

**REVIEW OF A COMPANY'S 8(A) BUSINESS
DEVELOPMENT PROGRAM ELIGIBILITY**

AUDIT REPORT NO. 6-19

MARCH 30, 2006

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

MANAGEMENT ADVISORY REPORT

Issue Date: March 30, 2006

Report Number: 6-19

TO: Sheila Thomas
Acting Associate Administrator for Business Development

/S/ original signed
FROM: Robert G. Seabrooks
Assistant Inspector General for Auditing

SUBJECT: Review of a Company's 8(a) Business Development Program Eligibility

The Office of Inspector General received complaints about [FOIA Ex. 4 and 6], (the company), an 8(a) Business Development (BD) company. In reviewing the complaints, we determined that the company was ineligible for 8(a) BD participation, and as such, should be removed from the program. When applying and after admittance to the 8(a) BD program, the company's disadvantaged owner¹ violated 8(a) BD eligibility requirements concerning good character, payment of federal financial obligations and control of the company; and though required, the company did not inform SBA that it failed to meet eligibility requirements. In doing so, the company violated seven of the good causes for termination from the 8(a) BD program cited in 13 CFR § 124.303, some of them for more than one reason. The company's violation of the good character requirement (13 CFR § 124.108 (a) (5)) requires SBA to initiate termination proceedings and suspend the company. Attachment 1 contains a timeline of pertinent events.

Although the company was out of compliance with 8(a) BD eligibility requirements, it received a \$9.3 million 8(a) BD contract on July 30, 2004. If SBA had been aware of the violations as they occurred, the company would not have been admitted into the 8(a) BD program and would not have received an 8(a) contract. An 8(a) BD company in compliance with the program regulations may have received that contract.

¹ In this memorandum, the company's disadvantaged owner refers to the company's disadvantaged owner at the time the company was admitted to the 8(a) BD program. During most of the application process, both of the company's owners were classified as disadvantaged.

Delinquency on a Significant Federal Debt

During the application process, the company's disadvantaged owner and President, was delinquent on over \$270,000 in taxes owed to the Internal Revenue Service (IRS). Though not finalized, SBA officials were recommending that the company not be admitted to the 8(a) BD program, partly because of this delinquency. Subsequent to these non-finalized recommendations, the company's disadvantaged owner negotiated a repayment agreement (July 2003 repayment agreement) with the IRS. The company provided the July 2003 repayment agreement to SBA, to demonstrate that its disadvantaged owner was no longer delinquent on his significant Federal debt. The disadvantaged owner, however, did not make the first or subsequent payments on the July 2003 repayment agreement. The first payment to the IRS on the July 2003 repayment agreement was due July 28, 2003, 11 days before SBA admitted the company into the 8(a) BD program and 19 days after the IRS sent the company's disadvantaged owner the finalized agreement. The company's disadvantaged owner remained delinquent on the July 2003 repayment agreement from July 2003 until November 2004², when he again negotiated his delinquent debt with the IRS for approximately \$.33 on the dollar.

On July 29, 2003, the day after the first payment was due but not paid, the company's disadvantaged owner falsely notified SBA that ". . . there are no changed circumstances since our original submission which would cause our firm to be ineligible for 8(a) program participation." This signed statement responded to an SBA request for information so that there would be a complete application package. When the disadvantaged owner made this certification to SBA, he had to know he was delinquent on the IRS debt, thereby making the company ineligible for program admittance or participation. We concluded that this was a willful violation of a material 8(a) BD regulation because (1) the application for admittance was held up until the company's disadvantaged owner entered into the July 2003 repayment agreement with the IRS so he would not be delinquent on his debt, and (2) less than three weeks before the first payment was due, the IRS mailed him a letter with the approved Installment Agreement, signed by the disadvantaged owner, listing the due date and amount of the first payment.

Based on the 8(a) BD program's Division of Program Certification and Eligibility's (DPCE) recommendation that the company be admitted to the 8(a) BD program, completed on August 7, 2003, or 10 days after the company's disadvantaged owner became delinquent on the July 2003 repayment agreement, it is obvious that SBA was not informed of this delinquency. The company's disadvantaged owner's statement that there were "no changed circumstances," quoted in the prior paragraph, is cited by the DPCE in its recommendation that the company be admitted to the 8(a) BD program.

Furthermore, financial records clearly show, and subsequent events validate, that the company's disadvantaged owner did not have the resources to make the agreed upon IRS payments. The annual payments to the IRS were over \$38,000, while the company's disadvantaged owner and his spouse's combined gross income was less than \$23,000 in 2002, the

² The disadvantaged owner's wife had indicated in her response to an IRS letter that an extension to the July 2003 IRS repayment plan was granted. However, neither the disadvantaged owner nor the IRS has provided evidence that the extension was official.

year before they entered into the repayment agreement. Their combined gross income was slightly over \$49,000 in 2003, the calendar year they entered into the July 2003 repayment agreement. Based on the company's disadvantaged owner's 2002 Personal Financial Statement, the monthly mortgage payment on their home was approximately \$2,000 a month or over \$24,000 a year. According to the Personal Financial Statements, signed August 21, 2002, the company's disadvantaged owner's net worth was approximately negative \$1.5 million and his spouse's was approximately negative \$365,000. Thus, the company provided SBA with the July 2003 IRS repayment agreement, which it's disadvantaged owner knew, or should have known, would lead SBA to mistakenly determine he would be able to make the IRS payments and not be delinquent on the debt. As such, we believe the representation can also be construed as knowingly submitting false information on the application.

Based on the preceding, we concluded that the company violated the following regulations:

13 CFR § 124.108 (a) (5):

“Good character. . . If, during the processing of an application, SBA determines that an applicant has knowingly submitted false information, regardless of whether correct information would cause SBA to deny the application, and regardless of whether correct information was given to SBA in accompanying documents, SBA will deny the application. If, after admission to the program, SBA discovers that false information has been knowingly submitted by a firm, SBA will initiate termination proceedings and suspend the firm . . .”

13 CFR § 124.108(e):

“Neither a firm nor any of its principals that fails to pay significant financial obligations owed to the Federal Government . . . is eligible for admission to or participation in the 8(a) BD program.”

13 CFR § 124.204:

“The applicant must inform SBA of any changed circumstances that could adversely affect its eligibility for the program . . . during its application review. Failure to inform SBA of any changed circumstances constitutes good cause to which SBA may terminate the Participant if non-compliance is discovered after admittance.”

Further, the company can be terminated from the 8(a) BD program for the following five good causes cited in 13 CFR § 124.303 (a) “What is termination?”:

(1) “Submission of false information in the concern's 8(a) BD application, regardless of whether correct information would have caused the concern to be denied admission to the program, and regardless of whether correct information was given to SBA in accompanying documents or by other means.”

- (2) "Failure by the concern to maintain its eligibility."
- (3) "Failure by the concern or one or more of its principals to maintain good character."
- (4) "... failure to report changes that adversely affect the program eligibility of an applicant or program participant under 13 CFR § 124.204 . . . , where responsible officials of the 8(a) BD Participant knew or should have known the submission to be false."
- (5) "Willful violation by a concern, or any of its principals, of any SBA regulation pertaining to material issues."

Compensation of employees

The company made two false statements to SBA in its application by stating that the company was not providing compensation to either of its owners. Based on these false statements, SBA is required to initiate termination proceedings and suspend the company. Additionally, for 2003, the first year that the company was in the 8(a) BD program, the company's President and disadvantaged owner, was not the highest compensated company employee. Thus, SBA should not consider the company's disadvantaged owner to control the company, making the company ineligible for program participation. Finally, though required, the company did not inform SBA that it was out of compliance with an 8(a) eligibility regulation. As such, the company violated three of the 8(a) BD regulations and violated seven of the good causes for termination cited in 13 CFR § 124.303. Four of these good causes were already cited in the previous section concerning non-payment of significant Federal debt.

During the application process, the company's disadvantaged owner submitted two signed statements to SBA that the company was not compensating its two owners. On October 7, 2002, the company's disadvantaged owner wrote the following in response to SBA's concern "Were you the highest compensated employee of your firm?":

"Statement concerning salaries. (The company) has paid no wages since the fourth quarter of 1998. Since the first quarter of 1999, revenues have been insufficient to cover the burden of wages, and . . . [The company's non-disadvantaged owner]³ and I decided not to take wages to ensure continuance of corporate operations. We have continued to loan the corporation funds to keep it in operation."

On July 29, 2003, the company's disadvantaged owner informed SBA that the company had no payroll activity in 2003.

³ In this memorandum, the company's non-disadvantaged owner refers to the company's non-disadvantaged owner at the time the company was admitted to the 8(a) BD program.

For the period 2001 through 2003, the company paid its non-disadvantaged owner \$173,239 in professional fees (\$23,234 in 2001, \$65,950 in 2002 and \$84,055 in 2003).⁴ In 2003, the company paid its disadvantaged owner \$49,717 in professional fees. Through July 2003, the company's two owners received at least \$94,000 from the company.⁵ According to the company's accountant, loans rather than salaries were given to the two officers throughout the year. Loan amounts were reduced based on repayments, and at year-end, a portion of the outstanding amount of the loans were considered professional fees. In reporting to SBA, the company did not include professional fees as compensation. On October 7, 2002, the same day that he informed SBA that he had not received wages from the company since 1998, the company's disadvantaged owner responded to SBA concerns on how he paid his homestead expenses. He discussed how he withdrew and re-paid the company sums of money. While acknowledging that funds were being withdrawn, he did not refer to them as professional fees, wages, compensation, etc. In discussing the issue of professional fees with the Auditing Division during our review, the company's disadvantaged owner summarized it as the two owners being consultants with clients and the company paying each of them fees in lieu of a direct salary. The disadvantaged owner was aware or should have been aware that the non-disadvantaged owner received professional fees prior to the application date; however, he did not disclose this on any of his responses to SBA's compensation inquiries. If SBA had been aware that the company was compensating its employees, it could have determined whether the disadvantaged owner was the highest compensated employee. By submitting the above two statements, the company should be terminated from the program based on 13 CFR § 124.108 (a) (5), quoted in the previous section.

During Calendar Year 2003 (the year SBA admitted the company into the 8(a) BD program), the company's President and disadvantaged owner's compensation from the company was less than 60 percent of the non-disadvantaged owner's. The highest compensated employee was the former majority stockholder. On October 15, 2004, as part of the company's Annual Review, a Dallas District Office official sent an e-mail to the company's accountant requesting clarification. On October 16, 2004, the company held a board meeting and retroactively lowered the company's non-disadvantaged owner's 2003 professional fees from \$84,054.95 to \$40,000. The company's disadvantaged owner's professional fees remained at \$49,717. The salaries for 2004 were set at \$100,000 for the company's disadvantaged owner and \$99,000 for its non-disadvantaged owner. There is no documentation in the files showing that the company notified SBA that the company's disadvantaged owner was not the company's highest compensated employee prior to this retroactive change.

The company was originally going to be denied participation in the 8(a) BD program because it's President at that time (the non-disadvantaged owner at the time of admission to the 8(a) BD program), the individual controlling the company's day to day activities, would have other employment in addition to his company position. Prior to the company being admitted to

⁴ In October, 2004, after being questioned by SBA, the company retroactively lowered the professional fees it paid its non-disadvantaged owner to less than its disadvantaged owner's for 2003. We are using the amounts originally reported to SBA.

⁵ While we requested a breakdown of the 2003 fees prior to the retroactive change, the company only provided us the information based on the retroactive change.

the 8(a) BD program, this individual gave up the company's Presidency and became the non-disadvantaged owner. The company was subsequently admitted to the program based on the company's sole disadvantaged owner controlling the company's day-to-day activities. Control is partially demonstrated by the company's disadvantaged owner receiving the highest compensation. Since the non-disadvantaged owner received the highest compensation, it raises the issue of who truly controlled the company. The company's disadvantaged owner signed the 8(a) BD application form, checking that no non-disadvantaged employee received compensation in excess of the highest ranking officer's, demonstrating he was aware of the requirement, but was apparently unwilling to abide by it. If the company's disadvantaged owner truly controlled the company's day-to-day operations, he had to be aware that his compensation was significantly less than the non-disadvantaged owner's.

In responding to our request for information concerning payments, the company's accountant stated that:

“there seems to be a problem with each party's understanding of financial terminology used. It appears that the use of the term ‘salaries’ as a synonym for all compensation regardless of the accounting practice for compensating shareholders employed may be the source of the misunderstanding.”

We believe that it was clear that in asking for “wages” and “payroll activity,” SBA was referring to payments made to its employees. No matter what the company called the compensation, it still needed to report what it was to SBA. Further, the company's disadvantaged owner checked that no non-disadvantaged employee received compensation in excess of the highest ranking officer; as such, we believe that he knew what SBA was requesting.

The company violated the following regulations:

13 CFR § 124.106 (e) (3):

“no such non-disadvantaged individual . . . may . . . Receive compensation from the applicant or Participant in any form . . . that exceeds the compensation to be received by the highest officer (usually CEO or President).”

13 CFR § 124.112:

“What criteria must a business meet to remain eligible to participate in the 8(a) BD program?” . . . The concern must inform SBA in writing of any changes in circumstances which would adversely affect its program eligibility, especially . . . control . . . As part of an annual review, each Participant must annually submit to the servicing district office . . . A certification that there have been no changed circumstances which could adversely affect the participants program eligibility.”

The company can be terminated from the 8(a) BD program for seven good causes cited in 13 CFR § 124.303 (a) “What is termination?” In addition to the five cited in the previous section of this memorandum, the company violated:

(1) “Failure . . . to maintain . . . control by disadvantaged individuals.”

(2) “Failure . . . to obtain prior written approval from SBA for any changes in . . . control.”

Recommendation

1. We recommend that the Associate Administrator for Business Development take the necessary steps to remove the company from the 8(a) BD Program.

SBA MANAGEMENT COMMENTS

The Acting Associate Administrator for Business Development stated that there is cause for the Office of Business Development to initiate termination proceedings and suspend the company from the 8(a) BD program. The Office of Business Development will notify the company of its intention to terminate it from the 8(a) BD program (See Attachment 2).

* * *

The findings included in this report are the conclusions of the Office of Inspector General’s Auditing Division. The findings and recommendation are subject to review, management decision, and corrective action by your office in accordance with existing Agency procedures for audit follow-up and resolution.

Please provide us your management decision for the recommendation within 30 days. Your management decisions should be recorded on the attached SBA Form 1824, “Recommendation Action Sheet,” and show either your proposed corrective action and target date for completion, or explanation of your disagreement with our recommendation.

Should you or your staff have any questions, please contact Robert G. Hultberg, Director, Business Development Programs Group at (202) 205-[FOIA Ex. 2].

Attachments

TIMELINE OF EVENTS

DATE	EVENT
2001	The company pays its non-disadvantaged owner \$23,234 in professional fees during the year.
August 2002	The company applies for admittance into the 8(a) BD program.
October 7, 2002	As part of the application process, the company's disadvantaged owner notifies SBA in writing that the officers had not received any wages since 1998.
2002	The company pays the non-disadvantaged owner \$65,950 in professional fees for the year.
January 15, 2003	SBA officials recommend the application be denied based on 13 CFR § 124.108 <i>Good character</i> , though SBA does not finalize this recommendation. According to the SBA analysis, the company's disadvantaged owner was delinquent on a \$278,000 debt owed the IRS for the 1993-1999 time periods, and had two civil judgments totaling over one million dollars that were reported as unpaid.
July 2, 2003	An IRS representative signs a repayment agreement between the IRS and the company's disadvantaged owner and his spouse, stating \$3,169 was due on July 28, 2003 and on the 28 th of each month thereafter until the liability is paid in full. The disadvantaged owner and his spouse had signed the agreement on May 28, 2003.
July 9, 2003	The IRS sends the repayment agreement to the company's disadvantaged owner and his spouse.
July 24, 2003	The company reallocates its stock to make the company's disadvantaged owner the majority owner and President.
July 28, 2003	The company's disadvantaged owner and his spouse's first \$3,169 payment to the IRS is due, but not paid.
July 29, 2003	In response to an SBA request for information so that there would be a complete application, the company's disadvantaged owner writes, ". . . there are no changed circumstances since our original submission which would cause our firm to be ineligible for 8(a) program participation" and "We had no payroll activity in 2003."
August 7, 2003	<p>The Supervisory Business Opportunity Specialist in the 8(a) BD Certification and Eligibility's Philadelphia office recommends the company be admitted to the 8(a) BD program. The following is included in the recommendation:</p> <p style="padding-left: 40px;">Note that . . . [The company's disadvantaged owner] has a repayment plan in place with the IRS. He has provided a recent repayment agreement. The D/O [District Office] must monitor to see that he is current with the plan.</p> <p>SBA also notes that the company's disadvantaged owner was the highest compensated individual at the company and the sole disadvantaged owner.</p>

Attachment 1

August 8, 2003	SBA admits the company to the 8(a) BD program.
August 28, 2003	The company's disadvantaged owner and his spouse's \$3,169 payment to the IRS is due, but not paid.
September 28, 2003	The company's disadvantaged owner and his spouse's \$3,169 payment to the IRS is due, but not paid.
October 28, 2003	The company's disadvantaged owner and his spouse's \$3,169 payment to the IRS is due, but not paid.
November 28, 2003	The company's disadvantaged owner and his spouse's \$3,169 payment to the IRS is due, but not paid.
December 28, 2003	The company's disadvantaged owner and his spouse's \$3,169 payment to the IRS is due, but not paid.
2003	The company pays professional fees of \$49,717 to the disadvantaged owner and the company's President, and \$84,055 to the non-disadvantaged owner for the year. In October 2004, the company retroactively reduces the fees paid to the non-disadvantaged owner.
January 28, 2004	The company's disadvantaged owner and his spouse's \$3,169 payment to the IRS is due, but not paid.
February 28, 2004	The company's disadvantaged owner and his spouse's \$3,169 payment to the IRS is due, but not paid.
March 28, 2004	The company's disadvantaged owner and his spouse's \$3,169 payment to the IRS is due, but not paid.
April 28, 2004	The company's disadvantaged owner and his spouse's \$3,169 payment to the IRS is due, but not paid.
May 28, 2004	The company's disadvantaged owner and his spouse's \$3,169 payment to the IRS is due, but not paid.
June 28, 2004	The company's disadvantaged owner and his spouse's \$3,169 payment to the IRS is due, but not paid.
July 28, 2004	The company's disadvantaged owner and his spouse's \$3,169 payment to the IRS is due, but not paid.
July 30, 2004.	The company receives a \$9.3 million 8(a) BD contract.
August 26, 2004	The company's disadvantaged owner makes a \$2,500 payment to the IRS. This is the first payment after the 2003 repayment agreement with any connection to repayment agreements that we were provided documentation. According to the company's disadvantaged owner, this was a deposit on 2004 taxes. Prior to making the August 2004 payment, the disadvantaged owner and his spouse submitted a new Offer-in-Compromise to the IRS. The August 2004 payment was made after the IRS informed the disadvantaged owner and his spouse that if filings and payments were not made, the new Offer-in-Compromise would be returned without appeal rights.
August 28, 2004	The company's disadvantaged owner and his spouse's \$3,169 payment to the IRS is due, but not paid.

Attachment 1

September 28, 2004	The company's disadvantaged owner and his spouse's \$3,169 payment to the IRS is due, but not paid.
October 15, 2004	As part of the company's Annual Review, a Dallas District Office official sends an e-mail to the company's accountant requesting clarification of which company employee was receiving the highest compensation.
October 16, 2004	The company holds a board meeting where it retroactively lowers the 2003 professional fees paid to its non-disadvantaged owner from \$84,055 to \$40,000.
October 28, 2004	The company's disadvantaged owner and his spouse's \$3,169 payment to the IRS is due, but not paid.
November 24, 2004	The company's disadvantaged owner re-negotiates his delinquent debt with the IRS for approximately \$.33 on the dollar.
January 31, 2005	The IRS receives the lowered amount in full.



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

DATE: March 29, 2006

TO: Marc Bickoff, Auditor Supervisor, Office of Inspector General

THRU: Cal Jenkins, DADA, Office of Government Contracting and Business Development, [FOIA Ex. 6]

FROM: Sheila Thomas, Acting A.A., Office of Business Development [FOIA Ex. 6] 3/29/06

SUBJECT: Review of [FOIA Ex. 4, 6] [REDACTED]

The Office of Business Development (BD) has conducted a thorough review of the draft management report (dated November 22, 2005) containing your proposed findings and recommendation as it relates to [] eligibility for continued participation in the 8(a) Business Development (BD) Program. [FOIA Ex 4 and 6]

Based upon this review, it is BD's determination that [] noncompliance and violation, (both at the time of initial application and upon admission to the 8(a) BD Program), of the terms and conditions governing 8(a) BD Program eligibility, is cause for SBA to initiate termination proceedings and suspend [] from the 8(a) BD Program. [FOIA Ex. 4 and 6]

BD will immediately notify [] by letter that SBA intends to terminate its 8(a) BD participation. The reasons for the proposed program termination are as follows: [FOIA Ex. 4 and 6]

- (1) 13 CFR 124.303(a)(1): Submission of false information in the concern's 8(a) BD application, regardless of whether correct information would have caused the concern to be denied admission to the program, and regardless of whether correct information was given to SBA in accompanying documents or by other means.
- (2) 13 CFR 124.303(a)(6): Failure by the concern or one or more of the concern's principals to maintain good character. [REDACTED]
- (3) 13 CFR 124.303(a)(3): Failure by the concern for any reason, including the death of an individual upon whom eligibility was based, to maintain ownership, full-time day-to-day management, and control by disadvantaged individuals.
- (4) 13 CFR 124.303(a)(2): Failure by the concern to maintain its eligibility for program participation.
- (5) 13 CFR 124.303(a)(19): Material breach of any of the terms and conditions of the 8(a) BD Program Participation Agreement.

Please feel free to contact me at (202) 205-[] if you have any questions or require additional information. [FOIA Ex 2]

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