The Interaction Between the Paycheck Protection Program and Federal Acquisition Rules: What It Means for Government Contractors

U.S. House of Representatives Committee on Small Business,
Contracting and Infrastructure Subcommittee

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Thank you, Chairwoman Velázquez, Ranking Member Luetkemeyer, and members of the subcommittee. It is an honor to provide testimony at this hearing.

Credentials

- Partner and Co-Leader of HKA's Government Contracting practice.
- Specialize in cost accounting for government contractors, with over 35 years' experience consulting on issues arising from the Cost Principles set forth in Federal Acquisition Regulation ("FAR") Part 31 and the Cost Accounting Standards ("CAS"), as well as the contract pricing and evaluation guidance found in FAR Part 15 and oversight of subcontractors found in FAR Part 44.
- My testimony on government contract cost issues has been accepted by courts and boards across the United States.
- Frequently lecture on government contract cost accounting issues. I was an adjunct professor at the George Washington University Graduate School of Business for several years, where I taught the Pricing and Cost Issues in Government Contracts course. I am also a member of the George Washington University's Government Contracts Advisory Board.
- Currently chair the Contract Finance Committee of the National Defense Industrial Association.
- Until recently, I chaired the Audit Committee of the Capital Area Food Bank.

FAR and FAR 31 Background

The FAR is the primary set of rules used by all US Government executive agencies in their acquisition of goods and services with appropriated funds.[1] It sets uniform policies and procedures, including the terms and conditions to be used in federal contracts, which ultimately will bind federal contractors.

There are agency supplements to the FAR. For example, the Department of Defense is also governed by the Defense FAR Supplement ("DFARS"), and the Department of Transportation is governed by both the FAR and the Transportation Acquisition Regulations.

The FAR is divided in 53 parts. FAR Part 31 is dedicated to cost principles and procedures. Generally, it applies to the pricing of contracts whenever cost analysis is performed, the determination of reimbursable costs in cost-reimbursable contracts and the calculation of indirect cost rates.[2]

The composition of the total cost of a contract is essentially the sum of allowable direct and indirect costs, <u>less any allocable credits</u>.[3]

FAR 31.201-5 defines a credit as "the applicable portion of any income, rebate, allowance, or other credit relating to any allowable cost and received by or accruing to the contractor…credited to the Government either as a cost reduction or by cash refund… ." Typical examples of credits include purchase discounts, income from sale of scrap, rental income, and refunds of various state and local taxes such as franchise, personal property, and income taxes.[4]

The FAR composition of total cost and credits provisions are not new. They have been part of the cost principles since the Armed Services Procurement Regulation ("ASPR") was first published in 1948. A later version of the ASPR, known as the Defense Acquisition Regulation, was replaced by the FAR in 1984.[5]

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[1] *See* FAR, "Foreword," available at: https://www.acquisition.gov/sites/default/files/current/far/pdf/FAR.pdf. *See also* FAR 1.000-1.101.

[2] *See* FAR 31.100- 31.110.

[3] FAR 31.201-1 (Composition of total cost).

[4] DCAA Contract Audit Manual Section 6-608.2(d)(5) (Miscellaneous Income and Credits).

[5] *See* Manos, Government Contract Costs & Pricing (2nd Edition, 2009) at 13 and 173.

Contract Types

There are many different types of contracts. As stated in FAR 16.101(b), "[t]he contract types are grouped into two broad categories: fixed-price contracts … and cost-reimbursement contracts… ."

On **cost-reimbursement contracts**, the amount paid to the contractor depends primarily on the allowable costs incurred by the contractor.[6] If the contractor incurs $1,000 in allowable costs, generally speaking, the contractor is reimbursed $1,000 plus some amount of fee, which is not addressed here. Any event that reduces the allowable costs incurred on a contract (including a credit) will reduce the amount reimbursed under a typical cost-reimbursement contract.

A **fixed-price contract** generally provides "for a price that is *not* subject to any adjustment on the basis of the contractor's cost experience... ."[7] In fixed-price contracts, the invoicing and payment provisions generally focus on the contractor demonstrating that it provided some contractually specified product or service, and requesting payment of the predetermined price for the delivered product or service. Events that reduce the allowable costs incurred on a contract (including a FAR 31.201-5 credit), will not reduce the amount reimbursed under a typical fixed-price contract.

A credit which reduces the contractor's allowable costs incurred reduces the amount paid to the contractor on a cost-reimbursement contract, *but not on a fixed-price contract*.

The impact, if any, of a credit associated with a PPP loan will depend on how the PPP loan funds were spent by the company. Any credit associated with PPP loan forgiveness should apply to contract costs in the same manner in which the PPP loan funds were originally spent by the contractor. For example, if a portion of the forgiven PPP loan was used to pay facility rent, the cost of facility rent should be credited. If that rent is part of an indirect cost pool, then the indirect cost pool would be reduced by the credit. If instead, a business used the PPP loan to pay its employees for work performed for commercial customers, the labor cost accounts associated with those commercial contracts would be credited.[8]

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[6] FAR 16.301-1.

[7] FAR 16.202-1 (Firm-fixed-price contracts, Description) (emphasis added).

[8] *See* e.g., DCAA Memorandum for Regional Directors dated 11 December 2020 with SUBJECT: "Audit Alert on Coronavirus Legislations and Regulations".

PPP Loan Example

Contractor A works solely with the Federal Government, and holds only firm-fixed-price contracts. Contractor A had a PPP loan worth $1,000,000 forgiven in 2020. There would be no repayment to the Government for any of the forgiven loan because FAR Part 31 does not apply to any of Contractor A's contracts.

Contractor B works solely with the Federal Government, and holds only cost-reimbursement contracts. Contractor B had a PPP loan worth $1,000,000 forgiven in 2020. At the time the loan was forgiven, Contractor B would repay the Government for the forgiven loan because FAR Part 31, and therefore the credits provision of FAR Part 31, applies to Contractor B's contracts.

Because of the application of FAR Part 31 to Contractor B's contracts and not Contractor A's contracts, Contractor A would experience an increase in cash of $1,000,000 in comparison to Contractor B, due to the forgiveness of the PPP loan.[9]

Direct and Indirect Costs

Costs can be segregated into direct and indirect cost classifications. The costs incurred on each contract include both direct and indirect costs. These terms are defined in the FAR.

"*Direct cost* means any cost that is identified specifically with a particular final cost objective. Direct costs are not limited to items that are incorporated in the end product as material or labor. *Costs identified specifically with a contract are direct costs of that contract*… ."[10]

"*Indirect cost* means any cost not directly identified with a single final cost objective, but identified with two or more final cost objectives or with at least one intermediate cost objective."[11] Contracts are typically final cost objectives. Indirect costs are typically accumulated into "pools" and allocated to "base" costs which the indirect costs were incurred for the benefit of, or which caused the indirect cost to be incurred.[12]

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[9] For purposes of simplicity, the impact of taxes has not been considered in this illustration.

[10] FAR Part 2 (Definitions of Words and Terms) (emphasis added).

[11] FAR Part 2 (Definitions of Words and Terms).

[12] *See,* e.g., 48 CFR § 9904.418-40 [Cost Accounting Standard 418] - Fundamental requirements. ("Pooled [indirect] costs shall be allocated to cost objectives in reasonable proportion to the beneficial or causal relationship of the pooled costs to cost objectives …")

"*Indirect cost rate* means the percentage or dollar factor that expresses the ratio of indirect expense incurred in a given period to direct labor cost, manufacturing cost, or another appropriate base for the same period (see also "final indirect cost rate")."[13]

General and administrative expense ("G&A") is a typical indirect cost. G&A costs normally include costs associated with running the business, such as costs for back-office functions (e.g., accounting and human resources) and C-level executives. In many companies, G&A is pooled and allocated to all other company costs (i.e., all costs other than G&A) on an annual basis. For example, if a company incurred G&A costs of $1 million in 2020, and all other costs incurred at the company were $50 million, the G&A rate would be 2% (i.e., $1M / $50M = 2%). For every dollar of non-G&A company costs, 2 cents would be added for G&A.

For any years that have already passed, a company can determine all of the direct and indirect costs which were incurred. After these costs are audited by the government, and the company and the government negotiate a final settlement, the parties agree to final indirect cost rates for each past year.[14]

<u>Forward Pricing Rates</u>

For years which are not yet completed (as 2021 is now), and for years which have not yet commenced, government contractors often develop estimates of the total amount of indirect and direct costs that will be incurred over the course of a year, so that the indirect cost rates for each uncompleted year can be estimated. The indirect cost rate estimates developed for future years are often referred to as forward pricing rates. These rates are used in the development of proposals for work in future years.

It should not be assumed that indirect rates in future years will exactly match the indirect rate in some prior year (e.g., non-recurring events, such as a PPP loan forgiven in a past year, should be analyzed when estimating indirect rates for future years).[15]

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[13] FAR Part 2 (Definitions of Words and Terms).

[14] FAR Part 2 (Definitions of Words and Terms) (*"Final indirect cost rate* means the indirect cost rate established and agreed upon by the Government and the contractor as not subject to change. It is usually established after the close of the contractor's fiscal year …").

[15] *See* e.g., DCAA Contract Audit Manual, section 9-702.2 ("Evaluation of indirect cost estimates requires consideration of anticipated future operations of a contractor. To determine what may be reasonably expected to occur, the auditor should utilize analyses and projections of historical cost patterns and related data. … <u>It should not be assumed that historical cost patterns and the results of overhead audits for prior years will continue without change</u>; the auditor must consider contemplated changes which may influence the projections. …" [emphasis added])

Example Illustrating Impact of a Credit on Forward Pricing Rates

The Contractor incurred G&A costs of $1 million in 2020. In the same year, the Contractor was forgiven a PPP loan of $100,000, and processed an associated credit which reduced its 2020 G&A pool from $1 million to $900,000. The Contractor calculated its G&A rate for 2020 as 1.8% (i.e., $900,000 / $50M), and based solely on its 2020 cost information, erroneously forecasted its G&A rate to be exactly the same for 2021 through 2024. (This approach would be erroneous, unless the Contractor believes and can support that its G&A costs will likely be $900,000, and its other costs will be $50 million in each forecasted year from 2021 to 2024. This level of stability is very rare of in my experience.)

The Contractor develops a proposal for a fixed-price contract assuming its contract costs will be $1 million in each year from 2021 to 2024, and adds 1.8% for G&A to arrive at a proposed contract cost of $1,018,000 (i.e., $1M + ($1M x 1.8%)) for each year from 2021 to 2024. The Contractor is awarded the fixed-price contract, and later experiences a G&A rate of 2% each year instead of 1.8%.

Because the Contractor understated its G&A rate in its proposal, and the contract was fixed-price, the Contractor incurs higher costs and lower profits on the fixed-price contract. Under the same circumstances, except that the Contractor was awarded a cost-reimbursement contract, the Contractor would bill and be reimbursed the higher G&A rates in 2021 through 2024.

FAR 31 Allowability Provisions

It is a basic principle of government contracting that not every cost a contractor incurs will necessarily be reimbursed. For a cost to be reimbursed under FAR Part 31, the cost must be allowable.

FAR 31.201-2 sets forth specific conditions under which costs are allowable for reimbursement. "A cost is allowable only when the cost complies with all of the following requirements: (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 this subpart."[16]

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[16] FAR 31.201-2 (Determining allowability).

A cost is considered "reasonable" if "it does not exceed that which would be incurred by a prudent person in the conduct of competitive business", and is thereby "recognized as ordinary and necessary for the conduct of the contractor's business."[17]

A cost is considered "allocable" if it is "incurred specifically for the contract," "[b]enefits both the contract and other work…and can be distributed to them in reasonable proportion to the benefits received", or "[i]s necessary to the overall operation of the business."[18] Similar to direct and indirect costs, credits must be allocable to the cost objective to which the credit is assigned.

The "standards promulgated by the CAS [Cost Accounting Standards] Board" only apply to contracts and subcontracts which meet certain criteria, of which size is one example. The CAS typically only apply to larger cost-reimbursement contracts or larger fixed-price contracts for which the prices were negotiated based on cost estimates shared with the government buyer. When the standards promulgated by the CAS Board do not apply to a contract, the allowability requirements default to "generally accepted accounting principles and practices appropriate to the circumstances." Companies who prepare audited financial statements (e.g., all public companies and many private companies) are subject to generally accepted accounting principles and practices appropriate to the circumstances.

"Terms of the contract" typically include other terms and conditions relating to the measurement, assignment or allocation of cost. In some instances, the terms of the contract impose requirements that go beyond those in FAR Part 31.

"Any limitations set forth in this subpart" is where the cost principles under FAR 31.205 come into play.

[17] FAR 31.201-3 (Determining reasonableness).

[18] FAR 31.201-4 (Determining allocability)