

**AUDIT REPORT ON  
8(a) PROGRAM CONTINUING  
ELIGIBILITY REVIEWS  
AUDIT REPORT NO. 4-3-H-006-021  
September 30, 1994**

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**U.S. SMALL BUSINESS ADMINISTRATION  
OFFICE OF INSPECTOR GENERAL  
Washington, D.C. 20416**

<b>AUDIT REPORT</b>
Issue Date: September 30, 1994
Number: 4-3-H-006-021

**TO:** Herbert L. Mitchell, Associate Administrator  
for Minority Enterprise Development

**FROM:** *Peter L. McClintock*  
Peter L. McClintock, Assistant Inspector General  
for Auditing

**SUBJECT:** Audit Report on 8(a) Program Continuing Eligibility Reviews

This is our audit report on 8(a) program continuing eligibility reviews. The summary section on page ii of the report provides a synopsis of the audit findings. The report contains 5 findings and 13 recommendations.

The findings included in this report are the conclusion of the Auditing Division based on the auditors' testing of program operations. The findings and recommendations are subject to review and implementation of corrective action by your office following existing Agency procedures for audit follow-up and resolution.

Please provide us with your management decisions for the recommendations within 30 days. Record your management decisions on the attached SBA Form 1824, "Recommendation Action Sheet," and show either your proposed corrective actions and target dates for completion, or an explanation of your disagreement with our recommendations.

Should you or your staff have any questions, please contact Dale C. Williams, Deputy Assistant Inspector General for Auditing, Headquarters Operations, at (202) 205-7204.

## **SUMMARY**

We completed an audit of 8(a) program procedures for SBA's continuing eligibility reviews. The objective of the audit was to evaluate the adequacy of procedures for assuring 8(a) program participants meet continuing eligibility requirements.

Our audit concluded that enhancements to the continuing eligibility review process are needed. Participants remain in the program even though they have accumulated substantial wealth or have overcome impediments to obtaining access to financing, markets and resources. Permitting wealthy individuals to remain in the 8(a) program is contrary to the goals of the program, reduces the opportunities available to those who are disadvantaged and undermines public support for the program. Specifically, we noted the following:

- Individuals that had overcome their economic disadvantage retained 8(a) eligibility because they understated their personal net worth and Business Opportunity Specialists (BOS) made errors in calculating the individuals' personal net worth.
- Participants with substantial income remained in the 8(a) program because personal annual income was not considered when economic disadvantage assessments were made.
- Continuing eligibility reviews did not include comparisons of 8(a) concerns to other concerns in the same or similar lines of businesses that were not owned and controlled by socially and economically individuals. This allowed participants to continue in the 8(a) program although the strong financial condition of their firms should no longer have qualified them as economically disadvantaged.
- Wealthy individuals continued to be eligible for the 8(a) program because the equity in their 8(a) firms and primary residences and the net worth of their spouses was not a factor in determining whether they remained economically disadvantaged.
- Annual financial statements were not always submitted or prepared in accordance with 8(a) program regulations.
- The form 8(a) participants are required to use to report their personal net worth was not structured in a way which simplified economic disadvantage determinations.

- Data used to conduct 8(a) program continuing eligibility reviews was not always compatible and timely.
- Firms in the 8(a) program can exercise significant control over other 8(a) firms and they can subcontract with the other 8(a) firms to work on 8(a) contracts in which they have outgrown the Standard Industrial Classification (SIC) code.

Our report includes recommendations to improve the 8(a) program continuing eligibility review process and correct the conditions cited in the report. We recommend that the Associate Administrator for Minority Enterprise Development:

- establish criteria for requiring more successful 8(a) program participants to annually submit personal financial statements that are reviewed or compiled by an independent public accountant;
- require 8(a) program participants to annually submit personal tax returns or file Form 8821 with the IRS authorizing SBA to receive their personal tax return information;
- direct SBA district offices to provide training to BOSs on personal net worth determinations and to place increased emphasis on personal net worth determinations during 8(a) program continuing eligibility reviews;
- establish guidelines for determining that 8(a) participants should no longer be considered economically disadvantaged based on unusually large amounts of funds withdrawn from their firms;
- establish procedures and standards for comparing the financial condition of 8(a) firms to similar firms not in the program to identify participants that should be graduated from the 8(a) program because they are no longer economically disadvantaged;
- establish procedures for determining whether 8(a) participants should no longer be considered economically disadvantaged based on their ownership interest in their 8(a) firms, the equity and market value of their primary residences, and the net worth of their spouses;
- instruct SBA district offices to place increased emphasis on 8(a) program participants' submission and preparation of financial statements;

- develop a standard form for reporting the adjusted personal net worth of 8(a) participants;
- realign 8(a) firms' program years with their fiscal years and the tax years of the disadvantaged owners;
- require 8(a) firms to submit annual financial statements (audited, reviewed, or compiled) within 90-days of their fiscal year end;
- require that disadvantaged owners and firms participating in the 8(a) program submit their personal and business tax returns to SBA by the 15th day of the 4th month after the respective tax year ends;
- require that disadvantaged owners' firms participating in the 8(a) program and associates of the owner(s) or firm be limited in their equity ownership interests in other 8(a) firms to no more than a combined 10 percent; and
- require that revenue earned from subcontracting on noncompetitive 8(a) contracts be classified as 8(a) revenue.

On June 27, 1994, we discussed the results of our audit with SBA Minority Enterprise Development officials. On August 22, 1994, we received written comments from the Associate Administrator for Minority Enterprise Development. The Associate Administrator for Minority Enterprise Development generally agreed with our findings, conclusions, and recommendations. We have evaluated and considered his comments in finalizing our report. The written comments are included in the report under the results of Audit.

The findings included in this report are the conclusion of the Auditing Division based on the auditor's testing of the auditee's operations. **The findings and recommendations are subject to review, management decision, and corrective action by your office in accordance with existing Agency procedures for audit follow-up and resolution.**

**AUDIT REPORT ON  
8(A) PROGRAM CONTINUING  
ELIGIBILITY REVIEWS**

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## INTRODUCTION

### A. Background

The 8(a) program was created to assist small businesses owned and controlled by socially and economically disadvantaged individuals to develop into viable competitors in the commercial marketplace. Under the program, SBA, as prime contractor, enters into contracts with other Federal agencies and subcontracts with program participants to perform the work. Program participants receive substantial benefits including sole-source contracts, business development grants, low interest loans, and free management consulting services.

The important purpose of the 8(a) program is severely undermined when individuals who are not disadvantaged are permitted to participate in the program. Participation by non-disadvantaged individuals reduces the opportunities available to those who are disadvantaged, diverts the energy and efforts of SBA, and could undermine public support for the program. Title 13 of the Code of Federal Regulations (CFR), Section 124.106 states that the 8(a) program is not intended to assist concerns owned and controlled by socially disadvantaged individuals who have accumulated substantial wealth or who have overcome impediments to obtaining access to financing, markets and resources.

Participation in the 8(a) program is limited to small businesses at least 51 percent owned and controlled by individuals who have been identified as socially and economically disadvantaged. Title 13 CFR § 124.106 states, for 8(a) program purposes, economically disadvantaged individuals are socially disadvantaged individuals whose ability to compete in the free enterprise system has been impaired due to diminished capital and credit opportunities, as compared to others in similar lines of businesses and competitive market areas who are not socially disadvantaged. Title 13 CFR § 124.106 further requires SBA to consider the personal financial condition of the individual(s) claiming disadvantaged status, the financial condition of the concern, and the concern's access to capital, credit and markets in determining economic disadvantage for purposes of 8(a) program eligibility.

SBA has established thresholds of personal net worth for the purpose of determining whether individuals are economically disadvantaged. An individual whose personal net worth exceeds \$250,000 is not considered economically disadvantaged for purposes of initial program eligibility. Upon admittance to the 8(a) program, individual personal net worth can not exceed \$500,000 in the developmental stage (first 4 years) and \$750,000 in the transitional stage (last 5 years) of the program. Whenever SBA calculates the personal net worth of an individual claiming disadvantaged status for purposes of the 8(a) program, by statute, the personal net worth of the individual's spouse, the individual's

ownership interest in the 8(a) concern, and equity in his or her personal residence not attributable to excessive withdrawals from the concern are excluded from the calculation. For concerns whose eligibility is based on multiple individuals claiming disadvantaged status, each individual is subject to the personal net worth thresholds on an individual basis.

The Small Business Act, as amended, requires SBA to conduct annual reviews of 8(a) participants to determine whether they continue to meet all eligibility requirements of the program. These determinations are made in conjunction with the annual review of the participant's program year.

#### **B. Objectives and Scope**

The objective of our audit was to evaluate the adequacy of procedures for assuring 8(a) program participants meet continuing eligibility requirements. Our audit included reviewing pertinent laws, regulations, and procedures related to continuing eligibility reviews of 8(a) participants.

To accomplish our audit objective, we selected the five SBA district offices that serviced the greatest number of active 8(a) firms that had received total 8(a) contracts valued over \$10 million. We further selected 10 firms from each of the five districts for review. The firms selected were among the 20 firms in each district that had received the greatest total dollar value of 8(a) contracts and were not due to graduate from the 8(a) program prior to January 1, 1994. Consequently, the results of our audit as discussed in the body of the report should not be taken as indicative of the entire universe because of our non-statistical sampling methodology.

We reviewed corporate and personal financial statements, annual updates and reviews, and corporate and personal tax returns of selected 8(a) participants. Discussions were held with Business Opportunity Specialists at the district offices, 8(a) participants, and independent public accountants employed by the 8(a) participants.

The audit covered 8(a) participants that were active in the program as of December 31, 1993. We conducted the audit between February 1993 and June 1994. On-site work was conducted at the Washington, Los Angeles, Richmond, Columbus, and Albuquerque District Offices. The audit was performed in accordance with government auditing standards.

#### **C. Follow-up on Prior Audits**

No prior audits of 8(a) program continuing eligibility reviews have been performed by SBA.

## RESULTS OF AUDIT

### A. Findings and Recommendations

#### Finding 1      Understated Personal Financial Statements (Net Worth) Go Undetected

Personal net worth was understated by some 8(a) program participants and incorrectly calculated by some Business Opportunity Specialists (BOS). This allowed seven participants to retain their 8(a) eligibility even though their net worth exceeded the thresholds for claiming economic disadvantage. Consequently, individuals that were truly economically disadvantaged may have been deprived of opportunities for 8(a) assistance. This condition occurred because the determination of personal net worth is a self certification process with little validation and emphasis.

Title 13 of the Code of Federal Regulations (CFR), Section 124.111, sets forth personal net worth limits for 8(a) program continuing eligibility purposes. Participants in the developmental and transitional stages of the program may have a personal net worth up to \$500,000 and \$750,000 respectively. In addition, each of the individuals for whom 8(a) eligibility is based upon must submit personal financial statements detailing their personal net worth as part of an annual review.

In our review of continuing eligibility assessments of 50 8(a) concerns, we found seven participants retained their 8(a) eligibility even though their net worth after exclusions exceeded the thresholds for claiming economic disadvantage. Although all seven participants' reported personal net worth fell within the limits for retaining 8(a) eligibility, they were no longer eligible to claim economic disadvantage because they understated their personal net worth or the Business Opportunity Specialists erred in making the personal net worth determination. We found participants understated their personal net worth after exclusions by as much as \$1.25 million and BOSs made errors totalling up to \$259,000. For example:

- One 8(a) participant reported a joint net worth before exclusions of \$530,724 when it was in fact \$11.3 million. We found the \$10.8 million difference was attributable to the participant not reporting the equity in the 8(a) firm and personal residence of \$9 million and \$517,000, respectively. Moreover, he overstated liabilities and assets by \$2 million and \$722,973, respectively. The 8(a) participant's reported personal net

worth was \$304,417 after excluding his spouse's personal net worth and the equity he had in the 8(a) firm and his primary residence. We found that his actual personal net worth after exclusions was \$1.7 million because his share of the reported assets and liabilities were overstated by \$701,623 and \$2 million respectively, and we determined that \$166,000 in withdrawals from the 8(a) firm was excessive and should be included as part of the participant's personal net worth.

- Another 8(a) participant reported that his personal net worth before exclusions was \$559,000. We found that the BOS used the reported amount without making any adjustments for the participant's business and home equity in determining whether the participant was economically disadvantaged because the reported amount was below the eligibility threshold. However, we found the personal financial statement submitted by the participant contained errors totalling \$259,000 that increased the participant's personal net worth over the eligibility threshold: (1) the sum of total assets was \$25,000 more than the amount shown, (2) the sum of stocks and bonds was \$10,000 more than the amount shown; (3) the sum of real estate was \$35,000 more than the amount shown; and (4) a \$189,000 mortgage on the participant's residence was shown as a liability although there was no corresponding asset shown for the primary residence. The 8(a) participant's actual personal worth was \$818,000 after making adjustments for the errors and excluding the equity he had in the 8(a) firm and his primary residence.

At present, personal net worth is not adequately validated and emphasized during 8(a) program continuing eligibility reviews. We found BOSs did not always have the skills and time needed to adequately analyze personal net worth. Consequently, reported personal net worth was generally accepted without question. For example:

- One of the 50 8(a) participants in our review submitted a personal financial statement that represented the joint assets and liabilities of the participant and his wife. We found that the BOS responsible for determining whether the participant continued to be economically disadvantaged was unaware that a joint statement had been submitted. As a result, the determination was based on joint net worth rather than the participant's personal net worth as required. In addition, we found

the BOS was unaware that the participant's reported joint assets were understated by \$954,943. We determined that the participant failed to report the following assets as a result of our review of the participant's personal tax returns, business tax returns, and business financial statements:

IRA or Other Retirement Accounts	\$396,948
Mutual Funds	\$163,855
Personal Loans to Individuals	<u>\$394,140</u>
Total	<u>\$954,943</u>

The participant's actual personal net worth was \$759,399 after inclusion of the participant's share of the omitted assets. Consequently, the participant was no longer eligible to continue in the 8(a) program because the personal net worth threshold had been exceeded.

Although all five of the district offices in our review required 8(a) participants to submit business tax returns and financial statements, only one required submission of personal tax returns. Discovery of understated assets, such as those described in the above example, is highly unlikely if 8(a) participants' personal tax returns are not available for review. Alternatively, submission of personal tax returns would not be necessary if 8(a) participants authorize the Internal Revenue Service (IRS) to release their personal tax return information to SBA. This can be accomplished by the 8(a) participants filing Form 8821, Tax Information Authorization, with the IRS. The latter alternative would reduce the paperwork burden to 8(a) participants and ensure that the personal tax return information made available for SBA review matches what was submitted to the IRS. Unless personal net worth determinations receive adequate validation and emphasis, participants may be able to remain in the 8(a) program even though they no longer meet the criteria for claiming economic disadvantage.

### Recommendations

We recommend the Associate Administrator for Minority Enterprise Development:

- 1A. establish criteria (e.g., based on salaries in excess of \$500,000, high equity in business, reported net worth, sales, etc.) for requiring 8(a) program participants to annually submit personal financial statements that are reviewed or compiled by an independent public accountant.

- 1B. require 8(a) program participants to annually submit personal tax returns or file Form 8821 with the IRS authorizing SBA to receive their personal tax return information.
- 1C. direct SBA district offices to provide training to BOSs on personal net worth determinations and to place increased emphasis on personal net worth determinations during 8(a) program continuing eligibility reviews.

#### SBA Management's Response

The Associate Administrator for Minority Enterprise Development provided the following comments:

- 1A. *"Criteria will be established to require reviewed or compiled personal financial statements prepared by an independent public accountants for firms with certain levels of 8(a) revenue."*
- 1B. *"We agree and this requirement will be mandatory with the annual review."*
- 1C. *"We agree with the recommendation and training will be conducted in FY '95."*

#### Evaluation of Management Response

In our draft recommendation, we suggested the personal financial statements be audited, reviewed or compiled by an independent public accountant. Although the Associate Administrator for Minority Enterprise Development agreed that criteria should be established for reviewed or compiled personal financial statements, he did not believe audited personal financial statements should be required. In our opinion, audited personal financial statements would provide the greatest assurance of accuracy. However, we recognize that the cost may outweigh the benefits. Therefore, we have revised our final recommendation accordingly, and believe the planned actions should result in the submission of more accurate personal financial statements. Actions planned to implement recommendations 1B and 1C by the Associate Administrator for Minority Enterprise are responsive.

**Finding 2      Participants with High Personal Income Remain in the Program**

Owners of 8(a) concerns receiving large salaries and bonuses continue to be classified as economically disadvantaged and can remain in the program. At least five of the owners included in our review earned over \$1 million in compensation over a two-year period. The personal income of individuals claiming disadvantaged status was not considered during 8(a) program continuing eligibility reviews. Although regulations governing 8(a) program continuing eligibility require consideration of personal income when assessing economic disadvantage, no specific income limits have been established to simplify the process. As a result, individuals with substantial income remained in the program and economically disadvantaged individuals were deprived of 8(a) assistance.

Title 13 CFR § 124.106, requires consideration of the personal financial condition of individuals claiming disadvantaged status when SBA assesses economic disadvantage for 8(a) program continuing eligibility purposes. One of the specific factors to be considered in making the assessment is the participants' personal income for at least the past two years.

In our review of continuing eligibility assessments of 50 8(a) concerns, we found the personal income of the individuals claiming disadvantaged status was not considered when determining whether individuals continued to be economically disadvantaged. The 50 8(a) concern owners' compensation ranged from \$0 to \$2.5 million as shown below:

<u>1991 and 1992 Compensation<sup>1</sup></u>	<u>Number of Owners</u>
\$1,000,000 to \$2,500,000	5
\$ 750,000 to \$ 999,999	7
\$ 500,000 to \$ 749,999	5
\$ 200,000 to \$ 499,999	19
\$            0 to \$ 199,999	14

For example:

- One of the 50 owners in our review received salaries and bonuses from his 8(a) firm totalling \$1,494,112 and \$1,022,111 for 1992 and 1991 respectively. Although the 8(a) firm was an S-Corporation that showed a total profit of \$1,460,000 for 1992 and 1991, there was no taxable

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<sup>1</sup> Compensation includes the owners' salaries, bonuses, and distributions from the 8(a) concerns less any distributions made to pay taxes attributable to S-Corporations.

impact on the owner because the carryover of prior period losses resulted in offsetting the profits. Accordingly, the owner did not receive any distributions from the firm to pay for taxes during 1992 and 1991. In addition, the 8(a) owner's spouse had non-8(a) compensation of \$20,356 and \$12,265 for 1992 and 1993, respectively. However, their December 31, 1992, reported joint net worth was only \$84,500 after excluding their equity in the 8(a) firm and their residence. We estimated that the owner and his spouse should have realized a net increase in their joint net worth of about \$1.5 million for the two year period ended December 31, 1992. We asked the 8(a) owner for an explanation as to why his reported net worth appeared so low. He explained that he was fully aware of the net worth limitations of the 8(a) program and he doubted that anyone in the program would be foolish enough to exceed the net worth thresholds. He further explained that his standard of living was very high and his monthly personal expenditures were around \$45,000.

- Another owner in our review received 1992 and 1991 salaries and bonuses of \$1,105,030 and \$1,173,782, respectively from his 8(a) firm. In addition, the owner received a \$2,239,514 distribution from the firm in 1992 to pay taxes attributable to the S-Corporation status of the firm. The owner did not receive any distributions prior to 1992 because the firm did not become an S-Corporation until 1992. The owner's spouse also received compensation of \$91,278 and \$439,250 from the 8(a) firm for 1992 and 1991, respectively.
- One other owner in our review received salaries and bonuses totalling \$824,968 and \$720,098 for 1992 and 1991, respectively, from his 8(a) firm. The owner also received distributions of \$915,416 and \$495,753 during 1992 and 1991, respectively, of which \$256,343 and \$282,866 was distributed to pay taxes attributable to the S-Corporation status of the firm. In addition, the owner's spouse received \$56,160 in compensation from the 8(a) firm in 1992 and in 1991.

In our opinion, owners who receive high annual compensation should be found ineligible for continued participation in the 8(a) program based on their compensation. For example, in 1990, only 2.8 percent of all tax returns filed in the United States had an adjusted gross income of \$100,000 or more and only .2 percent had an adjusted gross income of \$500,000 or more. In our opinion, individuals whose compensation over a two year period is greater than an SBA determined level of excessive compensation (after excluding amounts distributed to pay taxes attributable to S-Corporations) should no longer be considered

economically disadvantaged and should be graduated from the 8(a) program. In determining compensation, SBA should consider an amount that is reasonable for the average small business and a salary that is not excessive in comparison with the population of the United States.

### Recommendation

- 2A. We recommend the Associate Administrator for Minority Enterprise Development establish guidelines for determining that 8(a) participants should no longer be considered economically disadvantaged based on unusually large amounts of funds withdrawn from their firms.

### SBA Management's Response

The Associate Administrator for Minority Enterprise Development provided the following comment:

*"We do not agree that there should be a specific personal income limit. However, consistent with the Business Opportunity Reform Act Conference Report, we plan to address the issue of excessive withdrawals from the firm (including salary payment). The BOS will consider the impact of this withdrawal in terms of: (1) the firm's ability to access capital as well as (2) whether the withdrawal is determined to be detrimental to the development of the firm. Should it be decided that a firm has access to capital, the firm will be considered for graduation. Also, a determination that detrimental excessive withdrawals were made could result in the initiation of termination proceedings."*

### Evaluation of Management Response

After further evaluation of the legislative history of the Business Opportunity Development Reform Act, we agree that Congress did not intend to impose a salary cap on 8(a) participants and we have revised our final recommendation accordingly. However, in our opinion, it was the intent of Congress for SBA to annually evaluate whether an 8(a) firm and its owners remain economically disadvantaged. "An unusually large amount of funds withdrawn from the firm by its owners" was one of the reasons given by Congress for believing that an 8(a) firm and its owners were no longer economically disadvantaged. The two remaining reasons given were "demonstrated access of the firm and/or its owners to a substantial new source of capital or loans" and "unusually high personal net worth of such owners." While it appears our concerns may be addressed in the new procedures being contemplated by the Associate Administrator, we believe guidelines should be established to take into consideration unusually high salaries

when determining whether an individual is considered economically disadvantaged regardless if the salaries are detrimental to the firm or not.

**Finding 3**      **8(a) Concerns Larger And More Profitable Than Non-8(a) Concerns Are still Receiving 8(a) Assistance**

Some firms were allowed to remain in the 8(a) program even though the financial condition of the firms was significantly stronger than similar firms not in the program. This condition existed because continuing eligibility reviews of 8(a) concerns did not include comparisons to other concerns in the same or similar lines of businesses that were not owned and controlled by socially and economically disadvantaged individuals. Consequently, other truly economically disadvantaged individuals were deprived of 8(a) assistance and individuals were allowed to remain in the 8(a) program even though the strong financial condition of their firms no longer made them economically disadvantaged. In addition, the overall success of the 8(a) program is understated when firms that have demonstrated success are not graduated.

Title 13 CFR § 124.106, requires SBA to compare each 8(a) concern's business and financial profile with profiles of businesses in the same or similar line of businesses which are not owned and controlled by socially and economically disadvantaged individuals when determining economic disadvantage for 8(a) program continuing eligibility. At a minimum, the comparison should include business assets, revenues, pre-tax profit, working capital, and net worth of the concern.

Although we found the financial condition of 8(a) firms was analyzed in our review of 50 continuing eligibility assessments, comparisons were not made to similar concerns not in the 8(a) program. We compared the most recent financial data available for each of the 50 8(a) firms to other concerns with the same predominant<sup>2</sup> Standard Industrial Classification (SIC) codes and found the 8(a) firms to be larger and more profitable in most cases. Our analysis was based on five key industry averages obtained from Dun and Bradstreet. The results of our comparison are shown below.

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<sup>2</sup>Predominant SIC code used for each concern was the SIC code under which the concern received most of its 8(a) revenues.

<u>Category</u>	<u>Firms Exceeding Industry Average</u>	<u>Number of Times Industry Average</u>	
		<u>Range</u>	<u>Average</u>
Business Assets	48	1.1 - 61.7	11.6
Revenue	49	1.3 - 159.2	17.1
Gross Profit <sup>3</sup>	42	1.3 - 35.4	6.1
Working Capital	42	1.1 - 82.2	10.7
Net Worth	42	1.2 - 55.6	7.4

All five industry averages were exceeded by 32 of the 50 firms in our review.

Our audit disclosed that some 8(a) concerns had dramatically improved their capital and credit position and had grown to the point that they were larger and more profitable than other firms in the SIC code from which they received most of their revenues. For example:

- One concern substantially exceeded all five of the industry averages shown above. The concern's business assets of \$12.5 million and revenues of \$45.9 million were more than 60 times the industry average for its primary SIC code. The concern's gross profit of \$11.8 million and working capital of \$3.6 million also exceeded the industry average by 35 times and 48 times, respectively. In addition, the concern's net worth of \$5 million was over 4 times the industry average.
- Another concern exceeded all five of the industry averages by more than 15 times. The concern's business assets of \$11.9 million and gross profit of \$14.6 million were more than 30 times the industry average. The concern's net worth of \$2.7 million and working capital of \$2.1 million were 15.6 times the industry average. Also, the concern's revenues of \$40.7 million were 23.9 times the industry average.
- Another concern exceeded all five of the industry averages by at least 4.5 times. In addition, the firm's net profit after tax of \$8,543,753 was 105 times the industry average of \$81,435 and its profit margin of 35 percent was 17 times the industry average.

We believe firms should be graduated from the 8(a) program when their financial condition is substantially better than firms not in the program. SBA implemented a new management information system in late November 1993 that contains the industry financial data needed to make comparisons of 8(a) firms to

<sup>3</sup> Industry averages for gross profit were used in lieu of pre-tax profit which were not always available.

similar firms not in the 8(a) program. However, as of the time of our review, SBA had not established procedures and standards for making the comparisons. By establishing procedures and standards for making business financial condition comparisons, SBA will be able to identify 8(a) participants that should no longer be considered economically disadvantaged based on the financial condition of their firms.

### Recommendation

- 3A. We recommend the Associate Administrator for Minority Enterprise Development establish procedures and standards for comparing the financial condition of 8(a) firms to similar firms not in the program to identify participants that should be graduated from the 8(a) program because they are no longer economically disadvantaged.

### SBA Management's Response

The Associate Administrator for Minority Enterprise Development provided the following comment:

*"We agree and will implement procedures for use of analytical software for financial review."*

### Evaluation of Management Response

Actions planned by the Associate Administrator for Minority Enterprise are responsive to the recommendation.

### Finding 4 Exclusions From Personal Net Worth Calculations Disguise Economic Success

Individuals were considered economically disadvantaged and allowed to continue in the 8(a) program even though they had accumulated substantial wealth individually or jointly with their spouses. This occurred because SBA had not established procedures for determining when 8(a) participants should no longer be considered economically disadvantaged based on the equity in their 8(a) firms and primary residences and the net worth of the participants' spouses. Permitting wealthy individuals to remain in the 8(a) program is contrary to the goals of the program, reduces the opportunities available to those who are disadvantaged and undermines public support for the program.

SBA is required to formulate policies relating to 8(a) program eligibility by Section 7(j)(11)(A) of the Small Business Act. Section 8(a)(6)(E) states that whenever SBA calculates the personal net worth of an individual claiming disadvantaged status for purposes of the 8(a) program, the individual's ownership interest in the 8(a) concern and equity in his or her personal residence not attributable to excessive withdrawals from the concern will be excluded from the calculation. The implementing regulation, 13 CFR § 124.111(a), establishes personal net worth limits of \$500,000 and \$750,000 for maintaining 8(a) eligibility in the developmental and transitional phases, respectively.

#### Equity of 8(a) firms

Thirteen of the 50 8(a) participants claimed they met the criteria for claiming economic disadvantage even though they were considered millionaires based solely on their 8(a) firms' business equity. Congress included the business equity exclusion from the net worth calculation as an incentive for 8(a) participants to retain sufficient capital in the 8(a) firms to cover future business needs. However, this exclusion, if left unlimited, acts as a "safe-haven" from the net worth limit for large amounts of money or other assets accumulated by the 8(a) participant.

Ownership interest in the 8(a) firms excluded from the determination of the individuals' personal net worth ranged from \$70,460 to \$9 million as noted in the following chart.

<u>Ownership Interest In 8(a) Firm</u>	<u>Number Of Individuals</u>
\$1,000,000 to \$9,000,000	13
\$ 750,000 to \$ 999,999	6
\$ 500,000 to \$ 749,999	9
\$ 70,460 to \$ 499,999	20
Negative business equity	2

If the individuals' ownership interest in their 8(a) firms was not excluded, 29 of the 50 would exceed the personal net worth limits for claiming economic disadvantage status. For example, one participant had a personal net worth of \$509,343 after excluding the equity in his 8(a) firm and primary residence. At the time of our review, the 8(a) firm's net worth of \$4,109,448 was over 18 times the industry average of \$182,369. As all of the firm's net worth was excluded from the computation of the participant's personal net worth, he was allowed to remain in the program.

### Primary residences

Congress included the personal residence exclusion from the net worth calculation because of the belief that rapidly escalating real estate values and the wide disparity of real estate prices around the country may lead to inequitable treatment of home-owners in some areas. However, this exclusion, if left unlimited, acts as a "safe-haven" or loophole from the net worth limit for large amounts of money accumulated by the 8(a) participant. We believe the unlimited personal residence exclusion undermines the intent of the program as it allows wealthy individuals to remain in the 8(a) program. In addition, when 8(a) owners upgrade to more expensive homes, the amount of capital available to their 8(a) firms is reduced. Consequently, guidelines need to be established to close this loophole.

Home equity excluded from the personal net worth determinations of the 50 8(a) participants in our review ranged from \$21,000 to \$517,000 as shown in the following table.

<u>Home Equity</u>	<u>Number Of Individuals</u>
\$250,000 to \$517,000	9
\$125,000 to \$249,999	12
\$ 21,000 to \$124,999	29

Had home equity been considered in the determination of the individuals' personal net worth, 8 of the 50 would have exceeded the limits for claiming economic disadvantage.

We found that 43 of the 50 8(a) participants in our review lived in homes that had market values greater than the \$121,500 national median sales price of new privately owned one-family homes sold in 1992.<sup>4</sup> Primary residence market values ranged from \$45,000 to \$1.4 million as shown below.

<u>Primary Residence Market Value</u>	<u>Number Of Individuals</u>
\$800,000 to \$1.4 million	5
\$400,000 to \$799,999	10
\$200,000 to \$399,999	17
\$125,000 to \$199,999	11
\$ 45,000 to \$124,999	7

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<sup>4</sup> Source: U.S. Bureau of the Census, *Statistical Abstract of the United States: 1993* (113th edition)

We also found that it was not uncommon for 8(a) participants to move into higher priced homes after they entered the 8(a) program. For example, one participant was living in a home with a market value of \$250,000 (original cost - \$140,000) at the time he was approved for the 8(a) program. However, at the time of our review, the participant and his wife had moved into a house (Figure 1) with an assessed value of \$1.4 million (original cost \$980,000). The equity in the house exceeded \$470,000.



Figure 1

In another example, a participant when approved for the 8(a) program was living in a home with a market value of \$120,000 (original cost \$117,000) with a mortgage of \$98,000. At the time of our review, the participant had purchased a home with an assessed value of \$517,000 (market value unknown) (Figure 2) and had recently paid off the mortgage. The mortgage was approximately \$333,000 at the time it was paid off.

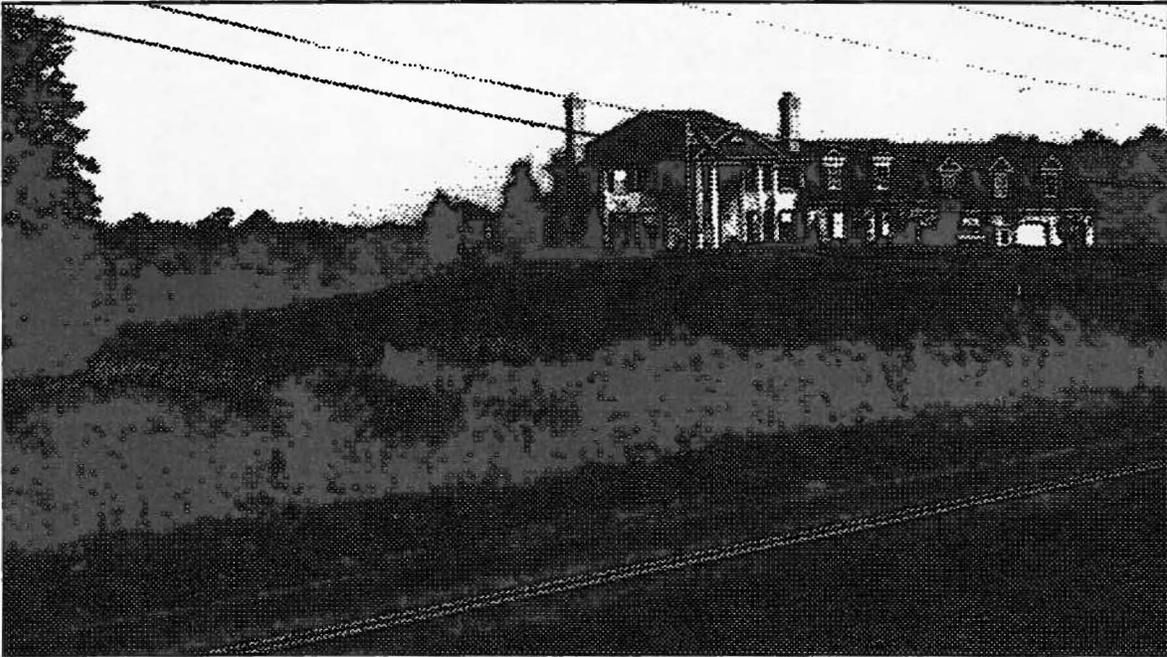


Figure 2

#### Net worth of spouses

Assessing economic disadvantage on an individual basis allows individuals to remain eligible for the 8(a) program even though they have accumulated substantial wealth jointly with their spouses. Married 8(a) participants not living in community property states are considered to be economically disadvantaged if their individual net worth is below the thresholds set by SBA regardless of the amount of their spouses' net worth. Participants living in community property states are limited to a joint net worth with their spouses of \$1 million in the developmental stage and \$1.5 million in the transitional stage of the program. Personal net worth of spouses excluded from the personal net worth determinations of the 50 8(a) participants in our review ranged from \$2,200 to \$771,874 after deducting the spouses' equity in the 8(a) firms and their primary residences. If the net worth of the individuals' spouses was not excluded, 10 of the 50 would exceed the personal net worth limits for claiming economic disadvantage.

#### Joint net worth without exclusions

With no exclusions, the joint personal net worth of the 50 8(a) participants in our review ranged from <\$1.2> million to \$11.7 million. Millionaire status had been achieved individually, or jointly if married, by 35 of the 8(a) participants as shown below.

<u>Personal Net Worth</u>	<u>Number</u>
\$1 million to \$11.7 million	35
\$750,000 to \$999,999	2
\$500,000 to \$749,999	7
\$0 to \$499,999	4
< \$1.2 > million to \$0	2

### Legislative History

In our opinion, it was not the intent of Congress to eliminate 8(a) participants' equity in their 8(a) firms and personal residences in a carte blanche manner. We recognize Congress enacted legislation excluding 8(a) participants' ownership interests in their 8(a) firms from their personal net worth to ensure 8(a) firms accumulate sufficient capital to cover future business needs. In addition, legislation excluding 8(a) participants' equity in their primary personal residence was enacted because of the belief that rapidly escalating real estate values and the wide disparity of real estate prices around the country may lead to inequitable treatment of home-owners in some areas. However, as evidenced in House Conference Report 100-1070, Congress also directed SBA to take appropriate steps to ensure that these exclusions were not subject to abuse. Although the value of business assets and primary personal residences are not to be considered as an element of personal net worth, Congress anticipated that SBA would consider whether such business assets and residences give individuals access to capital or loans such that he or she not be considered impaired in his or her ability to compete.

We also believe that the personal net worth of spouses should be considered in determining whether 8(a) participants continue to be economically disadvantaged. Unless consideration is given to all components of net worth, economically disadvantaged individuals will have reduced 8(a) program opportunities because individuals that have overcome their economic disadvantage will still be able to receive 8(a) assistance. Also, SBA could receive adverse publicity thereby undermining public support for the program.

### Recommendation

- 4A. We recommend that the Associate Administrator for Minority Enterprise Development establish procedures for determining whether 8(a) participants should no longer be considered economically disadvantaged based on their ownership interest in their 8(a) firms, the equity and market value of their primary residences, and the net worth of their spouses.

## SBA Management's Response

The Associate Administrator for Minority Enterprise Development provided the following comment:

*"The current statute precludes SBA from including the equity of the business and personal residence in determining a participant's personal net worth. We believe that while an individual's personal net worth may be below the applicable threshold, it does not preclude SBA from making a determination that the firm is no longer economically disadvantaged. If it is determined that the firm has the ability to compete and access to capital, SBA may graduate the firm. We plan to reemphasize this to the field offices."*

## Evaluation of Management Response

We believe SBA may have some flexibility under the current law. However, if SBA determines that the flexibility is not sufficient, SBA should seek legislative authority to close any loopholes. Although reemphasizing this fact to the field offices should be beneficial, we believe that abuses such as those described in the finding will continue unless specific guidelines addressing the equity and market value of primary residences, and the net worth of spouses are established.

## Finding 5      Other Observations

We also found other conditions that could negatively impact 8(a) program continuing eligibility reviews during our audit. Improvements are needed in these areas to help ensure that firms no longer eligible for the 8(a) program are graduated or terminated. Details of our observations are shown below.

## Financial Statements

Annual financial statements for 8(a) firms were not always submitted or prepared in accordance with 8(a) program regulations. This resulted because Business Opportunity Specialists did not fully understand the purpose of annual financial statements and they had too many other duties to perform to devote sufficient time to annual financial statements. Consequently, it was not always possible for Business Opportunity Specialists to adequately assess the financial condition and competitive mix of 8(a) firms.

We found the following for the 50 8(a) firms in our review:

- Three firms did not submit financial statements that were required to be audited or reviewed by an independent public accountant.

- Financial statements for 32 of the firms did not contain a breakdown of 8(a) and non-8(a) sales.
- The independent public accountants for two of the firms did not express an opinion on the firms' financial statements because of scope limitations.
- One firm submitted audited financial statements that were not prepared in accordance with generally accepted accounting principles.

In all but two cases, the BOSs accepted the financial statements as submitted. The two exceptions involved firms that did not submit audited financial statements.

#### Personal Financial Statements

The personal financial statement form that 8(a) participants are required to use to report their personal net worth is not structured in a manner that simplifies economic disadvantage determinations. SBA Form 413 "Personal Financial Statement" is used for all SBA programs. While it is adequate to calculate personal net worth for the purpose of obtaining or guaranteeing a loan, it is not structured to calculate adjusted net worth for 8(a) program eligibility purposes. Specifically, the form is not set up to exclude the 8(a) participants' ownership interest in their 8(a) firms and the equity in their primary residences to arrive at their adjusted personal net worth. Consequently, we found many instances in which Business Opportunity Specialists incorrectly calculated the adjusted net worth of 8(a) participants.

In addition, SBA's 8(a) Handbook currently instructs 8(a) participants to disregard the certification regarding the accuracy of statements made on SBA Form 413. As a result, it may be difficult to hold 8(a) participants accountable for making false statements regarding their personal net worth. SBA is presently in the process of removing the instruction that directed participants to disregard the certification and is also considering modification of SBA Form 413 consistent with the needs of the 8(a) program.

#### Incompatible Data

Data used to conduct 8(a) program continuing eligibility reviews was not always compatible and timely. This condition resulted because the program year of many of the firms in the 8(a) program is different than the firm's fiscal year and the owner's personal tax year. Section 7(j)(15) of the Small Business Act established a nine year program participation term for receiving 8(a) assistance. The first program year begins on the date that a firm is certified to participate in the program and ends one year later. Audited financial statements are not due

until 180 days after the firms' fiscal year end in accordance with 13 CFR § 124.209. In addition, many 8(a) program participants receive extensions to file their business and personal tax returns.

We found the program years were different from the firms' fiscal years and the owners' personal tax years for 38 of the 50 8(a) firms in our review. We also found instances in which business and personal tax returns were filed 9 months after the tax years ended and audited financial statements were filed 176 days after the firm's fiscal year end. As a result, continuing eligibility determinations were made more complex and time consuming because of incompatible and outdated data. Also, 8(a) participants that have overcome their economic disadvantage may be allowed to remain in the 8(a) program.

We found SBA was in the process of developing proposed changes to the 8(a) program at the time of our review. One of the proposed changes would require 8(a) firms to annually report their competitive business mix based on their fiscal year. However, this proposed change was not implemented as of the date of our review.

Ownership Interests In Other 8(a) Firms

Firms participating in the 8(a) program may hold up to a 10 percent equity ownership interest in other firms in accordance with 13 CFR § 124.103. Also, individuals affiliated with 8(a) firms as partners, stockholders, officers, or directors may hold up to a 10 percent equity ownership interest in other 8(a) firms. Consequently, 8(a) firms through their owners, spouses and managers can exercise significant control over other 8(a) firms by acquiring up to a 49 percent interest in the other 8(a) firms. As an example, 1 of the 50 firms in our review acquired a 40 percent interest in another 8(a) firm as shown below.

<u>Affiliated Individual Acquiring Ownership Interest</u>	<u>Percentage</u>
Disadvantaged owner	10
Disadvantaged owner's spouse	10
Non-disadvantaged owner	10
Non-disadvantaged owner's spouse	6
Key manager #1	2
Key manager #2	<u>2</u>
 Total	 <u>40</u>

In addition, 8(a) firms can subcontract with the other 8(a) firms to work on 8(a) contracts in those cases where they have outgrown the Standard Industrial Classification (SIC) code. These subcontracts are reported as non-8(a) business thereby improving their competitive mix. For example, the firm that acquired the 40 percent interest in another 8(a) firm was similar in nature as it had 11 matching SIC codes. However, even though the 8(a) firm in our review had outgrown four of its SIC codes, it continued to work on follow-on contracts with agencies that it had previous 8(a) contracts as a subcontractor for the 8(a) firm in which it had acquired the 40 percent interest. In addition, the work performed as a subcontractor was considered non-8(a) sales for competitive mix purposes.

### Recommendations

We recommend the Associate Administrator for Minority Enterprise Development:

- 5A. instruct SBA district offices to place increased emphasis on 8(a) program participants' submission and preparation of financial statements.
- 5B. develop a standard form for reporting the adjusted personal net worth of 8(a) participants.
- 5C. realign 8(a) firms' program years with their fiscal years and the tax years of the disadvantaged owners.
- 5D. require 8(a) firms to submit annual financial statements (audited, reviewed, or compiled) within 90-days of their fiscal year end.
- 5E. require that disadvantaged owners and firms participating in the 8(a) program submit their personal and business tax returns to SBA by the 15th day of the 4th month after the respective tax year ends.
- 5F. require that disadvantaged owners' firms participating in the 8(a) program and associates of the owner(s) or firm be limited in their equity ownership interests in other 8(a) firms of no more than a combined 10 percent.
- 5G. require that revenue earned from subcontracting on noncompetitive 8(a) contracts be classified as 8(a) revenue.

## SBA Management's Response

The Associate Administrator for Minority Enterprise Development provided the following comments:

- 5A. *"We agree."*
- 5B. *"We agree and it will be part of the annual review form."*
- 5C. *"We agree and have submitted this proposal as part of our legislative package."*
- 5D. *"MED previously increased the \$2.5 million threshold to \$5.0 million. Consistent with previous agreement with your office we will require firms with revenues exceeding \$5.0 million to submit audited financial statements within 120 days of their fiscal year end."*
- 5E. *"We do not agree that participants should waive their rights. However, we will require timely submission of personal and firm financial statements and will ensure that information is analyzed as part of the annual review."*
- 5F. *"We agree and have addressed this issue in our proposed regulations."*
- 5G. *"We do not agree because we feel it would discourage 8(a) companies from subcontracting to other 8(a) companies. The classification of work as 8(a) does not flow down to second tier subcontractors since there is no privity of contract between the U.S. Government and the second tier subcontractor."*

## Evaluation of Management Responses

Actions planned by the Associate Administrator for Minority Enterprise are responsive to recommendations 5A, 5B, 5C and 5F.

5D. The Associate Administrator for Minority Enterprise is correct in stating that we previously agreed that 8(a) firms should be required to submit audited financial statements within 120 days of their fiscal year end when their revenues exceed \$5 million. However, that agreement was made without the benefit of the information disclosed during our audit. Based on the results of our audit, we consider 90 days and \$2.5 million to be more appropriate. We believe that 90 days is ample time for the submission of audited, reviewed or compiled financial statements. Besides improving the compatibility of data available for annual

reviews, the 90 day requirement will make the 8(a) program consistent with other SBA programs.

5E. We agree that 8(a) participants should not be required to waive their right to file an extension on their tax returns. However, we do not believe that it is unreasonable for individuals benefiting from the 8(a) program to provide completed tax returns within agreed upon deadlines. Therefore, as an alternative, we suggest 8(a) participants should be required to submit their tax returns (as well as other required information) within the established time frames (75 to 105 days after tax year end) or suspend 8(a) assistance for those 8(a) participants who choose not to submit the required information within established deadlines. Without extensions, business and personal tax returns are due on the 15th day of the 3rd and 4th month after the tax year ends, respectively. In our opinion, these time frames are reasonable for 8(a) participants to submit tax returns. As a result, the annual review process will be simplified and strengthened.

5G. We disagree that 8(a) companies would be discouraged from subcontracting to other 8(a) companies if revenue earned from subcontracting on noncompetitive 8(a) contracts is classified as 8(a) revenue. While we have no objection to 8(a) firms working as subcontractors on noncompetitive contracts in which the firms have outgrown the SIC code, we believe it would be appropriate to classify revenue earned from those contracts as 8(a) revenue. We agree that there is no privity of contract between the U.S. Government and second tier subcontractors, but fail to see why that would prevent SBA from classifying work performed as 8(a) revenue.

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