






Playing by the NUMBERS

**Recalculating
How Many
Employees
Equal a
Small Business**

SBA's proposed new standard for determining small business status has been soundly criticized. However, with just a few adjustments, SBA's new standard can obtain the necessary buy-in of small businesses.

By Ralph C. Thomas III



Recently, the Small Business Administration (SBA) was soundly criticized by the small business community for the agency's efforts to establish a new standard for calculating the number of employees that define a "small business." To SBA's credit, the rationale it put forward in proposing the new rule in the July 27, 2007, edition of the *Federal Register* was basically sound. As the agency pointed out, the current method of calculating employees to determine small business eligibility is burdensome to small businesses. But while the small business community had no disagreement with SBA's premise, it almost unanimously objected to its solution. Faced with such opposition, SBA abandoned the effort and went back to the drawing board.

However, with just a few adjustments to its proposed rule, SBA can still meet its objective of changing the current method of calculating the number of employees to constitute a small business, while at the same time obtaining the necessary buy-in from the small business community.

Background

SBA is charged with setting size standards for businesses to be considered "small businesses," and it currently bases a firm's size on either the company's number of employees (known as the employee-based size standard) or its annual receipts (known as the receipts-based size standard). Generally, the size standard for manufacturing industries is employee-based, in that a company's size is determined by calculating the average employment of the company, including the employees of its domestic and foreign affiliates, based on the number of persons employed on a full-time, part-time,

temporary, or other basis, during each of the pay periods of the preceding 12 months. For service and construction companies, SBA, for the most part, uses a receipts-based standard, whereby it determines size by averaging a firm's annual receipts, including the receipts of its domestic and foreign affiliates (less returns and allowances, sales of fixed assets, and inter-affiliate transactions), for the previous three years

The Problem

On July 27, 2007, SBA requested public comment in the *Federal Register* on the agency's proposed rule to change the current method, as described in the existing regulations, for calculating the number of employees to determine whether or not a business is "small." That current rule states in relevant part that:

The average number of employees of the concern is used (including the employees

of its domestic and foreign affiliates) based upon numbers of employees for each of the pay periods for the preceding completed 12 calendar months.”

SBA’s proposed rule states in part that:

Average annual number of employees means the total number of employees of the concern (including the employees of its domestic and foreign affiliates) for the preceding three calendar years divided by three.

The following provision in the proposed rule is what caused most of the concern from the small business community:

SBA will use a concern’s IRS Form W-3, Transmittal of Wage and Tax Statement, and any corrections thereof, to calculate average annual number of employees. For purposes of counting employees obtained from a temporary employment agency, professional employer organization, or leasing concern, SBA will use contractual documents or invoices between the parties showing the number of individuals provided to the concern.

Small Business Reaction

The criticism of the proposed rule from the small business community focuses on the fact that SBA would use the Internal Revenue Service (IRS) Form W-3 to calculate the number of employees based upon block “c” of the form, “Total Number of Forms, W-2.” The IRS form identifies/counts unique IDs (individuals/employees). Critics of the proposed rule noted that such a unique ID method was a dramatic change from the method currently used, in which a small business simply takes a count of persons on the payroll at the applicable points in time (a ‘snapshot’ method), and recomputes the average over the 12-month period immediately preceding. The snapshot method neutralizes much of the effect of turnover and actually counts jobs, while the unique ID approach magnifies employee turnover in a punitive fashion by counting individuals.

As one small business commenter to the *Federal Register* notice put it, the proposed extended three-year period and the adverse



effects of turnover—both positive and negative—would further exacerbate the punitive effect of using this calculation base. Essentially, a small business experiencing positive growth will lose any inherent ‘offset’ effect by its inability to average its employee base month to month or pay period to pay period, while a small business that has lost significant amounts of business will still be required to count all of its former employees into its size standard calculations for an extended period, thus delaying its ability to recover from its business downturn.

Another commenter to SBA’s *Federal Register* notice pointed out that while SBA currently counts every employed person, the inflationary impact of that decision is greatly mitigated because the number of employees is counted for each pay period and then averaged. Therefore, if a particular company

employed four different individuals for a particular position during a single year, each pay period would have just one employee for that position, except for the few pay periods where there is an overlap. When the number of people for this position is averaged over the course of 26 pay periods, that average would still equal approximately one employee. In contrast, the proposed regulations would measure every person employed by the concern at any time during the year. Thus, if a firm employs four different individuals for a particular position during a year, it would be deemed to have four employees, even though there was just one position and one full-time-equivalent employee.

SBA’s Rationale

SBA’s justification for changing the rule in the first place was because it considers the

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SBA's justification for changing the rule in the first place was because it considers the current method to be burdensome to small businesses.

current method to be burdensome to small businesses. Under the current system of calculating employees, for example, a firm's size can fluctuate from pay period to pay period, necessitating a new calculation after each pay period. Furthermore, the time period for calculation would be similar to the method used for calculating receipts for size purposes, which are a firm's average annual receipts over the firm's last three completed fiscal years. For those businesses with fiscal years that end at the calendar year, both employment and receipts averages would be calculated at the same time. SBA felt this would be especially useful if a firm is operating under more than one North American Industry Classification System (NAICS) Code and the standard for determining size is receipts-based for one and employees-based for the other.

In addition, SBA saw this policy as being helpful to small businesses because it would coincide with the current regulatory requirement for a firm to update its size status on an annual basis in the Central Contractor Registration (CCR) (www.ccr.gov), as well as with Online Certifications and Representations Application (ORCA) databases. Presently, this must be done at least once a year, plus every time a firm's small busi-

ness size status changes, which could occur numerous times during the year using the current employee calculation method. SBA indicated that this is especially burdensome on small businesses that have different pay periods for different types of employees, i.e., bi-weekly paydays for hourly employees and monthly paydays for salaried employees.

The Solution

There is a way for SBA to both meet its goal and alleviate the concerns of the small business community. First, SBA should not use W-3's to calculate the number of a firm's employees. As stated by the commenters, the results would give a skewed picture of the actual size of a firm, often to the detriment of the small business. It is recommended that SBA's existing method of calculating employees be continued; however, the rolling average should be over 36 months of the three previous calendar years. This would meet both the interests of SBA in making the process less burdensome for small businesses, while at the same time not requiring firms to use W-3's in calculating the average number of employees.

This procedure would initially require somewhat more administrative work for

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companies, because they would have to average their employees over more pay periods, depending on whether they paid their employees monthly or bi-weekly. In the long run, however, it would require no extra administrative burden at all. SBA and the firm would know the size of the company at all relevant times, since the firm's employee size average for the previous three completed years would be readily available. As a result, in the case of size protest, or whenever a firm's size is called into question, the firm would not have to hurriedly pull together all of its pay period information on employees for the immediate preceding 12 months because its average number of employees over the previous three calendar years would be a matter of record.

Moreover, this approach would satisfy SBA's aim to have the time period for calculation of employees to be similar to the method used for calculating receipts for size purposes, which, as previously mentioned, is a firm's average annual receipts over its last three completed fiscal years. For those businesses with fiscal years that end at the calendar year, both employment and receipts averages could be calculated at the same time.

This method would also meet SBA's aim of being helpful to small businesses because it coincides with the currently regulatory requirement for a firm to update its size

status on an annual basis in the CCR and ORCA databases. As stated previously, firms must presently do this once a year, plus every time a firm's small business size status changes, which could occur many times during the year using the current employee calculation method.

Most importantly, the new method should substantially reduce size protests from disgruntled bidders in small business/8(a) set-aside competitions since a firm's size would be more readily known. Under the current system, when a company protests its loss of a contract to SBA, based on the fact that the winning firm has more employees than the size standard allows, the protestor is usually guessing or speculating that the business selected for the contract award is not a small business. The basis for such protests is usually based on the number of employees the protestor perceives the winning firm to have on its payroll at the time such firm submits its competitive proposal or offer when responding to a solicitation or request for proposals (RFP) by a federal agency, rather than considering the firm's average employees over a certain time period. The approach recommended in this article will make a firm's size more transparent to the public prior to the time it competes for a contract. Therefore, size protests will not be filed as readily, thus, saving

months of time in transition disruption and the delayed performance of contracts.

Put simply, this new approach to calculating employees meets both the desires of SBA to make the system for calculating employees less burdensome for small businesses and meets the concerns of small businesses by not using W-3's to calculate the number of employees for firms, which might cause many firms to become 'other than small' prematurely. Moreover, it will reduce the disruption, expense, and inconvenience of size protests based on a firm's number of employees. The suggested approach is a method that will work and should be implemented without undue delay. **CM**

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