



75-0122



REPORT TO THE CONGRESS

Questionable Effectiveness Of The 8(a) Procurement Program

Small Business Administration

*BY THE COMPTROLLER GENERAL
OF THE UNITED STATES*

GGD-75-57

702309 / 97056 APRIL 16, 1975




COMPTROLLER GENERAL OF THE UNITED STATES
WASHINGTON, D.C. 20548

B-132740

To the President of the Senate and
Speaker of the House of Representatives

This is the first in a series of reports to be issued pursuant to Public Law 93-386 which requires us to conduct a full-scale audit of the Small Business Administration. It discusses the effectiveness of the 8(a) procurement program.

We are sending copies of this report to the Director, Office of Management and Budget, and the Administrator, Small Business Administration.


Comptroller General
of the United States

C o n t e n t s

	<u>Page</u>
DIGEST	i
CHAPTER	
1 INTRODUCTION	1
Legislative history	1
Contracting procedures	2
Eligibility	3
Successful firms	3
Growth of the program	3
Business development expense	4
Sponsors used to assist firms	5
Internal audit review	5
Organization of SBA	5
2 LIMITED SUCCESS OF 8(a) PROGRAM IN HELPING FIRMS TO BECOME SELF-SUFFICIENT	7
Firms classified as deteriorated or out of business	9
Firms showing improvement but not achieving self-sufficiency	11
Firms classified as self-sufficient	13
Conclusions, agency comments, and our evaluation	15
Recommendation	17
3 EXTENT AND EFFECT OF SPONSORSHIP IN THE 8(a) PROGRAM	18
How and why experienced firms became sponsors	18
Controls exercised by sponsors	19
Cost of sponsors' services	23
Conclusions, agency comments, and our evaluation	24
Recommendation	26
4 NEED FOR PROGRAM ASSISTANCE NOT DOCUMENTED AND APPEARS QUESTIONABLE	27
Target group	27
Reliance on social causes of disadvan- tage	28
Written justification needed	29
Conclusions	31
Recommendation	31
Agency comments and our evaluation	31

COMPTROLLER GENERAL'S
REPORT TO THE CONGRESS

QUESTIONABLE EFFECTIVENESS OF
THE 8(a) PROCUREMENT PROGRAM
Small Business Administration

D I G E S T

WHY THE REVIEW WAS MADE

Section 8(a) of the Small Business Act of 1953 gives the Small Business Administration (SBA) the authority to enter into procurement contracts with Federal agencies and, in turn, subcontract the work to small businesses. SBA has used this authority to develop a program designed to assist socially or economically disadvantaged small businessmen in achieving a competitive position in the financial marketplace. Since 1968, when the 8(a) program was started, SBA has awarded 6,912 subcontracts totaling \$737,100,000 to over 2,800 business firms. (See pp. 4 and 5.)

Members of Congress have expressed concern over the benefits derived from the 8(a) program. Accordingly, GAO reviewed the program to determine whether eligible firms were becoming self-sufficient and viable.

GAO did most of its work in Washington, D.C., and in the Atlanta, Dallas, Detroit, Philadelphia, New York, and San Francisco areas. (See p. 35.)

FINDINGS AND CONCLUSIONS

Progress of 8(a) firms

SBA's success in helping disadvantaged firms to become self-sufficient and competitive has been minimal. From 1968 to August 1974, only 31 firms successfully completed the program.

GAO evaluated the progress of 110 firms that had received at least 1 subcontract before December 31, 1970. These firms received over \$81.4 million in 8(a) subcontracts. (See p. 7.)

Of the 110 firms, 73 had not reached self-sufficiency. Twenty firms deteriorated financially, 27 went out of business, and the remaining 26 had either a slight financial improvement (but not enough to make the firm self-sufficient) or no change. Of the remaining 37 firms, 18 became self-sufficient and 19 were not classified because of insufficient information.

A major reason for this lack of success was SBA's inability to control the supply of contracts from Federal agencies. Although applicants specify in business plans the amount of

GGD-75-57

viable businesses and at the same time make a profit. However, five said they had very little incentive to create viable businesses which later would become competitors.

SBA lacks criteria to define the extent to which sponsors can collect fees for services rendered. For example, the sponsors GAO reviewed charged fees ranging from about 6 percent to about 17 percent of gross receipts. Moreover, SBA does not regularly analyze financial transactions between sponsors and 8(a) firms to insure their propriety and reasonableness. (See p. 18.)

Eligibility

SBA requires that owners of applicant firms be socially or economically disadvantaged to be eligible for the 8(a) program.

SBA has admitted applicants in the program on the basis of social disadvantage without documenting the reason the assistance is needed. SBA field offices should be required to document in writing the connection between an applicant's social or economic disadvantage and his inability to compete successfully in the business world. Furthermore, some applicants whose need for assistance appears questionable have been admitted to the program. (See p. 27.)

Administration

SBA emphasizes that the performance of 8(a) firms must be closely monitored, but it has not regularly done so. Therefore, SBA has not been able to identify the contractual and management assistance requirements of 8(a) firms or to promptly fulfill these requirements. (See p. 32.)

Although SBA considers management assistance an important tool in correcting the deficiencies of 8(a) firms, it has not provided such assistance to about 52 percent of the firms GAO reviewed. Seven firms that requested management assistance did not receive it. Of the 88 firms that received management assistance, only 33 were satisfied with it. (See p. 32.)

SBA has established goals for the 8(a) program in terms of the number and dollar amount of contracts awarded. GAO believes this is not a valid measure of effectiveness.

For example, SBA has met its monetary goals, even though business plan projections were not met, in each of the last 3 fiscal years, but only 31 firms graduated from the program. A more appropriate goal would appear to be based on the desired number of successful program completions. (See p. 33.)

--Establish adequate internal controls to insure that 8(a) firms are provided management assistance. (See p. 34.)

audit of SBA--demonstrates the need for fundamental changes in SBA's 8(a) program if the longstanding congressional aim of assisting disadvantaged businessmen is to be achieved.

MATTERS FOR CONSIDERATION BY THE CONGRESS

This report--the first in a series pursuant to Public Law 93-386, which requires GAO to conduct a full-scale

The Congress may wish to review what is being done to correct the program's problems when considering future authorization and appropriation requests.

TEST DOCUMENT AVAILABLE

CHAPTER 1

INTRODUCTION

Section 8(a) of the Small Business Act of 1953 authorizes the Small Business Administration (SBA) to enter into procurement contracts with Federal agencies and, in turn, to subcontract the work to small businesses. The program currently emphasizes providing subcontracts to businesses owned by socially or economically disadvantaged persons.

LEGISLATIVE HISTORY

The concept of channeling contracts to small businesses through an intermediate Federal agency was an emergency measure to insure that small businesses were not bypassed in wartime. SBA, however, never used the section 8(a) authority for that purpose. Section 8(a) lay dormant for about 15 years because SBA believed that the efforts to start and operate an 8(a) program would not be worthwhile in terms of developing small businesses.

SBA first used section 8(a) during fiscal year 1968 in a test program initiated by the President of the United States following the 1967 civil disturbances. In announcing this program on October 2, 1967, the President said:

"We are launching today a major test program to mobilize the resources of private industry and the Federal Government to help find jobs and provide training for thousands of America's hardcore unemployed * * *.

"To initiate this effort, the resources of the Department of Commerce, Defense, Labor, Health, Education, and Welfare, and Housing and Urban Development, the Office of Economic Opportunity, the General Services Administration and the Small Business Administration will be combined to provide maximum assistance and to minimize the added cost of those in private industry willing to assume responsibility for providing training and work opportunities for the seriously disadvantaged * * *."

The decision to inaugurate such a program was an outgrowth of September 1967 recommendations of the Southern Governors Conference. The conference concluded that improved education and better jobs in inner cities were of paramount importance in meeting the needs of black Americans reaching for social equality. The program, referred to as the President's Test

ELIGIBILITY

To be eligible for the 8(a) program, a firm must be owned and controlled by a socially or economically disadvantaged person. Although the Congress has not precisely defined the term "disadvantaged," SBA has decided to base the eligibility criteria on a section of the Economic Opportunity Act of 1964, which indicated that SBA should attempt to assist small businesses in any way that furthers the purposes of the act. Although SBA recognizes that disadvantage may arise from cultural, social, or chronic economic circumstances or background or similar causes, it emphasizes that eligibility determinations should avoid any implication that eligibility is based principally on the race, creed, or ethnic background of an individual.

SUCCESSFUL FIRMS

SBA's intention is for a firm to graduate from the 8(a) program after achieving a competitive position in the marketplace. In a statement before the House Select Committee on Small Business in September 1973, the SBA Administrator stated:

"The Section 8(a) authority is utilized together with other available agency resources, to strengthen and upgrade these small business concerns. It is intended that through the assistance of program resources these concerns will enhance their opportunity to achieve a competitive and profitable position in the marketplace. It is not intended that 8(a) subcontracts would support a company indefinitely, but rather should serve as an adjunct to assist in its development."

Our evaluation of the effectiveness of the 8(a) program in helping firms to become competitive and financially sound is discussed in chapter 2.

GROWTH OF THE PROGRAM

SBA has succeeded in bringing many firms into the program and in obtaining an increasing volume of contracts. During the 15-month period ending September 30, 1974, the following types of firms participated in the program.

<u>Fiscal year</u>	<u>Appropriated by the Congress</u>	<u>Actual payments</u>	<u>Number of payments</u>
	(millions)		
1972	\$ 8	\$ 4.1	73
1973	14	6.1	127
1974	<u>8</u>	<u>5.9</u>	<u>84</u>
Total	<u>\$30</u>	<u>\$16.1</u>	<u>284</u>

SPONSORS USED TO ASSIST FIRMS

SBA uses profit-oriented business sponsors to assist 8(a) firms in managing their business operations and to provide them with capital and training. Thus, SBA can reduce the resources which it must commit. In return for their assistance, sponsors obtain limited stock ownership in 8(a) firms and/or receive fees from the firms.

The following table shows how the contracts were divided between sponsored and nonsponsored firms from the beginning of the program through June 30, 1974.

	<u>Sponsored firms</u>	<u>Nonsponsored firms</u>	<u>Total</u>
Number of firms	77	2,785	2,862
Number of contracts	356	6,556	6,912
Dollar amount of contracts	\$132,547,913	\$604,518,531	\$737,066,444
Average dollar amount	\$372,326	\$92,208	\$106,636

INTERNAL AUDIT REVIEW

In July 1973 SBA's Internal Audit Division identified several areas in which SBA's administration of the 8(a) program could be improved. The auditors pointed out that, because SBA's eligibility criteria for the program were vague, nondisadvantaged persons could be admitted. In November 1974 SBA revised its Standard Operating Procedures for the program. The internal auditors did not attempt to evaluate the effectiveness of the program in helping 8(a) firms to become self-sufficient.

ORGANIZATION OF SBA

SBA operates 10 regional offices and 81 branch and district offices to aid the 8.8 million small businesses

CHAPTER 2

LIMITED SUCCESS OF 8(a) PROGRAM

IN HELPING FIRMS TO BECOME SELF-SUFFICIENT

SBA's success in helping participating 8(a) firms to become self-sufficient and competitive has been minimal. According to SBA, over 2,800 firms have participated in the program since 1968; however, only 31 firms had successfully completed the program as of August 1974.

We evaluated the success of the program by measuring the progress of 110 firms, in 11 metropolitan areas, that began participating before December 31, 1970. These firms received \$81.4 million in 8(a) subcontracts. Although several firms improved their financial positions through increased sales, net income, and net worth, they still were not self-sufficient. Some firms became dependent on SBA for assistance and would suffer serious financial setbacks if SBA withdrew its support. Our evaluation of each firm was based on its gross sales, 8(a) sales, commercial sales, net profit, net worth, views of the owner, and views of SBA personnel.

We classified each of the 110 firms as not self-sufficient (deteriorated, out of business, improved, or no change), self-sufficient, or undeterminable on the basis of the following criteria.

--Not self-sufficient:

1. Operating at a loss or making less profit than before 8(a) participation and showing no evidence of being able to reverse the trend (deteriorated).
2. Having a negative net worth or a lower net worth than at the time of entry and showing no evidence of being able to reverse the trend (deteriorated).
3. Going out of business.
4. Improving financially but not capable of sustaining profitable operations without 8(a) assistance because of weak financial position or an inability to generate commercial sales (improved).

FIRMS CLASSIFIED AS DETERIORATED
OR OUT OF BUSINESS

The competitive status of 20 firms included in our sample deteriorated during their participation in the program. In addition, 27 of the firms sampled had gone out of business as of June 30, 1974. One reason for these setbacks was the inability of the 47 firms to generate commercial sales. For example, SBA awarded a newly formed western janitorial firm three consecutive 1-year contracts. However, when the third contract was completed and a new 8(a) contract was not forthcoming, the firm promptly went out of business.

Another reason, which we believe is a major weakness in the design of the program, is SBA's inability to control the supply of contracts from Federal agencies. SBA cannot effectively determine if enough contracts can be obtained at any given time to support new 8(a) firms.

Federal agencies voluntarily participate in the program and are under no obligation to provide SBA with any particular contract or group of contracts. SBA encourages the agencies to participate by reviewing planned procurements at each agency, identifying suitable contracts, and negotiating with agency personnel in an effort to designate contracts for the program. On occasion Federal agencies volunteer contracts to SBA.

The 8(a) program is designed to provide participating firms contractual and management assistance over a specified period. Applicant firms normally prepare a business plan to demonstrate how participation in the program will foster or expand the firm's opportunities to become self-sufficient. SBA's policy is not to approve a firm's business plan unless there is a reasonable likelihood that a contract can be awarded to the firm. However, at the same time, SBA informs the applicant firm that approval of a business plan is not a commitment to award a single contract, a continuing series of contracts, or any other assistance.

SBA did not provide adequate contract assistance to the 20 firms that deteriorated financially or the 27 firms that went out of business. Of these 47 firms, 16 projected assistance totaling \$17.1 million in their business plans, but SBA provided only \$5.8 million in subcontract assistance. The remaining 31 firms did not prepare business plans or make projections.

To illustrate the significance of this problem, we made the comparison on a larger scale. In fiscal year 1973 all 8(a)

The firm demonstrated the ability to generate commercial sales but needed 8(a) assistance after a drop in commercial sales between 1968 and 1969. At the time of approval, the firm estimated that it would need \$4.8 million in 8(a) assistance over a 3-year period but had received only \$756,000 by 1973. The president of the firm believed that this assistance was inadequate. In 1973 the firm requested \$1.6 million in 8(a) assistance but received only \$34,000. The inability of SBA to fulfill the needs of this firm appears to be a major cause of its deterioration.

A consulting firm hired by SBA to provide management assistance to the company estimated that the company needed to generate annual sales of \$2 million to break even.

Example B

A southeastern firm went out of business in 1972, after 3 years in the program. The firm was formed in 1947 and requested assistance in 1970 to expand its business. The firm became dependent on 8(a) subcontracts for 90 percent of its sales in 1971 and suffered a loss when SBA did not supply the volume of contracts projected by the firm when it entered the program.

<u>Year</u>	<u>Gross sales</u>	<u>8(a) sales</u>	<u>Commercial sales</u>	<u>Net profit or loss (-)</u>	<u>Net worth</u>
1969	\$ 50,000	\$ -	\$50,000	\$ 9,000	(a)
1970	72,000	24,000	48,000	4,000	(a)
1971	146,000	132,000	14,000	14,000	(a)
1972	39,000	7,000	32,000	-2,000	(a)
1973	Out of business				

a/No record.

The owner of the firm felt that there were two reasons for his business failure. First, he believed SBA would supply his projected \$340,000 in subcontracts over a 3-year period, but he only received \$163,000. Second, the firm was losing money on its contracts, and he did not realize it.

FIRMS SHOWING IMPROVEMENT BUT NOT ACHIEVING SELF-SUFFICIENCY

Although 21 of the firms in our sample improved their competitive positions through increased sales, net income, or net worth, they did not achieve self-sufficiency. The main reason for this was the firms' inability to generate

Example B

A northeastern consulting firm, formed in 1968, was approved for 8(a) assistance in 1969. The president and other officers of the firm all had several years of experience in the consulting field but had not been able to operate the firm profitably. After 3 years of losses, the firm showed increasing profits in 1972 and 1973. The firm's gross sales also increased from \$102,000 in 1969 to \$1.7 million in 1973.

The main limit to this firm's progress toward self-sufficiency is its inability to generate commercial sales and its heavy dependence on the 8(a) program. Of the firm's gross sales during 1973, 86 percent were from 8(a) subcontracts.

FIRMS CLASSIFIED AS SELF-SUFFICIENT

We classified 18 firms as self-sufficient; however, 11 of them had demonstrated the ability to sustain profitable operations on the same scale or a smaller scale before receiving 8(a) assistance.

The remaining seven firms appeared to become self-sufficient while participating in the 8(a) program. This success can be attributed to their ability to generate commercial sales while sustaining profitable operations. For example, six of the seven firms increased their gross sales and net income while in the program. Also, five of the firms derived less than 25 percent of their total annual sales from 8(a) contracts during the last year.

Example A

In 1970 SBA admitted to the program a western firm which had been in operation only 9 months and which had not yet established itself as a competitive business. The owner of the firm had an extensive technical background in electronics but no administrative experience. The 8(a) program was the means the owner needed to expand the firm, and he has been successful in his efforts.

The firm increased the number of its employees from 6 to 62 and expanded its production facilities by 4,000 square feet after entering the program. The firm has received \$260,000 in assistance since being awarded its first 8(a) contract. During the same period the firm increased its annual commercial sales by almost \$900,000, as shown below.

CONCLUSIONS, AGENCY COMMENTS,
AND OUR EVALUATION

The 8(a) program has had limited success in helping firms to become self-sufficient. This lack of success can be partly attributed to two problems: (1) SBA has no control over the supply of contracts for the program and (2) 8(a) firms have not generated enough commercial sales to become independent of the need for 8(a) assistance.

We believe that, without some control over the availability of contracts, SBA will not always be able to provide 8(a) firms with the volume of contractual assistance needed to support growth toward self-sufficiency. Thus, unless the design of the program is modified to allow SBA a better opportunity to meet the needs of its participants, the program may continue to have limited success.

In commenting on our report, SBA stated that:

"In the interests of a fair and more accurate assessment of the 8(a) program, we believe the following should be considered:

1. Included with the firms categorized were those which had received only one contract during a time period when the main thrust of the program was 'placement of contracts.' In many of these cases, SBA was unable to provide the contract assistance it would have liked because of availability of suitable requirements from procuring agencies. Alternatively, these floundering firms might have been dropped from the rolls, thus eliminating the possibility of sharing the responsibility for later failure. However, the firms were retained, because the program was still in its formative stages, and it was felt that additional contract support from the procuring activities would be forthcoming.
2. Some of the firms which have 'deteriorated' while in the 8(a) program have done so for reasons that can be attributed to losses on non-8(a) contracts. There is reason to believe that were it not for the support afforded these companies by the SBA during these marginal times, they most likely would have failed.

were showing minimal aptitude or application and were unable to profit from experience or management assistance. SBA envisions maintaining an 8(a) program portfolio of 1,500 active firms.

SBA's actions are commendable, however, as shown on page 4, SBA had provided only 1,132 firms with contracts during fiscal year 1974. As indicated in this chapter, many of these firms met with only limited success in developing businesses partly because of SBA's inability to supply an adequate amount of contract assistance. Accordingly, we question SBA's ability to support 1,500 firms with the number of contracts necessary to make them self-sustaining.

We also suggested that the Administrator provide 8(a) firms with more assistance and guidance in developing commercial sales so that the firms could decrease their dependence on SBA assistance.

SBA agreed with our second suggestion and said that assistance and guidance in developing sales for 8(a) firms was an early program objective and has been given additional emphasis in their new procedures. Also, according to SBA, there are now five times as many field management assistance personnel as there were in 1973. The November 1974 procedures provide that SBA shall arrange for management, marketing, technical, financial, and procurement assistance, as needed, from whatever source may be available and that other SBA assistance programs are available to 8(a) contractors. SBA also informed us that its Office of Management Assistance was giving high priority to the development of 8(a) companies' marketing ability.

We believe SBA should make periodic studies of the program to insure that field offices are following procedures, in particular, those requiring that field offices give assistance and guidance in developing sales so that firms may decrease their dependence on SBA assistance.

RECOMMENDATION

We recommend that the Administrator of SBA reconsider SBA's position of maintaining 1,500 active firms in its 8(a) program and periodically adjust the number of firms depending on the level of contracts that can be made available for the 8(a) program.

--The small disadvantaged firms usually lacked the capital and caliber of management required to successfully perform the large contracts.

--The independent contractors that previously obtained and performed the contracts competitively realized that they would lose contracts to the 8(a) program and became highly critical of SBA and the program.

The seven contractors told us they generally were very much opposed to SBA's practice of using large contracts for the 8(a) program. The service contractors contacted SBA officials, sought solutions in the courts, contacted congressional representatives, and ultimately sent a delegation of representatives to the White House. Then, the contractors became aware of the profit potential in becoming sponsors and decided not to fight SBA but to join in SBA's effort to develop viable businesses.

Six of the seven sponsors we interviewed said they had become sponsors to make profits and to protect their livelihoods. Although six sponsors expressed a desire to develop viable businesses, five said they had very little incentive to create viable businesses which would later become competitors and therefore preferred to establish a relationship of interdependency which would continue indefinitely.

The experienced contractors generally became sponsors by forming new corporations using former employees as stockholders and officers, getting the new corporations approved for the 8(a) program, and providing goods and services to the new corporations for a fee. Six sponsors also obtained 49 percent or less ownership in the new 8(a) firms.

CONTROLS EXERCISED BY SPONSORS

All of the 25 firms we reviewed were influenced by their sponsors; were very dependent on them; and had, through various actions or inactions, delegated a high degree of control to the sponsors.

The business plans and/or management agreements between the firms and their sponsors did not contain detailed descriptions of services to be provided by the sponsors or the fee to be charged for each service. Instead, they generally stipulated that the sponsors would provide the 8(a) firms those types of services customarily considered general and administrative items--training, accounting, figuring taxes, making management reports, and providing secretarial and clerical help. In addition, all of the sponsors generally represented the 8(a) firms in identifying and negotiating new

banks, usually located near the sponsors' places of business. The banks paid no interest to the firms because their funds were maintained in checking accounts. Although the accounts were sizeable, there were no indications that short-term investments were considered.

- Leasing equipment: Two sponsors and a leasing company owned by a stockholder of another sponsor leased equipment to 10 firms. None of the firms had an option to buy the equipment.
- Dealing with contracting agencies: All of the sponsors represented the firms in resolving problems arising from contract performance and in negotiating changes in contract specifications and any other items which would affect the successful completion of contracts.

SBA considers ownership of 51 percent or more of an 8(a) firm by disadvantaged individuals as evidence of their control. In February and October 1973, SBA's External Audit Group reviewed five 8(a) firms with two sponsors and concluded that control of these 8(a) firms rested firmly in the hands of the sponsors.

Example of a sponsorship arrangement

The manner in which control is exercised by a sponsor is sometimes difficult to understand. A description of the business relationship between a sponsor and 8(a) firms and the extent to which the sponsor exercised controls is discussed in appendix IV. This case should not be viewed as being typical for all sponsors; however, it did closely resemble those cases we reviewed.

The sponsor discussed in the example in appendix IV controlled two mess attendant firms in July 1974 in the following manner:

- Incorporating the firms as close corporations.
- Appointing its company personnel to key positions in the firms.
- Completely controlling cash expenditures.
- Controlling management policy through stock ownership.
- Maintaining the firms' books and records.

officer's wife said he spent all of his time working on the sponsor's farm.

In 16 of the 25 firms, the disadvantaged owners had previous experience in janitorial and kitchen police work as managers for the sponsoring businesses, in the military, or elsewhere.

COST OF SPONSORS' SERVICES

Sponsors were paid for their services by management fees. Our review of 25 firms showed the following expenditures were made as of June 30, 1974.

<u>Sponsor</u>	<u>8(a) firms</u>		<u>Service fees</u>	
	<u>Number</u>	<u>Total income</u>	<u>Paid to sponsors</u>	<u>Percent of gross income</u>
A	6	\$16,094,000	\$2,534,000	15.7
B	1	388,000	64,000	16.6
C	4	11,758,000	1,066,000	9.1
D	3	403,000	31,000	7.7
E	2	162,000	10,000	6.0
F (note a)	4	11,483,000	889,000	7.7
G	5	(b)	(b)	(b)
	<u>25</u>	<u>\$40,288,000</u>	<u>\$4,594,000</u>	11.4

a/Amounts shown are for the 11-month period ended May 31, 1974.

b/Not obtained.

SBA has not established criteria for determining the reasonableness of fees and other amounts paid to sponsors.

In addition to paying fees for services, 8(a) firms paid for other items provided by their sponsors or for the sponsors participation in profits as stockholders of 8(a) firms, as discussed below.

Salaries

Three sponsors received salaries from four firms.

Sale of ownership

SBA required two of the sponsors who acquired stock in eight firms to sell their stock on or before a specified date. The sponsors did so, and by agreement with the other stockholders of the firms, the sale price of the stock was

maintaining their relationships with 8(a) firms for as long as possible to continue to profit from their investments.

It appears that SBA relinquished to sponsors its responsibilities to insure that 8(a) firms were provided with capital, management services, and training to aid them in becoming self-sufficient. The sponsors often controlled the firms, which did not meet SBA's objective of helping them to become self-sufficient. This occurred because SBA did not (1) monitor the extent to which sponsors controlled 8(a) firms or (2) determine whether firms were becoming self-sufficient. Instead, SBA considered majority ownership of 8(a) firms by disadvantaged individuals as evidence of their control. SBA also did not establish procedures on sponsors' management fees.

We suggested that SBA establish a system to monitor (1) the extent to which sponsors control 8(a) firms and (2) the progress of the sponsor-controlled firms toward becoming self-sufficient. We also suggested that SBA develop criteria to define the extent to which sponsors can collect fees from 8(a) firms for services and other items provided during the performance of an 8(a) contract.

SBA agreed that sponsorship arrangements should be monitored to insure that they are consistent with SBA's objective of developing viable small businesses. They agreed that criteria are needed to define the extent to which sponsors can charge management fees for services provided to 8(a) firms. SBA noted that action has been taken toward accomplishing these objectives, as evidenced by revisions to SBA's procedures in November 1974. However, these procedures do not explicitly require the monitoring of sponsorship arrangements once they are approved by SBA.

We believe that the revisions to SBA procedures provide SBA field offices with adequate guidance needed to determine the extent to which sponsors control 8(a) firms and will, if properly implemented, insure the reasonableness of fees collected from 8(a) firms. We believe, however, that it is imperative that SBA also routinely monitor the activities of sponsors and the progress of the sponsor-controlled 8(a) firm to insure that (1) the sponsorship arrangement is being carried out according to the terms sanctioned by SBA at the time of its approval and (2) the fees collected by sponsors are consistent with the services actually provided.

CHAPTER 4

NEED FOR PROGRAM ASSISTANCE

NOT DOCUMENTED

AND APPEARS QUESTIONABLE

SBA has admitted applicants into the 8(a) program on the basis of social disadvantage without documenting the reason the assistance is needed. We believe SBA should require field offices to document in writing the connection between an applicant's social or economic disadvantage and his inability to compete successfully in the business world. Furthermore, some applicants whose need for assistance appears questionable have been admitted to the program.

TARGET GROUP

SBA's purpose for using the 8(a) authority is to improve disadvantaged individuals' economic positions and abilities to compete in the financial marketplace. SBA regulations state that disadvantage "may arise from cultural, social, or chronic economic circumstances or background or other similar cause." According to SBA, such individuals include, but are not limited to, members of the following minority groups: black Americans, American Indians, Spanish Americans, oriental Americans, and Eskimos and Aleuts. SBA's detailed requirements on ownership are shown in appendix V.

SBA's General Counsel has published additional eligibility criteria based on his interpretation of the Economic Opportunity Act. According to these criteria, an applicant may be considered disadvantaged because:

- His social background has prevented him from obtaining technical assistance or financing of a quality or quantity similar to that available to the average entrepreneur.
- Past discrimination based on race, religion, or ethnic background has impeded his normal entry into the economic mainstream.
- He has been frequently or marginally unemployed due to his residency in depressed areas or due to past discrimination based on race, religion, or ethnic background.
- He has been chronically in a low-income status.

WRITTEN JUSTIFICATION NEEDED

We attempted to analyze the status of the owners of 166 firms in the 8(a) program to evaluate their need for 8(a) assistance. Financial information on the owners was not available in 116 of the 166 cases, apparently because of SBA's reliance on social factors. In most cases SBA considered the individuals' eligibility for the 8(a) program primarily based on ethnic considerations, in which minority status was equated with being disadvantaged.

For the remaining 50 cases, we examined (1) the owners' financial positions when they entered the 8(a) program and (2) SBA's reasons for declaring the owners disadvantaged. Our analysis of owners' net worth is shown below.

<u>Range of net worth</u>	<u>Number of firms</u>
Negative to \$1,000	5
\$1,001 to \$5,000	3
\$5,001 to \$50,000	19
\$50,001 to \$100,000	9
\$100,001 to \$250,000	9
Over \$250,000	<u>5</u>
Total	<u>50</u>

As shown above, some owners had relatively high net worths, which indicates they had competed successfully in the marketplace. Whether firms belonging to such individuals need Federal assistance is questionable. Some of these owners said they had no urgent need for 8(a) assistance but had entered the program at SBA's invitation to help increase their sales and market penetration or to generate sales for slack seasons.

Following are examples of firms whose eligibility appears to be questionable, because of their owners' financial status.

--A midwestern firm, formed in 1973, entered the program at about the same time. The firm has received \$193,985 in 8(a) subcontracts and is owned by a black American. The firm had no sales when it entered and its initial capital was \$10,000. Information obtained from SBA showed that the owner had a \$24,000 annual salary from sources other than his 8(a) firm and a personal net worth of about \$416,000 at the time of his approval. SBA declared the owner eligible because of social disadvantage.

f. Frequency of unemployment or marginal employment due to * * * past practices of discrimination * * *.

g. History of applicant income status."

The new procedures state that the composite of the above factors and other pertinent information will establish a profile which will be used as the basis for determination of eligibility. The procedures require that the results of the evaluation of eligibility be summarized in writing.

CONCLUSIONS

Although new procedures were issued, their provisions are discretionary in that they suggest what may be considered. Because the above factors are discretionary, the profile resulting from the use of these factors will not show the connection between an applicant's social or economic disadvantage and his inability to compete successfully in the business world. As indicated on page 29, some applicants whose need for assistance was not documented and appears questionable have been admitted to the program. Accordingly, we believe that an applicant's financial position should be considered when justifying his need for assistance.

RECOMMENDATION

To insure that only eligible disadvantaged persons demonstrating a need for 8(a) assistance as defined in SBA regulations are admitted to the 8(a) program, we recommend that the Administrator of SBA revise the Standard Operating Procedures to require that field offices consider all of the suggested factors in determining the need for 8(a) assistance and document in writing the connection between an applicant's social or economic disadvantage and his inability to compete successfully in the business world.

AGENCY COMMENTS AND OUR EVALUATION

After we had received its formal comments, SBA advised us that it agreed that the procedures should be further revised to require field offices to consider all the previously mentioned factors in determining the need for 8(a) assistance. SBA stated that the procedures required the results of the evaluation of eligibility to be summarized in writing. We believe, however, that SBA, in determining an applicant's need for assistance, should emphasize those factors which indicate the applicant's current inability to compete in the business world.

areas, such as accounting and marketing. Assistance is available from SBA as well as from professional consultants under Federal contracts.

SBA central office officials have emphasized the importance of management assistance in establishing and expanding small businesses. They emphasize that the need for this assistance can be pointed out by failures that occur in the small business community every year and estimate that 9 out of every 10 business failures are due to managerial deficiencies. The need for timely managerial assistance for 8(a) firms is even more acute because such firms generally have had little practical experience in operating a business.

Our interviews with officials of 183 firms showed that management assistance was not provided to 95 firms (about 52 percent). Seven of these firms requested management assistance from SBA but did not receive it. We believe the lack of management assistance provided to 8(a) firms, especially in their early stages of development, has limited the program's success. In region IX, for example, firms that received management assistance did so an average of 21 months after they were admitted to the program.

SBA also has no system for evaluating the assistance it provides. Thus, even when assistance is provided, it may not be of value to the firm. Of the 88 firms that received management assistance, only 33 said they were satisfied.

GOALS NOT APPROPRIATE

SBA has established goals for the program in terms of the number and dollar amount of contracts awarded rather than in terms of successful program completions. We believe this is not a valid measure of effectiveness. Although SBA met its monetary goals the last 3 fiscal years, few firms reached self-sufficiency from the program. For example, as discussed in chapter 2, 33 of the 110 firms reviewed received over \$500,000 in 8(a) contracts, but only 6 became self-sufficient. Also, 18 of the 33 firms that received over \$500,000 in assistance still relied on 8(a) contracts for over 50 percent of their gross sales.

SBA, by establishing goals in terms of the number and dollar value of contracts awarded, is measuring the resources committed to the program rather than the actual benefits derived from awarding these contracts.

CHAPTER 6

SCOPE OF REVIEW

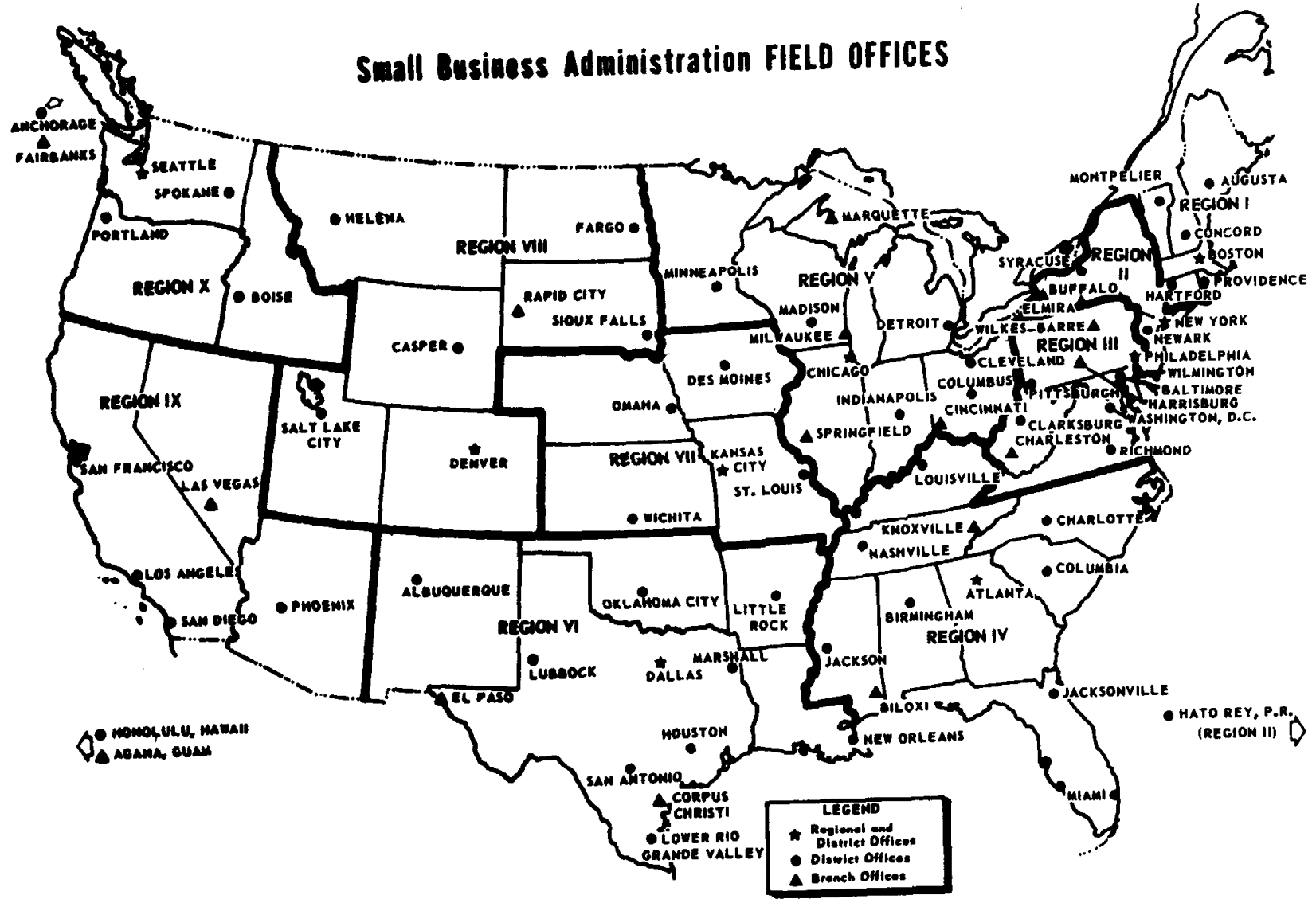
We examined records and spoke with SBA officials concerned with the 8(a) program in Washington, D.C., headquarters and in the field. We did our fieldwork between January and August 1974 in SBA regions II (New York), III (Pennsylvania and Washington, D.C.), IV (Georgia, Tennessee, North Carolina, and Florida), V (Illinois, Michigan, and Minnesota), VI (Texas), and IX (California).

We evaluated a total of 225 8(a) firms with approved business plans as of December 31, 1973. Of the 225 firms, we sampled 110 that had received at least 1 subcontract through the 8(a) program before December 31, 1970. We reviewed these 110 firms to measure their progress toward self-sufficiency. We also attempted to analyze 166 of the 225 firms to evaluate the owners' need for Federal assistance.

We interviewed managers of 183 of the 225 firms to obtain their views on the administration and effectiveness of the program. We also interviewed 19 contracting officials at Federal agencies supplying contracts to SBA.

In addition to evaluating 225 firms, we evaluated 25 other 8(a) firms receiving assistance from sponsors to determine the degree to which sponsors controlled the firms and the cost of the sponsors' services.

Small Business Administration FIELD OFFICES



37

CASE STUDY

This case study illustrates how and why one experienced firm became a sponsor. It also demonstrates the controls exercised by the sponsor and the type of payments the 8(a) firm was required to make to the sponsor while participating in the program. It should not be viewed as being typical for all sponsors; however, it does closely resemble those cases we reviewed.

BACKGROUND

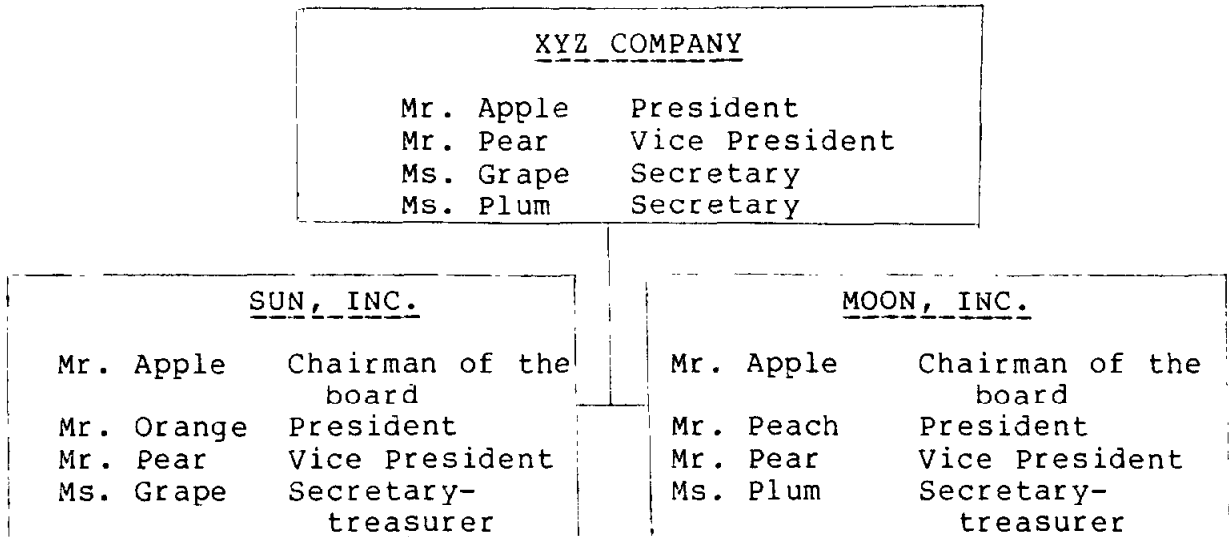
The XYZ Company, incorporated in September 1970 and wholly owned by Mr. Apple, began operating as a corporation in January 1971. The company's principal business is the operation of mess attendant services at military dining halls.

While in the military service, Mr. Apple was responsible for inspecting dining hall facilities and became acquainted with the contractor who had the food service contract at those facilities. This acquaintance grew into a friendship and led to social activities between Mr. Apple's and the contractor's families. When Mr. Apple retired from the military in January 1966, he became president of one of the contractor's subsidiaries. The subsidiary, started and backed by the contractor for Mr. Apple's benefit, involved the furnishing of civilian mess attendants by contract to military installations.

The subsidiary and the contractor's business both became very successful. In July 1969 they no longer qualified as small businesses under SBA's criteria, whereas most mess attendant contracts were restricted to small businesses. For this and for personal reasons, Mr. Apple resigned as president of the subsidiary in September 1969 and established a franchise--the XYZ Company--of the contractor's business as a sole proprietor. The XYZ Company was incorporated in September 1970.

Desiring to expand its business in the spring of 1971, the XYZ Company decided to bid on a mess attendant contract at a new military base. Military representatives, however, informed the company that the base was going to contract for its mess attendant services under SBA's 8(a) program. Since the company did not know about the program, Mr. Apple called the contractor, his friend and business associate.

The XYZ Company's inquiry into the 8(a) program revealed that neither the contractor nor other firms in the food service industry knew about the 8(a) program. Attempts by the



The XYZ Company's records showed that the Government has awarded the XYZ Company and the two 8(a) firms contracts totaling about \$8.5 million in fiscal years 1971 through 1975. Of the total, contracts worth about \$1.6 million were 8(a) contracts, as shown below.

<u>Calendar year</u>	<u>XYZ Company</u>	<u>Sun, Inc.</u>	<u>Moon, Inc.</u>
1971	\$ 707,000	\$ -	\$ -
1972	1,821,000	-	-
1973	2,230,000	-	-
1974	1,400,000	176,000	-
1975 (note a)	<u>830,000</u>	<u>945,000</u>	<u>435,000</u>
Total	<u>\$6,988,000</u>	<u>\$1,121,000</u>	<u>\$435,000</u>

a/Estimated.

The XYZ Company controlled each 8(a) firm by

- incorporating the 8(a) companies as close corporations,
- appointing XYZ Company personnel to key positions in the 8(a) firms,
- completely controlling cash expenditures,
- controlling management policy through stock ownership, and
- maintaining books and records of the 8(a) firms.

Mr. Apple told us it would be impractical to have checks cosigned because the disadvantaged presidents of the 8(a) firms were seldom at company headquarters. When the co-signer is not available, it hinders the prompt payment of bills and payrolls.

For Sun, Inc., the authority to sign checks was given to the firm's president and two of its officers. One additional authorization was granted to the treasurer of the XYZ Company, who was not an officer in Sun, Inc. For Moon, Inc., the president and two of its officers have the authority to sign checks.

We noted in our review of the books and records of Sun, Inc., that about \$48,000 in funds, including startup costs, were transferred between Sun and XYZ from June 1973 to June 1974. Mr. Apple told us the intercompany transfers were necessary because working capital was not available to meet payrolls. He also said that the XYZ Company had been experiencing financial difficulties, primarily because a wholly owned subsidiary was operating at a loss. He indicated that the XYZ Company's financial status was now stable and he no longer planned to follow this policy. He added that the president of Sun, Inc., was aware that funds were being transferred between the two companies.

After discussing this matter with Mr. Apple, we noted that a resolution of the board of directors of Sun, Inc., authorized the treasurer to borrow or lend money in the name of the firm. Consequently, it appears that the XYZ Company will continue to transfer funds between companies to meet contingencies.

Controlling management policy through stock ownership

Supplemental agreements among the stockholders of the two 8(a) firms limited management's decisionmaking powers. All major decisions regarding the operations of those firms had to be approved by 100 percent of holders of outstanding stock. Since all stock issued was outstanding and since the XYZ Company owned 40 percent of the stock in each firm, Mr. Apple had effective control of the management policy of each of the firms. Mr. Apple told us that the arrangement was binding on all parties and that management policy was established through mutual agreement.

first contract. The negotiation proceedings were in June 1974, and the contract was scheduled to start in July. The XYZ Company did not want to hold up and possibly lose the contract and went along with SBA's demand at that time.

The fiscal year 1975 contract given to Moon, Inc., is worth about \$435,000. If the 4-percent administrative fee is sustained, the XYZ Company will receive about \$17,000. If the fee is increased to 6 percent, the XYZ Company will receive about \$26,000.

Sun, Inc., had only one 8(a) contract under the XYZ Company sponsorship before fiscal year 1975. The XYZ Company received about \$10,000 for administrative services on this contract. In fiscal year 1975, the firm was awarded 8(a) contracts totaling about \$945,000. At a 6-percent fee, the XYZ Company will receive about \$57,000 for administrative services.

Payment of salaries to key officers

In fiscal year 1974 the key officers of Moon, Inc., did not receive salaries. The president of Sun, Inc., and the secretary-treasurer received salaries of \$350 and \$25 a week, respectively. In fiscal year 1975 the president of Sun, Inc., will receive \$600 a week. Also, the president of Moon, Inc., will begin receiving \$150 a week.

On the basis of contracts received for fiscal year 1975, the following salaries have been set for the XYZ Company officers occupying key positions in the 8(a) firms. The sponsor said that paying part of the salaries of his officers with 8(a) funds reduces the XYZ Company's overhead expenses.

	Salary per week			Total
	<u>XYZ Company</u>	<u>Sun, Inc.</u>	<u>Moon, Inc.</u>	
Vice president	\$225	\$300	\$ 75	\$600
Secretary	135	100	-	235
Secretary	<u>135</u>	-	<u>25</u>	<u>160</u>
Total	<u>\$495</u>	<u>\$400</u>	<u>\$100</u>	<u>\$995</u>

Retention of profits in retained earnings

It is the XYZ Company's practice to include in management agreements with the 8(a) firms the statement that profit "* * * will be held in retained earnings and no dividends will be paid."

SBA REQUIREMENTS AND CONDITIONS FOR DETERMINING
OWNERSHIP AND CONTROL OF 8(a) FIRMS

Proprietorships. The concern must be controlled by an eligible disadvantaged owner.

Partnerships. Ownership and control of at least 50 percent of the partnership by an eligible disadvantaged person will raise a rebuttable presumption of ownership and control of the company.

Corporations. Ownership and control of at least 51 percent of each class of voting stock by disadvantaged persons will raise a rebuttable presumption of ownership and control.

Divestitures. If an applicant concern is not owned and/or controlled by eligible disadvantaged persons, the persons exercising such ownership and/or control must execute a divestiture agreement. The purpose of divestiture is to insure that ultimate ownership and control will be vested in, and exercised by, disadvantaged persons within a reasonable period. All divestiture agreements must be approved by the Associate Administrator for Procurement and Management Assistance.

Management contracts. All contracts or agreements granting management and/or operational control over the ownership interests otherwise vested in eligible disadvantaged persons must be approved by the Associate Administrator for Procurement and Management Assistance.

Joint ventures. To perform a specific contract, an approved 8(a) concern may enter into a joint-venture agreement with another approved 8(a) concern or a nondisadvantaged concern. Each joint-venture agreement must be fair and equitable to, and for the primary benefit of, the 8(a) concern(s) and must be approved by the regional director.

Nonprofit organizations. Nonprofit organizations may participate in the 8(a) program to assist eligible concerns. However, such organizations may not own a controlling interest or exercise management control over an otherwise eligible 8(a) firm, except under a divestiture agreement approved by the Associate Administrator for Procurement and Management Assistance.

Indian tribes. Indian tribes, a majority of whose members qualify as disadvantaged, may organize, own, or coown firms and



OFFICE OF THE ADMINISTRATOR

U.S. GOVERNMENT
SMALL BUSINESS ADMINISTRATION
WASHINGTON, D.C. 20416

JAN 31, 1975

Mr. Victor Love
Director, General Government Division
General Accounting Office
Washington, D. C. 20548

Dear Mr. Love:

Pursuant to your letter of transmittal of the General Accounting Office draft report on the 3(a) program dated December 13, 1974, and in accord with the Small Business Administration reply of January 15, 1975, we are submitting herewith the agency comments on your report.

We appreciate your extensive effort in producing this first detached and objective observation of a rather controversial program. We find the report basically factual and we are pleased to reply that actions on seven of your eleven recommendations were taken prior to completion of your audit. We feel, however, that the conclusions of the report tend to be overly negative, which may be accounted for in part by the arbitrary criteria used in the classification of 3(a) contracts as presented in Chapter 3 (page 26).

[See GAO note 1, p. 74.]

In the interests of a fair and more accurate assessment of the 3(a) program, we believe the following should be considered:

1. Included with the firms categorized were those which had received only one contract during a time period when the main thrust of the program was "placement of contracts." In many of these cases, SBA was unable to provide the contract assistance it would have liked because of unavailability of suitable requirements from procuring agencies. Alternatively, these floundering firms might have been dropped from the rolls, thus eliminating the possibility of sharing the responsibility for later failure. However, the firms were retained, because the program was still in its formative stages, and it was felt that additional contract support from the procuring activities would be forthcoming.

SMALL BUSINESS ADMINISTRATION COMMENTS

ON

GENERAL ACCOUNTING OFFICE DRAFT REPORT

ENTITLED

"QUESTIONABLE EFFECTIVENESS OF SBA's 8(a) PROCUREMENT PROGRAM"

(Submitted to SBA, December 13, 1974)

[See GAO note 3, p. 74.]

B. Program Objectives

1. Becoming a businessman in this country is a difficult and risky undertaking for most people. To become a successful businessman able to compete on equal terms in the marketplace is an accomplishment that eludes the overwhelming majority of those who try.

Conservatively speaking, 50 percent of all new businesses started by nondisadvantaged persons fail. These are individuals that by the very nature of their position in society have a good education, access to credit, financial stability, managerial and administrative knowhow, social and cultural sophistication, and in general the characteristics, attributes, and background essential for success in the marketplace.

2. It is the purpose of the 8(a) program 50P 60-41-1, (11/14/74 Par. 37) "to assist in the expansion and development of existing, newly organized, or prospective profit-oriented small business concerns owned and controlled by eligible disadvantaged persons." Paragraph 4 of 60-41-1, (11/14/74) defines disadvantaged as "persons who have been deprived of the opportunity to develop and maintain a competitive position in the economy because of social or economic disadvantage." Paragraph 16a states that the objective of "the 8(a) program is to assist eligible firms to develop the capability to compete effectively in the nation's marketplace."

8(a) companies may be categorized as viable and able to compete in the marketplace.

Further examination also will tend to confirm that the few 8(a) companies meeting with success are precisely those owned and controlled by "disadvantaged" persons having the characteristics, attributes, and economic and social background found among the non-disadvantaged.

We believe the concept to be extremely restrictive especially in view of present day inflationary trends. As indicated before, such action will tend to limit participation in the 8(a) program to those with little if any true possibility of success in the marketplace. It will exclude participation by those persons best equipped to assume a role in the economy. A too restrictive concept will negate for all practical purposes some of the basic purposes of the program.

C. The Concept of Disadvantage

1. What is meant by social or economic disadvantage? The word "disadvantaged" as used in section 101 of the Economic Opportunity Act, is concerned with programs of education, vocational training, work experience, and counseling for "low-income, disadvantaged young men and women." It is used in section 638 of the Act in referring to "disadvantaged persons with limited education or other special handicaps."

6. In the context of SBA programs, no American is either excluded or included from the concept of being socially or economically disadvantaged on the basis of race, color, or creed. That is, no American is included or excluded from any SBA programs because of a classification based strictly on race, color, or creed.

But who are the disadvantaged in this country? The Administrator further testified that it was clear to him, and surely obvious to members of the Committee, that most of the 30 million disadvantaged Americans in this country happen to be Black Americans or Mexican-Americans or Puerto Ricans or Cuban Americans or Indians or Eskimos.

7. There have been particular difficulties in attempting to assess the role that being a member of a racial minority plays in proving social or economic disadvantage.

Blacks, Mexican Americans, American Indians and other minorities have in the past been subject of extensive discrimination - socially and economically - that they may, without more, be the beneficiaries of Federal programs established exclusively to compensate them for such past, and in many cases probably continuing discrimination. The Government has a political need as well as a moral obligation to be the pace setter in helping the less, or the least, privileged and to protect the weak against the strong. Does Government moral responsibility to redress past wrongs against a segment of the population automatically qualify the heirs of those wronged to receive com-

Although they have gingerly touched upon some aspects of the problem, the courts have not thus far definitively accepted or rejected "reverse" or "remedial" discrimination by public instrumentalities based upon race.

The SBA Administrator, Mr. Thomas S. Kleppe, in Exhibit 6(b) of "Report of the Small Business Administration to the Subcommittee on Small Business of the Committee on Banking and Currency, House of Representatives, March 20, 1974," (page 208 of the SBA Investigation Report, April 9, 1974), stated as follows:

"Those who have made formal survey reports on the program plus Agency auditors and field office program managers have noted time and again that the foregoing eligibility criteria is too imprecise and results in uneven handed subjective judgments from region to region and in the Central Office. What is a 'competitive position in the economy?' The answer to that will depend upon the individual's training experience and motivation. How long a period of time does the word 'maintain' encompass? Another question is what degree of economic disadvantage is necessary to determine an individual's eligibility to participate in the program? If a person has been able to earn a salary above the national average, should this disqualify him? If not, at what level of economic affluence do we stop? However, if the program objectives envision the lessening of the national imbalance of business ownership between the disadvantaged (basically minority group) and those in the non-disadvantaged class it will progress more efficiently by including as owners those of the disadvantaged group who have proven capabilities and greater potential for success in business

[See GAO note 2, p. 74.]

RECOMMENDATION NO. 3 [16] [See GAO note 4, p. 74.]

Identify and evaluate potential courses of action which could be taken to alleviate SBA's lack of control over supply of contracts.

RESPONSE: CONCUR - ACTION IN EFFECT

We believe that if the result of this recommendation could be obtained, significant benefits could be derived. The functional, administrative and interagency relationships that dictate and govern the operational activities of OBD are realities; however, OBD has initiated the following steps which we intend to mitigate the impact on 8(a) clients:

- 1) In CY 1975 we plan to introduce a new requirements management program based on more definitive information obtained from regional offices and national-buy companies.
- 2) OBD staff persons will be assigned to perform marketing functions on behalf of these companies.

OBD STAFFING (NATIONAL)

<u>Fiscal Year</u>	<u>SBA Request</u>	<u>Authorized</u>	<u>Total Agency Ceiling</u>
1970	—	53	4100
1971	118	109	4100
1972	355	129	4019
1973	136	135	4200
1974	169	144	4054
1975	202	182	4196

The above indicates the Agency has been assigned the responsibility for a major new program with little change in the level of personnel.

[See GAO note 2, p. 74.]

[See GAO note 2, p. 74.]

RECOMMENDATION 3C [16]

Reducing the number of firms active in the 8(a) program.

RESPONSE: CONCUR . . . actions to effect this started in 1973.

Other areas of SOP 60/41-1 (11/14/74) that speak to company qualification and participation in the 8(a) program are found in paragraphs 6b, 21a, 36, 37 and 38.

The regional offices have been advised to give priority to those 8(a) firms which are evidencing the best potential for success. On the other hand, those companies showing minimal aptitude or application and are unable to profit from experience or management assistance, should be terminated from the program.

RECOMMENDATION NO. 4 [17]

Provide firms with more assistance and guidance in developing sales so that firms may decrease their dependence on SBA assistance.

RESPONSE: CONCUR - Action in Effect

Assistance and guidance in developing sales for 8(a) companies was an early program objective.

This was contained in earlier SOPs and has now been given additional emphasis in SOP 60-41-1 dated November 14, 1974. Additional impetus to rendering such assistance and guidance resulted also from the massive and intense application of resources to the management assistance program beginning in the summer of 1973. This resulted in an increase of field management assistance personnel by a multiple of five.

Previous direction was in memorandum format on a case by case basis. This had culminated in the direction contained in SOP 60/41-1 (11/14/74). Positive action has been taken along this line. Control over sponsorship agreements cited in SOP 60/41-1 (11/14/74) is primarily spoken to in paragraph 4b which states ". . . the person(s) upon whom eligibility is based must be the primary recipient(s) of the benefits of the program objectives . . . eligible person(s) are expected to be engaged full-time in the day-to-day business operations and management" . . . and paragraph 5e ". . . all contracts granting . . . control of an 8(a) concern (by otherwise disadvantaged persons) . . . shall be with the written approval of the AA/PA" Paragraph 5d, 14, 19b and 19c of the SOP are also apropos where sponsor-controlled 8(a) firms are in effect.

RECOMMENDATION NO. 6 [25]

Develop criteria to define the extent to which sponsors can collect fees from 8(a) firms for service and other items provided during the performance of an 8(a) contract.

RESPONSE: CONCUR - Action in Effect

Paragraphs 19b and 19c of SOP 60/41-1 (11/14/74) speak to financial remuneration by 8(a) companies to their sponsorship companies. Paragraph 19b(2): "The (divestiture) agreement must state the terms for the selling price for stock acquisition by the eligible disadvantaged person(s) . . ."; paragraph 19b(4): "Dividends, capital . . . shall not be paid during the terms of the divestiture agreement except with the advance approval of SBA." Paragraph 19c(1) states that the regional director shall be certain that "the total remuneration for

such activity is appropriate, along with instructions from the Region to that effect."

Some of our comments to Recommendation No. 4 also apply to this recommendation.

Other SBA assistance programs complement the 8(a) program and are available to the 8(a) contractor at the time of his business plan application and during the course of his program participation. Paragraph 13 of SOP 60/41-1 (11/14/74), confirms this analysis in stating that ". . . 8(a) approved firms generally require more assistance than most small businesses to become viable and should therefore be involved in more SBA programs. (The) firm's business plan may reveal . . . needs for procurement . . . financial . . . management. . . (and) technical assistance, etc." Paragraphs 11b, 17, 24a(3) and 58 also speak to management and other SBA program assistance.

Our Office of Management Assistance has established a policy that every 8(a) contractor is a management assistance client. Through this program media, the considerable talents of the following are available to 8(a) contractors:

- (1) SBA field professionals
- (2) Service Corps of Retired Executives (SCORE)
- (3) Active Corps of Executives (ACE)
- (4) Consultant Contractors
- (5) Office of Minority Business Enterprise (OMBE) affiliates
- (6) SBA, Small Business Institute program

August 1974. With the downturn in the economy, our most recent analysis indicates that we will experience a considerable shortfall in achievement of the Program completion goal.

However, program emphasis and goals have shifted from number and value of contracts awarded during a fiscal year, to the number of successful program completions. Program completion goals are part of the SBA regional goal projection.

SOP 60-41-1, Chapter 6, provides extensive guidelines, instructions, and procedures for more effective determination of successful program completions. Paragraph 57a of Chapter 6 defines program completion as "An 8(a) firm's achievement of the business development objectives as set forth in its approved business plan, at which point the firm no longer requires additional 8(a) subcontract assistance."

However, the achievement of the program completion goal at this writing is not promising, as noted above. Many negative forces have been applied against the forecasted progression. The major deterrent to program completion has been the adverse impact in the down turn of the economy. While all businesses are suffering, the effect on the "disadvantaged" is staggering. What should have been profitable 8(a) contracts are resulting in disastrous losses in many cases. Previously planned procurement actions are being "slipped" or cancelled in anticipation of budget reductions, therefore, we must anticipate breaks in production for some of the most promising 8(a) contractors.

PRINCIPAL SBA OFFICIALS
RESPONSIBLE FOR ADMINISTERING ACTIVITIES
DISCUSSED IN THIS REPORT

	Tenure of office	
	From	To
ADMINISTRATOR:		
Thomas S. Kleppe	Jan. 1971	Present
Hilary J. Sandoval, Jr.	Mar. 1969	Jan. 1971
Howard J. Samuels	Aug. 1968	Feb. 1969
Robert C. Moot	Aug. 1967	July 1968
DEPUTY ADMINISTRATOR:		
Louis F. Laun	Sept. 1973	Present
Anthony Chase	Feb. 1971	Sept. 1973
Einar Johnson	June 1970	Feb. 1971
W. Donald Brewer	Oct. 1969	June 1970
Richard B. Blankenship	Mar. 1969	Oct. 1969
Howard Greenberg	Aug. 1967	Mar. 1969
GENERAL COUNSEL:		
H. Gregory Austin	Apr. 1973	Present
William T. Gennetti (acting)	Jan. 1973	Apr. 1973
John A. Knebel	Feb. 1971	Jan. 1973
Anthony Chase	Mar. 1970	Feb. 1971
William T. Gennetti (acting)	Jan. 1970	Mar. 1970
Leonard S. Zartman, Jr.	July 1969	Jan. 1970
Daniel Garbern (acting)	Apr. 1969	July 1969
William T. Gennetti (acting)	June 1968	Apr. 1969
Phillip F. Zeidman	Jan. 1965	June 1968
ASSOCIATE ADMINISTRATOR FOR PROCUREMENT ASSISTANCE (note a):		
Harold K. Fletcher	July 1974	Present
Louis F. Laun (acting)	Mar. 1974	July 1974
Marshall J. Parker	May 1970	Mar. 1974
Clyde B. Bothmer (acting)	Mar. 1970	May 1970
William Murfin	Mar. 1969	Feb. 1970
Irving Maness	Feb. 1961	Mar. 1969

Copies of GAO reports are available to the general public at a cost of \$1.00 a copy. There is no charge for reports furnished to Members of Congress and congressional committee staff members; officials of Federal, State, local, and foreign governments; members of the press; college libraries, faculty members, and students; and non-profit organizations.

Requesters entitled to reports without charge should address their requests to:

U.S. General Accounting Office
Distribution Section, Room 4522
441 G Street, NW.
Washington, D.C. 20548

Requesters who are required to pay for reports should send their requests with checks or money orders to:

U.S. General Accounting Office
Distribution Section
P.O. Box 1020
Washington, D.C. 20013

Checks or money orders should be made payable to the U.S. General Accounting Office. Stamps or Superintendent of Documents coupons will not be accepted. Please do not send cash.

To expedite filling your order, use the report number in the lower left corner of the front cover.

	<u>Tenure of office</u>	
	<u>From</u>	<u>To</u>
ASSOCIATE ADMINISTRATOR FOR OPERATIONS (note b):		
Williams M. Lendman	Oct. 1973	Present
Louis F. Laun	Feb. 1973	Sept. 1973
Stephen H. Bedwell, Jr. (acting)	Oct. 1972	Feb. 1973
Claude L. Alexander	Feb. 1972	Oct. 1972
Arthur Singer	June 1971	Feb. 1972

a/Before July 1974, this position was the Associate Administrator for Procurement and Management Assistance.

b/From June 1971 through February 1972, this position was the Associate Administrator for Operations and Investments. From February 1972 through April 1972, it was the Assistant Administrator for Administration and Operations. Then it reverted back to Associate Administrator for Operations and Investments in April 1972 and became the Associate Administrator for Operations in February 1973.

The financial outlook for 8(a) contractors is indeed gloomy. To all intents and purposes equity financing is unavailable to disadvantaged entrepreneurs. The scarcity of dollars has made high risk bank guaranteed loans nearly impossible to obtain and SBA has always had an extremely low level of direct loan funding.

It has become evident that there is little motivation to "completing the program." The contractor is more comfortable with the program blanket wrapped around him. Competitive contracts are expensive to bid, difficult to win and generally afford a lower profit. The procuring agencies, in general, are well satisfied with the better of the 8(a) performers, and prefer to have them continue in the program. This makes contracting easier and provides for agency 8(a) program dollar goal achievement with a minimum of effort. These same motives apply to SBA 8(a) field personnel. It well may be that quantifying the program in terms of dollars is counterproductive to achievement of program completion goals.

GAO notes:

1. Material deleted at SBA's request.
2. Deleted comments refer to material contained in draft report which has been revised or which has not been included in the final report.
3. SBA requested that the information on pages 53 to 60 be included for background information.
4. The numbers in brackets refer to pages in the report where our recommendations are discussed.

RECOMMENDATION NO. 8 [34]

Provide management assistance to firms as required while they are active in the program.

RESPONSE: CONCUR - Action to effect this started in 1973.

Continuing actions have been taken to meet such need. As discussed in response to Recommendation No. 7 our SOP 60/41-1 (11/14/74) paragraph 13, 11b, 17, 24a(3) and 58 speaks to the availability of management assistance programs to 8(a) contractors. Paragraph 11b states that "responsibility for implementation of corrective action rests with the management of the 8(a) concern. SBA will assist management in effecting (remedial) . . . actions to the . . . extent that available resources permit."

Our comments on Recommendations 4 and 7 are also pertinent to this recommendation.

RECOMMENDATION NO. 9 [34]

Establish realistic goals for the 8(a) program that would include the number of successful program completions.

RESPONSE: CONCUR - Action to effect this started in September 1973.

Program completion goals were first established in September 1973, in connection with the Agency's 1975 Budget submission to OMB. With further experience, and relating to actual personnel resources, the Agency goal was established in May 1974 and further refined to 131 program completions by the end of Fiscal Year 1975 in connection with SBA's "Presidential Goals and Objectives - Fiscal Year 1975" which was submitted to OMB in

management services is fair and reasonable and consistent with the services actually provided."

Paragraphs 5e and 14 of the SOP also refer to management and/or sponsor fees.

RECOMMENDATION NO. 7 [34]

Evaluate each firm's need for management assistance at the time of application and on a regular basis during participation in the program.

RESPONSE: CONCUR - Action to effect this started in 1973.

Further emphasis was given in a letter to our Regional Directors on July 8, 1974, issued by Louis F. Laun, (then Acting Administrator for Procurement and Management Assistance) which read: "The new SOP in process sets up a 'COC type' review procedure that requires Finance and Investment and Management Assistance input at the time of business plan submission and prior to awarding a new contract to an 8(a) firm. While awaiting the final SOP, which is still going around for clearance, it would be most helpful if all offices doing contracting implemented this procedure.

"As for those firms that are already working on 8(a) contracts, some of our field offices have already classified all of these as 'MA/Clients' and are providing MA assistance.

"The purpose of this memorandum is to request that all field offices do this for all 8(a) firms working on contracts and that this memorandum forwarded to all memorandum be forwarded to all District Offices where

The 8(a) program, as defined in paragraph 17, SOP 60/41-1 (11/14/74), assists contractors in technical and management fields that are designed "to achieve self-sustaining independence in the competitive economy. . . . During the period in which SBA assistance is provided . . . (SBA) shall insure that the firm's progress is being continuously monitored . . . to render advice, counsel, and guidance, . . . to arrange for management, marketing, technical, financial, and procurement assistance, as needed, from whatever source may be available."

Paragraphs 13, 19c and 58 of SOP 60/41-1 (11/14/74) also relate to other SBA assistance programs available to 8(a) contractors.

SBA's Office of Management Assistance is giving high priority to the development of 8(a) company marketing ability. This is being carried out on a nationwide basis through the cooperative effort of our Agency with the Office of Minority Business Enterprise, Department of Commerce, and through the use of call contracts for consultants. Additional marketing assistance for 8(a) contractors is furnished by such organizations as the National Purchasing Council for Minority Enterprise and the National Economic Development Association (NEDA).

Additional action has been taken by the establishment of the minority vendors program within the office of the AA/ME.

RECOMMENDATION NO. 5 [25]

Establish a system to monitor (1) the extent to which sponsors control 8(a) firms and (2) the progress of the sponsor-controlled firms toward becoming self-sufficient.

RESPONSE: CONCUR - Action in Effect

"With the maturation of the 8(a) program, we envision a leveling off of the 8(a) subcontracting activity for FY 1975 at \$250 million. This, in turn will require that we maintain an 8(a) program portfolio of 1500 active companies." - SBA Budget Estimate, FY 1975, page S&E 26

A directive from the AA/PA on September 9, 1974, urged our 8(a) field personnel to concentrate all available resources on significantly improving our support to those present portfolio companies that have a good chance toward viability.

Positive action is also reflected under the provisions of SOP 60-41-1 (11/14/74). The reviewing and screening of applicants for participation in the 8(a) program is defined in paragraph 24a (3) of SOP 60-41-1 (11/14/74) which in essence states that the reviewing office will "make a preliminary determination that the applicant has the necessary organization, experience, operational controls, materials, skills . . . and . . . has access to cash or credit from banks . . . to meet all financial requirements." This method of predefining the requisites necessary to contracting eliminates some candidates from 8(a) participation.

An area where 8(a) firms are curtailed in their program participation is cited in paragraph 4C of SOP 60-41-1, (11/14/74) which states: "A person's eligibility may be used in the qualification of only one (emphasis added) business entity."

[See GAO note 2, p. 74.]

- 3) Top level SBA personnel have met with major procuring agency counterparts to establish the best methods of identifying potential 8(a) contracts at the earliest possible time on an department by department basis.
- 4) The Interagency Council on Minority Enterprise and its Task Force on Procurement have time and again served as vehicles for group discussion on resolving the overall problems in reserving contracts for 8(a) companies in order to provide for continuing production and order backlog.

RECOMMENDATION 3A [16]

Allocate more SBA resources for identifying and processing suitable 8(a) contracts.

RESPONSE: CONCUR . . . this has been done within the limits of our resources. Every year for the last eight years, SBA has raised the same question. Unfortunately, Agency resources are limited and the program responsibilities too great.

Commencing with FY 1970 our Agency has requested increases in OBD professional and clerical personnel to accommodate the growth of the 8(a) program. In FY '70 the 8(a) program was staffed with 53 people, mostly located in the Central Office. In FY '75 we requested a national staff of 202 people and the Congress granted our Agency 182 positions, the overwhelming majority of which are located in our field offices.

management. To date, SBA has taken this approach even though vulnerable to the anomaly of assisting the affluent disadvantaged. Once again, this course is subjective, arbitrary and varied. Yet any language the Agency can find to be more precise inevitably results in discriminating against a segment of the very group it is bound to assist. With regard to this section of our policy, our critics and observers have offered nothing constructive to date. We would more than welcome any suggestions by the Committee to inject more objectivity into eligibility criteria."

Restricting eligibility to the "economically" disadvantaged would exclude many firms and individuals who are obviously intended beneficiaries of the 8(a) program. For example, a firm might be "economically" stable but has not had the same opportunities to expand as other firms in the mainstream of the economy. This failure of opportunity might have been due to past practices of discrimination as a result of which normal financing and other business assistance sources were not available to that firm.

compensation from the Government ad infinitum? If the answer is "yes," a Black or other minority business man would automatically be assumed eligible for 8(a) program assistance unless special circumstances were presented to overcome this presumption. This would be eligibility based upon race and ethnic background which might be stated directly - that all specified minorities are presumptively eligible, or indirectly - that all specified minorities are presumptively "disadvantaged" in the area of Government contracts and, therefore, eligible. If such criterion could be used in the area of Government contracts, adopting a generic eligibility classification, it might also apply, even more readily, in other areas throughout society, thus establishing presumptive eligibility for jobs, schools, Government benefits, etc., based upon a finding that specified minorities or other groups are "disadvantaged" as a group rather than as individuals. As can be seen, this principle could have sweeping implications through the social order. There might also be administrative problems in applying a purely racial or ethnic standard. Would a person who is one-quarter Indian be eligible? One-sixteenth? How is racial background proven? Who is a Spanish-speaking American?

The question of a racial presumption of eligibility is an aspect of one of the more complex legal questions facing the courts today. It is a question which the courts, as well as the political and social commentators of our society, have been debating for over a decade.

2. In Webster's Third New International Dictionary (unabridged) "disadvantaged" is defined to mean lacking in basic resources or conditions (such as medical, housing and educational facilities, civil rights) necessary to achieve an equal position in society (emphasis added).
3. While Congress has not defined "disadvantaged" in any precise way, it has suggested some of the factors which can be taken into account in determining whether a person is disadvantaged. These include membership in a racial minority; low-income; geographic location, e.g., urban ghettos, depressed rural areas; limited education; and other special handicaps.
4. Our Agency has, in the past, addressed itself to the problem of specific definition for "disadvantaged." The lack of statutory definition suggests that a precise definition is inappropriate and a flexible approach appropriate. Reliance should not ordinarily be placed on a single factor, but on a composite of many factors: financial history of the individual along with a general pattern of his life, his opportunities - education, social and economic.
5. Testifying before the Subcommittee on Minority Small Business Enterprise of the House Select Committee on Small Business on July 27, 1971, SBA Administrator Thomas S. Kleppe said that: "When the Agency uses the term 'minority person' it refers to those Americans who are socially or economically disadvantaged." The term "minority" is, in Kleppe's words, "a short form for the phrase 'socially or economically disadvantaged,'" a euphemism, if you will.

In general, the SBA proposes through the use of the 8(a) program to make business successes of concerns owned, controlled, and operated by individuals that by the very nature of their position in society have been the subjects (and are still) of discriminatory social and economic practices. These are the persons least likely to have the characteristics and attributes considered essential for success in the marketplace. If the above premise is accepted, then it can be deduced that the mortality rate among new businesses owned by disadvantaged persons would be significantly greater than among those owned by non-disadvantaged, perhaps several times higher, thus increasing considerably the percentage of disadvantaged owned businesses which we can expect to fail.

3. If participation in the 8(a) program is furthermore limited exclusively to disadvantaged individuals who are able to show incontrovertible evidence of economic-disadvantage - (i.e. - negative or minimal net worth, inability to obtain credit, or financial assistance), we are eliminating that segment of the set of disadvantaged persons possessing the characteristics and attributes essential for success in the marketplace. Under such circumstances, the thrust of the program will then be directed to assist the persons less likely to succeed. As such, it is reasonable to assume that the rate of failure and mortality among the businesses started by such individuals, regardless of SBA effort on their behalf, will be yet higher. Present statistics tend to confirm the above hypothesis, since to date such a small percentage of all

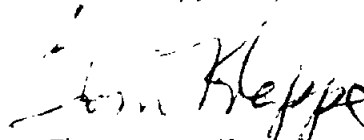
[See GAO note 2, p. 74.]

2. Some of the firms which have "deteriorated" while in the 8(a) program have done so for reasons that can be attributed to losses on non-8(a) contracts. There is reason to believe that were it not for the support afforded these companies by the SBA during these marginal times, they most likely would have failed.
3. Finally, the intangible benefits, such as management experience derived by the 8(a) contractor during his tenure in the program, cannot be quantified by an audit. These intangibles, while not always manifested in a company's financial statements, especially over the short term, are nonetheless important to the survival of the firm in particular and to the minority business community in general. The disadvantaged businessman, historically denied access to economic opportunity, is lacking in what some call the business instinct. The 8(a) program is helping to change this. We feel that the invaluable experience being gained by first and second tier managers will have a significant effect on the long term participation of disadvantaged persons in the business community.

You will note that our comments on most of your recommendations indicate concurrence and reference remedial measures contained in our Revision 1 to Standard Operating Procedure 60-41 dated November 14, 1974. It is interesting to note that the SBA Internal Audit of the program conducted at an earlier date also advanced many similar recommendations. Over the period of the past year, Government audit reports have contributed significantly to the development of our present procedures.

We endorse your suggestion that the Congress may wish to review the report and subsequent actions. Specific indications of how Congress feels the program should be conducted would be of great assistance to the SBA and other involved agencies.

Sincerely,



Thomas S. Kleppe
Administrator

Enclosure

BEST DOCUMENT AVAILABLE

may apply for 8(a) support provided the firms meet the eligibility criteria of paragraph 2 above and satisfy the ownership and control requirements for partnerships and/or corporations. This exception recognizes the separate and unique treaties, laws, and regulations governing ownership and control of property by Indian tribes.

Mr. Apple told us that the retention of profits increases the working capital of the 8(a) firm and gives the firm a greater opportunity to become viable. However, he also said it was not his intention that 8(a) firms under his sponsorship become viable to the point that they would become competitors in the mess attendant services industry. He also stated that once the 8(a) firms became viable he did not believe they could survive unless they diversified into other areas of the services industry, such as grounds maintenance or janitorial, institutional food, or security guard services.

Sale of stock ownership

A third 8(a) firm, Star, Inc., was formed in October 1971 with a total capitalization of \$10,000. The certificate of incorporation authorized 1,000 shares at \$10 a share. The XYZ Company purchased a 20-percent stock interest in Star, Inc., for \$2,000 and an XYZ Company executive purchased a 5-percent stock interest for \$500.

The certificate of incorporation of Star, Inc., provided that all stockholders give the corporation the right of first refusal, at the true book value, on all shares contemplated for sale. Therefore, upon divestiture Star, Inc., repurchased the XYZ Company's and the XYZ Company executive's stock for about \$23,000, or about \$90.50 a share.

Because dividends were not paid, the net worth of the firm and related book value of its stock increased more than 900 percent by the time divestiture occurred, 18 months after incorporation.

Maintaining the books and records
of the 8(a) firms

The XYZ Company maintained all the books and records for each 8(a) firm at its offices. The books and records are (1) the corporate kits which contain such information as the articles of incorporation, memorandums on stockholders' meetings, management agreements, and records of the issuance and receipt of stock certificates, (2) the accounting records which include the general ledger, general journal, cash receipts and disbursements journal, payroll registers, and checkbooks, and (3) other records, such as the contracts and correspondence files.

The 8(a) firms did not have offices of their own. However, the SBA district office required that one of the firms be registered in the State where it has a current contract, so the firm's president moved to that State. He told us his office is his apartment. The firm's address is a post office box number for which it pays a nominal fee.

COST OF XYZ COMPANY
SERVICES TO 8(a) FIRMS

The XYZ Company has obtained financial benefits from the 8(a) firms by

- administrative fees,
- payment of salaries to key officers,
- retention of profits in retained earnings, and
- sale of stock ownership.

Administrative fees

In sponsoring the firms, the XYZ Company is committed to training managers and supervisors for the new firms. In addition, the Company provides complete administrative services and on-the-job training and advice to the presidents of the 8(a) firms. For this, the XYZ Company receives 4 percent of the gross receipts of Moon, Inc., and 6 percent of the receipts of Sun, Inc.

Mr. Apple told us he did not believe the fees were excessive. In fact, he was appealing to SBA to permit the administrative fee for Moon, Inc., to be increased to 6 percent. He claimed SBA forced the 4-percent fee on him when he and the president of Moon, Inc., were negotiating for the firm's

Incorporating the 8(a) firms
as close corporations

According to the law of the State in which the 8(a) firms were incorporated, a close corporation is one that

- has no more than 30 stockholders,
- makes no public offering of its stock, and
- imposes restrictions on the transfer of stock to outsiders.

A close corporation's certificate of incorporation may provide that the business be managed by the stockholders rather than the board of directors. However, the stockholders of the corporation are considered to be the directors.

Mr. Apple told us that sponsors stand to lose their investments in 8(a) firms if they are not properly managed. Therefore, the XYZ Company incorporated 8(a) firms as close corporations to prevent the stockholders, who may be the firm's principal officers, from independently depleting the company's funds by setting their own salaries or by placing friends and relatives on the payroll.

Appointing XYZ Company personnel to key
positions in the 8(a) firms

The XYZ Company's corporate officers served as officers in the 8(a) firms. As stated before, Mr. Apple served as the chairman of the board of each firm. Mr. Pear served as the vice president of each firm, and the two secretaries served as secretary-treasurers for the firms. All of these officers were white Americans. The presidents of the 8(a) firms were black Americans and were the only minority members in key positions.

The presidents of the firms merely contributed their names and minority designation to the formation of the new firms. They did not contribute any personnel, equipment, or personal funds for the companies' capitalization. Mr. Apple told us that, although they did not contribute material assets to the firms, they contributed their managerial and leadership expertise.

Controlling cash expenditures

The XYZ Company controlled all cash expenditures of the 8(a) firms. Cosignatures on checks were not required.

industry to obtain clarification from Department of Defense and other military officials on the award of the contract to an 8(a) company were not successful. The industry lost additional contracts to 8(a) firms and became concerned.

In the fall of 1971, an association of food service industry members met in Washington, D.C., and some of these members decided to seek an injunction to prevent SBA from awarding mess attendant contracts on a noncompetitive basis to 8(a) firms. The members seeking the injunction were not able to obtain it and the association began to view the program as a threat to their business. In later meetings with SBA representatives, the association members were encouraged to sponsor 8(a) companies because (1) the program could not be stopped and (2) some of the military installations were dissatisfied with the performance of the unsponsored 8(a) firms. Essentially, this is how the XYZ Company got started in the 8(a) program.

Contracts awarded in 1972 under the program accounted for a large part of total industry receipts. However, in September and October 1972, the Congress was prepared to cancel the appropriation for all contracted mess attendant services, including 8(a) contracts, and have the military services revert to the military kitchen police system. The XYZ Company and other contractors in the industry which previously tried to stop the program reversed their position and went to Washington to lobby for the program.

CONTROLS EXERCISED BY XYZ COMPANY

Records showed that the XYZ Company incorporated seven mess attendant companies in conjunction with the 8(a) program. As of July 1974 the XYZ Company was sponsoring two 8(a) firms (Sun, Inc., and Moon, Inc.). Mr. Apple owned 40 percent of the stock in these firms and served as the chairman of the boards. The following chart shows the arrangement of the key officers in each firm.

GAO'S CLASSIFICATION OF BUSINESSES
BY METROPOLITAN AREAS

<u>Loca- ation</u>	<u>Not self-sufficient</u>				<u>Self- sufficient</u>	<u>Undeter- minable</u>
	<u>Deter- iorated</u>	<u>Out of busi- ness</u>	<u>Im- proved</u>	<u>No change</u>		
Dallas	-	-	1	1	-	1
Los Angeles	3	3	1	-	2	1
San Francisco	3	3	2	3	3	2
Detroit	1	-	-	-	1	-
Minneapolis	1	-	-	-	-	-
Chicago	3	-	-	-	1	-
Washington	6	8	13	-	6	6
Philadel- phia	3	2	-	1	1	-
New York	-	4	4	-	1	4
Atlanta	-	5	-	-	-	3
Miami	-	2	-	-	3	2
Total	<u>20</u>	<u>27</u>	<u>21</u>	<u>5</u>	<u>18</u>	<u>19</u>

DISTRIBUTION OF 8(a) CONTRACT AWARDS
BY SBA REGION FOR FISCAL YEARS 1968-74

<u>Region</u>	<u>Active contracts</u>	<u>Amount</u>	<u>Completed contracts</u>	<u>Amount</u>
I	163	\$18,482,880	167	\$ 9,302,537
II	270	59,079,745	313	21,249,906
III	763	73,513,169	507	30,776,051
IV	357	91,885,176	544	41,695,608
V	377	32,476,120	541	25,820,588
VI	351	54,604,539	503	49,083,324
VII	148	12,760,331	224	13,335,390
VIII	91	28,259,558	144	14,354,017
IX	430	81,931,012	582	54,237,324
X	218	15,932,512	218	7,653,965

AGENCY COMMENTS AND OUR EVALUATION

We suggested that SBA evaluate each 8(a) firm's need for management assistance at the time of application and on a regular basis during its participation in the program and provide assistance to firms when it is needed. SBA advised us that its revised procedures, issued in November 1974, require an evaluation of each firm's need at the time of application and on a regular basis while in the program.

We do not believe that SBA's failure to provide management assistance can be attributed to a need for formal written procedures, but rather to SBA's failure to adequately implement policies set out in program directives which were also in effect at the time of our review. As shown on page 33, SBA has failed to provide management assistance in a number of cases where the need for assistance was identified by a firm. Accordingly, we do not believe that sufficient action has been taken by SBA to insure that 8(a) firms receive adequate management assistance.

We also suggested that SBA establish realistic 8(a) program goals that would include the number of successful program completions. SBA stated that program emphasis goals had changed in September 1973 in connection with SBA's 1975 budget submission from number and value of contracts awarded to the number of successful program completions and that the revised procedures provided guidelines for determining successful program completions. We were subsequently advised by SBA that final program completion goals were not disseminated to its field offices until May 1974.

We believe these changes in program emphasis and goals to successful program completions together with guidelines to determine completion are a more valid measure of effectiveness.

RECOMMENDATION

To further improve program effectiveness, we recommend that the Administrator of SBA establish adequate internal controls to insure that 8(a) firms are provided management assistance as required while they are in the program.

CHAPTER 5

OTHER OBSERVATIONS

The achievement of the 8(a) program objective, in our opinion, depends partly on how well SBA designs and implements administrative procedures. Several areas of operation could be improved to enhance the program's effectiveness. These areas include

- monitoring 8(a) firms,
- providing management assistance to the firms, and
- establishing appropriate program goals.

INADEQUATE MONITORING PROGRAM

SBA has not adequately monitored and evaluated the performance of 8(a) firms. Therefore, it has been unable to identify the contractual and management assistance requirements of the firms and to promptly fulfill these requirements.

SBA emphasizes the need to closely monitor the performance of each 8(a) firm on a regular basis, as illustrated by the following statement in the program directives.

"Generally the lack of experience of approved 8(a) companies is such that the program development specialists must maintain continuous surveillance over each company's operations to assure the success of the contract and the survival of the company. The issuance of a contract to a newly approved company will not guarantee success. Unless careful monitoring and surveillance is given, conceivably a new contract could be a detriment, to an inexperienced firm."

SBA has no criteria delineating how often and by what standard 8(a) firms should be evaluated. We interviewed officials of 183 firms; 53 percent said SBA did not regularly contact them, and 15 percent said SBA never contacted them to evaluate their progress. SBA regional officials agreed that they did not have an adequate monitoring program and said they would be better prepared to provide needed assistance to firms if they did.

MANAGEMENT ASSISTANCE NOT PROVIDED

SBA has several programs to help small businesses solve their business problems. These programs include both management courses and individual assistance in specific problem

--A western firm, started in 1960, entered the program in June 1972 and received over \$750,000 in 8(a) sub-contracts. The firm is wholly owned by a black American. The year before 8(a) approval, the firm had a profit of about \$9,000 on sales of about \$186,000 and a net worth of about \$197,000. In addition, personal financial statements obtained from SBA's loan files showed that the owner had a net worth of about \$290,000. SBA, in its declaration of disadvantage, considered the owner to be both socially and economically disadvantaged.

--A western company, established in November 1969, was admitted to the program in August 1970 and was awarded over \$500,000 in 8(a) contracts. The firm is owned by a black American. Financial statements submitted to SBA showed a net profit of only \$169 on sales of about \$43,000 for the 8 months before 8(a) approval. However, financial statements filed with SBA's loan program showed that the president and principal stockholder of the firm was a practicing medical doctor with an annual income of about \$50,000 from his practice and a personal net worth of about \$132,000. SBA considered him eligible for the program "because he is a minority" and thus socially disadvantaged.

In November 1974, after our fieldwork was completed, SBA headquarters issued to its field offices revised procedures, which endeavored to provide adequate criteria and instructions for professional personnel to make valid determinations concerning 8(a) program eligibility. SBA directed that:

"* * * the following * * * factors may be considered in order to determine the applicant's eligibility:

- a. Vietnam era military service as it may affect social or economic disadvantage.
- b. Social background.
- c. Inability to obtain technical * * * [and] business assistance or financing.
- d. * * * obstacles encountered in entering * * * the economic mainstream resulting from discrimination or other circumstance.
- e. Inability to compete effectively in the marketplace because of restrictive practices * * *.

The General Counsel emphasized that SBA's eligibility determinations should carefully avoid any implication that eligibility is based principally on the race, creed, or ethnic background of the individual.

In August 1973 SBA revised its regulations to include Vietnam-era service in the Armed Forces as another factor to be considered in establishing social or economic disadvantage. These regulations also stated that disadvantage "may arise from cultural, social, or chronic economic circumstances or background or other similar causes."

These criteria are for the most part general and stress social causes of disadvantage. The criteria have not required documentation of administrative findings to justify an applicant's eligibility.

RELIANCE ON SOCIAL CAUSES OF DISADVANTAGE

In the regions we visited, SBA personnel relied mostly on social factors when determining disadvantaged. This reliance on social factors appears to have two causes: (1) economic disadvantage is difficult to analyze without specific criteria or standards and (2) social disadvantage is relatively easy to analyze.

Some eligibility determinations included descriptions of racial discrimination and injustice which occurred during the applicants' youth. Others reported that the applicants had been subjected to underemployment and ghetto living during maturity. Many determinations were based entirely on ethnic backgrounds, and minority status was equated with being disadvantaged. For example, a regional director said the national administration's intent, in his judgment, was to consider black Americans and others as automatically disadvantaged. The official told us that this unofficial policy evolved because SBA had no specific policies or procedures for determining eligibility and that each SBA office had no choice but to determine eligibility on the basis of individual judgment.

Similarly, an SBA regional program official advised us that participants were selected on the basis of their ethnic background. Also, a program official in another region said he could remember only two instances when eligibility was determined on the basis of economic considerations.

RECOMMENDATION

We recommend that the Administrator, SBA, establish a system to monitor a sponsor's compliance with the terms of the sponsorship arrangement as approved by SBA, especially management agreements establishing a sponsor's services and fees.

based on the projected value of the stock at a future date. This increased the sale price of the stock and provided the sponsors with substantial capital gains. For example, one sponsor acquired 3,100 shares of an 8(a) firm's stock in 1971 for \$3,100. In January 1974 he sold that stock back to the firm for \$263,500.

Lease of equipment

Two sponsors and a leasing company owned by a stockholder of another sponsor leased equipment to 10 firms. In one case a sponsor obtained a tooling machine for \$14,575 and leased it to an 8(a) firm for about 9 months at a total charge of \$45,000. In addition, the sponsor charged the firm \$3,000 for tools associated with the machine and \$3,000 for setting up the machine. The machine was never put into proper working order. The sponsor later sold the machine for \$9,000 to a third party.

In another case, the leasing company owned by a stockholder of a sponsor charged an 8(a) firm about \$17,000 for reconditioning and modifying aircraft refueling trucks to meet Government standards. The leasing company owned the trucks and intended that the 8(a) firm would bid on a refueling contract and, if successful, lease the trucks. The 8(a) firm was low bidder but was not awarded the contract because a preaward survey determined that the condition of the trucks was unsatisfactory for performance of the contract. Although the 8(a) firm never used the trucks and although the condition of the trucks was responsible for the firm's loss of the contract, the leasing company never reimbursed the firm the \$17,000 for the cost incurred in reconditioning and modifying the trucks. The firm did not have a written agreement specifying the terms of the lease.

CONCLUSIONS, AGENCY COMMENTS, AND OUR EVALUATION

Some experienced contractors became sponsors to make profits and to protect their livelihoods in the Government contracting industry. Their goal was accomplished by forming new corporations using former employees as majority stockholders and officers, securing minority stock ownership for themselves, getting the new corporations approved for the 8(a) program, identifying and negotiating contracts for the new corporations, and subsequently providing them with services and other items for a fee.

We believe that sponsors generally had little or no incentive to develop 8(a) firms into viable businesses. Instead, some sponsors benefited from the arrangement by

Furthermore, an official of the sponsor told us that it was not intended that the 8(a) firms become viable to the point where they would become competitors in the mess attendant services industry. He also stated that once the 8(a) firms became viable, he did not believe they could survive unless they diversified into other areas of the services industry, such as ground maintenance or janitorial, institutional food, or security guard services.

Examples of controls based on interviews

The activities of the owners of sponsored 8(a) firms we reviewed were often limited to supervising, including keeping employee time records and keeping the sponsors aware of any financial problems. Fourteen presidents were former employees of their sponsors.

We visited the business offices of the firms and interviewed 23 firm presidents to determine their familiarity with the operations of their businesses. Our interviews generally indicated that they lacked even a basic understanding of routine business matters and were not aware of very important matters specific to their own businesses. Of those presidents interviewed

- one did not know if he was on the board of directors;
- two did not know who prepared their firms' financial statements;
- three did not know if their firms were on a cash or accrual accounting basis;
- one did not know if his firm had paid dividends;
- two did not know if the fees for the general and administrative services provided by their sponsors were based on a percentage of gross income;
- three did not know if their firms were drawing interest on the cash in their bank accounts; and
- six said they were weak in finance and accounting, nine said they were weak in preparing contract bids, and two said they were weak in negotiating contracts.

One disadvantaged secretary-treasurer of an 8(a) firm signed corporate documents and checks with an "X." He stated that, as an officer of the firm, he cleaned up around the office. SBA external auditors reported that the

contracts, dealing with SBA, dealing with union representatives, and locating and obtaining financing.

The activities of the firms which were most commonly influenced by the seven sponsors were:

- Accounting: At one time the books of 20 firms were maintained by the sponsors at the sponsors' places of business. At the completion of our review, the books of 18 firms were still maintained there.
- Corporate records: At one time the corporate records of 20 firms were maintained by the sponsors at the sponsors' places of business. At the completion of our review, the corporate records of 11 firms were still maintained there.
- Cash expenditures: Six sponsors were authorized to make cash expenditures for 17 firms without obtaining cosignatures of officials of the firms.
- Payroll: This function, provided by 6 sponsors to 19 firms included (1) computing gross pay and withholding, (2) writing the checks, (3) signing the names of the firms' treasurers by machine, and (4) mailing checks to firms.
- Contract negotiations: The 7 sponsors represented 20 of their firms in negotiations with contracting agencies.
- Board of directors meetings: At one time 7 sponsors were on the boards of directors of 21 firms, and 3 of these sponsors controlled the boards of 5 of these firms. At the completion of our review, three sponsors were still on the boards of six of the firms, and two sponsors still controlled the boards of three of the firms.
- Stockholders meetings: Six sponsors held stock in 18 firms at some time and were in a position to influence the stockholders' meetings. Although the other sponsor did not have stock ownership, it had similar influence through a partnership agreement. Stock in six firms is still owned by three of the sponsors.
- Dealings with financial institutions: Four sponsors arranged for loans or lines of credit for 14 firms by arranging for assignment of contract receipts to

CHAPTER 3

EXTENT AND EFFECT OF SPONSORSHIP IN

THE 8(a) PROGRAM

SBA encourages nondisadvantaged businesses (sponsors) to provide management services, training, and capital to disadvantaged small businesses. However, the sponsors often retain control in 8(a) firms, which appears to be inconsistent with SBA's objective of helping small businesses become self-sufficient. SBA does not routinely review or monitor the activities of sponsored 8(a) firms to determine if they control the business.

Also, SBA lacks criteria to define the extent to which sponsors can collect fees from 8(a) firms for services provided during the performance of a contract. For example, the sponsors included in our review charged their 8(a) firms fees ranging from about 6 percent to about 17 percent of the firms' gross receipts. Also, SBA does not regularly analyze other financial transactions between each 8(a) firm and its sponsor to insure they are proper and reasonable.

We reviewed files at the 10 SBA regional offices and identified 89 8(a) firms which had sponsors. Our analysis showed that 77 of these firms received 8(a) contracts amounting to about \$132.5 million. We evaluated 25 of the 89 firms (20 of the firms had receipts of about \$40.2 million in 8(a) contracts) and contacted the 7 sponsors of the 25 firms to determine:

- How and why experienced non-8(a) firms became sponsors.
- What controls were exercised by sponsors.
- What services and other items cost 8(a) firms.

HOW AND WHY EXPERIENCED FIRMS BECAME SPONSORS

SBA awarded large Government contracts, mostly service type (janitorial and military kitchen police), to sponsored 8(a) firms rather than award smaller contracts to smaller nonsponsored 8(a) firms. The latter action would have required more of SBA's manpower and other resources for monitoring, training, and management assistance. However, the practice of obtaining large contracts presented SBA with two problems:

3. Finally, the intangible benefits, such as management experience derived by the 8(a) contractor during his tenure in the program, cannot be quantified by an audit. These intangibles, while not always manifested in a company's financial statements, especially over the short term, are nonetheless important to the survival of the firm in particular and to the minority business community in general. The disadvantaged businessman, historically denied access to economic opportunity, is lacking in what some call the business instinct. The 8(a) program is helping to change this. We feel that the invaluable experience being gained by first and second tier managers will have a significant effect on the long term participation of disadvantaged persons in the business community."

We agree with SBA's comments. As indicated on page 9, we believe SBA's inability to control the supply of contracts is a major reason why the 47 firms suffered financial setbacks. Also, although it may be true that some firms deteriorated due to losses on non-8(a) contracts, this condition will always exist. We also agree that intangible benefits accrue to 8(a) contractors while in the program. However, none of these factors alter our conclusion that the program has had limited success.

We suggested that the Administrator of SBA identify and evaluate ways to alleviate SBA's lack of control over the supply of 8(a) contracts. We said that we believed such an evaluation should include consideration of alternatives such as

--allocating more SBA resources to identifying and processing suitable 8(a) contracts and/or

--reducing the number of firms in the program.

SBA agreed that benefits could be derived if the result of this suggestion could be obtained. With regard to the alternatives proposed, SBA indicated it had attempted to add more staff to the 8(a) program. SBA also indicated it had identified and processed suitable 8(a) contracts within the limits of its resources and had directed its field offices in September and November 1974 to give priority treatment to those firms which were evidencing the best potential for success and to terminate from the program those firms which

<u>Fiscal year</u>	<u>Gross sales</u>	<u>8(a) sales</u>	<u>Commercial sales</u>	<u>Net profit or loss (-)</u>	<u>Net worth</u>
1970	\$ 53,000	\$ -	\$ 53,000	\$ 12,000	\$ 41,000
1971	350,000	61,000	289,000	47,000	27,000
1972	604,000	52,000	552,000	-43,000	-46,000
1973	1,092,000	147,000	945,000	206,000	149,000

The ability to generate commercial sales is the reason this firm has been successful. The owner believes that, by participating in the 8(a) program, he improved his management and technical skills and helped generate sufficient cash flow to expand commercial sales. Additionally, the firm received two SBA-guaranteed loans totaling \$230,000 to help its development.

SBA agreed that this firm had reached self-sufficiency and will end its 8(a) assistance during fiscal year 1975.

Example B

A northeastern general contractor which appeared to be self-sufficient before receiving 8(a) assistance entered the program in 1970. The firm was formed in 1952. Upon entering the program, the firm's sales, net profit, and net worth increased and have remained stable the last 2 years. During 1972 and 1973, the firm demonstrated it could generate enough commercial sales to maintain a strong financial position. The following table shows the firm's financial position from 1970 to 1973.

<u>Fiscal year</u>	<u>Gross sales</u>	<u>8(a) sales</u>	<u>Commercial sales</u>	<u>Net profit</u>	<u>Net worth</u>
1970	\$240,000	\$ -	\$240,000	\$ 2,000	\$30,000
1971	330,000	224,000	106,000	13,000	31,000
1972	320,000	58,000	262,000	13,000	33,000
1973	313,000	34,000	279,000	13,000	44,000

In addition to strengthening the firm's financial position, the program has enabled the firm to purchase additional machinery and enlarge its facilities. The firm also received SBA management assistance in recordkeeping and completion of job reports. As of June 1974 this firm appeared to be self-sufficient. SBA said it would review the status of this firm during fiscal year 1975 and would end 8(a) assistance if it agreed that the firm had become self-sufficient.

commercial sales. Of the 21 firms, 15 still rely on 8(a) subcontracts for 50 percent or more of their gross sales. Thus, they could become so dependent on 8(a) contract work that they could suffer serious financial setbacks if they did not receive such assistance. Some firms steadily increased their dependence on 8(a) sales, rather than increasing commercial sales and moving toward self-sufficiency.

Although the 21 firms in this category did not generate sufficient commercial sales to be self-sufficient, SBA provided them with enough 8(a) contracts to sustain profitable operations. Fifteen of these firms each received 8(a) contracts amounting to more than \$500,000. The other six firms each received at least \$100,000 in subcontracts.

Example A

A western firm, formed in 1969, was admitted to the program in 1970. Because the firm did not generate any sales, the owner requested 8(a) assistance to stay in business. During its first year in the program, the firm still could not generate any commercial sales and would have gone out of business without 8(a) contract assistance. Since that time the firm has penetrated the commercial market and has concurrently reduced its dependence on 8(a) subcontracts. The financial position of the firm has also improved, as shown below.

<u>Year</u>	<u>Gross sales</u>	<u>8(a) sales</u>	<u>Non-8(a) sales</u>	<u>Net profit or loss (-)</u>	<u>Net worth</u>
1969	\$ -	\$ -	\$ -	\$ -	\$ -
1970	27,000	27,000	-	(a)	(a)
1971	100,000	82,000	18,000	-26,000	-18,000
1972	113,000	56,000	57,000	14,000	-24,000
1973	98,000	9,000	89,000	14,000	5,000

a/No record.

The owner received management assistance on five separate occasions between May 1972 and January 1973 to aid the firm's development. In addition, SBA guaranteed two loans for the company.

We believe this firm should successfully complete the program within the next year, if it continues to progress at the same rate.

firms in three States projected a need for \$45.7 million worth of assistance, while SBA provided these firms only \$26.6 million in assistance, or about 58 percent of what the firms said they needed.

In addition to not providing enough assistance, SBA has had difficulty in matching the right kind of contract to the right 8(a) firm. For example, SBA may have a surplus of manufacturing-type contracts but no construction-type contract for a firm that badly needs one. This problem compounds SBA's problems in obtaining an adequate number of contracts.

SBA regional officials told us that the inability to obtain contracts when needed was a major, ongoing problem. One regional director said that, in his opinion, the only way to alleviate this problem was to reduce the number of firms in the program or to allocate more manpower for locating suitable contracts.

Even if SBA controlled the selection of contracts for use in the 8(a) program, it would have difficulty in making accurate projections. We asked 19 contracting officials at Federal agencies supplying contracts for the program if they could guarantee SBA contracts up to 3 years in advance. Five said they could; however, the remaining 14 said such projections were not practical. For example, one official told us that his requirements change so frequently that he could not accurately plan from year to year.

Following are examples of firms, classified by us as deteriorated or out of business, to which SBA did not provide adequate contractual assistance.

Example A

A midwestern firm, formed in 1961, entered the program in 1970. The firm was experiencing financial difficulties at the time but suffered more serious financial setbacks while participating in the program. The following table shows the firm's financial position from 1969 to 1973.

<u>Year</u>	<u>Gross sales</u>	<u>8(a) sales</u>	<u>Commercial sales</u>	<u>Net profit or loss (-)</u>	<u>Net worth</u>
1969	\$ 917,000	\$ -	\$ 917,000	\$ -68,000	\$207,000
1970	870,000	109,000	761,000	-125,000	168,000
1971	1,071,000	562,000	509,000	-241,000	-72,000
1972	1,545,000	51,000	1,494,000	-193,000	-265,000
1973	1,020,000	34,000	986,000	-149,000	-414,000

5. Showing no change in competitive status between the time of entry and the present (no change).

--Self-sufficient:

1. Operating profitably with a positive net worth.
2. Having a history of sufficient commercial sales to sustain profitable operations.

--Undeterminable:

1. Having insufficient information available on which to base a conclusion.

Our classification of the 110 firms is shown below.

<u>Business status</u>	<u>Number of firms (note a)</u>	<u>Percent</u>
Not self-sufficient:		
Deteriorated	20	18.2
Out of business	27	24.5
Improved	21	19.1
No change	5	4.5
Self-sufficient	<u>b/18</u>	16.4
Undeterminable	<u>19</u>	<u>17.3</u>
Total	<u>110</u>	<u>100.0</u>

a/See appendix III for a classification of firms by metropolitan area.

b/Eleven of the firms appeared to be self-sufficient before entering the program.

SBA field office officials agreed that our classification of 102 of 110 firms was reasonable. They reserved judgment on two of the firms classified as self-sufficient until they could more thoroughly analyze the status of these firms. The officials also believed five of the firms classified as undeterminable by us would be self-sufficient by June 30, 1975. However, no current financial data supports this position. Also, the officials believed a firm classified by us as deteriorated should be placed in the "no change" category. This firm, however, was dependent on 8(a) sales and had deteriorated financially since entering the program, as evidenced by a decline in net worth.

throughout the United States. Through these offices, SBA administers 17 programs, including the 8(a) program. SBA's set-aside program, for example, identifies contracts at Federal agencies and limits competition for the contracts to small businesses, including those owned by nondisadvantaged persons.

<u>Type of firm</u>	<u>Number</u>
Manufacturing	102
Services	666
Construction	<u>413</u>
Total	<u>1,181</u>

Since 1968 the number and value of subcontracts awarded to firms throughout the United States (see apps. I and II) have grown steadily, as illustrated in the following table.

<u>Fiscal year</u>	<u>Number of awards</u>	<u>Value</u> (millions)	<u>Firms awarded contracts</u>
1968	8	\$ 10.5	7
1969	28	8.9	21
1970	199	22.5	145
1971	809	67.8	506
1972	1,646	142.3	924
1973	1,976	213.0	1,067
1974	<u>2,246</u>	<u>272.1</u>	1,132
Total	<u>6,912</u>	<u>\$737.1</u>	

SBA envisions a leveling off of the subcontracting activity to \$250 million during fiscal year 1975. SBA reports that such a level will require 1,500 participating firms and that approximately 375 firms should reach their goals and graduate each year.

BUSINESS DEVELOPMENT EXPENSE

Since disadvantaged 8(a) firms are frequently not able to provide services at a cost as low as the fair market value, the Congress has appropriated Business Development Expense funds to pay the difference. The following table shows the amount of these funds which SBA paid during fiscal years 1972, 1973, and 1974.

Cities Program, was under the overall direction of the Departments of Commerce and Labor and relied primarily on the Department of Labor to provide training grants to a few companies hiring and training the unemployed.

SBA used the section 8(a) authority to obtain contracts from Federal agencies and subcontract them on a noncompetitive basis to firms agreeing to locate in or near ghetto areas and to provide jobs for the unemployed and underemployed--employees working at a skill level lower than their capabilities. The Department of Labor, in turn, issued training grants to these same firms. The 8(a) contracts were offered to small firms willing to hire and train the unemployed and underemployed in five metropolitan areas and were not restricted to minority-owned firms.

During the first stages of the program, SBA recognized that the solution to the problems of the hard-core unemployed involved more than the creation of jobs. It was evident that business ownership opportunities would have to be offered to minority and low-income people for them to become part of America's economic mainstream. SBA felt that it could make its greatest contributions by focusing attention on this ownership aspect.

SBA gradually changed the program emphasis, beginning in 1969, from hiring the unemployed in ghetto areas to developing successful firms owned by disadvantaged persons. SBA's present goal is to help disadvantaged firms to expand and develop so they will be able to achieve a competitive position in the commercial marketplace.

CONTRACTING PROCEDURES

In awarding an 8(a) subcontract, SBA hopes to provide a firm with enough work to operate at a profitable level while developing its own commercial and Government sales (referred to as commercial sales). Each firm normally prepares a business plan, subject to SBA approval, which projects, on a multiyear basis, the amount of subcontracting assistance needed to reach self-sufficiency. Each firm also projects the growth in commercial sales which it believes it needs to become self-sufficient.

SBA obtains from Federal agencies prime contracts that ordinarily would be competitively awarded. The contracts are negotiated first between the Federal agency and SBA (prime contractor) and then between SBA and the 8(a) firm (subcontractor).

RECOMMENDATIONS OR
SUGGESTIONS

GAO suggested that the Administrator of SBA consider the following as means of improving the 8(a) program:

- Identify and evaluate potential courses of action which could be taken to alleviate SBA's lack of control over supply of contracts by considering alternatives such as (1) allocating more SBA resources for identifying and processing suitable 8(a) contracts and/or (2) reducing the number of firms in the 8(a) program.
- Provide firms with more assistance and guidance in developing sales.
- Establish a system to monitor (1) the extent to which sponsors control 8(a) firms and (2) the progress of the sponsor-controlled firms toward becoming self-sufficient.
- Develop criteria to define the extent to which sponsors can collect fees from 8(a) firms for service and other items.
- Evaluate each firm's need for management assistance and provide such assistance as required while they are in the program.
- Establish realistic goals for the 8(a) program that would include the number of successful program completions.

AGENCY COMMENTS AND UNRESOLVED
ISSUES

SBA expressed general agreement with the facts contained in this report and described actions that had been taken to correct the problems noted in GAO's review. See pages 15, 24, 31, and 34 for SBA's specific comments concerning each suggestion.

Although the actions taken by SBA should improve the 8(a) program, GAO believes that additional improvements are necessary. Accordingly, GAO recommends that the Administrator, SBA:

- Reconsider SBA's position of maintaining 1,500 active firms in its 8(a) program and periodically adjust the number of firms depending on the level of contracts that can be made available for the 8(a) program. (See p. 17.)
- Establish a system to monitor a sponsor's compliance with the terms of the sponsorship arrangement as approved by SBA, especially management agreements establishing a sponsor's services and fees. (See p. 26.)
- Revise the standard operating procedures to require that field offices consider all of the suggested factors in determining the need for 8(a) assistance and document in writing the connection between an applicant's social or economic disadvantage and his inability to compete successfully in the business world. (See p. 31.)

assistance they need each year to become self-sufficient, SBA cannot guarantee any level of assistance.

SBA did not provide adequate assistance to the 20 firms that deteriorated financially or the 27 firms that went out of business. Sixteen of these 47 firms projected a need for \$17.1 million of assistance, but SBA provided only \$5.8 million in assistance. (See p. 9.)

Fourteen of 19 officials at Federal agencies supplying contracts to SBA advised GAO that they could not forecast their procurement needs so they could not guarantee SBA any given level of contracts for the 8(a) program. (See p. 10.)

Extent and effect of sponsorships

SBA encourages nondisadvantaged businesses (sponsors) to provide management services, training, and capital to 8(a) firms.

Ineffective monitoring by SBA of the activities of sponsors coupled with the high degree of control exercised by sponsors over disadvantaged firms permits some sponsors to maintain their standing in the marketplace by using the 8(a) program. Eighty-nine firms accepted into the 8(a) program had part owners and/or sponsors who were

nondisadvantaged. Of these firms, 77 received contracts amounting to about \$132.5 million under the program.

Experienced contractors normally become sponsors by forming new corporations using former employees as stockholders and officers and by providing goods and services to the new corporations for a fee. The sponsors also obtain 49 percent or less ownership in the 8(a) firms. (See app. IV for a description of the relationship between a sponsor and an 8(a) firm and the extent to which the sponsor exercised controls.) (See p. 19.)

It appears that SBA relinquished to sponsors its responsibility for insuring that 8(a) firms are provided with capital, management services, and training to aid them in becoming self-sufficient. The sponsors often controlled the firms, contrary to SBA's objective of helping the firms to become self-sufficient.

This occurred because SBA did not (1) monitor the extent to which sponsors controlled 8(a) firms or (2) determine whether firms were becoming self-sufficient. Instead, SBA considered majority ownership of the firms by disadvantaged individuals as evidence of their control.

Officials of six of the seven sponsors GAO reviewed expressed a desire to develop

		<u>Page</u>
CHAPTER		
5	OTHER OBSERVATIONS	32
	Inadequate monitoring program	32
	Management assistance not provided	32
	Goals not appropriate	33
	Agency comments and our evaluation	34
	Recommendation	34
6	SCOPE OF REVIEW	35
APPENDIX		
I	Distribution of 8(a) contract awards by SBA region for fiscal years 1968-74	36
II	Map illustrating locations of SBA field offices	37
III	GAO's classification of businesses by metropolitan areas	38
IV	Case study	39
V	SBA requirements and conditions for determining ownership and control of 8(a) firms	47
VI	Letter dated January 31, 1975, from the Administrator, Small Business Administration	49
VII	Principal SBA officials responsible for administering activities discussed in this report	75

ABBREVIATIONS

GAO	General Accounting Office
SBA	Small Business Administration

