the size criteria to qualify for BGF funding.
30. Therefore, in our view, the network aspect of the criteria is inconsistent with the Cabinet minute. This has implications for The Warehouse grant as discussed below.

Does The Warehouse grant meet the size criteria?

31. The Warehouse is clearly not a medium size business with a turnover less than \$50 million or fewer than 100 staff. However, we note that The Warehouse was not a direct beneficiary of the BGF funding. The beneficiaries were the group of supplier companies who were to use the BGF funding to achieve Enviro-Mark certification. We also note that INZ approved the grant on the basis of the network aspect of the size criteria discussed above.

32. We reviewed the size of the supplier companies. Under the INZ guidelines, a subsidiary company inherits the eligibility of the parent company. In other words, a large company quite rightly cannot use a smaller subsidiary company to access the BGF funding. Eight of the ten companies met the indicative size criteria of the BGF. The remaining two companies did not. One company is a subsidiary of a larger company, that does not meet the criteria. The other company does not meet the criteria itself and is also a subsidiary of a large company that also does not meet the criteria.
33. In our view, The Warehouse grant does not meet the size criteria of the BGF. This is because, in our view, the network aspect of the size criteria used by INZ in approving the grant is not consistent with the Cabinet minute. Therefore, this represents a breach of the output (contractual) agreement between the Minister and INZ.

The Growth Criteria

34. One of the eligibility criteria for the BGF as stated in the Cabinet minute is that the business(es) must *have clear growth potential and a demonstrated commitment to growth*.
35. The Cabinet paper on the BGF scheme says that the *intended target for the grants is businesses and groups of businesses that have a real potential to develop and grow beyond their current level of operation*. It also states that the scheme is focused on small to medium established businesses that *are entering a significant growth phase*.
36. The Cabinet paper does not specify any growth targets. However, the Committee agreed that INZ should assist companies that can achieve either or both of the following:
- ◆ create not less than 20 (FTE) jobs over the three years following receipt of funding, or not less than 50 over five years; or
 - ◆ sales growth of at least \$5 million in aggregate or 20% per annum over the five years following receipt of funding, whichever is the greater.
37. The BGF guidance approved by the Committee provides examples of the types of assistance available and states:
- The overriding criterion is that the fund is not intended to assist with “business as usual”. It is intended to assist with new initiatives and new directions aimed at having a significant impact on the business and leading to substantial growth.*
38. Therefore, it is clear from all the documentation that we have reviewed that the focus of the BGF scheme is clearly on business growth. Grant recipients are expected to deliver growth targets agreed with INZ. Targets are flexible but are generally expected to be within the parameters set in the guidelines.

Does The Warehouse grant meet the growth criteria?

39. The grant for the Enviro-Mark project does not target an increase in sales or employment. In the section of the financial support agreement (the contract) where the targeted growth in the recipient's business over the next five financial years is to be stated, the contract states:

Enviro-Mark data indicates that the project may be expected to deliver cost savings of 1% of annual turnover to participant companies through improved business processes and eco-efficiency. This enhanced competitiveness may enable the companies to maintain or generate sales that would otherwise be lost to lower cost offshore competitors (i.e import substitution).

40. The project proposal states, in the section on planned results:

If the project saves 1% of current sales from going off-shore (or increases sales by about the same amount) then the economic targets will have been achieved. While this calculation is the reverse of the conventional BGF targets, it is a realistic approach to the import replacement side of Industry New Zealand's 'balance of trade' objective. However, the target is almost completely immeasurable.

41. We discussed the project in considerable detail with INZ staff. They advised us that INZ was satisfied that the commitment from supplier companies to undertake the Enviro-Mark certification programme constituted a strategy for business growth and clearly demonstrates a commitment to growth because the proposal would:

- ◆ show that the supplier companies were committed to innovative and sustainable business practices;
- ◆ deliver tangible economic benefits to New Zealand in terms of import substitution;
- ◆ make the supplier companies more internationally cost competitive leading to export growth opportunities;
- ◆ open up further opportunities by qualifying the companies to supply major offshore companies who apply certification criteria;
- ◆ free up capital through identified cost savings for reinvestment in research and development of new products or new market development for existing products;
- ◆ deliver long-term environmental benefits leading to sustainable business and consequential employment preservation and growth opportunities;
- ◆ through identified cost savings, deliver bottom line enhancements equivalent to revenue growth in the order of \$7 million;

- ◆ provide an opportunity for the supplier group to informally discuss and review a broader range of management practices leading to enhanced management capability across the group and possible future joint initiatives (e.g. international marketing).
42. They also pointed out that INZ is allowed some flexibility in the application of the funding. The Cabinet Minute states that the BGF *funding will be flexible and will be applied to a range of areas of need and added value which will be identified through appraisals*. In approving this grant, we were told INZ utilised the flexibility they are allowed in the application of the funding.
 43. We accept that a measure of flexibility is permitted by the Cabinet minute. However, in our view that does not entitle INZ to make grants that are inconsistent with the mandatory eligibility criteria for the scheme.
 44. We also accept that INZ made a considered decision, as outlined in paragraph 41, to approve The Warehouse grant. But in our view, the grant does not meet the BGF eligibility criteria that applicants must have *clear growth potential* and *a demonstrated commitment to growth*. We explain the basis for our views.
 - ◆ The participating companies did not agree to specific growth targets, as per the requirements in the INZ evaluation criteria. We accept that INZ has some flexibility in setting the actual targets but that flexibility does not extend to having no agreed growth targets. By not having any growth targets, we believe the participating companies did not show clear growth potential and a demonstrated commitment to growth.
 - ◆ The participating companies only agreed to achieve Enviro-Mark certification. Cost savings were expected, but not certain, to result from the project. However, cost savings are not a growth statistic and may not, per se, generate growth. Cost savings undoubtedly present an opportunity to reinvest for growth but the participating companies had not committed to reinvest any cost savings for growth.
 45. This means that INZ are in breach of the output (contractual) agreement between the Minister and INZ.
 46. We recommended that NZTE take the necessary action to remedy the breach.

Remedying the Breach

47. NZTE has informed us that it has cancelled the grant to the suppliers of The Warehouse. The contract with The Warehouse is to be dissolved. The Warehouse will repay NZTE the sum of \$21,090.42 that has already been paid out under the contract.
48. We are satisfied that these actions will remedy the breach of the output agreement.

Improvements to Processes

49. NZTE acknowledges that the issues we have raised in relation to The Warehouse grant has shown that some aspects of operational policy in relation to the BGF could be improved to ensure Cabinet criteria are effectively operationalised.
50. The Growth Services Fund has now replaced the BGF, following the establishment of NZTE. Most of the eligibility criteria of the BGF will continue to apply to the Growth Services Fund, including the size and growth criteria. NZTE has designed a new eligibility criteria checklist and guidance relating to the criteria, in consultation with the Ministry of Economic Development to ensure the criteria are correctly applied in future. The operating guidelines will also be reviewed and amended and staff are to be made aware of how the criteria should be applied.
51. During our review of The Warehouse grant, we also identified two further matters about the BGF processes as follows.

Grant approval procedures

52. The list of suppliers who were to receive BGF funding was not final at the time The Warehouse grant was approved (in May 2002) and even subsequently, when the contract with The Warehouse was signed (in August 2002). This list was only finalised in April 2003. Under the contract, payment of the grant was not conditional on the final list of suppliers meeting the eligibility criteria of the BGF.
53. We recommended that NZTE review its grant approval procedures to ensure that the grant funding is not approved until it is satisfied that all the eligibility criteria have been met. Where appropriate, NZTE should make payment of the grant conditional on meeting the criteria.
54. NZTE agrees with our recommendation and this point will be included in NZTE's operating guidelines. Key staff involved in the approval process and contract administration have also been alerted to this issue.

Contracts for groups of businesses

55. The contract for the BGF grant to the suppliers of The Warehouse is between INZ and The Warehouse. The contract names The Warehouse, rather than the supplier companies who are the actual beneficiaries of the funding, as the recipient of funding. Therefore, the supplier companies are not contractually committed in any way.
56. NZTE has recognised that the standard agreement is not appropriate in circumstances where it is making grants to groups of companies using a lead company as the channel for distribution of the grant monies. The contract template is being amended to highlight issues that need to be addressed in cases where groups of companies are being funded.

57. We would be pleased to discuss any aspect of this letter further with you, if you wish.

Yours sincerely

A handwritten signature in black ink, appearing to read 'Wendy Venter'. The signature is stylized with a large, sweeping flourish that extends upwards and to the right, crossing over the name.

Wendy Venter
Sector Manager