

Congress of the United States
U.S. House of Representatives
Committee on Small Business
2361 Rayburn House Office Building
Washington, DC 20515-6515

To: Members, House Small Business Committee

From: Joe Walsh, Chairman, Subcommittee on Economic Growth, Capital Access and Tax

Re: Subcommittee Hearing: "Professional Services: Proposed Changes to the Small Business Size Standards"

Date: April 28, 2011

On Thursday, May 5, 2011, at 10:00 am in Room 2360 of the Rayburn House Office Building, the Subcommittee on Economic Growth, Capital Access and Tax will meet for the purposes of reviewing the Small Business Administration (SBA) proposed rule increasing the small business size standards for 35 industries and one sub-industry. Any questions regarding this hearing should be addressed to Emily Murphy, Senior Counsel with the Committee, at 202-225-5821. A copy of the proposed rule, "Small Business Size Standards: Professional, Scientific and Technical Services," 74 Fed. Reg. 14323 (March 16, 2011), is attached. It addresses industries within North American Industry Classification System (NAICS) Sector 54, Professional, Scientific and Technical Services, and one industry in NAICS Sector 81, Other Services. Examples of industries covered by Sector 54 include legal services, accounting and tax preparation, architectural and engineering services, computer systems related services, management services and advertising.

The proposed changes to the Sector 54 size standards will affect all business within these industries that are seeking SBA assistance through the loan or entrepreneurial development programs. Further, it informs regulators as agencies study the impact of proposed rulemakings on small businesses pursuant to the Regulatory Flexibility Act, 5 U.S.C. § 601-612. When legislation addresses small business, unless an alternate definition is specified, these size standards determine applicability. These standards are of particular importance to the Committee because they dictate which companies are eligible for the various small business contracting programs. Of the over \$500 billion in Federal prime contracts awarded in FY 2010, \$109 billion were

awarded to small businesses, and over \$32 billion small business prime contracts were awarded in Sector 54.

A transcript of the hearing will be submitted to the SBA for consideration as part of the rulemaking process. Representatives from the American Institute of Architects, American Council of Engineering Companies and the Professional Services Counsel are scheduled to testify. This memorandum provides a brief statutory background to the proposed rule, an overview of SBA's methodology when establishing size standards, a brief summary of the proposed rule, some context regarding the importance of the size standards in government contracting, and concludes with issues the Committee hopes its witnesses will address.

I. Importance of the Sector 54 Size Standards within Federal Contracting

SBA's lending and entrepreneurial development programs often draw from a different pool of small businesses than the Federal contracting programs. The small businesses seeking assistance from a Small Business Development Center are only rarely concerned with the size standard because their level of revenue or number of employees do not approach the maximum size requirement for small business status. With the passage of the Small Business Jobs Act of 2010, P.L. 111-240 (Sept 27, 2010), loan thresholds increased so that they became an option for more small businesses, however most small businesses seeking government contracts are large enough to have access to commercial lending without the government guarantee. However, the complexity and long business cycle for government contracts requires that businesses pursuing them have greater resources, so those small businesses tend to be larger small businesses. Additionally, contracting opportunities are by definition finite – there are a limited number of contracts, and a limited number of successful awardees – whereas entrepreneurial assistance and the SBA loan guarantees are available to any qualified small business. Thus, the pressure to implement the correct size standard receives greater scrutiny from the Federal contracting community, where a business receives a competitive advantage if it is deemed small and its competitor is deemed large.

Eligibility for small business set asides, the 8(a) Business Development program, the HUBZone program, the Service Disabled Veteran Owned Small Business program, and the Woman Owned Small Business Program are of great importance to those reaching the top of the size standard. This is particularly the case in NAICS Sector 54, since over \$151 billion in Federal prime contracts were awarded in this NAICS code in FY 2010 – this is over a quarter of all Federal contracts. Over \$32 billion of the Sector 54 contracts were awarded to small businesses. In all NAICS codes combined, small businesses received just over \$109 billion in FY 2010, so nearly 1 out of every 3 dollars awarded to small businesses was in Sector 54.

As previously discussed, SBA derives an initial size standard after it analyzes average firm size, start up costs and entry barriers, industry competition, and distribution of firms by size. However, based on the unique requirements of Federal contracting, SBA then designates a size standard one level higher for any industries where the small business share of total Federal contracting dollars is between 10 and 30 percentage points lower than their shares in total industry receipts, and at two

levels higher than the current size standard if the difference is more than 30 percentage points.

Of the 46 industries reviewed in this proposed rule (including 45 industries in NAICS Sector 54 and one industry in NAICS Sector 81), 26 industries received an average of \$100 million or more annually in Federal contracting dollars during fiscal years 2007–2009. The Federal contracting factor was significant (i.e., the difference between the small business share of total industry receipts and small business share of Federal contracting dollars was 10 percentage points or more) and a separate size standard was derived for that factor in 15 of those 26 industries.

II. The Small Business Act – Statutory Background to the Proposed Rule

Section 3(a)(1) of the Small Business Act, 15 U.S.C. § 632(a)(1), provides, in pertinent part:

[a] small business concern ... shall be deemed to be one that is independently owned and operated and which is not dominant in its field of operation.

The Act does not define the terms “independently owned and operated” or “dominant in its field of operation.” Instead, the Administrator is authorized to:

specify detailed definitions or standards by which a business concern may be determined to be small for purposes of this Act or *any other Act*.

15 U.S.C. § 632(a)(2)(A) (emphasis added). The Administrator is authorized to consider number of employees, dollar volume of business,¹ net worth,² net income, other factors, or any combination of those factors. In short, Congress has granted the Administrator substantial discretion in the factors that will be utilized in calculating the size of a small business. The SBA’s discretion is tempered by the fact that any size standard determined by the factors set forth in § 3(a)(2) of the Small Business Act must meet the overarching principle – the business must be independently owned and operated and not dominant in its field.

III. SBA’s Process for Establishing Size Standards

The SBA took the authority granted by Congress and developed size standards for individual categories of small businesses. Originally, the size standards were developed based on four-digit

¹ Current SBA size standards use gross revenue as a measure of dollar volume. Nothing in the Act requires reliance on dollar volume and other measures could be used.

² The net worth standard is used, for among other purposes, to determine eligibility for investments made by small business investment companies, loans made pursuant to Title V of the Small Business Investment Act of 1958, and for participation in the program established by § 8(a) of the Small Business Act.

classifications of each type of business using Standard Industrial Classifications or SIC codes. When the Federal government moved to the more exact North American Industrial Classification System or NAICS for data collection, the SBA modified its size standards to fit the new NAICS codes.

Historically, the SBA utilized two distinct standards for determining whether a business was not dominant in its field. Manufacturers, distributors, and certain utilities were measured by the number of employees. All other businesses, both services and retail establishments, are calculated by the gross revenue of the firm. The two standards never overlapped. If the SBA determined that a particular industry was measured by gross revenue, the SBA also did not impose an employee threshold. Thus, the SBA created a bright line standard in which a business either was required to enumerate employees or tabulate gross revenue.

SBA formalized its process for establishing size standards when it published a white paper entitled “Size Standards Methodology” detailing the five primary industry factors considered when establishing size standards. 74 Fed. Reg. 53940 (October 21, 2009). An in-depth explanation of the current process would be quite lengthy, so this memorandum attempts to summarize the process. However, the full methodology is available at www.sba.gov/size.

The five factor analysis begins by examining four economic characteristics of the industry: average firm size, start up costs and entry barriers, industry competition, and distribution of firms by size (13 CFR § 121.102(a)). Additionally, and perhaps most relevant here, SBA’s fifth factor examines the impact of an existing size standard as well as the potential impact of a size standard revision on SBA’s Federal contract assistance to small businesses. After considering the primary evaluation factors, SBA will then assess any industry specific factors, such as technological changes and industry growth trends. This methodology supports the Committee’s longstanding view of how size-standards should be developed: granular analysis of specific industry characteristics.

In some cases where industries are closely related, SBA will consider a common size standard, even if the underlying analysis would otherwise support different size standards. This will most often occur when many of the same businesses operate in the same two or more industries, so SBA believes that the common size standard will better reflect the industry marketplace. As an example, in the proposed rule being considered by the Committee, SBA is proposing a common size standard for the Computer Systems Design and Related Services industries (NAICS 541511-541519), because firms engaged in Information Technology related services typically perform activities in two or more other related industries.³

Data for this analysis is drawn from the Economic Census, and County Business Patterns, each published by the U.S. Census Bureau, as well as the U.S. Bureau of Labor Statistics’ Quarterly Census of Employment and Wages and Business Employment Dynamics, the Risk Management Association’s Annual Statement Studies, the Federal Procurement Data System, and SBA’s own lending data. After

³ This is the reason that NAICS 811211, Computer and Office Machine Repair Maintenance is considered with the current rulemaking. SBA considers the services closely related to the Computer Systems Design and Related Services NAICS codes (541511-541419).

the analysis is complete, SBA then proposes what it believes to be the correct size standard. Final size standards are selected after input from the public through notice and comment rulemaking.

Currently, there are roughly 1100 industrial classifications for which the SBA has implemented 41 separate size standards. These standards are based on either the number of employees, gross revenue, or other factors⁴ that the SBA believes reflect the correct size of the business. However, to simplify the size standards, SBA has proposed selecting future size standards from a limited number of fixed size standards. The eight revenue based standards will be \$5.0 million, \$7.0 million, \$10.0 million, \$14.0 million, \$19.0 million, \$25.5 million, \$30.0 million, and \$35.5 million, and the eight employee based standards will be 50 employees, 100 employees, 150 employees, 200 employees, 250 employees, 500 employees, 750 employees, and 1,000 employees. The SBA will transition to these size standards over the course of five years, as it conducts a systematic review of all its size standards, and the current proposed rule is an important first step in this transition.⁵

IV. The Proposed Rule

The proposed rule before the Committee addresses 45 industries and three sub-industries in NAICS Sector 54, and another industry in NAICS Sector 81. If the proposed rule takes effect as written, SBA will increase the small business size standards for 35 industries and one sub-industry in NAICS Sector 54, and one industry in NAICS Sector 81. The Sector 81 industry, Computer and Office Machine Repair Maintenance, is considered as part of this rulemaking as it is closely related to many of the industries considered in Sector 54.

Because of the sheer number of industries covered by the proposed rule, the chart on page 7 was created to explain the proposed changes. If SBA is proposing consolidating related industries into a common size standard, that common group is presented in the first column. The second column lists the individual NAICS codes covered by the proposal and their descriptions, while the third provides the current size standard. The fourth column details the proposed increase to the size standard, and the final column provides the new proposed size standard. However, certain Sector 54 industries are missing from this chart and analysis, because SBA considered secondary factors, all of which related to their decision on whether to maintain sub-industry standards, and all of which resulted in some industries being excluded from this rulemaking.⁶

First, in the case of engineering services, there are currently four size standards that apply to engineering services – one general size standard and three exceptions geared to different types of Federal contracts. SBA drew information on companies operating in these specialized areas from

⁴ For example, asset size is used to determine whether a bank is small.

⁵ Pursuant to the Small Business Jobs Act of 2010, P.L. 111-240 (Sept 27, 2010), SBA must conduct a detailed review of all size standards and to make appropriate adjustments to reflect market conditions, and at least one-third of all size standards must be reviewed every 18-months.

⁶ In the case of Map Drafting Services, which is currently an exception to NAICS 541340, Drafting Services, SBA determined that there are less than \$10 million in Federal contracts awarded in this sub-industry annually, so that it no longer needs the specific exemption. The lack of Federal contracting opportunities for Map Drafting Services is one that the Committee intends to explore at a later date.

the Federal Procurement Data System and Central Contractor Registry, and this data actually suggested decreasing the size standards for two of the subspecialties. However, SBA determined that it would not be in the best interest of the economy or those industries – Military and Aerospace Equipment and Military Weapons – to decrease the size standard, so the size standard was left static and is not included in the chart.

Second, Information Technology Value Added Resellers (ITVAR) are a recognized exemption to NAICS 541519, Other Computer Related Services. SBA believes the data supports maintaining a sub industry standard for ITVAR of 150 employees. An ITVAR is a company that adds features or services to an existing information technology product, then resells it to the end user as an integrated product or complete solution. The added value can come from professional services such as integrating, customizing, consulting, training and implementation. The value can also be added by developing a specific application for the product designed for the customer's needs which is then resold as a new package. ITVARs are not subject to the nonmanufacturer rule, which normally requires that a small business receiving a set aside provide the product of a small business.

Third, NAICS 811212, Computer and Office Machine Repair and Maintenance, was included in this review as it is closely related to the Computer Design and Related Services Industry Group. This is consistent with SBA's efforts to assess sizes of closely related industries. Conversely, for the fourth sub-industry group, the SBA has excluded NAICS 541711, Research and Development (R&D) in Biotechnology and 541712, R&D in the Physical, Engineering and Life Sciences (Except Biotechnology) from this rule making because, unlike the other Sector 54 NAICS, these industry size standards are employee based. SBA intends to review these size standards when it conducts its review of the size standards for the manufacturing section.

It is worth noting that in each case, the SBA is increasing the size standard. SBA estimates that about 9,450 additional firms will become small if this proposed rule is implemented. That represents 1.2 percent of total firms in effected industries. However, in some cases the increase to the size standard is by as much as 400%. As a result, the American Institute of Architects expects that 98% of its members will be small under the new rule. This is not necessarily problematic, as it could simply reflect that all but the largest architectural firms are not dominant in their fields. In other cases, such as the Computer Systems Design and Related Services and Computer and office Machine Repair and Maintenance Industry Group, the increase is a mere 2%. Given the scale by which this industry is growing, it remains to be seen whether this is the appropriate level increase.

Proposed Changes to Sector 54 and 811212 Size Standards

Proposed Industry Group for Common Size Standard	NAICS Code and Industry Title	Current Size Standard (Millions)	Proposed Change (Millions)	Proposed Size Standard (Millions)
Legal Services	541110, Offices of Lawyers	\$7.0	+\$3.0	\$10.0
	541191, Title Abstract and Settlement Offices			
	541199, All Other Legal Services			
Accounting, Tax Preparation Bookkeeping and Payroll Services	541211, Offices of Certified Public Accountants	\$8.5	+\$5.5	\$14.0
	541213, Tax Preparation Services	\$7.0	+\$7.0	
	541214, Payroll Services	\$8.5	+\$5.5	
	541219, Other Accounting Services	\$8.5	+\$5.5	
Architectural, Engineering and Related Services	541310, Architectural Services	\$4.5	+\$14.5	\$19.0
	541320, Landscape Architectural Services	\$7.0	+\$12.0	
	541330, Engineering Services, Except Marine Engineering & Naval Architecture	\$4.5	+\$14.5	
	541340, Drafting Services	\$7.0	+\$12.0	
	541350, Building Inspection Services	\$7.0	+\$12.0	
	541360, Geophysical Surveying and Mapping Services	\$4.5	+\$14.5	
	541370, Surveying and Mapping (except Geophysical) Services	\$4.5	+\$14.5	
	541380, Testing Laboratories	\$12.0	+\$7.0	
n/a	541330, Marine Engineering and Naval Architecture	\$18.5	+\$7.0	\$25.5
Computer Systems Design & Related Services, and Office Machine Repair and Maintenance	541511, Custom Computer Programming Services	\$25.0	+\$0.5	\$25.5
	541512, Computer Systems Design Services			
	541513, Computer Facilities Management Services			
	541519, Other Computer Related Services			
	811212, Computer and Office Repair and Maintenance			
Management Scientific, and Technical Consulting Services	541611, Administrative Management and General Management Consulting Services	\$7.0	+\$7.0	\$14.0
	541612, Human Resources Consulting Services			
	541613, Marketing Consulting Services			
	541614, Process, Physical Distribution and Logistics Consulting Services			
	541618, Other Management Consulting Services			
	541620, Environmental Consulting Services			
	541690, Other Scientific and Technical Consulting Services			
n/a	541720, Research & Development in the Social Sciences & Humanities	\$7.0	+\$12.0	\$19.0
Advertising and Related Services	541810, Advertising Agencies	\$7.0	+\$7.0	\$14.0
	541820, Public Relations Agencies			
	541830, Media Buying Agencies			
	541840, Media Representatives			
	541850, Display Advertising			
	541860, Direct Mail Advertising			
	541870, Advertising Material Distribution Services			
	541890, Other Services Related to Advertising			

V. Issues Before the Committee

A. Should SBA Reduce the Number of Size Standards?

To simplify size standards, SBA has proposed reducing the number of size standards from the current 30 receipt based standards to eight fixed size levels for receipts based size standards: \$5.0 million, \$7.0 million, \$10.0 million, \$14.0 million, \$19.0 million, \$25.5 million, \$30.0 million and \$35.5 million. The Committee hopes to receive testimony as to whether this will indeed simplify the size standard process, or whether it will unduly constrain SBA and keep them from developing industry specific size standards.

B. Are the Proposed Size Standards Appropriate?

From the witnesses providing testimony to the Committee, the Committee hopes to elicit comments on whether SBA has arrived at the correct size standards. Specifically, the Committee seeks feedback on whether the proposed levels of size standards appropriately assess the economic characteristics of their industry or sub-industry, and whether an alternative size standard would better address those characteristics. For example, are there better measures of size standards? Some have suggested looking at profit per employee or at the number of projects executed above a specified dollar threshold.

C. Should SBA Propose Common Size Standards for Industry Groups?

For those industries where SBA has identified common industry groups, should a common group size standard be established, or should each industry retain its own size standard? Presumably, smaller businesses are less likely to participate in more than one industry, so such a proposal may favor larger businesses. However, given that the industries are so closely related, removing the confusion as to which NAICS code is appropriate may assist small businesses attempting to identify Federal contracting opportunities. Additionally, a single industry standard would not allow contracting officer to choose a NAICS code in order to include or exclude certain companies, so this would reduce the number of protests filed over the incorrect NAICS code being used.

As a corollary to this question, as the industry groups are developed, are the correct size standards being implemented?

D. Are the Increases to the Size Standards Appropriate?

As previously noted, some of the increases in the size standards are significant. Specifically, SBA proposes to increase the size standard for Marine Engineering and Naval Architecture, to \$25.5 million from \$18.5 million. For the architectural and engineering industries, the proposed size standards increase from \$4.5 million to \$19.0 million. The Committee hopes to explore whether these changes accurately reflect changes within the industry, or if they are artificially inflating the definition of a small business.