

## 2.17 Investment in a Manufacturing Company

### Introduction

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#### Background

There are two Government entities involved financially with a manufacturing company in the City of Mount Pearl.

#### *Newfoundland and Labrador Industrial Development Corporation (NIDC)*

This Corporation operates under the authority of the *Industrial Development Corporation Act* to provide long-term financing to industrial and resource based companies.

The affairs of NIDC are managed by a Board of Directors appointed by the Lieutenant-Governor in Council and administered by Department of Finance employees.

#### *Department of Innovation, Trade and Rural Development (INTRD)*

INTRD provides funding and assistance to businesses operating in the Province in its efforts to strengthen and diversify the economy on a Provincial and regional basis.

The Department administers several programs in fulfilling this mandate.

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#### Investments in manufacturing company

Government has invested a total of \$750,000 in the manufacturing company. The following chart summarizes Government's investment in this company:

Year	Government Entity	Amount Invested
2001	Newfoundland and Labrador Industrial Development Corporation	\$450,000
2004	Department of Innovation, Trade and Rural Development	300,000
<b>Total Government Investment</b>		<b>\$750,000</b>

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### Audit Objectives and Scope

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#### Objectives

Our objectives were to:

- document Government's financial involvement in the manufacturing company; and
  - review the approval and monitoring processes used by NIDC and INTRD relating to their investments in the manufacturing company.
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#### Scope

We interviewed officials at NIDC and INTRD and reviewed files and correspondence as well as financial and other information received from the company by these entities.

We completed our review in November 2005.

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### Conclusions

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#### Loan provided contrary to recommendation of Departmental officials

Contrary to the recommendations of officials at the Department of Finance and the Department of Innovation Trade and Rural Development, a directive from the Premier's Office in December 2003 resulted in a manufacturing company being provided with a \$300,000 loan in 2004.

Officials cited issues such as:

- the loan would not be secured in that prior liens of other investors would have claim to the company's assets in the event of bankruptcy;
- the investment would not generate additional employment in the Province;
- a revised business strategy of the company was not advanced enough to determine if the company would be viable; and
- several other existing investors were not prepared to increase their investment.

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Furthermore, officials were aware that this company had been experiencing financial difficulties since it commenced operations in 2001 and was unable to make any payments on the \$450,000 loan which NIDC provided in 2001. In fact, in 2003 the company requested and received Government approval to convert the NIDC loan to redeemable preference shares of the company. As a result, the company does not have to repay the \$450,000 loan and the Province now holds 43,269 Class D redeemable preference shares of the company.

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### Status of loan

Officials at INTRD have determined that repayment of the \$300,000 loan is doubtful and accordingly a provision for this expected loss has been recorded in the Province's financial statements for the year ended 31 March 2005.

At the time of our review in November 2005, the company was not in compliance with two conditions relating to the \$300,000 loan:

- The company had not maintained the required employment level of 30 full-time equivalent employees in the Province. In December 2004, when the company had 22 full-time equivalents, it formally requested the required employment level be reduced. Although the 30 full-time employees is still a requirement of the loan, as of November 2005, the company only employed 17 full-time equivalents.
  - The company had not provided Government with the required audited financial statements for the year ended 31 July 2005 and were a year late in providing the financial statements for the year ended 31 July 2004.
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## Findings and Recommendation

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### Loan Provided Contrary to Recommendation of Departmental Officials

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#### Background: initial Government involvement

In late 2000, a manufacturing company located in the City of Mount Pearl requested funding from the Newfoundland and Labrador Industrial Development Corporation (NIDC) to assist with establishing a technologically advanced business to manufacture its products for wholesale to Canadian and U.S. markets.

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**Initial strategy:** The company's initial strategy was to manufacture its products using a new technology that would be aimed at the high end retail market.

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**Government provides \$450,000 loan**

In response to the funding request, a \$450,000 loan was provided to the company in March 2001. Details relating to the approval of this loan are as follows:

- Officials of NIDC reviewed the company's application and business plan, and recommended approval to the NIDC Board of Directors.
  - In October 2000, the Board approved \$450,000 in debt financing with no interest to be charged.
  - As required under the *Industrial Development Corporation Act*, approval of the Lieutenant-Governor in Council was obtained.
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**Company unable to make payments**

Under the loan agreement, the loan was to be repaid in five annual installments payable within three months from the fiscal year end commencing with the fiscal year ended 31 July 2002. The annual payment was to be calculated as 20% of excess cash flow up to a maximum payment of \$90,000 annually.

**Monitoring:** As required under the loan agreement, NIDC obtained audited financial statements from the company for the years ended 31 July 2002 and 31 July 2003. Based on a review of the financial statements, NIDC determined that the company was in a poor financial position. Therefore, no payments were required to be made under the loan agreement as no excess cash flows were available.

Government officials and a review of the company's financial statements on file indicated that the company had incurred significant losses and working capital deficiencies since commencing operations in 2001.

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### Loan converted to preference shares

In a meeting with NIDC in August 2003, a request was made by the company's President for NIDC to write off the existing loan. Reasons for this request were to:

- address the company's significant losses and working capital deficiencies;
- strengthen the company's balance sheet; and
- enable the company to secure additional financing by providing security for other lenders.

The request to write off the loan was denied; however, it was agreed that the loan could be converted into preference shares subject to the approval of the Minister of Finance and the Minister of Innovation, Trade and Rural Development.

**Approval granted:** In late August 2003, NIDC obtained approval from the Minister of Finance and the Minister of Innovation, Trade and Rural Development to convert the loan into redeemable preference shares and in January 2004, the loan was converted into 43,269 Class D Redeemable Preferred Shares.

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### Company requests funding for new strategy

In December 2003, officials of the manufacturing company indicated that they had significantly revised their business strategy and intended to market a modified (low end) version of their technology, while contracting out the manufacturing to China. They intended to scale back production (of high end products) in the Province and mitigate the loss from local manufacturing with anticipated profits from the Chinese production.

**Funding request:** The company requested additional funding of \$300,000 from Government as part of an \$887,500 program with the remaining \$587,500 to be provided by other financial sources. Departmental officials indicated that the \$887,500 was to be used to:

- purchase production from China;
  - finance returned product from a former distributor;
  - attend a marketing trade show in Los Angeles; and
  - cover operating losses.
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### **Funding request reviewed**

A review of the request was performed by the Department of Finance and the Department of Innovation, Trade and Rural Development in December 2003. This review included an analysis of:

- audited financial statements for the years ended 31 July 2002 and 31 July 2003;
  - unaudited financial statements for the three months ended 31 October 2003;
  - internally prepared financial projections;
  - intentions of other possible and existing investors; and
  - the company's revised business strategy.
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### **Officials recommend against request**

Based on their analysis, officials of the Department of Finance and the Department of Innovation, Trade and Rural Development recommended against any additional investment by Government.

Reasons provided for this recommendation were:

- the loan would not be secured in that prior liens of other investors would have claim to assets in the event of a bankruptcy;
- the investment would not generate additional employment in the Province;
- a revised business strategy of the company was not advanced to a stage to determine if the strategy was viable; and
- several other existing investors were not prepared to increase their investment.

Furthermore, officials were aware that this company had experienced financial difficulties since it commenced operations in 2001 and was unable to make any payments on a \$450,000 loan which NIDC had provided in 2001.

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### **Funding approved**

Contrary to recommendations of officials at the Department of Finance and the Department of Innovation, Trade and Rural Development, a directive from the Premier's Office in December 2003 resulted in the company being provided with the additional \$300,000 they had requested.

In January 2004, the Department of Innovation, Trade and Rural Development provided the company with a \$300,000 interest bearing convertible debenture. The original agreement required interest, at the rate of 10%, as well as principal to be paid at maturity in December 2005. However, following a request from company officials, in April 2005, the maturity date was extended to December 2006.

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### **Additional working capital requested**

In March 2005, officials of the manufacturing company indicated that they were again experiencing cash flow difficulties. They requested additional funding of \$100,000 from Government as part of a \$400,000 program with the remaining \$300,000 to be provided by other financial sources. Departmental officials indicated that the \$400,000 would be used primarily for working capital.

A review of the request was performed, and based on results of analytical procedures, officials of the Department of Innovation, Trade and Rural Development recommended against any additional investment by Government.

At the date of the review, in November 2005, the company has not been provided with any additional financing from Government.

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### **Status of Loan**

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### **Loan conditions**

The \$300,000 loan to the company came with underlying conditions including:

- maintaining an employment level of 30 full-time equivalent employees in the Province;
- submission of annual audited financial statements;
- written confirmation of the receipt of funding from other sources;
- restrictions on salaries and directors' remuneration;

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- restrictions on future borrowings; and
- restrictions on capital expenditures.

**Monitoring:** It is the responsibility of the Department of Innovation, Trade and Rural Development to follow up on these conditions as required by the loan agreement. If the company is in contravention of any of the underlying conditions, the Department has the right to call the loan.

### Conditions violated

Our review indicated that as of November 2005, the company was not in compliance with two of these conditions. Details are as follows.

**Employment levels:** Although the company is required to maintain an employment level of at least 30 full-time equivalent employees, as of December 2004, the company only employed 22 and as of November 2005 only employed 17 full-time equivalent employees.

In December 2004, the company formally requested that the requirement to maintain 30 full-time equivalent employees be reduced. As of November 2005, the Department had not responded to this request.

**Audited financial statements:** Although the company is required to submit audited financial statements to the Department within 90 days of each fiscal year end (i.e. 31 October), commencing with the fiscal year ended 31 July 2004, as of November 2005, the Department had not received audited financial statements for the fiscal year ended 31 July 2005. These statements were required to have been submitted by 31 October 2005. Furthermore, financial statements for the fiscal year ended 31 July 2004 were not received until 31 October 2005, one year later than the deadline of 31 October 2004.

Although the company is not in compliance with certain conditions of the loan, the Department has not called the loan.

### Loan deemed doubtful of collection

The Province's financial statements for the year ended 31 March 2005 show a loan receivable from the manufacturing company for \$335,000, which represents the loan receivable for \$300,000 and accrued interest of \$35,000.



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Officials at the Department of Innovation, Trade and Rural Development have determined that collection of the loan is doubtful and have recorded a provision for an expected loss of \$335,000 in the financial statements of the Province for the year ended 31 March 2005.

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### Recommendation

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#### Monitor investments

*The Department of Finance, Newfoundland and Labrador Industrial Development Corporation and the Department of Innovation, Trade and Rural Development should continue to closely monitor Government's investments in the company.*

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### Department of Finance/Newfoundland and Labrador Industrial Development Corporation's Response

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*The description of NIDC's financial involvement in the manufacturing company is factual. With respect to the Recommendation, NIDC will continue to monitor its preference share investment through the receipt of annual audited financial statements; updates on the company's business strategy; and visits to the premises.*

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### Department of Innovation, Trade and Rural Development's Response

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*The department has proactively monitored Government's investment in this company. When Government made its initial investment, it was aware that there would be unique challenges given the nature of this initiative. We have kept a close liaison with the company's principal, monitored its financial performance and have endeavoured to permit sufficient flexibility to maintain this operation in the Province.*

*Going forward, we will continue to closely monitor this account and are prepared to consider whatever action that may be necessary to secure the Province's investment, while at the same time allowing the company to remain in operation and continue to provide full time employment opportunities.*

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*This investment involves a young entrepreneur, leading edge technology, the potential to increase export sales, and levered additional capital funding for the company, all priorities of this administration. Because of this, government was willing to take a greater risk and decided to provide a new loan to the company, which was approved pursuant to a Minute of Council.*

*Employment Levels: We are cognizant of the fact that the number of full-time equivalent employees has fallen below the level specified in the underlying conditions attached to the debenture. We will likely be making an amendment to the debenture to address this issue. In the meantime, we consider the current level of employment to be significant with potential for future growth, assuming the company is successful in maintaining operations. In the meantime, the Department does not intend to precipitate any action that would threaten or impair the existing level of operations.*

*Audited Financial Statements: We endeavour to obtain these statements on a timely basis bearing in mind the company's situation. To mitigate this time lag, the department maintains close liaison with the company principal and receives interim statements on a periodic basis. We will contact the company once again with respect to its audited statements for the fiscal year ended July 31, 2005.*

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