JUNE 25, 2019

SBA Proposes (Finally) to Change Method of Calculating Size Status/Annual Revenues

Since its formation, the Small Business Administration ("SBA"), and regardless of the programs arising therefrom (including the 8(a) Economically Disadvantaged, HUBZone, Small Business, Woman-Owned Small Business, and Service Disabled Veteran Owned Small Business Concern Programs), the SBA has defined the term "small" as an entity that meets the NAICS standards under 13 C.F.R. § 121.201. Traditionally, the NAICS standards have been based on upon industry/classification, either the number of employees a concern has, or more broadly the total average annual revenues of the concern over the past three years. *See*, 13 C.F.R. 121.104. Fundamentally, this calculation takes the past three years' annual receipts of a business concern, adds them up and divides by three to get that average. It is a simple calculation, but with critical importance, particularly to small businesses and any government contractor. In fact, a three-year calculation has been applied by the SBA since January 1956.

The Three Year Average for Small Business Size Determination

Given this importance in determining the fundamental question of whether an entity is "small", the formula is applied strictly. What this also means, however, is that if a small business has an exceptional year of revenue or growth, it may no longer qualify as small, even though its other applicable revenue years defined the entity as small. For example, if a size standard of a business is $15.7 million/year, and the entity's prior three years had revenue of $10 million in 2017, $12 million in 2018, and $17 million in 2019, then the average annual revenue calculation for the past three years is $13 million -- still under the size standard. If, however, an entity had revenue of $12 million in 2017, $12 million in 2018, and $25 million in 2019, then the average annual revenue is $16.3 million -- which exceeds the standard, all due to one exceptional year. While an entity can attempt and plan to maintain its small size status, there are times where more work comes in than is planned in a given year (the entity receives more awards than planned) or work from one contract year is pushed to another year due to delays or other impacts (shifting that revenue to a different year that may push the business over the average). Utilizing only three years to develop and calculate this average provides little "cushion" for small businesses who are successful but not looking to become large.

The Small Business Runway Extension Act

Congress has heard the concerns and complaints of small businesses for years. With the passage of the Small Business Runaway Extension Act of 2018 (PL 115-324), Congress modified the Small Business Act to now require that small business size standards be based upon an average of gross receipts over the preceding five years, replacing the prior three years. Published on June 24, 2019, the SBA has issued a Notice of Proposed Rulemaking that, among other things, proposes to effectuate the increase from the current three-year period to five years. 84 Fed. Reg. 121 at 29,399 *et seq*.

For concerns that have been in business for less than five years, the proposed rule calculates the total receipts over five years, by dividing the number of weeks in a short year and the other full fiscal years,

and multiplies by 52 weeks, which is the same process SBA uses under the three- year period.

What Does This Mean For Me?

While not universal (some entities are still measured against the number of employees, mostly in the manufacturing space), the increase of the average revenue period from three to five years should result in allowing more entities, particularly mid-size concerns, to retain their small business status over a longer period while "absorbing" the occasional year in which it exceeds the size standard. This would allow an entity to either retain its size status as it grows, or regain its small business size status if it became other than small over the prior three-year calculation period as a result of providing an average over a longer period of time. This benefits small and large businesses alike, as it will allow more businesses to remain small, and give large businesses the ability to award work from more small business subcontractors and vendors/suppliers.

Final Note

The SBA has invited comments from the public and industry on this proposed rule, a rule that is almost certain to go into effect in the relatively near future. Commentary information is available in the Notice, cited above.