Increasing the number of years currently used to calculate size standards

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Solutions Proposal

A practical and streamlined solution to smoothen the transition from small to large business status in all size standards would be to increase the number of years in which revenues or employees are counted in determining small business status from three to five fiscal years.

The current regulations require a company to compare its average revenues from the preceding three fiscal years to the applicable size standard to determine business size. Years of experience with this standard have demonstrated that the transition from small to large business size is incredibly risky, often impeding firms from achieving long-term success. Some small businesses chose to halt their growth, and thereby restrict job growth, to avoid facing businesses tens to hundreds of time larger in full and open competition. These businesses are forced not to contribute their full potential to strengthen the nation's industrial base. Those that forge ahead face a significant risk of failure and are often forced to sell to larger organizations. This serves as a prime example of the failure of present size standard policies.

It is important as the SBA (Small Business Administration) goes through its process of analyzing the public commentary for the proposed 2011 rule, that the SBA reach out to the community and organizes a series of working groups. We are recommending working groups and not dog and pony shows because history reveals that the SBA's previous community outreach efforts of travelling the country and spending tax dollars has failed. A new model needs to be selected by the SBA which includes working with knowledgeable experts and respected small business owners who focus on the interest of the overall community and not just their own interests.

Addressing the problem also presents a serious challenge to the SBA. Increasing size standards too much creates the risk that start-up organizations will not be able to compete with established small businesses near the size standard ceiling. On the other hand, doing nothing endangers the continued success of small businesses that emerge from SBA's set-aside programs to compete against multi-billion dollar contractors.

A relatively simple solution would be requiring a company to compare its average revenues from the preceding **five** fiscal years to the applicable size standard to determine business size. In most cases, this would ease the transition to large business status by allowing companies to grow for a few more years before being forced into full and open competition. They would have additional time to plan and would have increased their capacity and capability when emerging to large business status. This can also be applied to the time frame for the employee count size standards, where five years would provide a more reasonable range for small businesses.

This approach would be easy for SBA to implement. It applies to all size standards equally and does not require wholesale redesign of the existing small business regulatory structure.

Finally, this solution will clearly contribute towards small businesses ability to increase their capabilities to become competitively viable and survive in competition against the large companies. This change does not increase size standards and will not require small businesses to compete against very large businesses. They will only be required to compete against companies they compete against today for a somewhat longer time. In exchange, today's small businesses will enjoy the benefit of the more gradual transition as they grow to become tomorrow's large businesses.

We also recommend the SBA perform a study to look at some real small businesses and the way in which size standards impact them.

Background

Under the current system, the definition of small business in a majority of industries hinges on an entity's three-year average receipts. Most small businesses provide services in which the NAICS ceiling is set either at $7 million or $25 million (see Appendix, Table 1). The highest annual receipts-based size standard for small business in any service industry is $35.5 million.

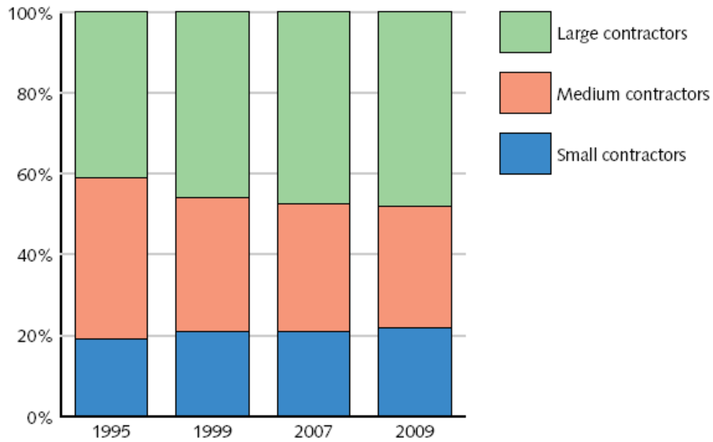
This system fails to effectively address economies of scale when small businesses are forced to compete against significantly larger businesses such as Northrop Grumman, Lockheed Martin, SAIC, EDS-Hewlett Packard, and General Dynamics. These mega-corporations average sales of $30 billion per year and have 130,000 employees. Once the dollar threshold of the NAICS definition for small business is surpassed, every business, even one with only $8 million per year in sales, is thrust into the unrestricted fully competitive market without the infrastructure and capital needed to compete successfully against significantly larger businesses, such as the top six federal government systems integrators named above. How can an $8 million be expected to compete against a $30 billion giant on a consistent basis?

The purpose of small business set-asides is to provide a level playing field for competitors of similar size. However, the present size standards design cannot be interpreted as being reasonable in promoting competitive viability for developing firms or aiding their ability to gain competitive capacity. Due to the lack of any realistic modification to size standard thresholds over the years, small businesses' ability to sustain themselves after exceeding their size standard thresholds is questionable. They are forced to travel a bumpy road just to survive. Consequently many have been sold or closed their doors.

For many years, second-tier companies in the federal services sector have been highly regarded as a source of innovation and productivity. They have the ability to perform and manage complex contracts with low risk. Because of their success in establishing themselves beyond the first-tier small business threshold, they have proven infrastructures and management processes, capabilities invaluable to the government and to our economy as a whole.

Changing the revenue size standards to employee head count more properly reflects the reality of today's marketplace. Having never been defined formally, there is much discussion about what constitutes the size of a mid-tier company. Regarding the professional services industrial base, the November 2010 report by the Gregory Sanders et al.'s report *Structure and Dynamics of the U.S. Federal Professional Services Industrial Base 1995-2009* clearly shows that second/mid-tier firms, by virtue of being neither small enough nor large enough to successfully compete, have seen their share of the market decline considerably, as demonstrated in the figure below.

Figure 3-14. Market Share of Small, Medium, and Large Contractors in the Federal Professional Services Industry, 1995, 1999, 2007, and 2009



Source: Federal Procurement Data System; analysis by CSIS Defense-Industrial Initiatives Group.

Below are reprinted some of the report's significant findings:

> "The scale, range, and magnitude of critical mass has changed. In 1995, contract awards near a half billion dollars allowed an organization to be contractor number 20 in the top 20; in 2009 that ranking required annual awards of $1.9 billion."
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> "[I]t is clear that those in the middle tier have suffered an erosion of their relative share. (…) Thus, the middle tier has been squeezed from above by consolidation and from below by the slight growth in small contractors' share of the market."
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> "Policymakers must determine whether a robust middle tier of services companies is important or desirable for the federal marketplace. If so, current incentives for companies to enter and remain in this mid-market level must be revisited."

Indeed, mature/second-tier small businesses lose all of the contracting incentives provided under the Small Business Programs. The impact this has on the marketplace, was illustrated by the House Armed Services Committee report on acquisition reform in March 2010, which states:

> "Mid-tier companies are either absorbed or decide to abandon defense acquisition for [the] more competitive commercial sphere (…). Winning or losing individual contracts becomes such a critical matter that the incentives to protest contract awards are overwhelming. (…) The end result of this process is the gradual erosion of competition and innovation in the defense industrial base."

Many are beginning to realize that something needs to change for mature/second-tier small businesses to remain competitively viable. The numerous size standards based on three-year average annual revenue/receipts is no longer consistent with marketplace dynamics. All annual revenue dollars are the basis for calculation of the three-year average. Often, computer size standards, hardware and subcontracting are part of the contract award dollars. The success of a graduated small business is dependent on building an infrastructure to compete with companies that have billions of dollars in annual revenue.