

## SBA's Proposal of a New Method for Calculating Size for Employee-Based Size Standards Would Exclude Many Companies from Small Business Status

On July 27, 2007, the Small Business Administration (SBA) issued a proposed regulation that would change the method of calculating the number of employees for the purpose of determining a company's size status. (72 Fed. Reg. 41239 (July 27, 2007)). Depending upon the industry, the SBA determines whether a company qualifies as a small business under a particular size standard either by using the company's average annual revenues or the number of its employees. This proposed regulation affects only the calculation for employee-based size standards. Under the proposed regulation, the SBA would average the annual number of employees for the last three years, rather than following the current method of using the average of the number of employees for each of the last twelve months.

The SBA states that the new method for calculating the number of employees will more closely resemble the method utilized for calculating receipts for revenue-based size standards. The SBA also notes that this calculation approach will provide a government-validated document to verify employment size, reduce the administrative burden to small businesses, and provide stability to a concern's size status. The proposed regulation, however, also will have the unintended consequence of changing the size status of many small businesses that are currently within approximately 20 percent of their employee size standard.

Currently, the SBA uses a rolling twelve-month average to determine whether a concern qualifies as a small business under an employee-based size standard. One criticism of this rolling average methodology is that a company could qualify as a small business one month, not the next, and then qualify again during the third month. Under the proposed regulation, the SBA would use a company's annual employee number and a company's size status would be stable for at least the following year. To ease the administrative burden, the SBA proposes to use the annual number of employees listed on an existing document, a company's W-3 that is filed with the IRS.

The SBA's proposed shift from monthly employment numbers to annual employment numbers increases the significance of the SBA's existing practice of counting every individual employed during the period, rather than the number of full-time equivalent employees. The W-3 will list every individual who was employed at any time during the year, including those with part-time or temporary status. There will be no mitigation for employee turnover or seasonal surges in the work force during the year. In contrast, the current rolling twelve-month average method tends to mitigate the distorting effect of employee turnover and seasonal surges in the work force numbers, because individuals are only counted in the months they are employed.

This proposed calculation methodology could increase a company's size over the applicable size standard by 20-30 percent, based upon the annual, rather than monthly, impacts of employee turnover and seasonal hiring. Moreover, because the new method will calculate the number of employees based on a three-year average, a small business that becomes "other than small" due to high employee turnover or a temporary surge in its workforce could be forced to wait several years until its average employment again reflects its status as a small business. While the SBA has at least partially recognized this effect, the agency has apparently underestimated the amount of employee turnover and seasonal employment that many small businesses experience, because the SBA states that the new calculation methodology will only affect companies that are "near" the employee size standard.

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To prevent many current small businesses from losing their small business size status pursuant to this new methodology, the SBA should either increase the existing employee-based size standards by an appropriate percentage to account for employee turnover and seasonal hiring or use only the number of full-time equivalent employees to calculate size status.

Comments on the proposed rule must be submitted to the SBA by September 25, 2007.

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