



Government Contractors Council



Chamber Events



Chamber Membership



State & Local Policy

The GovCon Report



Articles

The Hidden Impacts of the New SBA Recertification Regulations

By [John T. Schell III](#), President, [Altus Associates](#) and [David J. Lundsten](#), Partner, [Cherry, Bekaert & Holland, L.L.P.](#)

Risk and return on future revenues is the primary driver of service company valuations, especially government contractors, regardless of the valuation methodology used. Contractors working on “small business” set-aside or preference contracts under U.S. Small Business Administration (SBA) programs face new risks to future revenues and thus to their current fair market value due to the new SBA rules effective June 30, 2007 (71 FR 66434) requiring small business contractors to recertify their small business status in a number of new circumstances, including mergers and acquisitions and the 5th year of a long-term contracts. Full detail on the new regulations and the direct effects on small business contracts are set forth in the January *GovCon Report* article by Peter McKeen, “[SBA Issues Final Rule on Small Business Size Recertification](#)”.

However, there are many adverse effects not set forth in the regulations due to the interrelationship of the small business preference with the wide range of federal contract and procurement regulations. This article examines many of those material and possibly unintended effects.

Effects on Novation and M&A Transactions

The shorthand business transaction term “merger and acquisition” (M&A) is not defined in the new regulations and there is no use of the term in existing SBA Rules and Regulations. Recertification will certainly be triggered by the purchase of “all or substantially all” of a company’s ownership or assets or contract changes requiring novation. However, there is no minimum size, aspects of control or operation of the post-transaction entities that would make a business transaction subject to these triggers. Will recertification be triggered by the purchase of a supermajority or even 51% control? Will recertification be triggered by the acquisition of divisions or business lines? Will recertification be triggered by stock transfers typically not considered M&A transactions, such as those pursuant to the exercise of rights under financial instruments such as convertible preferred stock, warrants, etc.? Until the terms merger and acquisition are defined, future small business awards and exercise of option years will be at risk if a company undertakes a transaction that could be considered an M&A transaction under the new regulations.

These questions may be analyzed (though not necessarily resolved) by reference to the extensive SBA regulations and case law concerning “affiliation” of companies in evaluating a contractor’s small business qualifications. The SBA deems businesses to be affiliated where one company “controls or has the power to control” the other company. Affiliation may be found if the totality of circumstances (rather than only a single factor) demonstrates that businesses are affiliated. If the affiliation rules control interpreting what happens in an M&A transaction or a contract novation, risks of receiving future small business revenues will be substantially increased.

Post-transaction risks are increased further by the possibility that recertification requirements will also apply to the existing small business contracts of the *acquiring company*. Recertification must be made contract by contract on the NAICS code assigned each contract based on the size of the *combined companies*. Application of the recertification requirement to the acquirer’s contracts is not explicitly referenced in the regulations, but it is implied since “the contractor” must recertify all small business contracts within 30 days *after* the transaction becomes final. There is a brief statement in the Comments implying that the recertification requirement would not apply to large acquirers with small business contracts. Recertification requirements for a small or even large business acquirer will be the subject of future industry discussion and possibly litigation, but, in any event, will place pressure on acquirers with material small business contract revenues to give more attention to the risks of making any acquisition after June 30, 2007.

Effects on Future Orders

Recertification’s greatest risk to future small business revenues is that an agency will not be able to award any more competed small business set-aside orders under existing contracts, if a contractor fails to meet the relevant size regulations after recertification required by any one of the 5 triggers: (1) within 30 days after a contract novation; (2) within 30 days after an acquisition or merger is complete; (3) within 120 days prior to the end of the 5th year on a long term contract; (4) before any option exercise after the 5th year on long-term contracts; and (5) on any competition for an order under a long-term contract, if requested by the contracting officer.

Although the regulations do not specifically require disqualification, this result is almost assured by a number of interacting regulations. First, a contractor having failed a recertification for any NAICS code will be prohibited from a set aside order award by the SBA regulations and the Federal Acquisition Regulations. Second, the failure to qualify will become promptly known to all agencies of the federal government since the new regulations require a company failing to qualify and its contracting agency to revise all “applicable Federal contact databases to reflect the new size status”. Third, the regulations will relax the requirements for an award protest based on size. Fourth, even if a competed order is not set-aside, the fact that the agency will lose the small business credit for that order will increase the contracting officer’s incentive to issue the order to a competitor that is a qualified small business.

Unpredictable Future Effects

Recertification requirements under the new regulations can be predicted for most of the triggers. However, because of the contracting officer’s discretion to request recertification before the award of any order, the timing of the risk of loss of small business status is unpredictable. Moreover, if the contractor is unable to certify that it is small under contracts over 5 years in duration, one cannot predict whether the contracting officer will decide to exercise or not exercise options or to award the contractor future orders, even if the option is exercised. In exercising his or her discretion, the contracting officer can consider a myriad of unknown policy and factual issues, such as the agency’s small business contracting status under its own small business goals; whether the contractor has a strong record of service; whether the contractor’s services/supplies are mission-critical; or whether the agency has viable alternative small business contractors with effective contract vehicles in place. The resulting effect on the valuation of a small business will likely be to reduce future revenue expectations. More conservative valuations may eliminate all future revenues from all small business contracts.

Another unpredictable risk with significant potential effects on future revenues is the possibility that subcontracts will be covered. The regulation specifically excludes subcontracts from the recertification requirements; however SBA and Congress have both indicated that they may give further consideration to eliminating the exclusion. Since prime contractors typically have their own small business goals and great leeway in terminating subcontractors, the risk of immediate loss of *all* revenues under a subcontract upon the inclusion of subcontracts under the regulations cannot be predicted.

Finally, the regulations specifically provide that the sole effect of a failure to certify will not “change the terms and conditions of the contract.” However, termination “for the convenience of the government” is always available to agencies to enforce their small business contract requirements or to achieve their small business goals.

Valuation issues

Your company value could be affected whether you are performing a valuation for internal reasons (issuing stock options, estate and gift planning, making charitable contributions, converting from an S corporation to a C corporation, or shareholder disputes), external merger & acquisition reasons (buying or selling a company), or post-sale reasons (FAS 141 purchase price allocations).

Effects of SBA Re-certification on Valuation for Internal or External Reasons

Valuations are based on expectations of future cash flows. An underlying assumption for small business contractors is that your company would be capable of generating new contract awards for future work. If recertification is required prior to the exercise of option periods beginning in the sixth contract year, the uncertainty related to obtaining work from unexercised option periods would be of concern and thus increase the risk factor applied to the anticipated future revenues. This increased risk is handled in valuations by increasing the discount rate and/or reducing the applied probability of receiving option period awards to the unfunded option periods in your cash flow projections.

Additionally, a valuator would be more likely to shy away from using comparable benchmarks for valuations for small businesses using a “market approach” – an approach that uses guideline/comparable companies. Using comparable companies will be much harder to apply in the world of recertification requirements because those companies did not have to recertify. Currently existing data for peer group valuation methodology assumes the firm’s ability to continue small business work. With the new re-certification rules, this long-held assumption of work continuation may not apply. Valuators will be forced to use a cash flow methodology. As mentioned above, the result of recertification uncertainty is likely to be reduced cash flow projections that would result in a decrease in a company’s value.

A small business contractor would need to demonstrate a stronger pipeline of new work outside the realm of small business contract set-asides in order to maintain its value. In addition, the small business contractor has to show that its growth strategy can be maintained post merger or acquisition rather than be significantly reduced due to the new rules.

Effects of SBA Re-certification on Valuation for Financial Reporting

A buyer of a small government contractor will have to record the fair value of assets acquired in a transaction under the purchase method of accounting outlined in Financial Accounting Standard 141. This requires that the buyer allocate the purchase price to various assets – tangible and identifiable intangible assets with the remaining difference recorded as goodwill. One of the main types of identifiable intangible assets is contract backlog, which is valued by determining the present value of expected cash flow streams for funded and unfunded contract amounts.

When a small business concern becomes other than small due to acquisition or merger, such as when the contractor becomes an operating subsidiary of a large business, the expected cash flow streams become riskier based on the new re-certification rules. The uncertainty increases as to whether option periods will be exercised on existing contracts because, if the contractor no longer qualifies as a small business, then the CO may not exercise the option and the contract could be lost by the contractor. Riskier cash flow streams means a higher discount rate would apply, resulting in a lower recorded value of contract backlog. This would also mean that the percentage of the purchase price allocated to goodwill could be higher because goodwill is allocated based on remaining amounts not identified as tangible or identifiable assets.

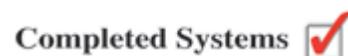
Clearly there remain many unresolved issues, but no matter what clarification is issued by the SBA, it is likely that the company valuations for many small businesses will be significantly reduced from the perspective of a potential buyer and a valuation expert.

John T. Schell, III is President of Altus Associates, management and financial consultants to government contractors. He can be reached at jtschell@altus-associates.com. David J. Lundsten, MBA, CVA is a Partner in the Government Contractor Services Group of the regional accounting and consulting firm Cherry, Bekaert & Holland, L.L.P. He can be reached at dlundsten@cbh.com.

Editor’s note: Due to the significant effect of this new rule on the small business world, the GovCon Report will continue to keep you informed on this issue. We will provide coverage of the upcoming Insider’s lunch on this topic, which is already sold out.

Download this article in PDF format: 

The GovCon Report is sponsored by [Cassidy & Pinkard](#), real estate experts specializing in the needs of Government Contractor's. For your free consultation, please contact Dale Powell, Managing Director, at (703) 770-3401. The GovCon Report is produced by the Northern Virginia GovCon Council's communications committee: Co- chairs: Anne Crossman ([Completed Systems](#)) and Dave Lundsten ([Cherry Bekaert & Holland LLP](#).) If you wish to submit an article for consideration by the communications committee, send them to govconarticle@fcc.org.



The Government Contractors Council Report is a monthly newsletter distributed by the Northern Virginia Government Contractors Council, an initiative of the Fairfax County Chamber of Commerce for Washington, DC metropolitan area government contractors.

Fairfax County Chamber of Commerce
8230 Old Courthouse Road Suite 350
Vienna, VA 22182
P: (703) 749-0400 • F: (703) 749-9075
www.fccc.org