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Report to the Chairman,
Committee on Small Business,
House of Representatives

April 1994

SMALL BUSINESS ADMINISTRATION

Inadequate Documentation of Eligibility of Businesses Receiving SSBIC Financing

GAO/RCED-94-182

GAO

United States
General Accounting Office
Washington, D.C. 20548

Resources, Community, and
Economic Development Division

B-256971

April 26, 1994

The Honorable John J. LaFalce
Chairman, Committee on Small Business
House of Representatives

Dear Mr. Chairman:

The Small Business Investment Act of 1958 created a program to help small businesses obtain financing for starting, maintaining, and expanding operations. Under the program, small business investment companies (SBIC) provide financing to small businesses through equity investments (purchasing their stock) and debt (issuing them loans). In 1972, the Congress amended the act to establish a new class of SBICs, sometimes called specialized SBICs, or SSBICs. Using their own funds as well as government funds provided through the Small Business Administration (SBA), SSBICs provide financing to small businesses that are owned by persons who are socially or economically disadvantaged.[1] As of February 1994, there were 99 active SSBICs, with investments in over 3,000 small businesses. As of October 1, 1993, SSBICs had over $300 million in funding from SBA.

SBA's Investment Division administers the SSBIC program, licenses the investment companies, and maintains regulatory oversight of them. This oversight includes ensuring that SSBICs finance only eligible businesses. You requested that we review (1) the operations of Capital Management Services, Inc.—an SSBIC—and (2) SSBICs' compliance with SBA's guidance laying out eligibility criteria for firms seeking financing from SSBICs. Separately, we reported in March 1994 on the operations of Capital Management Services, Inc.[2] This report discusses the extent to which SSBICs comply with SBA's guidance for documenting that the small businesses receiving financing are owned by persons who are socially or economically disadvantaged. In order to provide national estimates, we randomly selected 30 SSBICs and spoke with the owners/managers for each of them. Additionally, for all but one of these SSBICs, we randomly selected up to 20 small businesses receiving financing, for a total of 381 small businesses. For each of these small businesses, we reviewed the eligibility

[1]Government funding of SSBICs may take the form of SBA-guaranteed debentures or SBA-purchased preferred stock and reduced interest rate debentures.

[2]Small Business Administration: Inadequate Oversight of Capital Management Services, Inc.—an SSBIC (GAO/OSI-94-23, Mar. 21, 1994).

documentation maintained by the SSBIC.[3] As agreed with your office, we did not verify that these small businesses did, in fact, meet SBA's criteria for social or economic disadvantage.

Results in Brief

SSBICs often do not comply with SBA's guidance for documenting the eligibility of the small businesses they finance.[4] On the basis of our random sample, we estimate that for more than a third of all of the small businesses financed, SSBICs did not prepare eligibility profiles to document that the businesses were owned by persons who were socially or economically disadvantaged, as required by SBA.[5] Even when SSBICs do prepare eligibility profiles, they often cite a single factor as the basis for eligibility—typically that the owners are minorities—though SBA has instructed SSBICs to base eligibility on a composite of factors such as owners' minority status, limited education, and low income. Specifically, we estimate that SSBICs based eligibility on one factor alone for 62 percent of all of the small businesses they financed, and for 72 percent of these small businesses, SSBICs based eligibility upon minority status alone.

One possible reason why SSBICs do not comply with SBA's guidance is that they believe such documentation is not needed in all cases—particularly when the small business is owned by a minority. In fact, even within SBA, guidance concerning the bases used for determining eligibility is inconsistent. That is, while SBA requires that SSBICs not rely on a single factor when determining the eligibility of the small businesses they finance, SBA also instructs its examiners to accept SSBICs' documentation of eligibility if membership in a designated minority group, a single factor, is cited. We cannot say whether relying on a single factor as the basis of eligibility has resulted in SSBICs' financing businesses owned by persons who are not socially or economically disadvantaged. However, the requirement placed on SSBICs to not rely on a single factor in determining the eligibility of businesses they finance is not enforced given the current instructions provided to examiners.

[3]For one SSBIC, we could not obtain access to its files: It was closing its operations, and its records were not available for review.

[4]Neither the law nor SBA's regulations define social or economic disadvantage. Rather, criteria for establishing social or economic disadvantage are contained in SBA's guidance to SSBICs. See app. I.

[5]App. III includes the sampling errors and confidence intervals for the statistical estimates included in this report.

Background

SSBICs were created by the 1972 amendments to the Small Business Investment Act of 1958. This new class of investment companies was an outgrowth of a similar program created by SBA in 1969, which targeted assistance to minority-owned businesses. The 1972 amendments require that SSBICs invest only in small businesses owned by persons whose participation in the free enterprise system is hampered because of social or economic disadvantage.[6] But neither the legislation nor SBA's regulations define social or economic disadvantage—though SBA has established criteria for determining whether a small business is socially or economically disadvantaged. However, at the time of the amendments, the House Committee on Banking and Currency reported that in order to bring benefits to as many worthy individuals as possible, the phrase "minority enterprise SBIC" should be eliminated from the name of the program, since the phrase implies that only members of minority groups are eligible for this type of assistance.[7]

SBA, in its 1980 Policy Release 2017, specified procedures for determining whether a business is owned by a person who is disadvantaged and is therefore eligible for financing from an SSBIC.[8] These procedures state that reliance should not be placed upon a single factor, but on a composite of factors that have prevented owners of small businesses from obtaining financial or other assistance available to the average entrepreneur in the economic mainstream. SBA's policy release cites several factors that may be considered in determining whether the owner of the small business is disadvantaged, including minority status, limited education, low income, a physical or other special handicap, the fact that the owner is a Vietnam era veteran, an inability to compete in the marketplace, and an unfavorable location of the business. Finally, SBA requires that SSBICs complete a separate profile of this information for each small business they finance and that this eligibility profile be maintained by the SSBIC.

In exchange for financing only businesses owned by socially or economically disadvantaged persons, SSBICs may receive more liberal funding from SBA than do other investment companies. That is, SSBICs may

[6]Other similar SBA programs have a different requirement. For example, section 8(a) of the Small Business Act, as amended, established the Minority Small Business and Capital Ownership Development Program or 8(a) Program. The 8(a) Program is intended exclusively to help small businesses owned and controlled by "socially and economically disadvantaged" individuals. (Emphasis provided.)

[7]Amending the Small Business Investment Act of 1958, H.R. Rep. No. 92-1428, 92nd Cong., 2nd Sess. (Sept. 21, 1972).

[8]Determination of "Disadvantaged Small Business Concern," SBA Policy and Procedural Release #2017 (May 1, 1980).

receive a 5-year, 3-percent interest rate subsidy for debentures sold to SBA. In addition, SSBICs may receive funding by selling 4-percent preferred stock to SBA. SBICs, in comparison, receive neither the interest rate subsidy nor the opportunity to sell 4-percent preferred stock.

SBA's Investment Division, as part of its role in administering both the SBIC and SSBIC programs, is responsible for conducting biennial examinations of SBICs and SSBICs. These examinations focus on the investment companies' financial condition, SBA's financial risk with regard to the investment companies, and SBICs' and SSBICs' compliance with provisions of the Small Business Investment Act and SBA's regulations. In general, the time and resources devoted to an examination depend upon the regulatory history of the SBIC or SSBIC and the amount of SBA's outstanding funding.

SSBICs Do Not Comply With Requirements for Documenting Eligibility

Many SSBICs do not comply with SBA's guidance on documenting the eligibility of the small businesses they finance. Often SSBICs do not complete eligibility profiles, or they rely upon a single factor in determining eligibility. We estimate that SSBICs did not prepare eligibility profiles for 37 percent of all of the small businesses in their portfolios. Of the 29 SSBICs for which we reviewed eligibility profiles, 10 had none for businesses in their portfolio, 6 had completed the profiles for some of the businesses in their portfolio, and the remaining 13 had completed the profiles for all of the businesses in their portfolio.

Even when SSBICs do prepare eligibility profiles, many of these profiles cite only one factor as the basis for eligibility. Specifically, we estimate that 62 percent of all of the small businesses receiving financing for which profiles were prepared were deemed eligible on the basis of one factor only. For those profiles having only a single factor cited, minority status was the factor most often cited, appearing in an estimated 72 percent of these profiles.

Overall, minority status was the most often cited factor—cited alone or in combination with other factors for an estimated 67 percent of all of the small businesses financed by SSBICs. The next most often cited factor was limited education—cited alone or in combination with other factors for an estimated 24 percent of all of the small businesses financed.

Some SSBIC owners and managers believe that documenting eligibility and basing eligibility upon a composite of factors are not needed in all instances. About 17 percent of the SSBIC officials we spoke with said that they do not document eligibility in a profile statement as SBA requires. In our discussions with SSBIC owners and managers, some volunteered that they saw no need for such documentation when the business is owned by a minority. In fact, the managers/owners of all 10 of the SSBICs having no eligibility profiles said that all or nearly all of their businesses were eligible on the basis of their minority status. This perception is not new. In 1979, we reported that two of the nine SSBIC officials we spoke with thought that minorities, by virtue of that fact alone, were disadvantaged.[9]

In fact, even within SBA, criteria for establishing eligibility is not consistent. That is, in a June 1993 memo, SBA's Deputy Associate Administrator for Investment instructed examiners that small business owners who are members of a designated group such as Black-, Hispanic-, or Asian-Americans are assumed to be socially disadvantaged, and no additional information need be considered.[10] This instruction, however, is not consistent with SBA's guidance to SSBICs, which instructs them to use a composite of factors to determine that a small business is owned by a person who is socially or economically disadvantaged. More recently, in an attempt to clarify the determination that a business is disadvantaged, SBA proposed to an SSBIC industry group criteria that would presume that members of designated minority groups are socially disadvantaged. No action was taken on this proposal, though SBA is currently exploring changes to its criteria for establishing social or economic disadvantage.

Conclusions

SSBICs often do not comply with SBA's guidance for documenting and determining the eligibility of the businesses they finance. SBA's requirement that examiners accept eligibility determinations based upon minority status alone continues to be inconsistent with SBA's instructions to SSBICs to use a composite of factors as a basis for determining eligibility. Consequently, examiners would not be expected to detect instances in which SSBICs are financing small businesses that may not be socially or economically disadvantaged according to the criteria in the instructions to SSBICs.

Recommendation

The Administrator of SBA should resolve the inconsistency between its guidance to SSBICs and SBA examiners as to whether minority status alone

[9] Efforts to Improve Management of the Small Business Administration Have Been Unsatisfactory—More Aggressive Action Needed (GAO/CED-79-103, Aug. 21, 1979).

[10] The June 1993 memo to examiners was written in anticipation of changes—which have not yet been made—to SBA's criteria for establishing social disadvantage. These changes would allow citing membership in a designated minority group alone as the basis for eligibility. See app. II.

is sufficient to establish eligibility. If the agency deems that minority status alone is sufficient to establish eligibility, it should modify Policy Release 2017 to instruct SSBICs of this. However, should the agency continue to instruct SSBICs to use a composite of factors in determining the eligibility of the businesses they finance, then SBA should instruct examiners to look for such a composite when assessing SSBICs' compliance with SBA's requirements for documenting and determining eligibility.

Agency Comments

We discussed the contents of this report with SBA's Associate Administrator for Investment and the Directors of the Office of Examinations and Office of Investment. They generally concurred with the factual content of the report. They did suggest several clarifications, which we have incorporated. As requested, we did not obtain written comments from SBA.

Scope and Methodology

To assess SSBICs' compliance with SBA's requirements for documenting businesses' eligibility, we selected a random sample of 30 SSBICs. We interviewed the SSBICs' owners or managers about their familiarity with SBA's policy on eligibility, the bases they use for establishing the eligibility of the businesses in their portfolio, and their methods for documenting eligibility. We then set about reviewing the eligibility profiles prepared by all but one of these SSBICs.[11] When the SSBIC had 20 or fewer businesses in its portfolio, we examined all of the eligibility profiles prepared for these businesses. For SSBICs with a larger portfolio, we selected a random sample of 20 businesses in their portfolio. From our review, we estimated the percentage of small businesses for which SSBICs prepared eligibility profiles and cited various factors justifying businesses' eligibility. As with all estimates, these estimates are subject to a margin of error, which varies for each estimate. We prepared our estimates at the 95-percent confidence level. All of our estimates and their margin of error are included in appendix III. We also reviewed SBA's policy and procedures for documenting eligibility and reviewed the legislative history of the amendments creating the SSBIC program. Our analysis of SSBICs' compliance with SBA's guidance laying out eligibility criteria was limited to reviewing eligibility profiles maintained by SSBICs. We did not verify the accuracy of the information contained in these profiles. Our work was conducted between December 1993 and March 1994.

[11]As explained earlier, the records of one SSBIC were not available for review.

While GAO's policy is to allow requesters to restrict further distribution of a report for up to 30 days, we will be contacting your office to arrange for an earlier release of this report to other interested parties. This work was performed under the direction of Judy A. England-Joseph, Director, Housing and Community Development Issues, who may be reached at (202) 512-7631 if you or your staff have any questions. Major contributors to this report are listed in appendix IV.

Sincerely yours,

Keith O. Fultz
Assistant Comptroller General

Contents

Abbreviations

SBA	Small Business Administration
SBIC	Small Business Investment Company
SSBIC	Specialized Small Business Investment Company

"SBA Policy and Procedural Release #2017"

SBA POLICY AND PROCEDURAL RELEASE #2017

Subject: Determination of "Disadvantaged Small Business Concern."

The purpose of this memorandum is to provide guidance to Section 301(d) and other licensees in their determination that a small business concern is socially or economically disadvantaged, and to outline minimum information needed for such determination.

I. STATEMENT OF POLICY

A disadvantaged small business is a small business concern which is at least 50 percent owned, and controlled and managed by socially or economically disadvantaged individuals. No assistance may be provided by Section 301(d) licensees to small business concerns unless such concerns are socially or economically disadvantaged.

II. LEGISLATION RELATING TO 301(d) LICENSEES

Section 301(d) of the Small Business Investment Act of 1958 was added in 1972 to give legislative authority to a program of providing assistance to present or potential business persons whose participation in the free enterprise system is hampered because of social or economic disadvantages. Prior to the 1972 amendment to the Act, the Small Business Administration had licensed a special class of small business investment companies (MESBICs). These MESBICs were licensed solely for the purpose of rendering financial and management assistance to members of minority races and to those persons who are socially or economically disadvantaged.

Section 301(d) of the Act provides for the licensing by SBA of a small business investment company, "the investment policy of which is that its investments will be made solely in small business concerns which will contribute to a well-balanced national economy by facilitating ownership in such concerns by persons whose participation in the free enterprise system is hampered because of social or economic disadvantages . . ."

III. REGULATIONS

Pursuant to this authority, SBA has defined a Section 301(d) license in Section 107.3 of the Regulations as "a licensee organized under a State business or nonprofit corporation statute, and licensed pursuant to Section 301(d) of the Act" and having an investment policy limited to "making investments solely in Small Concerns which will contribute to a well-balanced national economy by facilitating ownership of such concerns by persons whose participation in the free enterprise system is hampered because of social or economic disadvantages." "Disadvantaged Concern" is defined in terms of the statutory language as one "owned by a person or persons whose participation in the free enterprise system is hampered because of social or economic disadvantages." The regulations also make special provisions for investments in disadvantaged concerns by Licensees other than Section 301(d) Licensees. See, for example § 107.301(a).

Revised May 1, 1980

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IV. MEANING OF SOCIALLY OR ECONOMICALLY DISADVANTAGED

Except to recommend the elimination of any suggestion that only members of minority groups are eligible for assistance under this program and to specify that the program is to aid all who are hampered in achieving full citizenship in our economic system by virtue of their social or economic disadvantages, Congress has not fully defined the words "socially or economically disadvantaged." This lack of precise legislative definition suggests that a precise definition is inappropriate, and that flexibility is warranted.

V. PROCEDURES RELATING TO ELIGIBILITY DETERMINATIONS OF DISADVANTAGED BUSINESSES

In determining whether small business concerns are socially or economically disadvantaged, reliance should not be placed upon a single factor, but on a composite of such factors as the social or economic background of the principal owners, controlling individuals and managers of the concern, along with the general pattern of their life, opportunities and education which have prevented them from obtaining financial or other assistance available to the average entrepreneur in the economic mainstream. Such persons may often include, but are not limited to Negroes, Indians, Eskimos, Aleuts, and persons of Mexican, Puerto Rican, Cuban, Filipino, or Oriental extraction. In determining whether the owners of small business concerns are "disadvantaged," consideration may be given to the following factors:

(a) low income;

(b) unfavorable location such as urban ghettos or depressed rural areas and areas of high unemployment or under-employment;

(c) limited education;

(d) physical or other special handicap;

(e) inability to compete effectively in the marketplace because of prevailing or past restrictive practices; and

(f) Vietnam era service in the Armed Forces, (August 5, 1964 to May 7, 1975),

or such other factors as contribute to a disadvantaged condition in the ordinary (dictionary) meaning of that word: lacking in basic resources or conditions necessary to an equal position in society.

VI. DOCUMENTATION

The composite of the foregoing factors and other pertinent information will establish a profile to be used as the basis for determining eligibility. A separate profile should be completed by the licensee with respect to each small business concern assisted, and maintained for SBA's inspection.

Revised May 1, 1980

SBA's Memo to Examiners on Determinations That Business Owners Are Socially Disadvantaged

Date: June 23, 1993

To: Chuck Mezger, Acting Director of SBIC Examinations
SBIC Examination Managers and Examiners

From: Charles Shepperson
Deputy/AAI

Re: Clarification Regarding Interpretation of Socially Disadvantaged Business Owners

Please note that this memo supersedes your Draft Memo dated December 15, 1992, subject as above.

There has been confusion regarding the determination of disadvantaged small business concerns among both the SBA staff and the licensees. The terms socially or economically disadvantaged provided by PPR #2017 are unclear because they are not specific.

This issue was considered at a meeting on December 7, 1992 of Investment Division management including Wayne Foren, Ned Shepperson, Joe Newell, Marvin Klapp, Chuck Mezger and Virginia Campbell. It was determined that the Office of Program Development will formulate a general policy regarding the interpretation of socially disadvantaged. Until further notice, the guidelines below which reflect the anticipated policy formulation should be followed by the Office of Examinations:

1. If the business owner is a member of a designated group specified in either PPR #2017 or CFR 13 Section 124.105(b) (i.e., Black Americans, Hispanic Americans, Native Americans, Asian Pacific Americans, and Subcontinent Asian Americans), then he/she may be assumed to be socially disadvantaged, and no further information (including the financial status of the owner) will be considered.

2. A person who is <u>not</u> a member of one of the designated groups must establish his/her individual social disadvantage. For factors to consider see CFR 13, Section 124.105(c).

3. The examiner should request the information he/she needs to document an eligibility determination. If such information is either not available in the licensee's files or not readily forthcoming upon request, the examiner should report the factors that were included in the eligibility profile, and cite, if applicable, that sufficient information was not available to make a determination regarding the claimed disadvantage. The examiner should report the facts and <u>not</u> become involved in a dialogue with the licensee as to whether or not the small business owner is disadvantaged. This determination will be made by the Office of

Operations based on the facts provided in the examination report, and input from the licensee.

4. It is the obligation of the licensee to make a reasonable eligibility determination based on the facts of each case. A separate profile should be completed by the licensee for each small business concern assisted, and the profiles should be maintained for SBA's inspection. See PPR #2017.

cc: Foren
Shepperson
Newell
Klapp
Mezger
Campbell

Scope and Methodology

To assess Specialized Small Business Investment Companies' (SSBIC) compliance with requirements for determining and documenting eligibility and to obtain data on the bases used for determining eligibility, we interviewed owners or managers of 30 randomly selected SSBICs and used a two-stage cluster sample of SSBICs and the businesses they finance. For each of the 30 SSBICs, we interviewed the owners or managers about their familiarity with SBA's policy on eligibility, the bases they use for establishing the eligibility of the businesses in their portfolio, and their methods for documenting eligibility. These same 30 randomly selected SSBICs served as the first stage of the two-stage cluster sample described below.

First, we randomly selected the 30 SSBICs out of the universe of 99 SSBICs. We then obtained eligibility profiles for randomly selected small businesses in each of the SSBICs' portfolios. When the SSBIC had 20 or fewer small businesses in its portfolio, we examined all of the eligibility profiles prepared for these businesses. For SSBICs with a larger portfolio, we selected a random sample of 20 businesses in their portfolio. The 30 randomly selected SSBICs represent the first stage of the two-stage cluster sample, and the small businesses sampled represent the second stage of the sample. We chose this approach as appropriate for constructing a sample because the 99 SSBICs closely resembled one another but were in separate locations. The files for one of the sampled SSBICs were inaccessible because this SSBIC was in liquidation. This reduced our sample size for SSBICs to 29, and we proportionally reduced our population size to 96. The 29 randomly selected SSBICs financed a total of 916 small businesses. From the 916, we sampled a total of 381 small businesses. Initially, we looked at whether or not a profile was available for each small business, and then, if a profile was available, we looked at the criteria used to determine eligibility.

Because we used random samples at both stages to develop our estimates, each estimate has a measurable precision, or sampling error, which may be expressed as a plus/minus figure. A sampling error indicates how closely we can reproduce from a sample the results that we would obtain if we were to take a complete count of the universe using the same measurement methods. By adding the sampling error to and subtracting it from the estimate, we can develop upper and lower bounds for each estimate. This range is called a confidence interval. Sampling errors and confidence intervals are stated at a certain confidence level—in our case, 95 percent. This confidence level of 95 percent means that in 95 out of 100 instances, the sampling procedure we used would produce a confidence interval containing the universe value we are estimating. We calculated the sampling errors at the 95-percent confidence level for those statistical estimates used in this report. The upper and lower bounds of the confidence intervals for the estimates in this report are shown in table III.1.

Table III.1: Documentation of Small Businesses' Eligibility

Characteristic of documentation	Estimated percentage of small businesses with the characteristic	Confidence interval at the 95-percent confidence level (percentage)
No eligibility profile prepared	36.8	15.1 to 58.5
Minority status cited alone or in combination with other factors as the basis for eligibility	67.4	45.2 to 89.6
Limited education cited alone or in combination with other factors	23.5	9.7 to 37.3
Only one factor cited as the basis for eligibility	62.0	42.2 to 81.8
Minority status cited alone	71.9	53.2 to 90.6

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