



Agriculture and
Agri-Food Canada

Agriculture et
Agroalimentaire Canada



Audit of the Hog Industry Loan Loss Reserve Program

Office of Audit and Evaluation

Final Report

June 24, 2010

Canada

The AAFC Audit Committee recommended this audit report for approval by the Deputy Minister, on June 24, 2010.

To obtain more information on the Office of Audit and Evaluation, please visit:

http://www.agr.gc.ca/aud_eval

Permission to reproduce.

Select and insert appropriate permission to reproduce notice.

© Her Majesty the Queen in Right of Canada, 2010

Cat. No. A22-523/2010E-PDF

ISBN 978-1-100-17185-2

AAFC No. 11167E

Aussi offert en français sous le titre : *Vérification du Programme de réserve pour pertes
sur prêts dans l'industrie du porc*

TABLE OF CONTENTS

| | |
|--|----|
| TABLE OF CONTENTS | I |
| EXECUTIVE SUMMARY..... | II |
| 1.0 INTRODUCTION | 1 |
| 1.1 Background..... | 1 |
| 1.2 Audit Objective..... | 2 |
| 1.3 Audit Scope | 2 |
| 1.4 Audit Approach | 3 |
| 1.5 Conclusion | 4 |
| 1.6 Statement of Assurance | 4 |
| 1.7 Acknowledgements..... | 4 |
| 2.0 DETAILED OBSERVATIONS, RECOMMENDATIONS AND MANAGEMENT RESPONSES | 5 |
| 2.1 Development of Contribution Agreements | 5 |
| 2.2 Program Guidance and Documentation..... | 7 |
| APPENDIX A - AUDIT CRITERIA | 9 |

EXECUTIVE SUMMARY

Over the last four years, Canadian hog and pork producers have struggled with a number of significant crises. As a result, between early 2006 and 2009, the Canadian hog and pork sector experienced a period of significant rationalization and consolidation, losing 28 percent of its hog farms and 20 percent of its hog inventory. In the spring of 2009, the Canadian Pork Council, on behalf of the industry, sought assistance from the Government of Canada to support producers with viable operations who wanted to remain in the industry. In response, in August 2009, the government announced the Hog Industry Loan Loss Reserve Program (HILLRP) a contribution program that was designed to increase access to credit for eligible producers.

The approved Terms and Conditions for the HILLRP provide Agriculture and Agri-Food Canada (AAFC) the authority to enter into contribution agreements with lending organizations to provide reserve backed loans to hog producers. The loan terms can be up to 15 years in duration.

Total approved funding for the program is \$411 million including a maximum of \$404 million for contributions to the loan loss reserves for the 2009-10 fiscal year and \$7 million in departmental operating costs. At the end of the application period, 264 eligible loans totalling \$408.2M had been registered, resulting in a total of approximately \$243.8M of program contributions to the loan loss reserves of the lending institutions.

In November 2009, an audit of the Hog Industry Loan Loss Reserve Program was approved as an addition to the AAFC Risk-Based Audit Plan. The objective of the audit was to provide assurance that the governance, risk management and control frameworks for the program are adequate during the early stages of the program lifecycle and provide a reasonable expectation that funds will be used for their intended purpose and that the planned outcomes for the Program will be achieved.

The audit, conducted between February and April 2010, concluded that the governance, risk management and control frameworks developed and implemented for the Program are adequate and provide a reasonable expectation that funds will be used for their intended purpose and that planned outcomes will be achieved. Controls are in place over Program payments, and payments are made in accordance with the provisions of the contribution agreement, Program Terms and Conditions, the Treasury Board Policy on Transfer Payments, and the Financial Administration Act.

In designing the HILLRP, the Department faced tight deadlines to develop and implement a program that would be responsive to the urgent needs of the industry. Despite that, a number of positive management practices were noted during the audit including engagement of key stakeholders during the design and implementation of the program, identification and assessment of key program risks, development of detailed lenders guidelines and ongoing monitoring and reporting activities related to Loan Registrations.

The audit did note, however, that the Contribution Agreements with the Financial Institutions did not include a requirement to collect and report data required to support a key performance indicator. The audit also noted that, while not required as of the date of the audit, additional program guidance, such as operating procedures and roles and responsibilities documents for the later stages of the program lifecycle, should be developed and communicated.

1.0 INTRODUCTION

1.1 Background

For the three years prior to the spring of 2009, Canadian hog and pork producers faced a significant revenue and income crisis. The crisis was prompted by a strong Canadian currency, high feed prices, rising energy costs and low pork prices world-wide. The crisis was exacerbated by the more recent global economic crisis, declining exports to the United States and export market closures in 2009 due to the outbreak of influenza A (H1N1). As a result, between early 2006 and 2009, the Canadian hog and pork sector experienced a period of significant rationalization and consolidation, losing 28 percent of its hog farms and 20 percent of its hog inventory.

To help address the situation, the government introduced two initiatives in support of hog producers:

- The Hog Farm Transition Program (HFTP), intended to assist hog producers to exit the industry for a minimum of three years; and,
- The Hog Industry Loan Loss Reserve Program (HILLRP), to assist viable hog operations with their short term liquidity pressures by encouraging lenders to provide producers with long term loans.

The HILLRP is designed to increase access to credit for eligible producers who can provide a business plan which demonstrates that the business is, or can be, viable and can demonstrate a reasonable prospect of repaying the loan. The program is available to all hog producers currently producing hogs that are grown in Canada. Producers cannot benefit from both the HFTP and HILLRP for the same hog operation.

With the HILLRP, the Government of Canada is sharing the risk with financial institutions in consolidating short-term debt into long term loans for eligible hog producers. The HILLRP requires AAFC to enter into contribution agreements with lending organizations to provide reserve backed loans to hog producers. Lenders have the responsibility for assessing applications, extending and managing loan amounts in accordance with the program's terms and conditions, managing their Reserve Fund and for any losses beyond those that can be drawn from the Reserve Fund. As such, lenders are bearing a proportion of the risk for loans extended under the HILLRP.

The total planned cost of the program is \$411 million, including up to \$404 million in contributions and \$7 million in departmental operating costs. Of the total funding, \$405 million had been planned to be spent during the 2009/10 fiscal year, with the remainder spread over the following four years of the program.

Since October 2009, many financial institutions were ready to initiate discussions with pork producers in regards to the government backed loans under the HILLRP. Producers were required to develop long-term business plans to demonstrate viability. In total, 21 Contribution Agreements with recipients (lending institutions) had been signed and 264 loan registrations were approved. However, due to lower than expected program uptake, \$243.8 million was actually committed.

Within AAFC, the program is managed by the Financial Guarantee Programs Division (FGPD) of the Finance and Renewal Programs Directorate under the Farm Financial Programs Branch. Resources dedicated to the program include a Program Manager and a Program Officer, supported by the Division Finance Manager. Oversight is provided by the Assistant Director, HILLRP and APP East, and the Director and Director General of FGPD. Management activities to date have focused on implementing Contribution Agreements, reviewing and approving loan registrations provided by lenders and, calculating and monitoring the funds committed to the Loan Reserve.

In designing the HILLRP, the Department faced tight deadlines to develop and implement a program that would be responsive to the urgent needs of the industry. Despite that, a number of positive management practices were noted during the audit including engagement of key stakeholders during the design and implementation of the program, identification and assessment of key program risks, development of detailed lenders guidelines and ongoing monitoring and reporting activities related to Loan Registrations.

The requirement for the audit of the HILLRP was identified in the Treasury Board Submission covering both the HFTP and the HILLRP. The Submission included the requirement for a “Program Under Development” audit to be undertaken early in the program lifecycle. This audit was also approved as an addition to the AAFC Risk-Based Audit Plan as the program was announced after the Plan had been developed.

1.2 Audit Objective

The objective of the audit was to provide assurance that governance, risk management and control frameworks are effective during the early stages of the HILLRP lifecycle to provide a reasonable expectation that funds will be used for the intended purpose and that planned outcomes will be achieved.

1.3 Audit Scope

The audit examined the risk, governance, and management control frameworks currently in place to support the implementation and ongoing management of the HILLRP.

At the program level, the audit examined the risks and controls related to the following areas:

- Program Design and Approval
- Program Implementation and
- Program Monitoring and Reporting.

At the level of the Contribution Agreement, the audit examined the risks and controls related to:

- Eligibility and Evaluation of Recipients
- Agreement Development and
- Agreement Monitoring and Reporting.

The audit was conducted between February and April 2010 and was carried out in the Financial Guarantee Programs Division offices in the National Capital Region. The period under review was from the time of program inception to March, 2010.

1.4 Audit Approach

The audit, including the planning phase, was carried out between February 2010 and April 2010 and was conducted in accordance with the *Standards for the Professional Practice of Internal Audit* and the Treasury Board (TB) *Policy on Internal Audit*. These standards require that the audit be planned and performed in such a way as to obtain reasonable assurance that audit objectives are achieved.

In addressing the audit objective, audit criteria were developed against which observations, assessments and conclusions were made. These audit criteria were derived primarily from AAFC's audit criteria for Grant and Contribution Programs and the Treasury Board Policy on Transfer Payments, October, 2008 and related directives. The audit criteria are presented in Appendix A to this report.

The schedule for the audit was as follows:

| | |
|-----------------|------------------------|
| Planning Phase | February to March 2010 |
| Conduct Phase | March to April 2010 |
| Reporting Phase | April to May 2010 |

During the Planning Phase, risks related to the governance and management of the HILLRP were identified and assessed. The risk assessment was developed from information derived from:

- interviews with managers and staff responsible for program design and development and implementation of the HILLRP
- review of relevant program documentation and
- review of program processes.

Information from the Planning Phase led to the development of the HILLRP audit program and served to further clarify the audit scope and objectives and better define audit criteria for the conduct phase of the audit.

Audit work performed included:

- Review of relevant program documentation including but not limited to Authority Documents, Agreements, correspondence involving the Canadian Pork Council and lenders, news releases and media plans and the AAFC website
- Interviews with departmental and program management and staff who participated in the design and implementation of the HILLRP

- Detailed examination of a sample of 50 lender files and related loan registration and
- Review of 100 percent of payments, comprising the first installment to financial institutions, up to the date of the Conduct Phase of the audit.

1.5 Conclusion

It is the opinion of AAFC's Internal Audit Directorate that based on the results of our audit work, the governance, risk management and control frameworks established for the HILLRP are adequate and provide a reasonable expectation that funds will be used for their intended purpose and that planned outcomes will be achieved. Controls are in place over Program payments, and payments are made in accordance with the provisions of the Contribution Agreement, Program Terms and Conditions as approved by Treasury Board, and the *Financial Administration Act*.

Our audit work identified opportunities to improve program management, both for the HILLRP in subsequent years and for any new program to be designed and approved by AAFC. The opportunities identified are discussed in detail in Section 2.0 of the report.

1.6 Statement of Assurance

In the professional judgment of the Chief Audit Executive, sufficient and appropriate audit procedures have been conducted and evidence gathered to support the accuracy of the opinion provided and contained in this report.

The opinion is based on a comparison of the conditions, as they existed at the time, against pre-established audit criteria that were agreed on with management. The opinion is applicable only to the entity examined. The evidence was gathered in compliance with Treasury Board policy, directives and standards on internal audit, and the procedures used meet the professional standards of the Institute of Internal Auditors. The evidence gathered is sufficient to support the audit opinion expressed in this report.

Original signed by:

Graham Barr
A/Chief Audit Executive

Date

1.7 Acknowledgements

The Office of Audit and Evaluation would like to thank those individuals who contributed to this project and, in particular, departmental interviewees who provided insights and comments useful to this audit.

2.0 DETAILED OBSERVATIONS, RECOMMENDATIONS AND MANAGEMENT RESPONSES

2.1 Development of Contribution Agreements

The Contribution Agreements with the Financial Institutions did not include a requirement to collect and report on a key performance measure and the program has not identified an alternative means to collect this data.

The Directive on Transfer Payments requires that departmental managers develop a performance measurement strategy for ongoing performance management of the transfer payment program, including the performance measures and indicators and the supporting data requirements and data collection strategy.

A Performance Measurement Strategy (PMS) was developed as part of program design and implementation for HILLRP and was included in the Treasury Board submission for the program. The PMS outlined expected outcomes, included baseline targets for performance, identified key performance indicators and methodologies for collecting performance related information.

One key performance indicator identified in the PMS was the percentage of reserve backed loans provided by lenders in relation to applications received. The audit found however, that the Contribution Agreements with the Financial Institutions did not include a requirement to collect and report on such information and that the program has not identified an alternative means to collect this data.

The collection of information related to this performance indicator would improve the ability of the program to assess the performance of the HILLRP.

In the event that performance indicators presented in the Performance Measurement Strategy cannot be implemented as planned, program management should determine whether alternative means can be found to collect the required data. If alternative means cannot be found, it may be necessary to adjust the performance indicators.

Recommendation

The ADM, FFPB should:

1. Consider identifying and assessing the feasibility of alternative means to collect information on the percentage of reserve backed loans provided by lenders in relation to applications received for the HILLRP.

Management Response: Agreed

Management agrees that an alternative means of measuring the number of HILLRP loan applications that lenders approved and the number that were rejected, should be assessed.

Action Plan

Management will evaluate alternative means to collect information on the percentage of reserve backed loans provided by lenders in relation to applications received for the HILLRP and will implement an approach if feasible and cost effective. If an alternate means to collect the information cannot be found, the Performance Measurement Strategy will be adjusted.

Target Date for Completion

September 30, 2010

2. Ensure that data collection strategies are implemented for all performance indicators.

Management Response: Agreed

Management agrees that data collection strategies should be implemented for all performance measures identified in the Performance Measurement Strategy (PMS). In instances, however, where the PMS is finalized in advance of negotiations with Agreement signatories, and it is not possible to obtain the data necessary as planned or through alternative means, as was the case in HILLRP, the PMS may have to be modified to reflect these negotiations.

Action Plan

Management will ensure that all staff are aware of the need to have performance data requirements identified in the PMS incorporated into Contribution Agreements by including this into the next version of the Department's mandatory training module for program staff administering Grants and Contribution Programs.

Target Date for Completion

December 31, 2010

2.2 Program Guidance and Documentation

Now that the program is entering the maintenance and monitoring stage, there is a need to develop additional guidelines and procedures and to document roles and responsibilities.

During the early stages of the program lifecycle, sufficient guidance has been provided to program staff, lenders and hog producers to ensure understanding of program objectives and a consistent process for registering eligible loan applications consistent with program terms and conditions. This guidance has been in the form of program information on the AAFC website, the Lenders' Guidelines document and related application, registration and declaration forms to be completed by borrowers and lenders.

As of the date of the audit, the program was entering the second, 'maintenance and monitoring stage' which is expected to last up to 15 years. While not required during the early stages, there is now a need for a program management strategy for ongoing administration which could include:

- Development of annual work plans and identification of required resource levels
- Identification of specific activities to be undertaken, assignment of responsibilities and, documenting related guidance as necessary
- Consideration of the establishment and implementation of a Monitoring Committee as envisioned in the Terms and Conditions of the program
- Recipient monitoring and auditing activities consistent with a risk based approach and,
- Ongoing reporting activities

The audit noted that program management is aware of the need for additional program management guidance and intends to address this once the loan registration eligibility period has ended and resources become available.

Recommendation:

The ADM, FFPB should ensure that additional guidelines, procedures and roles and responsibilities documents required to support the program and staff on an ongoing basis, are developed and communicated.

Management Response: Agreed

Management agrees and has anticipated that documents to support program stakeholders and staff will be developed and communicated in the next phases of the program.

Action Plan

- a) A second version of the Lenders Guidelines is near completion and will be shared with participating financial institutions for comments and feedback. The guidelines will include, but will not be limited to, information on the financial institutions reporting requirements, examples of collection activities in the event of defaulted loans, and fund recoveries by the Minister.

Target Date for Completion

July 2010

- b) Detailed desktop procedure manual for program staff will be developed and communicated. Specific activities to be undertaken, assignment of responsibilities, and documenting related guidance will be included in the manual.

Target Date for Completion

August 2010

Appendix A - Audit Criteria

| |
|--|
| 1. Program Design and Approval - The program is designed based on an actual need, in alignment with defined Departmental mandate and priorities, and is appropriately approved. Expected outcomes, and data collection requirements in support thereof, are well established |
| 2. Program Implementation - Appropriate policy and procedures, resources, systems and supporting tools are developed at the program level to facilitate consistent implementation of the program and to promote the achievement of program objectives. |
| 3. Program Monitoring and Reporting - Sufficient monitoring and oversight activities are conducted on a timely basis by program management to promote the achievement of program objectives. Identified issues that adversely impact program objectives are addressed in a timely manner. |
| 4. Eligibility/Evaluation - Funding requests are assessed in a timely, fair and transparent manner. Only eligible recipients and activities are approved for funding and only at a level consistent with the financial need, expected benefits or results, and risks. |
| 5. Agreement Development - Formal agreements, containing complete, appropriate and compliant terms and conditions, are established with the recipient on a timely basis. |
| 6. Agreement Monitoring and Reporting - Activities are monitored to ensure compliance with program terms and conditions and with the funding agreement. Payments are made only upon fulfillment of requirements |