Chapter

5

Industry Canada

Management of the Canada Small Business Financing Program

The audit work reported in this chapter was conducted in accordance with the legislative mandate, policies, and practices of the Office of the Auditor General of Canada. These policies and practices embrace the standards recommended by the Canadian Institute of Chartered Accountants.

Table of Contents

Key Message 1

Introduction 3

Events since our audit of 1997 3
The program today 3
Focus of the follow-up 6

Observations and Recommendations 6

Measuring program performance 6

A performance evaluation framework is in place 7
Data collection on the Program's performance has begun 7
Still a need to define criteria for assessing the Program's success 7

Cost recovery 8

The Department is unlikely to achieve its cost recovery objective 8
Monitoring capacity is improving; forecasting methods need to be enhanced 9

Improving the Program's delivery 10

Tools being developed to monitor compliance with the Act and Regulations 10
The issue of related entities has been clarified 10
The claims-processing procedure is effective 10
The Department has reduced the interest paid to lenders 11

Accountability to Parliament 12

Information provided to Parliament still needs improvement 12

New issue of importance 13

The decrease in the number of loans warrants further study 13

Conclusion 13

About the Follow-Up 15

Industry Canada

Management of the Canada Small Business Financing Program

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Key Message

5.1 Industry Canada has made progress in addressing some of the issues raised in our 1997 Report, as outlined in the table below. We are still concerned about the ability of the Department to achieve its cost recovery objective for this Program. At 31 March 2001, losses on loans guaranteed between 1995 and 1999 amounted to $155 million, and we estimate that they will reach at least $200 million. There are also indications that disbursements on claims will exceed revenues for loans guaranteed after 1999. Industry Canada must develop a better model to forecast the financial performance of the Program. Parliament must also be informed on a timely basis of any anticipated losses.

ORIGINAL ISSUES	PROGRESS	RATING*
Measuring program performance		
5.2 The Department should clearly define the expected results of the Program and obtain relevant information on the Program's results.	The Department developed a program evaluation framework in 1998 and used it to guide its data collection activities. However, it still needs to define criteria for assessing the Program's success, including a target range for incrementality.	LIMITED PROGRESS
5.3 The Department should ensure that the *Small Business Loans Act* eligibility requirements and conditions lead to the results expected for the Program.	Program eligibility criteria and conditions were examined as part of the review of the *Small Business Loans Act* in 1998 and changes were made to Program conditions. The impact of these changes on the Program's expected results, including cost recovery, will need to be carefully assessed.	LIMITED PROGRESS
Cost recovery		
5.4 We expressed uncertainty about whether full cost recovery would be achieved. We concluded that the dual objectives of increasing access to financing while recovering the costs of the Program called for careful analysis. The Department should carefully monitor the performance of the loans portfolio and improve systems and practices for forecasting the future performance of the Program.	The Department considers that it will not meet its cost recovery objective for loans guaranteed between 1995 and 1999. We estimate that disbursements on claims for that period will exceed revenues by at least $200 million. There are also indications that the Department may not meet its cost recovery objective for loans guaranteed after 1999. The Department now has good information on portfolio risks. This provides a basis for monitoring the financial performance of the Program. The Department has yet to adjust its claims forecasting model.	LIMITED PROGRESS

*Possible ratings are: completed, satisfactory progress, limited progress, no progress, rejected, unknown. (See About the Follow-Up for an explanation of the ratings.)

ORIGINAL ISSUES	PROGRESS	RATING*
Improving the Program's delivery		
5.5 The Department should ensure that lenders have exercised due care in making loans and have complied with the Small Business Loans Act and Regulations.	Legislation was amended to reinforce the principle of due diligence by financial institutions and to give the Minister authority to conduct compliance audits. The Department is working on an audit strategy, and it plans to start conducting audits in the fall of 2002.	SATISFACTORY PROGRESS
5.6 The Department should assess the need to limit access to loans by related entities to the maximum amount allowed and, if the need exists, seek amendment to the *Small Business Loans Act*.	The *Canada Small Business Financing Act* clarifies this matter, and the Department now requires the borrower to declare that it has not exceeded the maximum loan limit.	COMPLETED
5.7 The Department should take the necessary measures to reduce the amount of interest paid on claims made by lending institutions.	The Department has introduced two main measures: the interim payment of a claim before the borrower's personal collateral has been collected and the non-payment of interest beyond 24 months following the date of the loan default.	COMPLETED
Accountability to Parliament		
5.8 The Department should ensure that parliamentarians are provided with the necessary information to assess the extent to which the Program is managed efficiently and is achieving its objectives.	The Department has improved information on cost recovery but it provides limited information on the expected financial performance of the Program and efficiency of operations.	LIMITED PROGRESS
5.9 The Department should report information on job creation that reflects actual results attributable to the Program.	The Department has clarified the meaning and indicated some limitations of the information provided on the number of jobs to be created by the Program.	SATISFACTORY PROGRESS

NEW ISSUE
5.10 Since 1998 there has been a significant decrease in the number of loans made through the Program. The Department should continue its efforts to determine the reasons for the drop and how they affect the rationale for the Program and its parameters. It should also investigate the concerns that financial institutions have expressed about the administrative requirements of the Program.

*Possible ratings are: completed, satisfactory progress, limited progress, no progress, rejected, unknown. (See About the Follow-Up for an explanation of the ratings.)

Industry Canada has responded. The Department has generally agreed with our conclusions. Its response, presented at the end of the chapter, elaborates on the action it intends to take to address both the issues we raise in the report and our recommendation.

Introduction

5.11 In Chapter 29 of our December 1997 Report, we reported on Industry Canada's management of the Small Business Loans Program, governed at the time by the *Small Business Loans Act*.

5.12 In that chapter, we said that Industry Canada needed to define more clearly the results it expected the Program to achieve and better measure its performance toward achieving them. We questioned whether the Department could meet its objective of full cost recovery, given the fee structure and loss-sharing ratio then in effect. We emphasized the need to carefully analyze the dual objective of making loans more accessible while recovering the costs of the Program. We stressed that Industry Canada needed tighter controls to ensure that lenders exercised due diligence in granting loans. We said it should take appropriate steps to reduce the amounts it was paying to financial institutions in interest on their claims. Finally, we noted that Parliament needed better performance information on the Program.

Events since our audit of 1997

5.13 In 1998, the Standing Committee on Public Accounts held hearings on our report and made recommendations similar to ours in its own report to Parliament. The House of Commons Standing Committee on Industry and the Standing Senate Committee on Banking, Trade and Commerce each held public hearings on the Program that same year to better understand the financing needs of Canadian small and medium-sized enterprises (SMEs).

5.14 These reviews led to the *Canada Small Business Financing Act*, which came into force on 1 April 1999 and replaced the Small Business Loans Program with the Canada Small Business Financing Program. The new legislation maintains the fundamental objective of the Program and its key parameters (percentage guaranteed by the government, type and size of business, and registration and administrative fees). It also provides for a mandatory comprehensive review of the Program every five years; the next review report must be tabled in Parliament in 2004–05. It reinforces the principle by which financial institutions must show due diligence in managing loans registered under the Program, and it gives the Minister authority to conduct on-site audits to verify their compliance. Exhibit 5.1 provides additional information on the history of the Program. Exhibit 5.2 provides data on the value of loans guaranteed over the past 10 years.

The program today

5.15 The purpose of the Canada Small Business Financing Program is to increase the availability of financing to establish, expand, modernize, and improve small business enterprises. Industry Canada is committed to compensate financial institutions for 85 percent of their eligible losses on loans they have made under the Program. Any business (except for religious, not-for-profit, and farming organizations) with gross annual revenues below $5 million is eligible for financing to a maximum of $250,000. The maximum repayment period for a loan under the Program is 10 years. A lender is allowed to obtain a personal or a corporate guarantee from the borrower, although a personal guarantee cannot exceed 25 percent of the loan amount. Businesses can use the loans to finance real property and buildings, leasehold improvements, or equipment. Exhibits 5.3 and 5.4 show loans guaranteed under the Program in 2000–01, by industry sector and by area of use.

Exhibit 5.1 Program history

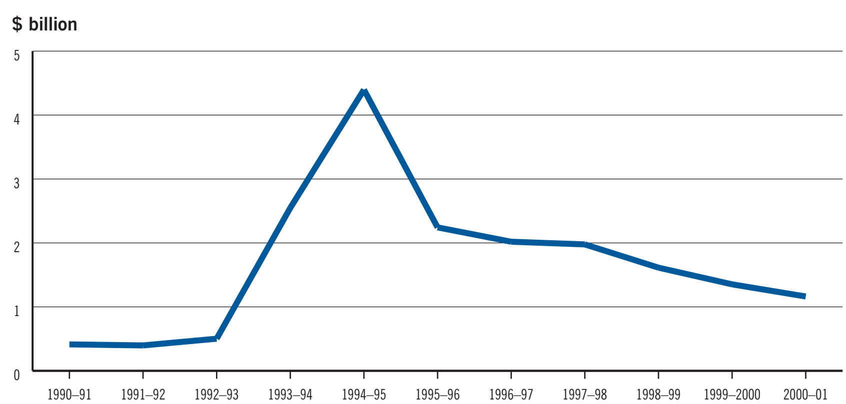
From 1961 until 1993, the Small Business Loans Program was stable and relatively modest. Between 1990 and 1993, the average annual value of loans guaranteed under the Program was $438 million, and the Department paid financial institutions an average of $41 million a year in claims and interest for losses on loans they had made under the Program.

In 1993, a number of changes to the *Small Business Loans Act* broadened the eligibility criteria for the Program by raising from $2 million to $5 million the maximum annual revenue of a business defined as “small business.” Also raised were the maximum loan amount, the portion of a loan that the Department would guarantee, the percentage of a project’s total funding allowable under the Program, and the registration fees.

The result was more loans, for higher amounts. The annual value of loans guaranteed under the Program rose from $502 million in 1992–93 to $2.5 billion in 1993–94 and $4.4 billion in 1994–95. This unprecedented increase created concern about the financial consequences for the government: very likely, it would see a corresponding increase in claims by financial institutions for losses. In fact, by 31 March 2002, loans guaranteed between 1 April 1993 and 31 March 1995 had generated $527 million in claims, which the government paid. We estimate that the actual loss suffered by the government was $388 million after taking into account the registration fees it had received for the same loans.

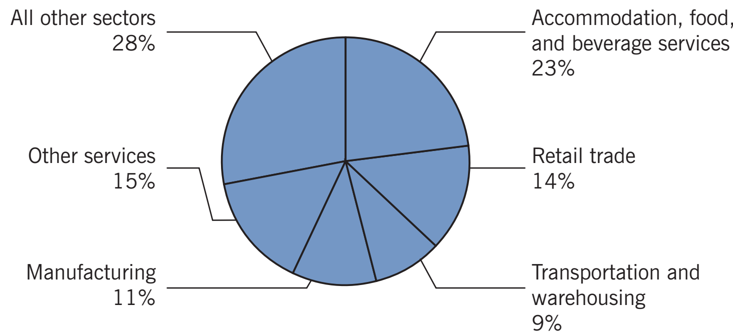
That concern led Parliament in 1995 to tighten certain of the 1993 amendments to the Act that had broadened eligibility for the Program, and the Program’s major parameters have remained the same since then.

Exhibit 5.2 Annual value of loans guaranteed from 1990–91 to 2000–01



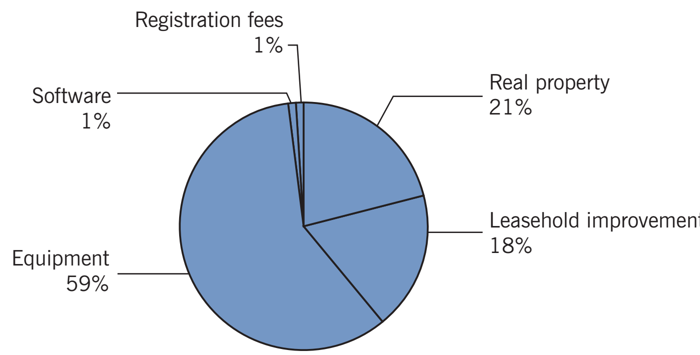
Source: Industry Canada

Exhibit 5.3 Loans guaranteed though the Program to industry sectors in 2000–01



Source: Industry Canada

Exhibit 5.4 Areas of use of loans guaranteed through the Program in 2000–01



Source: Industry Canada

5.16 Industry Canada delivers the Program in partnership with financial institutions. A small business applies to an institution for financing; the institution assesses the application and assumes responsibility for deciding whether or not to grant the loan. If it does, it makes the loan directly to the applicant. It is responsible for all aspects of credit management.

5.17 When a financial institution determines that a loan meets the conditions of the Program, it submits it to the Department for registration as a guaranteed loan with a 2 percent registration fee it has collected from the borrower. An annual administration fee of 1.25 percent based on the average monthly loan balance is also charged and turned over to the Department. Lenders cannot charge more than 3 percent above the prime lending rate on floating-rate loans or more than 3 percent above the residential mortgage rate on fixed-rate loans; the interest charges include the 1.25 percent administration fee. If the borrower defaults, the financial institution must collect the security pledged against the loan before it can submit a claim to Industry Canada.

5.18 The Small Business Loans Administration Directorate of the Department's Operations Sector administers the Program under the provisions of the Act and its Regulations. The Directorate has an annual operating budget of $3 million and a staff of 30 people, most of them assigned to claims processing. The Small Business Policy Branch, part of the Department's Policy Sector, provides strategic direction for the financing of small businesses.

5.19 In 2000–01, more than 14,000 loans with a value of about $1.2 billion were registered under the Program. The average amount of each loan was about $80,000. In the same period, the Department paid out about $171 million in claims for loans guaranteed under the previous and the new legislation.

Focus of the follow-up

5.20 Our follow-up looked at Industry Canada's management of the Canada Small Business Financing Program and its administration of the *Canada Small Business Financing Act* and the *Small Business Loans Act,* which guide the Program. The purpose of our follow-up was to assess Industry Canada's progress in addressing the issues raised in our 1997 audit and to determine whether the Department now has in place the systems and practices to manage the Program efficiently, cost-effectively, and in accordance with legislative authority. Our follow-up scope and criteria are set out in About the Follow-Up at the end of the chapter.

Observations and Recommendations

Measuring program performance

5.21 According to Industry Canada, investment stimulates economic growth and innovation and helps ensure sustainable development; one of the Department's strategic objectives is to promote investment in Canada. It views limited access to capital as a barrier to investment by small and medium-sized enterprises (SMEs).

5.22 The intent of the Canada Small Business Financing Program is to encourage financial institutions to give small businesses greater access to financing for their creation, expansion, modernization, and improvement.

5.23 Our 1997 report recommended that Industry Canada clearly define the results it expected the Program to deliver and obtain relevant information on the results it achieved. We also stressed the need to ensure that the Program's eligibility requirements and conditions foster the achievement of the desired results. After examining our report in 1998, the Standing Committee on Public Accounts recommended that the government clearly define its expectations for the Program's performance, set clear targets for incrementality, establish appropriate indicators of performance, and ensure that the Program met the financing needs of small businesses.

A performance evaluation framework is in place

5.24 In 1998, the Department developed a performance evaluation framework for the Program. This evaluation framework, developed as part of the review of the *Small Business Loans Act*, identifies evaluation issues, performance indicators, data collection requirements, and options for the future evaluation of the Program. Issues to be evaluated are the relevance of increased access to financing for small business and the need for federal involvement; the level of incrementality achieved by the Program; progress toward cost recovery; reliability of claims forecasting; the Program's impact on job creation, maintenance, and displacement; awareness of the Program; and the performance of borrowers.

Data collection on the Program's performance has begun

5.25 In 1998 the Task Force on the Future of the Canadian Financial Services Sector (MacKay Task Force) found that the development of a public policy on the financing of small and medium enterprises (SMEs) was hindered by a lack of data. It recommended that the government make a concerted effort to improve the quality and quantity of information on SME financing. In response, Industry Canada, Statistics Canada, and the Department of Finance Canada launched the SME Financing Data Initiative. The Department has carried out six studies under the initiative to better understand the issue of SME financing and plans to continue studying it over the next few years. The studies provide valuable information on the relevance of the program.

5.26 To measure the effectiveness of the Program, the Department has conducted a survey of businesses to assess the impact on both the job creation and the performance of businesses that had received loans. It also surveyed SMEs to better understand their experience in looking for and obtaining financing and to determine how much they knew about the Program

Still a need to define criteria for assessing the Program's success

5.27 In 1997, we indicated that it was important for the Department to define the level of incrementality it expected the Program to achieve, and adjust the parameters of the Program accordingly; the Standing Committee on Public Accounts made the same recommendations in 1998. (The level of incrementality is the extent to which businesses obtain financing through the Program that otherwise would not be available to them or would be available on less favourable terms.) The evaluation framework developed by the Department still does not specify the rate of incrementality that would represent success. The latest related study by the Department, in 1996, found that 54 percent of the loans guaranteed through the Program could not have been obtained without it.

5.28 The Department is presently reviewing its 1998 evaluation framework to take into account Treasury Board Secretariat's new policy on measurement of results. The review is intended to lead to a new results-based management and accountability framework. According to the Department, the new framework will be in place by the fall of 2002 and will guide the evaluation of the Program in 2004.

Cost recovery

The Department is unlikely to achieve its cost recovery objective

5.29 Under the cost recovery policy adopted in 1995, the Department aims to balance the Program's costs (claims and interest it pays to financial institutions) with its revenues (registration and administration fees). The Program costs in this equation exclude the Department's salary and operating expenses for the Program.

5.30 In 1997, we questioned whether the Department could achieve cost recovery given the fee structure and loss-sharing ratio then in effect. In this follow-up, we reviewed the Department's data and reports on the Program's financial results for loans guaranteed between April 1995 and March 1999 under the *Small Business Loans Act* and between April 1999 and March 2002 under the *Canada Small Business Financing Act*.

5.31 **Financial performance—1995 to 1999.** In its 2000–01 annual report on the Program, the Department stated that it does not expect to meet its cost recovery goal for loans guaranteed between 1 April 1995 and 31 March 1999. It considers that cost recovery can be achieved only if paid claims do not exceed 6.25 percent of the value of guaranteed loans, and it has indicated that claims to be paid on loans guaranteed during that period will amount to 9 percent of the total value of the loans. At the end of March 2001, this represented losses of $155.8 million. We estimate that these losses will exceed $200 million over the life of the loans.

5.32 **Financial performance—1999 to 2002.** When it reviewed the Program in 1998, the Department considered that no changes were needed in the Program's key parameters (percentage guaranteed by the government, size and type of business, and registration and administrative fees structure). It did recommend changes, however, that it believed would allow for a better balance between revenues and expenditures. Among the changes were an obligation for lenders to exercise the same diligence as they do with their conventional loans; the possibility for the Department to conduct on-site audits of lenders' files; new provisions to prevent loan splitting; interim payment of claims to reduce interest costs; and a broadening of the rules on security pledged against loans made under the Program. These recommended changes were incorporated in the revised legislation.

5.33 A study conducted for the Department in November 2001 on payment defaults and claims for loans registered from 1995 to 1998 identified the sectors with the highest loss rates. The rate for the accommodation, food, and beverage industry was 11.6 percent, for leasehold improvements 9.7 percent, and for franchising 9.6 percent. The study also showed that loans of $100,000 or more also carried a higher loss rate, at 14.4 percent.

5.34 Our review of the distribution of loans guaranteed since 1999 shows that with one exception, the same sectors represent an increasing share of the portfolio, suggesting that the overall level of risk is increasing as well:

- The proportion of total loan value that went to the accommodation, food, and beverage industry increased from 13.1 percent to 22.7 percent.
- The proportion of total loan value that went to the leasehold improvements sector increased from 14.2 percent to 17.5 percent.
- Loans of $100,000 or more increased from 21.6 percent to 27.8 percent of the total number of loans.

The exception is the franchising sector, whose share of the total loan value has decreased from 12 percent to 11 percent over the same period.

5.35 Our analysis of claims paid to date on loans guaranteed in 1999–2000 suggests that there is no downward trend in the loss rate. Claims paid on loans registered in 1999–2000 amount to 3 percent of the value of the loans. This three-year loss rate is similar to three-year loss rates observed since 1995–96. We believe it is unlikely that the rate of claims paid will decline enough to allow for cost recovery. The Department is still faced with the difficult objective of achieving cost recovery while maintaining an acceptable rate of incrementality.

Monitoring capacity is improving; forecasting methods need to be enhanced

5.36 In 1997, we recommended that to improve its chances of meeting its cost recovery objective, Industry Canada monitor changes in the performance of its loan portfolio more closely and consider any new economic factors that could prevent cost recovery. We also recommended that it enhance the systems and practices it used in forecasting how well the Program would perform. We believed that the Department needed to analyze its loan guarantee portfolio regularly for risks inherent in characteristics such as industry sector, type of loan, region, and age of the business.

5.37 The November 2001 study of payment defaults and claims for loans registered from 1995 to 1998 allowed the Department to understand better the factors contributing to increased risk in its loan portfolio and to determine the actual financial performance of these loans. The Department had last carried out such a study in March 1997. This provides a basis for future regular monitoring of the Program's financial performance. Also, the Department's annual report on the Program now includes the level of claims paid, by industry sector; and the net cost of the program, by year in which the loans were made.

5.38 The Department has had a model to forecast the financial performance of the loan portfolio since 1994; responding to our 1997 recommendation, it said it would revise the model. In this follow-up, we observed that the Department has not made the changes that would allow its forecasting model to better reflect factors that could impact the level of claims. We still believe that a better forecasting model would give the Department an effective tool to ensure prudent management of public funds and inform Parliament of anticipated shortfalls.

Improving the Program's delivery

Tools being developed to monitor compliance with the Act and Regulations

5.39 In 1997 we examined files of financial institutions on loans made under the *Small Business Loans Act,* and we observed that they did not always contain evidence that the Program rules had been followed. We stressed that the Department needed mechanisms to ensure that financial institutions were exercising due care when they issued loans.

5.40 The changes made to the legislation in 1999 reinforce the principle that financial institutions must exercise due diligence in making and administering loans under the Program. The Regulations now require that lenders apply the same procedures to these loans as they would to their conventional loans.

5.41 The new Act also gives the Minister the authority to audit for compliance with the Act and Regulations, including the due diligence and documentation requirements. The Department is finalizing an audit strategy for on-site review of practices used by financial institutions. It has not yet started conducting audits; it has informed us that it will begin in the fall of 2002.

The issue of related entities has been clarified

5.42 We noted in 1997 a number of separate corporations with substantially common ownership had obtained among them more than $250,000 in loans to operate the same business. We said that situations like this increased credit risk and could cause higher losses in the loan portfolio. We also pointed out that the Act contained no provisions to prevent a group of related entities from obtaining loans that totalled more than the maximum allowed by the Program. We recommended that Industry Canada tighten its controls and examine the possibility of limiting to $250,000 the maximum guaranteed loans to related entities.

5.43 The 1999 Act and Regulations define related borrowers more precisely and limit to $250,000 the financing to which related entities can have access. Furthermore, the Department now asks borrowers to declare on the loan registration form that they are not exceeding the allowable limit on financing. Also, the action plan for compliance audits of financial institutions includes audit procedures aimed at loans between persons with a non-arm's-length relationship.

The claims-processing procedure is effective

5.44 The Department processed 3,748 claims in 2001–02. The average time it took to process a claim was 35 days from the receipt of all required information; over the last five years, this has fluctuated between 28 and 45 days. These data reflect claims related to loans guaranteed under both the *Small Business Loans Act* and the *Canada Small Business Financing Act*.

5.45 The Small Business Loans Administration Directorate uses a number of tools to ensure that staff assigned to claims processing follow uniform practices. It developed a procedures guide; and it documented its policies on the interpretation of the Act and Regulations and its decisions on new issues in claims processing. It has also adopted an appeal mechanism to review decisions that lenders dispute. We noted that staff assigned to claims processing have the needed experience and expertise to process claims.

5.46 The claims-processing procedure includes a number of steps; the most important is analyzing the information that the financial institution provided to justify the amount of its claim. In this step, the Department verifies whether the loan met the conditions of the Program (size of the business, activity, type of asset financed, interest rate, and terms of the loan) and whether the financial institution collected the collateral that secured the loan before submitting its claim.

5.47 Our examination of a sample of claims processed in 2001–02 showed that the Department uses a valid procedure to ensure that claims are properly justified.

The Department has reduced the interest paid to lenders

5.48 A lender has up to three years to claim its losses on a defaulted loan. During that time, it must take all possible measures to collect on the loan before submitting a claim. The claim is to include the eligible proportion of the unpaid principal as well as interest on that amount. The $144 million in claims paid in 2001–02 included interest of $24 million and, on average, lenders submitted their claims 19 months after the borrower had defaulted on the loan. These data reflect claims related to loans made under both the *Small Business Loans Act* and the *Canada Small Business Financing Act*.

5.49 In 1997 we recommended that the Department take appropriate steps to reduce the total amount it was paying in interest on claims submitted by financial institutions.

5.50 The Regulations to the 1999 Act introduced a provision allowing a lender to submit an interim claim before having collected a borrower's personal collateral, but after collecting on all other guarantees. In 2001–02, interim claims represented 23 percent of settled claims.

5.51 The Regulations to the 1999 Act also shortened the period for which the government will pay interest to the lender. While lenders still have three years after a default to submit their claims, the Department no longer pays interest to the lender on that whole period. As it did before 1999, it pays for the first year a rate of interest equal to the rate at which the loan was issued, and for the second year it pays half that rate. As of 1999, however, it pays no interest for the third year. We estimate that in 2001–02 this measure contributed to a reduction of $800,000 in interest paid.

5.52 Whether financial institutions can collect on loan security and submit their claims sooner depends on general economic trends as well as conditions in the local real estate and property trade-in markets. The realization of secured assets takes time, but it is essential; in 2001–02 the net amount realized in relation to claims settled in that year was $46 million. Current rules governing interest payments aim to strike a balance between the amount of interest paid and the due diligence exercised by financial institutions in realizing secured assets.

Accountability to Parliament

Information provided to Parliament still needs improvement

5.53 We noted in 1997 that Parliament was receiving mainly operational information on the Program and not the kind of information needed to assess its performance. The Department was providing no information on the extent to which it had achieved its cost recovery and incrementality objectives. We also questioned the reliability of its information on the job creation impact of the Program.

5.54 In this follow-up, we reviewed the Department's annual reports on the Program for the last five years. We noted that they now include better information on the achievement of the cost recovery objective. The Department has also clarified the meaning of the data it provides on the number of jobs created by the Program and has indicated some of the data limitations. We also saw more information on Program activities.

5.55 **Cost recovery.** The annual report presents financial information on revenues and on claims expenditures. However, it provides no information on the Program's expected financial performance. For example, the Department states that it will not achieve its cost recovery goal for loans guaranteed between 1995 and 1999. It gives no specific indication of the possibility of recovering its costs for loans guaranteed from 1999 on, because it believes it does not have enough data on claims for this period.

5.56 **Job creation.** The Department now provides information on the expected number of jobs to be created, by industry sector and by business size. The information is presented with the caveat that it comes from borrowers' projections of the number of jobs they expect to create. In 2002, Industry Canada commissioned a survey of firms that had obtained loans under the Program between January and July 2000. It asked them to confirm how many jobs they had created; most confirmed their initial estimates. The Department plans to repeat the survey at regular intervals.

5.57 The Department still does not indicate clearly all the limitations of its data on job creation. The information does not account explicitly for potential job displacement due to the creation of a new business or the modernization of an existing business, or for the fact that a number of businesses that receive funding under the Program also obtain funding from other sources.

5.58 **Efficiency.** The annual report contains little information on the administrative efficiency of the Program's operations. For example, it does not provide data on the cost and the length of time required to process a claim, the number of claims denied, and the number of appeals on rejected claims and their results.

5.59 The Department has informed us that it remains committed to improving the information it provides to Parliament in its annual report, particularly on the expected financial performance of the Program.

New issue of importance

The decrease in the number of loans warrants further study

5.60 The number of loans made through the Program has dropped significantly since 1998. To understand the reasons, the Department commissioned a study in the form of a survey of financial institutions; the study report was released in January 2002. The financial institutions see as the major reason for the decline the amount of administrative work involved in processing the loans and the Department's growing tendency to deny claims. During our follow-up, we met with representatives of major financial institutions to obtain their views on the administration of the Program and to understand how they deliver it. They reiterated to us their concern about the administrative burden of the Program.

5.61 Other reasons mentioned in the study were the lack of profit on these loans, a greater choice of financing options for borrowers, the possibilities for borrowers to get loans with better conditions, an increase in financing through internal means, and competition among lending institutions. The Department has not yet validated the conclusions of this study.

5.62 The study provided the Department with interesting leads to explain the decline in loans under the Program. However, its scope and methodological limitations affected the depth of analysis and the reliability of conclusions.

5.63 **Recommendation.** Industry Canada should

- thoroughly examine the reasons for the decline in the number of loans and assess their impact on the rationale and the design of the Program, and
- investigate the concerns of financial institutions about the administrative requirements of the Program.

Industry Canada's response. The Department has responded to the chapter overall; its response follows the Conclusion.

Conclusion

5.64 Industry Canada spent considerable time and effort in 1998 to review the *Small Business Loans Act*. The Act was subsequently replaced in 1999 by the *Canada Small Business Financing Act*. Some of the issues we had raised in our 1997 Report were addressed directly in the new Act with the inclusion of the due diligence principle in the legislation, clarification of the concept of related entities, and inclusion of measures to reduce interest paid on claims submitted by lenders.

5.65 The Department has taken measures to improve the management of the Program. It developed an evaluation framework and has begun to collect data to measure the Program's performance. It has yet to define criteria for assessing the Program's success. We are still concerned about the Department's ability to achieve the cost recovery objective of the Program. It has improved its capacity to monitor the Program's financial performance but has yet to enhance its claims forecasting model.

5.66 The Department has also made progress in its accountability to Parliament. It now provides information on the Program's revenues and expenditures but not on its expected financial performance. The Department provides little information on the limitations of its job creation data and the efficiency of its operations.

5.67 The decline in the number of loans under the Program is a new issue the Department needs to monitor. It needs to understand the reasons for this drop and the impact on the rationale and design of the Program.

Industry Canada's response and comments. As recognized by the Auditor General in the chapter's conclusion, Industry Canada has made considerable progress with respect to issues raised in the Auditor General's 1997 Report. In addition, the Department expects that further progress will be achieved in the fall of 2002 with the implementation of its audit plan and a new results-based management and accountability framework, which will further define performance indicators for the Program.

Industry Canada acknowledges that continuous monitoring of the Program is essential to achieving its objectives of incrementality and cost recovery. Concerning cost recovery, Industry Canada forecast in its 2000–01 Annual Report that over the life of the loans made in 1995 to 1999, disbursements on claims will exceed revenues received. The development of an improved forecasting model is a high priority and has been since the introduction of the new Act. Having collected program data for three years, consistent with the new Act, Industry Canada is now positioned to adjust its forecasting model. In addition, Industry Canada will be reviewing these data to determine whether to recommend any changes to the Program to meet the cost recovery objective.

Finally, Industry Canada will, as recommended, continue to carefully monitor changes in the level of use of the Program. The administrative requirements will also be monitored in order to achieve the appropriate balance between the informational and regulatory requirements necessary to meet our performance measurement and other commitments on the one hand, and the burden on lenders and borrowers in responding to these conditions on the other.

About the Follow-Up

Objective

The overall objective of the follow-up audit was to assess the progress made by Industry Canada in addressing the issues raised in our December 1997 Report. We wanted to determine whether the Department now has the systems and practices in its Program to manage it efficiently, cost-effectively, and in compliance with legislative authorities.

Scope

The follow-up covered Industry Canada's management of the Canada Small Business Financing Program and its administration of the *Small Business Loans Act* and *Canada Small Business Financing Act,* which govern the Program. (The follow-up excluded the capital leasing pilot project launched by the Department in April 2002 to make capital leasing more accessible to SMEs.) We examined the responsibilities and activities of Industry Canada, in particular the Small Business Loans Administration directorate and the Small Business Policy Branch, and those of lenders.

Criteria

Our examination was based on the following criteria:

- The objectives and the expected results of the program related to small business loan guarantees should be clearly stated.
- The Department should have management practices and controls that would ensure that small business loan guarantees are processed efficiently and cost-effectively, that the risks of the program are minimized, and that the objectives of the program are achieved.
- Parliament should be provided with relevant, reliable, and understandable information on the economy, efficiency, and effectiveness of the program.

Approach

We interviewed Industry Canada employees and representatives of financial institutions. We reviewed the studies and reports produced by and for Industry Canada and examined the Department's systems and practices. We also conducted analyses based on the Department's data.

Ratings

We assessed the action of departments/agencies against our original audit recommendations (see Key Message at the beginning of the Chapter). We used the following ratings:

- **Completed.** Corrective action has been fully implemented.
- **Satisfactory progress.** Progress is being made at a satisfactory pace.
- **Limited progress.** Some progress is being made, but the pace or scope is not satisfactory.
- **No progress.** No evidence of progress although the department or agency accepted the recommendation from the original audit.
- **Rejected.** The department or agency did not accept the recommendation from the original audit.
- **Unknown.** Status of progress is unknown or information is not available.

Audit team

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