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The Small Business Investment Act of 1958

A BRIEF REVIEW

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The Small Business Administration (hereinafter referred to as SBA) was created in 1953 and is the first peacetime government agency created for the sole purpose of advising and assisting small business enterprises. Five years later, July 18, 1958, SBA was established as a permanent agency of the Government; and on August 21, 1958, the Small Business Investment Act was approved and thereby a Small Business Investment Division was established within the Small Business Administration.

The purpose of the Small Business Investment Act of 1958 is stated in the Act as follows:

"It is declared to be the policy of the Congress and the purpose of this Act to improve and stimulate the national economy in general and the small business segment thereof in particular by establishing a program to stimulate and supplement the flow of private equity capital and long-term loan funds which small-business concerns need for the sound financing of their business operations and for their growth, expansion, and modernization, and which are not available in adequate supply; provided, however, that this policy shall be carried out in such manner as to insure the maximum participation of private financing sources.

* * *

Section 102.

Reference to the Regulations promulgated pursuant to the Small Business Act of 1958, as amended, is necessary for definitions of those "small business concerns" likely to be benefited or to be eligible for assistance from small business investment companies. Section 103.4 provides that for the purpose of financial and other assistance (except Government procurement assistance) a small business concern is one, including its affiliates, which is not dominant in its field of operation and which also qualifies under the following criteria:

1. Manufacturing concerns:
   A. Less than 250 employees—small
   B. More than 1,000 employees—large
   C. More than 250 employees but less than 1,000 employees—either large or small depending on its industry and various employment size standards within the industry.

2. Wholesale concerns:
   A. Annual dollar sales volume of $5 million or less—small
   B. If engaged in manufacturing as well as wholesaling activities, it must qualify under both standards.

3. Retail concerns:
   A. Annual sales of $1 million or less—small
   B. Primarily engaged in making retail sales of general merchandise, or new and used motor vehicles, or groceries with fresh meats, and with annual sales of $2 million or less—small.

4. Service trades concerns:
   A. Annual receipts of $1 million or less—small
   B. Hotel or power laundry with annual receipts of $2 million or less—small.

5. Construction concerns:
   A. Average annual receipts of $5 million or less during the preceding three years—small.

6. Local and long distance trucking and warehousing:
   A. Annual receipts of $2 million or less—small.

7. Taxicabs:
   A. Annual receipts of $1 million or less—small.

Thus, it will be seen that business concerns meeting the above qualifications may be able to avail themselves of the financing facilities provided for by the Small Business Investment Act.

Herefore small business concerns have found it extremely difficult to obtain financing on other than a short-term basis. Now, privately-owned and operated small business investment companies and State and local development companies are authorized to make long-term loans to and purchase convertible debentures from such small business concerns.

The Small Business Investment Division of the SBA will have no direct contact with concerns whose funds are provided by the private investment companies; it has responsibility and authority to:

1. License, regulate and examine small business investment companies (this will include, until June 30, 1961, authority to grant
charters in those States not now permitting chartering of investment companies under State Law;
2. Lend funds to small business investment companies;
3. Lend funds to State and local development corporations. Licenses will be issued by the SBA based upon its determination of the applicant's ability to carry out the purposes of the Act, with priority consideration being given to those applicants proposing to utilize or obtain private financing for initial capital and surplus and not contemplating SBA assistance. Funds available for lending by the SBA will come from a revolving fund appropriated by Congress.

Forming the Small Business Investment Company

Small business investment corporations must, when State law permits, be chartered under State laws and to qualify for an SBA license, must have, in cash, a paid-in capital and surplus of $300,000. Of this amount, SBA is authorized to provide a maximum of $150,000, through the purchase of subordinated debentures, which shall be subordinate to any other obligations issued by a company, but which shall be considered as a part of the paid-in capital and surplus for the purposes of the minimum capital required for formation of an investment company. Section 302 (a).

Subject to State law, stock may be purchased by individuals, partnerships, corporations, insurance companies and financial institutions, including Federal Reserve member banks and nonmember insured banks. In the case of such banks, no Federal Reserve bank or nonmember bank may hold shares in investment companies in an amount aggregating more than 1% of its capital and surplus. Section 302 (b).

After the incorporation and initial stock issue of a small business investment company, all subsequent stock issues must be for cash.

Operating the Small Business Investment Company

In addition to the subordinated debentures provided for upon initial formation of small business investment companies, the SBA will make operating loans to licensees in amounts up to 50% of their paid-in capital and surplus. Section 303 (b).

The rate of interest on subordinated debentures and other loans of small business investment companies purchased or made by SBA will be 5% per annum, but this rate may be adjusted from time to time without affecting the rates on previously-purchased debentures or existing loans. The maximum maturity on subordinated debentures purchased by SBA will be 20 years, and the agency has discretion to defer requirements for any payments during the first half of the loan. The agency also has authority to establish the interest rate and repayment terms on subsequent loans to licensees.

The major portion of funds of small business investment companies is expected to come from private sources, and the ratio of debt to capital and surplus (including subordinated debentures held by SBA) may not exceed 4 to 1.

Equity capital will be provided for small business concerns by small business investment companies only through the purchase of convertible debentures on terms and at rates fixed by the investment companies. Such debentures shall be callable on any interest date and upon three months’ notice at par plus accrued interest, and shall be convertible, at the option of the lender or of any holder in due course, into stock of the small business concern at the “sound book value” of such stock as determined by the parties at the time of issuance of the debentures. Section 304.

As a condition of loans by small business investment companies, the borrower may be required to refinance all outstanding indebtedness so that the investment company is the only holder of any evidence of indebtedness of the issuer and may, in addition, be required to obtain the approval of the investment company before incurring any indebtedness thereafter. Furthermore, the borrower will be required to purchase stock in the investment company in any amount equal to 2% of the first $50,000 received, 3% of the second $50,000 received and 5% of all amounts in excess of $100,000 received. The borrower and lender have the privilege of agreeing upon the type or class of such stock and its voting rights and privileges, giving full effect to applicable laws and the charter and approved plan of operation of the investment company. Reg. 107.304 (b).

Small business investment companies will, for the most part, make long-term loans to incorporated or unincorporated small business concerns. Long-term loans must have maturities of not less than 5 years; however, incidental short-term loans may be made when necessary to protect the investment company's interest. Maturities of loans may not exceed 20 years, but maturities may, under certain circumstances, be extended or loans renewed for additional periods not exceeding 10 years. Section 305.

The aggregate amount of obligations and securities acquired and for which commitments may be issued to a single small business con-
cern by any small business investment company shall not exceed 20% of the combined capital and surplus of the investment company unless prior approval of the SBA is obtained. However, two or more investment companies may join to provide assistance to a single business concern.

Small business investment companies are authorized to handle any servicing or initial investigation required for loans through banks and other financial institutions on a fee basis. They may, in addition, use the advisory services of the Federal Reserve System and of the Department of Commerce. Conversely, such companies are authorized to have on their staffs persons competent to provide consulting and advisory services on a fee basis. Section 308.

Regulations promulgated under the Small Business Investment Act of 1958 provide for a minimum of Federal governmental control and interference in the management of licensees, but they do contain several requirements of particular interest to CPA's.

Licensees are required to keep current financial records in accordance with generally accepted accounting principles and to make full and complete disclosures to their investors and shareholders with respect to their activities. They must also submit to shareholders and to the SBA an interim report covering operations for the first six months of each fiscal year. At the end of each fiscal year, they are required to submit "a report containing financial statements for the year and an opinion thereon by an independent Certified Public Accountant based on an audit conducted in accordance with generally accepted auditing standards." Reg. 107.302-3.

The SBA has recently announced that it is preparing special manuals to guide CPAs who audit financial reports of small business investment companies. It is contemplated that these manuals will prescribe minimum requirements for auditing and examining the investment companies. The Administrator of SBA has indicated that the program of audits by CPAs will be given "a good trial, and I feel that it will be successful—with savings to the taxpayers through the use of fewer Government employees and with benefits to the investment companies." (See "Government," Journal of Accountancy, August, 1959, page 10.)

Each licensee shall be subject to examinations made under direction of the SBA by examiners selected or approved by it; the costs of such examinations may, in the discretion of the SBA, be assessed against the licensee.

Licensees are also required to submit, in a form prescribed by the SBA, a supplementary report to it at the end of each six months period, which report must include a review of activities of the licensee during the period involved, with a statement and evaluation of such debentures, notes, loans, etc., as have been acquired during the reported period. Licensees shall also, upon request or call by the SBA, furnish interim reports covering such matters as SBA shall require. Reg. 107-308-5.

Licensees shall maintain fidelity or such other types of bonds or insurance as shall be required by SBA.

Under certain circumstances, securities of small business investment corporations are exempt from registration under the Securities Act of 1933. See Securities and Exchange Commission Regulation E.

Also of interest to CPAs are certain provisions of the Technical Amendment Act of 1958 with respect to tax treatments of losses on small business investment company stock and losses of small business investment companies. Section 57.

In an article, "Accountants and the Small Business Investment Act," Journal of the Accountancy, July 1959, pages 28-30, John M. Stoy, Chairman of the AICPA's Small Business Committee, comments on some of the ways in which CPAs can be of assistance to clients contemplating financing from small business investment companies. He also points out certain danger areas for the prospective borrower.

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