



Testimony for the Record

On Behalf of

GovEvolve

For the

House Committee on Small Business
Subcommittee on Contracting and Infrastructure Hearing

“Leveling the Playing Field: The State of Small Business
Contracting”

May 11, 2023

GovEvolve is pleased to submit the following testimony for the record. GovEvolve is the leading advocacy organization for small and midsize businesses that support government innovation. The organization works to support the technology industry by promoting public policies that encourage innovation and competitiveness.

As the voice for these diverse businesses, GovEvolve's mission is to help ensure that the Government has access to the most modern technology. Even though governmentwide information technology ("IT") spend totals billions each year, the Government continues to support IT equipment well beyond its intended lifecycle. As federal agencies adopt emerging technologies, they often struggle to keep pace with issues such as cybersecurity threats. GovEvolve supports mitigating the impediments to federal procurement and ensuring a robust acquisition landscape through engagement with Congress and Federal agencies.

There have been significant changes in the way the Government buys IT services in the past decade. As the focus of federal spending shifts towards innovative, comprehensive solutions, small businesses are providing the Government with IT including hardware, software, and cloud computing, more than ever before. In many cases, these small businesses are resellers that provide efficient and cost-effective solutions for complex IT procurements, including beneficial value-added services. However, frequent misclassification of IT procurements by the acquisition workforce creates missed opportunities for small businesses to compete.

The most viable solution to address these issues is to fully review the current North American Industry Classification System ("NAICS") and create a new NAICS code that accurately captures the core competency of the IT value-added reseller. Below is a white paper expanding on the importance of creating this new classification and the potential impact on small businesses.

New NAICS: Opportunities for Small Businesses in the Federal IT Market

As the focus of government spending shifts more and more towards innovation and meeting agencies' burgeoning technology needs, small businesses are providing the Government with IT, including hardware, software, and cloud computing, more than ever before. In many cases, these small businesses are resellers that can provide efficient and cost effective solutions for complex IT procurements. These small businesses provide beneficial value-added services, help the Government meet its small business goals, and create more competition in the market. The Federal Government depends on small businesses to round out its supply chain and facilitate achievement of important procurement goals, and small business IT resellers are critically important to federal government procurement.¹ In 2019, out of a total of about \$500 billion spent on federal contracting, \$132.9 billion (or 26.5%) went to small businesses.²

However, issues and restrictions surrounding small business procurements have led to frequent misclassification of IT procurements and potential liability for contractors. The current regulatory landscape includes a patchwork of rules and regulations for small businesses, including recent rules specific to the IT industry, that are unworkable in many cases. This, coupled with contractor misunderstanding of the rules and unwillingness by agencies to grant necessary waivers, has made it challenging – and in many cases impossible – for small business IT resellers to participate in federal procurements without potentially violating the law. In many instances, small business IT resellers are forced to choose between missing out on federal business opportunities and potentially opening themselves to considerable liability. As IT evolves, so too should the rules applicable to IT procurements, particularly where this will allow more opportunity for small businesses to compete. This paper seeks to highlight these issues and to propose a plausible solution.

I. Benefits of the Small Business IT Reseller in Federal Contracting

Due to changes in how the Federal Government uses and procures IT, the number of small businesses providing IT to the Government has increased considerably, resulting in a new category of small business – the small business IT reseller. The small business IT reseller has been able to fill an important role where, generally, the Government (1) prefers to obtain IT equipment and supporting services from a single source; (2) regularly uses a single acquisition to obtain numerous IT products that typically are not produced by any one original manufacturer; and (3) requires the contractor to customize computer hardware or software to meet an agency's

¹ U.S. SMALL BUSINESS ADMINISTRATION, FY 2020 Goaling Guidelines, 2 (Oct. 2019), *available at* https://www.sba.gov/sites/default/files/2020-05/FY20_Small_Business_Goaling_Guidelines_Draft_2020.pdf; *See* Small Business Act of 1958 § 2(a), 15 U.S.C. § 631. Each year, Congress sets Federal small business procurement goals in order to ensure “small businesses have the maximum practical opportunity to participate in providing goods and services to the Federal Government.”

² U.S. SMALL BUSINESS ADMINISTRATION, *Federal Government Exceeds Small Business Contracting Goals By Awarding Record-Breaking \$132.9 Billion to Small Businesses*, (Aug. 12, 2020), *available at* <https://www.sba.gov/about-sba/sba-newsroom/press-releases-media-advisories/federal-government-exceeds-small-business-contracting-goals-awarding-record-breaking-1329-billion>.

specific needs.³ IT resellers purchase IT products from the original manufacturer (or from another distributor) and resell the products to end users.⁴

Rather than acting solely as an intermediary, IT resellers provide valuable, customized IT solutions. Many of these services are provided pre-award, and thus are not directly reflected in eventual contract award amounts. Specifically, IT resellers provide access to engineers and architects with subject matter expertise that assist the Government in creating and implementing customized, scalable solutions. They serve to strategically connect Government with original equipment manufacturers (OEMs) in innovative ways. Further, IT resellers provide pre-contract services to include access to demonstration centers, which allows the Government customer to conduct proof of concept testing to ensure the proposed solutions and equipment work as expected prior to making a final purchasing decision. Due to their industry position and structure, IT resellers can ensure that Government-required cybersecurity and supply chain risk management standards are in place to safeguard Government data and systems. These critical services are provided with minimal cost to the government because they are included in overhead costs, covered by narrow margins on the IT products. As such, IT resellers exist as a trusted and cost-effective conduit for original manufacturers to reach Government customers, and they pass these savings along to the Government.

II. North American Industry Classification System (NAICS) Codes

The North American Industry Classification System (“NAICS”) is the standard hierarchical classification system used by the Federal Government to classify businesses and establishments into specific industries.⁵ Although the NAICS Codes in many cases do not entirely mirror their specific requirements, agencies have adopted NAICS codes for – and these codes have a substantial impact on – federal procurements.⁶

In federal contracting, NAICS codes have two primary purposes: (1) to identify the purpose of the procurement, and (2) to identify the size standard an entity must meet to qualify as a small business for that procurement. When issuing solicitations, contracting officers are required to designate a single NAICS code that “best describes” the primary purpose of the procurement.⁷ Often, a procurement for IT-related acquisitions may be a mixed procurement, involving both products and services. For these mixed procurements, the contracting officer still must assign a single NAICS code according to the “component that accounts for the greatest percentage of contract value.”⁸ This causes problems for IT resellers because in many cases these

³ See Small Business Size Standards: Industries With Employee Based Size Standards Not Part of Manufacturing, Wholesale Trade, or Retail Trade, 81 Fed. Reg. 4436, 4443 (Jan. 26, 2016), *available at* <https://www.govinfo.gov/content/pkg/FR-2016-01-26/pdf/2016-00922.pdf>.

⁴ Anne Pilon, *How to Become an IT Reseller*, SMALL BUSINESS TRENDS (Sept. 11, 2018), *available at* <https://smallbiztrends.com/2018/09/it-reseller.html#:~:text=An%20IT%20reseller%20is%20a,intermediary%20in%20the%20distribution%20process>.

⁵ U.S. Census, North American Industry Classification System: Introduction to NAICS, *available at* <https://www.census.gov/eos/www/naics/#:~:text=The%20North%20American%20Industry%20Classification,to%20the%20U.S.%20business%20economy> (last visited Oct. 20, 2020).

⁶ *Id.*

⁷ 13 C.F.R. § 121.402(b).

⁸ 13 C.F.R. § 121.402(b)(2).

entities provide a combination of products and services not contemplated by traditional NAICS codes, and offer new technology, *i.e.*, software and/or cloud, that reasonably can be classified as a product or a service.

The existing traditional NAICS codes used for federal contracting, and the corresponding SBA size standards, generally are not appropriate for small business IT resellers. Establishments that are “primarily engaged in” providing services can properly be classified under a Service Code.⁹ Small business IT resellers provide hardware, software, and related products (supplies) that are manufactured by other companies along with services related to those products. Thus, the primary focus of the offerings available from IT resellers are not services and IT resellers generally cannot properly be classified under the Service Codes. Likewise, the Supply Codes used for federal procurements cover establishments that *manufacture* each specific product. Since the products IT resellers provide often are manufactured by other companies, small business IT resellers do not fit neatly under the NAICS Supply Codes either.¹⁰ In sum, traditional NAICS Supply Codes and Service Codes present unique problems in the federal procurement context.

III. Unique Challenges for IT Small Businesses

Recognizing the traditional rules and regulations cannot properly be applied to IT resellers, federal agencies have sought numerous workarounds. The rules have not adapted to quickly changing technology-related procurements and ultimately this piecemeal approach has failed. As a result, at least one government agency now is attempting to acquire a blanket waiver that will allow it to circumvent the onerous requirements.¹¹ This clearly demonstrates the need for a more complete solution, specifically tailored to meet the unique requirements of the Government and enable contractors to provide the best possible solutions with respect to IT procurements.

A. ITVAR Code 541519 (Footnote 18)

The SBA created a new sub-industry category for Information Technology Value Added Resellers (“ITVARs”) under NAICS code 541519, with a corresponding size standard of 150

⁹ Each NAICS code description begins with “This industry comprises establishments primarily engaged in” See, e.g., NAICS Association, NAICS Code Description for 334111 – Electronic Computer Manufacturing, available at <https://www.naics.com/naics-code-description/?code=334111> (Last visited Oct. 21, 2020).

¹⁰ Many small business IT resellers could be appropriately categorized under the Wholesale Trade NAICS codes (e.g., 423430 – Computer and Computer Peripheral Equipment and Software Merchant Wholesalers). However, SBA regulations explicitly prohibit the government from classifying acquisitions for supplies under Wholesale Codes. See *NAICS Appeal of Global Precision Systems, LLC*, SBA No. NAICS-5681 (2015) (explaining 13 C.F.R. § 121.402(b)(2) requires that “[a]cquisitions for supplies must be classified under the appropriate manufacturing or supply NAICS code, not under a Wholesale Trade or Retail Trade NAICS code.” Thus, even though the solicitation called for the contractor to distribute items manufactured by others, because the “heart of the procurement” is for supplies, it must be categorized under a manufacturing or supply code.); see also <https://smallgovcon.com/naics-code-appeals/no-wholesaler-naics-codes-for-set-aside-contracts-sba-oha-confirms/>

¹¹ DHS currently is seeking a waiver for its FirstSource III contract. See FirstSource III information at <https://beta.sam.gov/opp/1d1105e4b3c440f5822ce86892fb5db1/view>.

employees.¹² To accomplish this, it amended 13 C.F.R. § 121.201 by adding a footnote (Footnote 18), which provides a definition of ITVAR and describes the circumstances under which a procurement could properly be classified under the industry code 541519. The stated purpose of establishing this industry category was to “better apply small business eligibility requirements under Federal contracts that combine substantial services with the acquisition of computer hardware and software.”¹³ SBA believed establishing the ITVAR industry category was a “more effective approach to addressing the size eligibility requirements of nonmanufacturers providing substantial services along with IT products.”¹⁴ However, the ITVAR exception under NAICS code 541519 is not working as intended.

Specifically, Footnote 18 requires an ITVAR classified under 541519 to “provid[e] multi-vendor hardware and software along with significant value added services. Significant value added services consist of, but are not limited to, configuration consulting and design, systems integration, installation of multi-vendor computer equipment, customization of hardware or software, training, product technical support, maintenance, and end user support.”¹⁵ As set forth in the regulation, the percent of value added services under Footnote 18 is measured as follows:

For purposes of Government procurement, an information technology procurement classified under this exception and 150-employee size standard must consist of at least 15% and not more than 50% of value added services, as measured by the total contract price.

Thus, to qualify, a small business IT reseller must provide and charge the Government for value added services equivalent to between 15% and 50% of the total contract price. As discussed above, much of the value-added services provided by IT resellers occur prior to contract award and/or are built into existing pricing and not separately charged. Under the current rule, measuring the percent of value added services as compared to the total contract price, the 15-50% requirement is unrealistic and will serve to unnecessarily increase the costs to the Government of meeting its small business goals.

The ITVAR exception under NAICS code 541519 is insufficient to categorize the products and services required in recent complex agency IT procurements.

B. Potential Liability for Small Businesses Under the Current System

The Government regularly issues solicitations under inappropriate NAICS codes, and many times small businesses do not fully understand the complicated rules. Since there is little compliance oversight by the Government with respect to NAICS codes, the onus has shifted to small businesses to use already scarce time and resources to police government agencies via

¹² Small Business Size Standards; Information Technology Value Added Reseller, 68 Fed. Reg. 74833 (Dec. 29, 2003), *available at* <https://www.govinfo.gov/content/pkg/FR-2003-12-29/pdf/03-31795.pdf>.

¹³ *Id.*

¹⁴ *Id.* at 74841.

¹⁵ 13 C.F.R. § 121.201 n. 18.

protests. Relying on protests to check this frequent misuse is unrealistic, costly, and unfair for small businesses.

Misapplication of the ITVAR Code by assigning 541519 to solicitations when it is not appropriate is specifically problematic for small businesses in the IT space. In this situation, small businesses that otherwise meet the value-added requirements are stuck between a rock and a hard place. They can choose to bid, knowing they will not provide services that account for 15-50% of the total contract price as required by 541519, and thus potentially setting themselves up for an allegation that they have violated the law or made a false certification. Or, the small business can forgo the opportunity altogether, while less risk-averse competitors are awarded the work.

Ultimately, where a small business contractor is not compliant with the SBA regulations, it is susceptible to size protests, potential suspension or debarment, or False Claims Act liability. Relatedly, if a small business submits a bid or proposal for a small business set-aside contract based on a false statement about its size or status, this is likely to be viewed as a *willful and intentional* false certification.¹⁶ Thus, simply by submitting a proposal where the business cannot comply with the 15-50% service requirement under the ITVAR Code – even in situations where the contractor did not understand or know the rules – a small business contractor could potentially expose itself to liability, suspension or debarment, a size-based protest by a competitor, contract termination, and loss of business.

IV. Solution: Create a Separate ITVARs NAICS

The current system for classifying and executing procurements involving IT resellers has serious flaws that should be addressed. The most viable solution to address these issues is to create a new NAICS code that accurately captures the core competency of the IT reseller. The new code should focus on the IT reseller's role as a consultant that provides pre-sales engineering and subject matter expertise on a variety of software and hardware products.

The Office of Management and Budget and Economic Classification Policy Committee should create a new, stand-alone NAICS code for IT value-added resellers. Once established, the SBA should then revise its current size standards accordingly and eliminate 541519 Footnote 18. Suggested language for the new NAICS code description (suggested as code 541520) includes the following –

541520 – Information Technology Value-Added Reseller (ITVAR) Services

This U.S. industry comprises establishments primarily engaged in providing a total solution to information technology acquisitions by providing commercially available multi-vendor hardware and software items manufactured by original equipment manufacturers (OEMs), along with significant value-added services. The value-added services are the primary function of the IT reseller, and are

¹⁶ See 13 C.F.R. § 121.108(b) (Submission of a bid or proposal for a contract that is set aside for award to small businesses “shall be deemed affirmative, willful and intentional certifications of small business size and status.”)

provided both before and after the item reaches the end-user. Significant value added services consist of, but are not limited to, configuration consulting and design, systems integration, installation of multi-vendor computer equipment, customization of hardware or software, training, product technical support, maintenance, and end user support.

As soon as practicable after this new NAICS code is implemented, SBA should revise its size standards to account for the new NAICS code and institute an appropriate employee-based size standard of 300 employees. Recognizing that IT resellers typically operate on low margins even though their annual receipts may be high, the size standard should be based on employee count rather than annual revenue.

V. Conclusion

Small business IT reseller participation is critically important to the federal government's ability to acquire and implement COTS IT solutions. Yet, a patchwork of rules and regulations specific to small businesses and the IT industry have led to frequent misclassification of IT procurements and have made it challenging, and in some cases impossible, for small business IT resellers to participate without potentially violating the law. The current landscape clearly demonstrates the need for a more complete solution. Creating a new NAICS code specifically tailored to account for the unique aspects of the IT reseller industry, would enable small contractors to provide the best possible IT solutions to the Government.