U.S. SMALL BUSINESS ADMINISTRATION
OFFICE OF INSPECTOR GENERAL
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AUDIT REPORT
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TO: William A. Fisher
Acting Associate Administrator for
Minority Enterprise Development

FROM: Peter L. McClintock
Assistant Inspector General for Auditing

SUBJECT: Memorandum Audit Report - 8(a) Program Eligibility Of International Data Products Corporation (IDP)

The Office of Inspector General (OIG) completed an audit of IDP's 8(a) program eligibility. To be eligible to participate in the 8(a) program, companies must be at least 51 percent owned by individual(s) determined by SBA to be socially and economically disadvantaged. Individuals are not considered economically disadvantaged for initial and continuing eligibility purposes if their net worth exceeds $250,000 and $750,000, respectively.

IDP was approved to participate in the 8(a) program on June 3, 1994, and is eligible for 8(a) assistance until June 2, 2003, unless it graduates early, voluntarily withdraws, or is terminated. IDP's 8(a) eligibility is based on social and economic factors of its two 50 percent owners, *(FOIA Deletion)* and *(FOIA Deletion.)* As of June 23, 1997, IDP had been awarded nine 8(a) contracts with an estimated value of about $26 million.

OBJECTIVE AND SCOPE

The audit objective was to determine IDP's initial and continuing 8(a) program eligibility under Title 13 of the Code of Federal Regulations, Part 124. Field work was performed from April 1997 through June 1997. OIG auditors reviewed 8(a) program regulations, corporate records, financial statements, tax returns, and other pertinent documentation. They also interviewed SBA officials and IDP's owners and attorneys. The audit was performed in accordance with Government Auditing Standards.

PRIOR AUDIT RESOLUTION

This is the OIG's first audit of IDP's 8(a) program eligibility.

RESULTS OF AUDIT

Based on the OIG audit findings, IDP should not have been admitted to the 8(a) program because one owner's net worth exceeded the initial $250,000 limit for claiming economic disadvantage. In addition, both owners exceeded the $750,000 net worth limitation for continuing eligibility in 1996; therefore, IDP's nine 8(a) contracts totaling about $26 million should not have been awarded.

Initial Eligibility

When IDP was admitted into the 8(a) program, *(FOIA Deletion)* included three investment properties as part of *(FOIA Deletion)* primary residence in reporting *(FOIA Deletion)* net worth to SBA. Under 8(a) program regulations, the equity in an individual's primary residence is excluded when determining net worth. IDP did not disclose material facts regarding *(FOIA Deletion)* real estate holdings that, if known by SBA, would have resulted in a determination that the three properties were investment properties rather than part of *(FOIA Deletion)* primary residence -- a $*(FOIA Deletion)* reduction from what *(FOIA Deletion)* claimed as equity in *(FOIA Deletion)* personal residence and a corresponding increase in *(FOIA Deletion)* net worth. Consequently, SBA determined *(FOIA Deletion)* net worth was less than $250,000 and allowed IDP into the 8(a) program. Based on the audit's findings, *(FOIA Deletion)* net worth when applying for the 8(a) program was *(FOIA Deletion)*, exceeding the initial eligibility limit.

IDP's 8(a) application indicated that *(FOIA Deletion)* primary residence had a market value of $ *(FOIA Deletion)* and their equity in the residence totaled $ *(FOIA Deletion)*. A schedule of their real estate holdings also showed five descriptions of property, four of which had a combined market value equal to the amount claimed as the *(FOIA Deletion)* primary residence. In response to a request by SBA to clarify the schedule, IDP responded that the four descriptions of property were but one single unified piece of real estate and were purchased as one lot having only one property tax identification. Moreover, this piece of real estate constituted *(FOIA Deletion)* primary residence. IDP further stated that the four separate descriptions indicated future plans to subdivide the property and approximate market values if the land were to be subdivided; IDP also submitted a real estate tax bill to substantiate the four properties were taxed as a single unified property. As a result of IDP's clarification, SBA excluded *(FOIA Deletion)* one-half interest in the equity of the four properties, valued at $ *(FOIA Deletion)*, when calculating his net worth.

Based on the OIG audit, three of the four properties should not have been considered part of *(FOIA Deletion)* primary residence and *(FOIA Deletion)* one-half share of the three investment properties, valued at $ *(FOIA Deletion)*, should not have been excluded from his net worth. The three properties should have been included in his net worth as investment properties because *(FOIA Deletion)* had submitted preliminary subdivision plans prior to applying to the 8(a) program, and *(FOIA Deletion)* had contracted to sell the three properties at the time IDP provided clarification to SBA regarding his real estate holdings. In addition, final approval of the subdivision occurred prior to IDP's acceptance into the 8(a) program. Had SBA been aware of these facts, *(FOIA Deletion)* would not have been found to be economically disadvantaged and IDP would not have been approved for the 8(a) program.

Continuing eligibility

The 1996 net worth of *(FOIA Deletion)* and *(FOIA Deletion)* for 8(a) program purposes was found to be valued at $*(FOIA Deletion)* and $*(FOIA Deletion)*, respectively. This exceeded the $750,000 limit, making them ineligible for continuing participation in the program.

In personal financial statements filed with SBA for the 1996 annual review, *(FOIA Deletion)* omitted a jointly-owned company which was transferred to their spouses during the preceding year. SBA officials did not question the omission of the asset that had been reported in 1995. SBA regulations, however, require that assets transferred to a spouse within 2 years are presumed to still be owned by the individual upon whom the 8(a) eligibility is based, according to 13 CFR 124.106(a)(2)(i)(A)(*1*). This method of calculating net worth is used in measuring the $750,000 net worth limit for continuing eligibility, according to 13 CFR 124.111(a)(2). The value of the transferred company at the time of the 1996 annual review was at least $ *(FOIA Deletion)*,[1] half of which should be attributed to each brother. The *(FOIA Deletion)* said they thought they did not have to include assets transferred after becoming a program participant.

RECOMMENDATION

We recommend that the Acting Associate Administrator for Minority Enterprise Development initiate action to terminate IDP from the 8(a) program.

[1] Audited financial statements as of December 31, 1995, and September 30, 1996, reflected the value at $*(FOIA deletion)* and $*(FOIA deletion),* respectively. To be conservative, the lower amount was used to calculate net worth at the time of the June 3, 1996, annual review.

AUDITEE'S RESPONSE AND EVALUATION OF AUDITEE'S RESPONSE

While IDP's attorney disagreed with the finding and recommendation, IDP's owners voluntarily withdrew from the 8(a) program subsequent to the issuance of their response to the draft report. This action meets the intent of our recommendation.

SBA MANAGEMENT'S RESPONSE

The Acting Associate Administrator for Minority Enterprise Development (AA/MED) agreed that IDP should not have been admitted into the 8(a) program; however, he disagreed that IDP's owners exceeded the $750,000 net worth limitation for continuing eligibility in 1996. The AA/MED stated that program regulations, in effect at the time of determination of continuing eligibility, would not have supported initiation of termination proceedings and the transfer of assets by the principals of IDP to their spouses was not considered or questioned in the annual review for continuing eligibility. He also stated that although the regulations require that assets transferred by program applicants to their spouses within two years of the date of application to the 8(a) program are presumed to be the applicants for initial eligibility purposes, the regulations are silent with regard to the applicability of spousal transfers for purposes of determining continuing program eligibility.

EVALUATION OF SBA MANAGEMENT'S RESPONSE

The OIG believes that if IDP had not voluntarily withdrawn from the 8(a) program, a termination proceeding should also have been based on IDP's ineligibility for continuing program participation in 1996. Until such time as the proposed 8(a) regulations become effective, SBA's interpretation of the "2-year rule" opens the door for other 8(a) participants to take advantage of a loophole that allows them to transfer assets to their spouses in order to be considered economically disadvantaged and remain eligible for program participation. The OIG believes this loophole is contrary to the intent of the program.

The OIG auditors disagree that existing program regulations are silent regarding the applicability of spousal transfers for purposes of determining continuing program eligibility. Program regulations at 13 CFR 124.111(a)(1) state that in order for a concern to remain eligible for program participation, it must continue to meet all eligibility criteria contained in sections 124.101 through 124.109. In addition, 13 CFR 124.111(a)(2) requires that personal net worth for continuing eligibility purposes be calculated pursuant to 13 CFR 124.106(a)(2)(i). Accordingly, the requirement in 13 CFR 124.106(a)(2)(i)(A)(*1*) that assets transferred to a spouse within two years are presumed to still be owned by the individual upon whom 8(a) eligibility is based, applies to continuing eligibility determinations.

Even assuming the regulations are ambiguous, the courts have held that an agency is entitled to great deference in interpreting and applying its own regulations. Given the references in the regulations that the initial eligibility criteria apply to continuing eligibility, and the loophole that would be created if interpreted otherwise, it would appear logical for SBA to conclude that the “2-year rule” applies to continuing eligibility. The Inspector General fully discussed this interpretation and its implications with the Administrator before issuing this report.

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The findings included in this report are the conclusions of the Office of Inspector General's Auditing Division based on testing of the auditee's corporate and personal financial records. **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 sign the attached management decision and final action for the recommendation within 30 days on the SBA Form 1824, Recommendation Action Sheet. It states that the final actions have been completed.

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Should you or your staff have any questions, please contact Victor R. Ruiz, Director, Headquarters Operations at (202) 205-7204.