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The Interaction between PPP and the FAR: What it means for Government Contractors

Chairman Mfume, Ranking Member Salazar, and Members of the Committee, thank you for the opportunity to speak to you today. My name is Susan Moser and I am a partner in Cherry Bekaert, LLP, a national CPA and consulting firm primarily serving small and middle market clients in a number of different industries. I lead our firm's government contracts practice which I founded 20 years ago, after being a client of the firm as a CFO for an 8(a)-government contractor. Today my firm works with over 250 government contractors of various sizes and industries, but the bulk of our clients are small businesses as defined by the Small Business Administration (SBA). As small business government contractors operate within a regulated industry with unique and strict compliance requirements, I have spent the past 20 years helping them understand and navigate the accounting and compliance issues under the Federal Acquisition Regulations (FAR) and various agency supplements.

The Paycheck Protection Program (PPP) was initially enacted as Sections 1102 and 1106 of the Coronavirus Aid, Relief, and Economic Security (CARES) Act. However, those sections were amended by the Consolidated Appropriations Act of 2021 and the American Rescue Plan Act. The PPP program, while tremendously beneficial and necessary for so many small businesses, including many companies who contract with federal and state government agencies, has created much angst, uncertainty and confusion among government contractors, due to ever-changing, and often conflicting guidance from a variety of sources and agencies. The PPP was designed to provide needed assistance to all types of small businesses. However, the reality for many contractors who received a PPP loan and intend to seek forgiveness is a concern that the offered assistance from a practical standpoint, based on the FAR requirements, which I will discuss, will equate to little or no benefit, but instead add to compliance concerns and certainly confusion on how to properly report forgiveness proceeds.

As originally written, a small business could apply for a PPP loan if the company had no more than 500 employees or could meet some alternative size standard test. That size standard has now been reduced to 300 employees, and the alternative size standards generally have been eliminated. As an aside, regardless of which of these standards was used to determine eligibility for a loan, many companies that received a PPP loan would not be considered a small business under the FAR because the FAR uses revenue based size standards to determine size for many procurements.

Under the PPP loan program, if a company receives a loan, proceeds can only be spent on certain expenses. These include, among others, payroll costs, interest on mortgages, rent, and utilities. However, at least 60% of the amount to be forgiven must have been spent on payroll costs. This leads to the interaction with the FAR credits cost principle.

FAR Part 31 contains what are known as cost principles. The cost principles are used for pricing contracts, subcontracts and modifications to contracts and subcontracts whenever cost analysis is performed on a proposal. Part 31 is divided into subparts containing cost principles for various categories of contractors. For our discussion today, I will focus on Subpart 31.2, which contains the cost principles for commercial organizations including small business concerns.

The FAR describes different contract types. Generally, these contract types are classified by how they are priced. Most of these contract types are considered flexibly priced contracts because the amount the contractor is entitled to be paid for performing the contract is not fixed at the time of contract award. Instead, the contractor is paid based on the allowable costs it incurs in performing the contract. In the FAR context, an allowable cost is a cost for which a contractor may be reimbursed for performance of flexibly priced government contracts. The cost principles in FAR 31.2 are used to determine what costs are allowable for flexibly priced contracts, which include cost reimbursement contracts (Cost), time and materials (T&M) contracts and fixed price incentive contracts. Each of these contract types incorporates a FAR clause that specifically makes the cost principles in FAR 31.2 applicable to the contract. In contrast, the cost principles do not determine what a contractor is paid under a firm fixed price (FFP) or fixed price with economic price adjustments (FP-

EPA) contract including FFP and FP-EPA contracts for commercial items. Under this contract type, the contractor is paid the stated contract price regardless of the costs incurred in performing the contract.

In my experience, most contractors have a mix of contract types based on the nature of the service or solution being delivered. The type of contract issued (FFP, T&M, Cost or a hybrid) is determined by the procuring agency depending on a number of factors including level of risk, ability to define the scope and/or outcome, and other factors. The government's preference is to use FFP whenever possible.

For flexibly priced contracts, one of the FAR 31.2 cost principles is known as the credits cost principle. The credits cost principle has been in the FAR since its promulgation on April 1, 1984. Before that, a similar cost principle was included in predecessors to the FAR, the Armed Services Procurement Regulation (ASPR) applicable to DoD and the Federal Procurement Regulation applicable to civilian agencies. Thus, the credits cost principle has been a reflection of government procurement policy for several decades.

The credits cost principle states in pertinent part "[t]he applicable portion of any income, rebate, allowance, or other credit relating to any allowable cost and received by or accruing to the contractor shall be credited to the Government either as a cost reduction or by cash refund." As noted by the Court of Federal Claims, the credits cost principle is "concerned with assuring that if the Government pays a cost and later that cost is reduced, by whatever means, the Government receives the benefit of that reduction. This is fair and reasonable." It is important to analyze the cost principle in the context of the PPP loan program.

First, the government is only entitled to a cost reduction or cash refund if the contractor receives a credit relating to an allowable cost charged to a government contract that is subject to the cost principles, i.e., a flexibly priced contract. As noted previously, PPP loan proceeds can be used for, among other things, payroll costs, interest on mortgages, rent, and utilities. Generally, payroll costs are considered allowable costs, but may be unallowable in some circumstances. Consequently, PPP loan amounts that were used for payroll costs can be subject to a credit. Interest on mortgages is an expressly unallowable cost. Therefore, no credit is due the government if a contractor receives a credit for this cost. Rent is generally an allowable cost, but in some circumstances, some of the rent may be unallowable. To the extent rent is an allowable cost that cost will be subject to any credit the contractor receives for rent. Finally, utilities are generally an allowable cost that is subject to a credit.

As noted earlier, FAR 31.201-5, the credits cost principle provides that "the applicable portion of any income, rebate, allowance, or other credit relating to any allowable cost and received by or accruing to the contractor shall be credited to the Government either as a cost reduction or by cash refund."

In cost-reimbursement and T&M contracts, a FAR clause 52.216-7(h)(2) is incorporated that provides that, as a condition to final payment under those contracts, the contractor must give the Government an assignment wherein the contractor promises to "pay to the Government any refunds, rebates, credits, or other amounts (including interest, if any) accruing to or received by the Contractor or any assignee under this contract, to the extent that those amounts are properly allocable to costs for which the Contractor has been reimbursed by the Government. Reasonable expenses incurred by the Contractor for securing refunds, rebates, credits, or other amounts shall be allowable costs if approved by the Contracting Officer."

> FAR 31.201-2(a) defines cost allowability: "A cost is allowable only when the cost complies with all of the following requirements: (a) (1) Reasonableness. (2) Allocability. (3) Standards promulgated by the CAS Board, if applicable, otherwise, generally accepted accounting principles and practices appropriate to the circumstances. (4) Terms of the contract. (5) Any limitations set forth in the subpart."

> FAR 31.201-2(d) further states: "A contractor is responsible for accounting for costs appropriately and for maintaining records, including supporting documentation, adequate to demonstrate that costs claimed have been incurred, are allocable to the contract, and comply with applicable cost principles in this subpart and agency supplements. The contracting officer may disallow all or part of a claimed cost that is inadequately supported."

The forgiveness of a PPP loan would meet the definition or example contemplated in FAR 31.2 as a type of credit to which the Government is entitled on flexibly priced government contracts. The next step is to determine how the credit is to be applied to those contracts. If the credit relates directly to an allowable cost chargeable to a government contract, the credit should be applied in the same manner as the cost receiving the credit was applied. For example, if the cost generating the credit was charged to the contract as a direct cost, the credit should be applied as a direct cost of the contract. Conversely, if the cost generating the credit was charged as an indirect cost, the credit should be applied to the same indirect cost pool as the cost. This conclusion is based on the FAR requirement for consistency in the way costs are allocated to contracts. A cost is allocated as a direct cost of a contract if the cost is caused by or benefits only that contract. However, if a cost is caused by or benefits more than one contract, it is to be allocated to those contracts as an indirect cost. If credits are not allocated in the same way as the cost being credited, it may result in the government not receiving the full benefit of the credit to which it is entitled or a contractor being required to provide a larger credit than is warranted.

In the case of a credit received by a contractor (i.e. loan forgiveness) which is related to any allocable cost incurred on a flexibly priced contract, such a credit must be credited back to the government. Essentially, if you are already receiving payment for costs of labor and other indirect costs such as rent, you cannot "double-dip" and receive PPP loan forgiveness and bill the government for these same expenses.

A problem with applying this concept to any credit to which the government is entitled as a result of a PPP loan forgiveness is the multiple uses that can be made of a PPP loan. In most credit situations, the credit is identified with a specific cost element such as direct labor or state taxes. However, PPP loan proceeds can be applied to several cost elements which are accounted for differently and with some cost elements being allowable and others unallowable. Obviously, this can cause some confusion as to how credits are to be computed and credited back (or returned) to the government.

This question of the interaction between PPP and the FAR was first addressed on April 17, 2020, when the Department of Defense updated its Frequently Asked Questions (FAQs) as follows:

> **Q23:** Please confirm that neither the FAR Credits provision, FAR 31.201-5, the credit provision in the Allowable Cost and Payment Clause, FAR 52.216- 7(h)(2), nor any other FAR or DFARS provision imposes an obligation on a contractor to credit any amount of [PPP] loan that is forgiven to any flexibly priced government contract or subcontract. I consider a contractor that has received a PPP loan will use the loan proceeds as it would any other funds in its corporate treasury to pay costs of doing business."
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> **A23:** I disagree, any PPP loan that has been forgiven necessarily can be treated as though it belongs to the company to use as it pleases. FAR 31.201-1, Composition of Total Cost, states that total cost is the sum of the direct and indirect costs allocable to the contract less any allocable credits. Accordingly, to the extent that PPP credits are allocable to costs allowed under a contract, the Government should receive a credit or a reduction in billing for any PPP loans or loan payments that are forgiven. Furthermore, any reimbursements, tax credits, etc. from whatever source that contractors receive for any COVID-19 Paid Leave costs should be treated in a similar manner and disclosed to the government. (Updated: April 24, 2020)

This early guidance issued by DoD, indicated that DoD had determined that when a federal contractor experiences PPP loan forgiveness, the amount of that forgiveness becomes an allowable cost credit. As an allowable cost credit, FAR credit provisions dictate that the contractor **must** give such credit back to the government. It should be noted, that by analogy benefits received from the Employee Retention Credit would require the same treatment.

Subsequent to this guidance, contractors were more confused because (a) most companies have a mix of flexibly priced and firm fixed price contracts, (b) many contractors planned to only include certain costs in forgiveness applications, and

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(c) those costs could be a mix of indirect costs and direct costs (which may have been incurred on firm fixed price contracts or commercial contracts so the credits provision does not apply to those costs incurred). In addition, many contractors applied and received PPP loans did not intend to seek forgiveness for any costs. While the impact of PPP forgiveness on Cost contracts has been addressed, the contractor community needs clarity around how to handle forgiven costs under other contract arrangements, as well as, contracts with state Department of Transportation agencies .

Almost a year after the CARES Act, agencies have issued limited guidance which contain conflicting and confusing information that many contractors are struggling to understand and practically apply.

DCAA issued guidance in the form of a Memorandum for Regional Directors – 20-PIC-006(R)-Revised on January 28, 2021. DCAA did make clear that credits should be recorded based on where the original cost was incurred. They also made clear that contractors may receive loan forgiveness that was based on costs that are not all allocable to government contracts, therefore 100% of the loan forgiveness may not be subject to the credits clause. They also provided guidance on the question of the appropriate accounting period to assign the credit. DCAA issued guidance to its auditors that a credit resulting from PPP loan forgiveness should be allocated to the accounting period in which the forgiveness is received. For most contractors, costs were incurred in 2020, but the forgiveness will be received in 2021. However, that guidance is only to be used by DCAA auditors in the conduct of contract audits. It is not binding on contractors or contracting officers. Moreover, there are at least two decisions by the Court of Federal Claims and its predecessor court that indicate a credit is to be assigned to the accounting period in which the cost being credited was incurred. For example, in *Grumman Aerospace Corp. v. U.S.,* the Court said

> Plaintiff's 1968 franchise tax costs having been reduced by a subsequent refund, defendant is contractually entitled to its proper share of that reduction computed on the basis of its 1968 reimbursement of costs.
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> * * *
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> Without regard to how GAAP and sound accounting logic might treat the refund for income tax accounting purposes, the contract language controls here.

As confusing and conflicting as this issue has been for contractors, the Employee Retention Credit, which was made available to companies who had received a PPP loan as a result of the Consolidated Appropriations Act of 2021 is sure to encounter the same type of challenges for contractors with the interaction of the FAR.

I believe much of the confusion and concern regarding guidance has come from architect and engineering (A&E) firms that do business with state Department of Transportation agencies who receive funding from the Federal Highway Administrations (FHWA), Department of Transportation. There is concern with potential draft guidance being considered by the FHWA that would require **all** PPP loan forgiveness credits to be accounted for as an indirect cost. This concern flows from the text of 23 USC §112(b)(2)(D), which states "[o]nce a firm's indirect cost rates are accepted under this paragraph, the recipient of the funds shall apply such rates for the purposes of contract estimation, negotiation, administration, reporting, and contract payment...". The concern is that accounting for any credits in this way would result in reduced indirect cost rates for the year in which the credit is applied. Further, the concern is that the reduced rates would apply throughout the life of multi-year contracts awarded in the year in which the reduced rates were established causing contractors to unfairly be subject to reduced indirect cost rates due to PPP forgiveness for multiple years. I have heard this concern in numerous blogs, trade orgs and various meetings, but FHWA has not actually issued any guidance.

As discussed above, I believe this "presumed" guidance is inconsistent with the FAR cost principles. Importantly, the cost principles of FAR Part 31 are to be used when conducting audits of contracts awarded under the authority of 23 U.S.C. §112. Title 23 of the Code of Federal Regulations Section §172.11 clarifies that the phrase "recipient of funds" as used in 23 U.S.C. §112 refers to the agency awarding a contract to the A&E firm. Moreover, I do not interpret the requirement that "contracting agencies shall apply such indirect cost rate for the purposes of contract estimation, negotiation, administration, reporting, and contract payment" as eliminating the use of business judgment in negotiating a price or fee that is fair and reasonable to both parties. Significantly, 23 CFR §172.11(b)(1)(vi) seems to allow for the indirect cost rate applied to a multi-year contract to vary from year to year when it says:

A consultants accepted indirect cost rate for its 1-year applicable accounting period shall be applied to contracts; however, once an indirect cost rate is established for a contract, it may be extended beyond the 1-year applicable period, through the duration of the specific contract, provided all concerned parties agree. Agreement to the extension of the 1-year applicable period shall not be a condition or qualification to be considered for the work or contract award.

Understandably, many A&E firms are concerned with the implications of anticipated FWHA guidance. In addition, as FWHA funds flow down to many state Department of Transportation (DoT) agencies for contract awards, the state contracts carry many of the same FAR requirements and clauses. Most state DoTs require A&E firms to have an indirect rate audit (overhead audit) conducted by a CPA firm. Our firm has expertise in these audits and performs them for many A&E firms. The guidance we have seen from many of the state DoT audit departments indicates they are still trying to get additional guidance from FHWA, but absent that, are making blanket statements to rely on existing regulations and cost accounting standards in determining credits. As a practical matter, my firm plans to apply the applicable credit (which may not be the entire PPP loan forgiveness) for forgiven indirect expenses to the overhead pool (which we believe is consistent with FAR Part 31.2), and include in the footnotes, a statement of what the overhead rate would be with and without the credit. It seems logical that A&E firms should provide credits for forgiven costs in the same manner that costs were incurred; that is, forgiven indirect costs should be credited to the indirect costs pool; forgiven direct costs should be credited to direct costs; no credit should be provided for costs that are not reimbursed by government funds in any way.

I believe there are three areas where guidance would assist government contractors, especially for A&E firms. First, standardizing the period in which the PPP loan forgiveness credit should be recorded as a credit and included in any overhead rate audit. Including this credit in the year in which the costs were incurred regardless of when forgiveness was awarded would align with both existing generally accepted accounting principles and prior court decisions. Thus, PPP forgiveness awarded in 2020 would apply to 2020 costs and 2021 forgiveness awarded prior to the issuance of 2020 overhead rate audits would likewise be included in the 2020 audit and calculated rate.

Second, I recommend that regardless of when or if forgiveness has been applied for or received, any contractor receiving PPP funds should disclose in the notes to the overhead audit statements the calculated overhead rate both with and without anticipated PPP loan forgiveness credits. This same note could also be included as information in annual Incurred Cost Submissions for companies required to submit to federal agencies who have flexibly priced contracts.

Lastly, inform procurement agencies (primarily state DoT agencies) that the rates included in overhead rate audits should be used in negotiations but that final rates can incorporate consideration of the impact of PPP forgiveness. Specifically, while the rate including PPP loan forgiveness may be used in year one of a multi-year contract, subsequent years should be renegotiated using rates that are not impacted by credits for PPP loan forgiveness.

I believe each of these recommendations align with existing generally accepted accounting principles, as well as, existing FAR guidance. Furthermore, guidance incorporating these recommendations would reduce confusion and ensure government contractors receive the benefit originally intended by the CARES Act, but not benefit government contractors more, with a potential “double dip”, than companies receiving PPP loan forgiveness who do not contract with government agencies.

Thank you for your attention. I will be glad to answer any questions that you have.

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