



June 15, 2004

HAND-DELIVERED

Mr. Gary M. Jackson
Assistant Administrator
Office of Size Standards
U. S. Small Business Administration
409 Third Street, S. W.
Washington, DC 20416

Re: Comments on IT Size Standard Proposals

Dear Mr. Jackson:

Thank you for your presentation to the Association for Small Businesses in Technology, Inc. (ASBT) and other trade associations and industry representatives on May 11, 2004 detailing the SBA's Size Standard Proposal. We appreciate having the opportunity to provide comments and offer suggestions to improve this proposal. Subsequent to your SBA Briefing, ASBT convened a Size Standard Response Committee and developed this letter in partnership with other small business trade associations and small business owners. As you recall, during the Briefing, we agreed to provide you with a draft response. Please let us know if any aspect of this letter requires further discussion on or before July 2, 2004 because elements of this letter will be shared with our members and industry representatives nationally.

Our Committee has unanimously concluded that the SBA's proposal regarding the 150 employee size standard for the IT classifications is unrealistic and will have disastrous effects for small businesses in technology. We are recommending the following:

- 1) That the Size Standard Proposal be re-analyzed, taking into account the small business realities of working in the Federal market;
- 2) That the SBA establish a working group that will include small business industry members to assist the SBA in drafting an amended Size Standard proposal and;

- 3) That the 150 IT NAICS should be increased to a realistic level based on the appropriate research and practical and proven business experience.

Our reasoning for these recommendations is outlined below:

It is our belief that businesses of all sizes should share in the opportunity to win and execute contracts with the federal government and that the opportunity should never be diminished. We will offer suggestions as to how the government might allocate contracting opportunities based upon a company's size near the end of this letter. Without carving out contracting opportunities for small businesses of all sizes, it is likely that only large businesses would ever be able to obtain and execute government contracts. Large businesses are able to exploit economies of scale and the economies of influence while small businesses cannot.

We believe that our society and social character is made better when small companies are included and given hope for a better future resulting from the beneficial economies of participation in contract services. With a solid business foundation, contractors will be able to provide outstanding, zealous and innovative services to its customers. The government's case against Microsoft demonstrates the government's understanding that true innovation and customer service comes from many businesses competing at all levels rather than a just few monoliths controlling the outcomes of us all.

We believe that the SBA understands these social benefits and the value of helping its constituents to become viable, community serving, taxpaying companies. We believe that the SBA sees the value of helping people with possibly limited opportunities otherwise and giving them hope, new possibilities and the guidance to become winners, leaders and taxpayers.

We believe that the SBA wants to do the job until it is finished rather than abandon its mission when only partially complete. We believe that the SBA wants to make a permanent, significant and positive difference.

In this regard, we believe that the proposed small business size standard of 150 employees for IT companies is significantly below the level of a viable established company, which is the standard that we believe the SBA is trying to encourage. The following points illustrate how far from being viable a 150-person IT company attempting to provide service under government contracts happens to be:

1. Fundamentally, contract sales for an IT company are based upon reimbursements or billings for estimated and actual costs plus a fee for its services under various contract forms. The costs of Labor, Fringe Benefits, Overhead, General and Administrative Expenses and Fee are the key elements for calculating billings or sales. Direct and indirect costs are allocated over the volume of a company's contracts and used to determine billing rates per hour. Competition holds down billing rates, which, as a result, may not cover all core indirect operating costs. The volume of contract activity as well as the intensity of the competition

determines the affordability of core operating expenses that are critical to operate a company and be sufficiently viable to compete effectively. In addition, sales may increase by means of billing for reimbursement of Other Direct Costs, Consulting and Subcontracting expenses. These costs, as they are billed, add to sales but contribute very little to providing reimbursement for core operating expenses but frequently, based upon their volume, make a small company look much larger. Any size standard determination should exclude Other Direct Costs such as Materials and Equipment from sales before determining a company's size. We agree that gross receipts are a misleading indicator of size or viability. Using these concepts, we evaluated the economic viability of a 150-person company.

2. We have calculated that an average 150-person company, without sales comprised of Other Direct Costs, Consultants or Subcontracts would only have sales of between \$13 to \$14 million rather than the \$21 million SBA estimate that was reflected in the presentation (also the current IT size standard). Depending upon the intensity of price competition, we have calculated that it would require between 225 and 300 employees to reach \$21 million and the company would probably also lose money if it had an infrastructure sufficiently large and viable to face competition from much larger companies.

Our calculated sales are lower because billable salaries adding to sales are much lower than the SBA estimates. This is because of the following:

- a. 11% to 18% of a small company's employees provide indirect labor support and are not directly billable reducing average contract sales per employee.
- b. The directly billable employees are not fully billable also reducing sales because a portion (approximately 13% or more on average) is made available for vacation, holiday, sick, jury duty, military leave, bereavement leave, etc. and is therefore not directly billable adding to contract sales. Downtime, not included, would reduce potential billings even more.
- c. Gross average wages for small companies, company-wide, are approximately \$60,000 annually and not as high as the average wage in the SBA assumption.

Consequently, after reductions (from sales) for non-billable personnel (who may not bill) and reductions (from sales) for non-billable leave (which is not directly billable) and reductions for lower wages than the SBA has estimated (which reduces annual sales per employee) sales per employee in a 150-employee company are closer to \$87,000 to \$93,000 per person per year. This is a far cry lower than the \$140,000 of sales per employee that it would take a 150-person company to get to \$21 million, the current IT size standard.

At \$87,000 of average annual sales per person, it requires 241 employees just to reach \$21 million of annual sales. It requires even more employees if heavy competition depresses billing rates. Gross receipts are an inadequate measure to

evaluate a company's viability to face competition and gross receipts totaling \$21 million in 1997 was too low to begin with. The example above indicates that a size standard of only 150 employees is inadequate and doesn't even come close to the current \$21 million size limit.

However, beginning with the \$21 million size standard, and applying the U. S. Department of Labor Bureau of Labor Statistics Urban CPI increase of 17.13% in 2004 from 1997, the size standard of \$21 million in 1997 would increase to approximately \$24.6 million in 2004 and if \$24.6 million were divided by \$87,000 of average annual sales per person, you would see that it takes approximately 283 employees just to reach that inflation adjusted level of sales. Again 150 employees is an inadequate size standard as a substitute for \$21 million. For the sake of example, using a size standard of 300 employees would be far more reasonable but even that would not correct for the fact that \$21 million in 1997 was too low to begin with.

3. The annual sales totals of \$13 to \$14 million in our calculation for a 150-employee company above are probably on the high side because they were developed using generous loading factors for Fringe Benefits, Overhead, General & Administrative Expenses and Fee. (Loading factors are used to allocate real costs as percentages over the entire contract workload). In the real world, even with competition only among peers, to win contract awards, the loading factors representing real indirect costs are much lower than actual expenses reducing the resulting sales in the example from \$13 to \$14 million to \$11 to 12 million more realistically.

Competition drives down the amount of sales by employee requiring more employees billing at lower amounts just to get back to the sales necessary for a small company to survive. A size standard based upon an employee limit of 150 employees is not viable to face competition from much larger companies.

4. We have calculated that a 150-employee company might have sales of only \$11 to \$12 million but even if sales were \$13 to \$14, the company with a viable infrastructure would probably still lose between \$.6 and \$4.6 million dollars. Obviously, this example reflects that a \$150-employee company is not in the category of a viable, successful enterprise of which the SBA would be proud.

It is true that the way smaller companies struggle through is to refrain from providing the support, the service, the benefits and the reasonable wages that the larger companies are able to afford due to their scale. That's how companies survive when they are not viable but that is not the kind of independent and strong company that the SBA aspires to produce.

The examples show that if firms were viable enough to face outside competition, they would require more than a minimal infrastructure, and if they had an adequate infrastructure, they would have to have sufficient sales volume to cover

the cost of that infrastructure. Until they reach the necessary level of sales, they simply cannot afford an adequate infrastructure to face larger company competition and without an adequate infrastructure, they will never reach a sufficient sales volume to cover costs. It is definitely an issue of scale even among other small companies but especially between large and small companies.

Small companies cut their infrastructure to cut costs in order to avoid or minimize losing money but that diminishes their hopes of ever becoming viable companies especially when facing competition from much larger companies. All companies bid rates that may or may not result in profitable or unprofitable operations. Scale is important and it is only speculation that the scale estimated would be adequate to recover the indirect costs at the billing rates that bidders have proposed. If volume is too low, companies will either lose money or cut their infrastructure (decreasing their long-term potential) or both. If volume is adequate or higher than expected, companies will either make money or increase their infrastructure (increasing their long-term potential) or both.

The SBA has historically provided an environment where similar sized companies can compete on their way to becoming economically and structurally viable to face larger company competition. The examples simply show the kind of scale that is necessary to begin to mature from small to medium to self-sustaining.

5. I have attached Schedule A to define the Components of Fringe Benefits that current and prospective employees demand in this region. Only a viable company can provide them and I believe that the mission of the SBA is to assist companies to become viable. If not, which benefits should we cut? Which benefits does the government not provide its employees?
6. I have attached Schedule B to define the Components of Overhead (OH) and General & Administrative Expenses (G&A). The components are real costs that contractors must pay. OH is indirect operating support such as rent or office supplies or telephone support in a common facility that is allocated among two or more contracts, respectively. G&A is the administrative support for the total company, not just operations, and it includes costs to support activities such as Payroll, Accounts Payable, Human Resources, Contract Administration, Business Development and the Office of the President. G&A supports indirect as well as direct activities of the company.
7. I have attached Schedule C to define the Indirect Job Titles and Salaries of a modest but viable company as an example of functional areas that viable companies have to provide and pay in the course of conducting contract operations in this geographic area. Net indirect labor (reduced by the 13% fringe component discussed earlier) accounts for approximately 25% of OH and G&A total costs. Using that factor, total actual OH and G&A costs were estimated in the Statements of Operations. As stated earlier, sales were calculated utilizing competitive Fringe, OH and G&A factors. The Statements of Operations reflect

that billings were not adequate to cover the actual indirect costs of a company viable enough to face larger company competition.

8. I have attached Schedule D to display comparative Statements of Operations that may help to reflect the assumptions in an income statement format. Again, a viable company should have certain functional areas of the company staffed. The financial results indicate that a company has to struggle for a significant period before it can pay for all of the requirements that a viable company must provide. The various models indicate that for a viable company to cover core-operating expenses, it may have to have well over 600 employees to begin to compete with companies of 1000 to 2000 employees.
9. Please note that small businesses also need to borrow money and consequently pay interest expense and income taxes as well if they are lucky enough to be profitable. Purposely, these line items were left blank so as not to detract from the principal issues of scale and the necessary size standards to support small companies on their way to becoming viable.

It is our belief that small businesses may need the assistance of the SBA until they exceed 1500 employees, significantly higher than the 150-employee standard proposed. This is because business growth is an evolutionary process and the competition from companies with 1000's and 10's of 1000's of employees will always have the power to out-scale, overcome and eradicate very small competitors if given the chance to do so. Very often small businesses are forced to sell out or close in the face of competition form huge oligopolies.

Thank you for your patience and your attention to this recap of our arguments requesting rejection of the 150-person IT size standard and a re-examination of a much larger and more effective size standard for small companies struggling to become viable competitors. This is a complex matter. I know that the SBA believes in pursuing changes that result in a permanent positive benefit to people, to companies, to employees and entrepreneurs alike, to the economy and to the better welfare of the nation. The SBA wants to fulfill its mission and see it through until it is finished.

Please let us know if we can offer any additional details that will be helpful.

Very truly yours,

Fernando V. Galaviz
Chairman

Enclosures

cc: The Hon. Olympia Snowe
Chair, Senate Committee on Small Business and Entrepreneurship
The Hon. John Kerry

Ranking Member, Senate Committee on Small Business and Entrepreneurship
 The Hon. Donald Manzullo, Chair, House Committee on Small Business
 The Hon. Nydia Velasquez, Ranking Member
 House Committee on Small Business
 The Hon. Hector Barreto, SBA Administrator

SMALL BUSINESS, INC.
SCHEDULE A – HYPOTHETICAL COMPONENTS
OF FRINGE BENEFITS

<u>ACCOUNT DESCRIPTION</u>	
HOLIDAYS	\$
ANNUAL LEAVE	
SICK LEAVE	
OTHER PAID LEAVE	
SEVERANCE PAY	
FICA	
SUTA	
FUTA	
GROUP INSUR DEDUCTIONS	
GROUP INSUR-MEDICAL	
GROUP INSUR-DENTAL	
GROUP INSUR-AD&D	
GROUP INSUR-LIFE	
GROUP INSUR-LG TRM DISAB	
GROUP INSUR-SRT TRM DISAB	
401(K) CONTRIBUTIONS	
401(k) ADMIN & BENEFIT EXP	
PARKING	
TUITION ASSISTANCE	
EMPLOYEE WELFARE	
WORKERS COMPENSATION	
STATE DISABILITY INSUR	
TRAINING-CA EMPLOYMENT	
TOTAL FRINGE EXPENSES	<u>\$</u>
TOTAL NON-FRINGE LABOR	<u>\$</u>
FRINGE RATE	<u>%</u>

SMALL BUSINESS, INC.
SCHEDULE B - HYPOTHETICAL COMPONENTS OF OVERHEAD
AND GENERAL & ADMINISTRATIVE EXPENSES

ACCOUNT DESCRIPTION	
LABOR	\$
COMPUTER SUPPLIES	
CONFERENCES & SEMINARS	
DUES & SUBSCRIPTIONS	
EQUIPMENT RENTAL	
OFFICE SUPPLIES	
PARKING	
POSTAGE & MESSENGER	
REPAIRS & MAINTENANCE	
TELEPHONE	
TRAVEL - LOCAL	
ACCOUNTING FEES	
BANK FEES	
BUSINESS LICENSES & FEES	
FUTURE	
LEGAL FEES	
TAX-PERSONAL PROPERTY	
STORAGE EXPENSE	
TAX-STATE INCOME	
INSURANCE	
TAXES - VARIOUS LOCAL	
TEMPORARIES	
CONSULTANTS	
TRAVEL-OUT OF TOWN-OTHER	
TRAVEL-OUT OF TOWN-MEALS	
TRAINING	
BONUS	
PERS/PR ALLOCATION	
FACILITIES ALLOCATION	
FRINGE - INDIRECT LABOR	
B&P - (G&A Pool Only)	
TOTAL EXPENSE	\$
 ALLOCATION BASE	\$

INDIRECT RATE

 %

SMALL BUSINESS, INC.
SCHEDULE C - HYPOTHETICAL INDIRECT JOB TITLES & SALARIES

	Model # 1 150 Employees	Model # 2 150 Employees	Model # 3 300 Employees
Office of the President			
President	\$ 175,000	\$ 175,000	\$ 175,000
Assistant to the President	40,000	40,000	40,000
Executive Vice President	140,000	-	140,000
LAN, Telephone & Communications Manager	90,000	-	90,000
Office of Human Resources			
Director of Human Resources	110,000	110,000	110,000
Human Resources Benefits & Recruiting	55,000	55,000	55,000
Human Resources Benefits & Recruiting	55,000	-	55,000
Office of Contract Administration			
Director of Contracts Administration	130,000	130,000	130,000
Contract Administrator & Cost Proposals	90,000	90,000	90,000
Contract Administrator & Cost Proposals	60,000	-	60,000
Office of Accounting & Finance			
Chief Financial Officer	150,000	150,000	150,000
Senior Accountant or Controller	90,000	90,000	90,000
Staff Accountant	50,000	50,000	50,000
Staff Accountant	50,000	-	50,000
Staff Accountant	50,000	-	50,000
Office of Operations			
Chief Operations Officer	150,000	150,000	150,000
Division Manager	130,000	130,000	130,000
Division Manager	130,000	-	130,000
Division Manager	130,000	-	130,000
Division Manager	130,000	-	130,000
Office of Business Development			
Vice President of Business Development	150,000	150,000	150,000
Business Development Professional	90,000	-	90,000
Business Development Professional	90,000	-	90,000
Proposal Manager	120,000	120,000	120,000
Graphics Artist	50,000	50,000	50,000
Office of Purchasing and Administration			
Purchasing Manager	75,000	75,000	75,000
Administrative Staff	40,000	-	40,000

Receptionist	<u>35,000</u>	<u>35,000</u>	<u>35,000</u>
Unloaded gross indirect labor - 28, 26 & 28 staff	<u>\$ 2,655,000</u>	<u>\$ 1,600,000</u>	<u>\$ 2,655,000</u>
Indirect Employees	28	16	28

SMALL BUSINESS, INC.
SCHEDULE D - HYPOTHETICAL STATEMENTS OF OPERATIONS

	<u>Model # 1</u> <u>150</u> <u>Employees</u>	<u>Model # 2</u> <u>150</u> <u>Employees</u>	<u>Model # 3</u> <u>300</u> <u>Employees</u>
Contract revenue	<u>\$ 13,057,261</u>	<u>\$ 14,341,582</u>	<u>\$ 29,111,273</u>
Cost of revenue production			
Direct costs	6,368,400	6,994,800	14,198,400
Indirect costs	<u>11,360,077</u>	<u>7,897,268</u>	<u>13,967,467</u>
	<u>17,728,477</u>	<u>14,892,068</u>	<u>28,165,867</u>
(Loss) earnings from operations	(4,671,216)	(550,486)	945,406
Other income (expenses), net	<u>-</u>	<u>-</u>	<u>-</u>
Earnings before interest charges and taxes	(4,671,216)	(550,486)	945,406
Interest charges and taxes	<u>-</u>	<u>-</u>	<u>-</u>
Net (loss) earnings	(4,671,216)	(550,486)	945,406
Less - Provision fee	<u>854,213</u>	<u>938,234</u>	<u>1,904,476</u>
(Excess) indirect costs resulting from lack of adequate scale	<u>\$ (5,525,429)</u>	<u>\$ (1,488,720)</u>	<u>\$ (959,070)</u>

SMALL BUSINESS, INC.
SCHEDULE D - HYPOTHETICAL STATEMENTS OF OPERATIONS

	Model # 4 150 Employees	Model # 5 225 Employees	Model # 6 592 Employees
Contract revenue	\$ 13,057,261	\$ 21,084,267	\$ 48,487,472
Cost of revenue production			
Direct costs	6,368,400	10,283,400	29,440,800
Indirect costs	11,360,077	12,663,772	19,043,186
	17,728,477	22,947,172	48,483,986
(Loss) earnings from operations	(4,671,216)	(1,862,905)	3,486
Other income (expenses), net	-	-	-
Earnings before interest charges and taxes	(4,671,216)	(1,862,905)	3,486
Interest charges and taxes	-	-	-
Net (loss) earnings	(4,671,216)	(1,862,905)	3,486
Less - Provision fee	854,213	1,379,345	1,864,903
(Excess) indirect costs resulting from lack of adequate scale	\$ (5,525,429)	\$ (3,242,250)	\$ (1,861,417)