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Preparing for the Coming Onslaught of Government Investigations and Audits of COVID-19 Relief Funds and Contracting—Part II

*By Merle M. DeLancey Jr., Craig Stetson, and Jennifer A. Short**

This is the second in a series of articles concerning the audits and investigations related to the contracts and grants awarded, and relief funds provided, in response to the COVID-19 pandemic. This article first discusses the Defense Contract Audit Agency's current direction, interests, and initiatives related to contractors' receipt of COVID-19 relief funds and the impact an uncertain business environment may have on government contract pricing and costing forecasts. It then reviews audits and investigations involving Paycheck Protection Program loans.

The first article in this series discussed the enforcers and the likely categories of programs, contracts, and companies the government might investigate or audit related to COVID-19. This article first discusses the current direction, interests, and initiatives of the Defense Contract Audit Agency (“DCAA”) related to contractors’ receipt of COVID-19 relief funds and the impact an uncertain business environment may have on government contract pricing and costing forecasts.¹ Then, this article explores audits and investigations involving Paycheck Protection Program loans.²

COVID-19 RELIEF FUNDS

The Coronavirus Aid, Relief, and Economic Security Act (“CARES Act”) funding opportunities come with unique government contract compliance requirements and financial reporting obligations. The funding is not “free” and may result in financial consequences to unwary contractors. DCAA knows this and will be conducting audits to test contractors’ compliance with unique relief fund requirements. Contractors unaware of these accounting and reporting requirements risk DCAA questioning or denying costs.

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¹ This section was prepared by Merle M. DeLancey Jr. and Craig Stetson.

² This section was prepared by Merle M. DeLancey Jr., Craig Stetson, and Jennifer A. Short.

In January 2021, DCAA issued an audit alert to its regional offices pertaining to COVID-19 relief legislation and regulation.³ The audit alert includes frequently asked questions and answers (“FAQs”) concerning contractors’ request or receipt of COVID-19 relief funding. Originally released last summer, the FAQs have been revised and expanded several times. The FAQs telegraph DCAA’s position on various instances where COVID-19 relief funding intersects with or impacts government contract cost accounting and compliance.

It is clear that COVID-19-related audit procedures will now be included in routine annual incurred cost proposal audits. Contractors are contractually required to submit to the DCAA incurred cost proposals in conjunction with performance under cost reimbursement contracts.

Specifically, two COVID-19-related funding opportunities will be included in DCAA incurred cost proposal audits: (i) loans received and forgiven under the Paycheck Protection Program (“PPP”),⁴ and (ii) reimbursements sought under Section 3610 of the CARES Act.

Forgiven PPP Loans

The Department of Defense and DCAA consider forgiven PPP loans to be credits under Federal Acquisition Regulation (“FAR”) 31.201-5, Credits. Thus, some or all of the forgiven amount may be due the government in the form of a cost reduction or cash refund if the loan proceeds were used to pay a contractor’s incurred allowable costs that were reimbursed by the government under a flexibly-priced contract.

DCAA will likely inquire about contractors’ PPP loan status when conducting incurred cost proposal audits. If the loan has been forgiven, a contractor will need to demonstrate how the loan proceeds were used and if any of the costs paid with the proceeds are allocable to flexibly-priced government contracts. If use of the proceeds aligns with costs allocable to a government contract, DCAA may question the costs in its audit report and recommend reimbursement to the government. A contractor would then be required to agree or not with the DCAA audit findings and negotiate a resolution and settlement with its contracting officer. Contractors need to be aware and able to demonstrate the use of these funds to determine if the government is due potential credits under applicable contracts.

³ See MRD 20-PIC-006(R). A revised guidance is *available at* [https://www.dcaa.mil/Portals/88/Documents/Guidance/MRDs/REVISED%2020-PIC-006\(R\)%20Revised%20Audit%20Alert%20on%20Coronavirus%20Legislation%20and%20Regulations_1.pdf?ver=JVxkE84cTWGnZQLDAbAUdQ%3d%3d](https://www.dcaa.mil/Portals/88/Documents/Guidance/MRDs/REVISED%2020-PIC-006(R)%20Revised%20Audit%20Alert%20on%20Coronavirus%20Legislation%20and%20Regulations_1.pdf?ver=JVxkE84cTWGnZQLDAbAUdQ%3d%3d).

⁴ Contractors are eligible to receive PPP loans only if certain small business size standards are met; conversely, large businesses should not have received any PPP loans.

Section 3610 Reimbursement Requests

Contractors may seek reimbursement under Section 3610 of the CARES Act for costs incurred related to paid time off for employees who could not report to work or work on a remote basis. Typically, contractors will seek reimbursement through a request for equitable adjustment (“REA”). When seeking reimbursement under Section 3610, a contractor will need to report these costs and potential REAs in its annual incurred cost proposal. The form in which these costs are to be reported is not discretely defined and is subject to discussion and agreement with the contracting officer.

DCAA likely will ask questions regarding the REA and request explanation and documentation to determine if these costs have been accumulated and accounted for in accordance with the government’s extensive proposal submission and cost accounting requirements. DCAA will likely delve into the:

- Contracting officer’s initial determination of the contractor’s “affected contractor” status;
- Discrete capture of specific costs and separate contract line item reporting;
- Comprehensive rationale and clear entitlement arguments regarding the paid leave situation;
- Various representations regarding notification to the government if credits are received in the future; and
- Review and opinion on the adequacy and compliance of REAs received from subcontractors.

These are simply examples; other reporting requirements exist and may be the subject of audit procedures performed by DCAA.

Contractors seeking reimbursement under Section 3610, whether related to fixed-price or cost reimbursement contracts, need to understand the reporting and accounting requirements. The first step to a favorable settlement with the government is a successful DCAA audit. The government has wide discretion to pay costs claimed under Section 3610 but it is not mandated to pay anything.

Be proactive, communicate with your contracting officer and DCAA frequently. Thoroughly document all aspects of DCAA’s requests and maintain contemporaneous, clear, and proper supporting documentation to maximize the likelihood of favorable settlement.

PRICING AND COSTING FORECASTS

DCAA will also be looking at forward pricing proposals or other similar arrangements to determine if revisions to these forecasts may be recommended

due to a variety of circumstances arising from COVID-19. Examples of COVID-19-related factors that may impact financial forecasts include fluctuating sales volumes due to changes in customer demands, employee headcount and availability of resources, changes in overall budgets and spending patterns and ongoing disruptions in general related to as-planned performance and execution of contracts.

The results of a DCAA audit of forward-looking financial models may lead to contracting officer requests for contractors to revise pending proposals or renegotiate existing agreements to incorporate the estimated financial effects of the current and short-term business environment.

Outstanding price proposals subject to the submission of certified cost or pricing data should be reviewed to determine if applicable disclosures to the government are required to avoid or mitigate defective pricing risks.

The ultimate effect of these types of DCAA audits will not likely result in the questioning or denial of incurred costs; rather, the more likely result will be a change in the estimate of future costs.

PAYCHECK PROTECTION PROGRAM AUDITS ARE UPON US—BORROWERS PREPARE!

Having discussed above how the acceptance, use, and forgiveness of PPP loans can be viewed in the context of a DCAA audit, this article now focuses on audits and investigations involving PPP loans. Close scrutiny of PPP loans is not a prediction; it is reality. The Small Business Administration (“SBA”) has announced it will audit all PPP loans in excess of two million dollars following a lender’s submission of a borrower’s loan forgiveness application, and it reserves the right to “spot check” any PPP loan of a lesser amount at its discretion. The U.S. Department of Justice already has charged multiple individuals with PPP fraud. And this is just the beginning of what many think will be a tidal wave of enforcement activity involving PPP loans.

Overview of the PPP

The PPP is the largest relief measure for small businesses under the CARES Act. The government has made available nearly one trillion dollars in PPP relief funds through four separate funding measures (\$349 billion via the CARES Act; \$310 billion via the PPP and Health Care Enhancement Act; \$284 billion via the Consolidated Appropriations Act of 2021; and \$7.25 billion via American Rescue Plan Act of 2021).

The PPP makes available guaranteed SBA loans to small business that meet certain eligibility requirements. In addition, PPP loans can be forgiven fully if used properly to cover specified business expenses such as payroll, rent, utilities,

mortgage interest, and other limited uses. As of April 11, 2021, the SBA had approved more than 9.5 million loans totaling more than \$755 billion using more than 5,400 lenders.

PPP Loan Recipients Are Ripe for Audit

The SBA Office of Inspector General (“SBA-OIG”) and the Government Accountability Office (“GAO”) have flagged PPP loans as fertile hunting ground for fraud.

First, because the loans are fully guaranteed by the government, lenders may exercise less diligence in originating the loans.

Second, the unprecedented volume of loans, lenders, and loan amounts makes monitoring extremely difficult.

Third, the speed at which PPP loans were processed and approved made it more difficult for lenders and the SBA to identify red flags in loan applications. All of these factors suggest an increased potential for fraud.

GAO has been sounding the alarm about PPP loan risk for nearly a year, echoing the SBA-OIG’s concerns. GAO included the PPP on its latest “High Risk List” as a troubled federal government program in need of significant improvement. Since June 2020, GAO has recommended that SBA develop and implement plans to identify and respond to risks in the PPP to address possible fraud. Those recommendations extend to loans of less than two million dollars, which rely on borrowers’ self-certifications, leaving the PPP vulnerable to exploitation.

Areas Auditors and Investigators Likely Will Scrutinize

With that background, there are numerous areas on which PPP auditors and investigators are likely to focus, including whether borrowers met all of the PPP loan eligibility requirements. PPP applicants need to be careful in making the multiple certifications required to obtain a loan.

Some eligibility requirements have changed from Round 1 (First Draw), Round 2 (Second Draw), and Round 3 of PPP funding. The good news is that many eligibility requirements were eased. For example, Round 3 expanded lending to some who were previously precluded from applying, including: small business owners with non-fraud related felonies, those with delinquent federal student loans, and non-citizen lawful U.S. residents.

Even so, applicants need to be mindful of the program requirements and exclusions so as to avoid making false statements or certifications.

Some eligibility requirements are objective and easily tested by auditors or negotiators. For example:

- Having 500 or fewer employees to be eligible for Round 1 funds (lowered to 300 or fewer employees for Round 2 loans);
- The business has been in operation since February 15, 2020, and has not permanently closed;
- The company has not filed for bankruptcy protection; and
- The applicant does not have other pending PPP loans, or has not received duplicative PPP loans.

Other eligibility requirements are more subjective in nature. For example, an applicant's certification that the "uncertainty of current economic conditions" makes the loans "necessary" was the subject of much debate last year, when businesses that reportedly had access to other lines of capital were able to obtain large PPP loans. The SBA announced that it will be reviewing loans of two million dollars and more to assess whether this certification was made in good faith at the time borrower applied for a PPP loan. But, at the end of the day, SBA officials admit that this certification is largely subjective. Time will tell whether the agency takes action to demand loan repayment based on this certification requirement.

Finally, remember: in addition to the PPP-specific eligibility and certification requirements, the usual SBA rules regarding small business status and affiliation also apply.

Enforcement

Thus far, U.S. Department of Justice ("DOJ") and SBA-OIG enforcement actions involving the PPP have focused on low-hanging fruit, where loan applicants have patently lied on their applications (e.g., inflating payroll expenses or applying on behalf of companies that do not exist) or used PPP proceeds for improper purposes (e.g., purchasing real estate, cars, and luxury items). In some cases, applicants resorted to submitting fake tax records, creating "dummy" payroll and business income records, and stealing personal identification information from unsuspecting victims.

Over time, auditors and investigators will likely use more sophisticated methods to identify fraudulent PPP activity. DOJ has said that it is using data analytics to identify redundant personally identifiable information across multiple PPP applications, to flag inconsistencies between PPP applications and data in other government databases, and to identify the repeated use of information across applications such as identical supporting documents and bank accounts.

To date, more than 120 defendants have been charged with criminal offenses related to the PPP program. As of December 2020, DOJ had initiated 66

criminal fraud investigations involving over \$250 million in PPP loans. DOJ has charged unscrupulous borrowers with a range of offenses, including bank fraud, wire fraud, false statements, false claims, and money laundering.

In addition to potential criminal liability, DOJ has signaled its willingness to pursue civil penalties against those who manipulate or misuse the PPP. The first civil settlement of an alleged PPP fraud was announced in January 2021. That case involved a borrower who misreported its bankruptcy status on its PPP loan applications, but subsequently disclosed the error—and returned the \$350,000 in loan proceeds. Nonetheless, the government pursued claims under the False Claims Act (“FCA”) and the Financial Institutions Reform, Recovery, and Enforcement Act (“FIRREA”), asserting that the borrower faced legal exposure under those statutes of more than four million dollars.

PPP Whistleblower Complaints

In addition to enforcement efforts initiated through government oversight, private citizen whistleblowers are another likely source of enforcement activity. In the fall of 2020, SBA-OIG reported that it had received 42 times the number of calls to its fraud hotline compared to the previous year. The FCA allows whistleblowers to file lawsuits on behalf of the United States against those who allegedly have engaged in fraud against the government. Those cases are filed under seal while DOJ investigates whether and how to proceed.

Anecdotal information from attorneys who regularly represent whistleblowers and the DOJ attorneys who handle these investigations suggests that a fair number of the FCA cases filed in the last year relate to COVID-relief programs, including the PPP.

Companies Should Prepare Now to Mitigate Risk

Companies that have received, or might apply for, a PPP loan can take several steps now to prepare for a potential government audit, review, investigation, or enforcement action:

1. Document, Maintain, and Organize Relevant Records

If not already done, companies should collect and organize the information necessary to defend a government audit or investigation of its PPP loan. Such information includes:

- *Records supporting a company's determination that the loan is necessary to support the company's ongoing business operations.* Additional eligibility requirements were created under the Economic Aid Act for second-draw PPP loans, including the 25 percent revenue decline test. Documenting a company's reasonable and good faith judgments in connection with its represen-

tations and certifications in loan applications can help reduce exposure.

- *E-mails and other communications with lenders.* These communications may help establish a company's state of mind and demonstrate that it acted in good faith. Companies should be aware of the eligibility and certification requirements that were in effect at the time they submitted their PPP loan application and forgiveness application, and be able to explain their understanding of any ambiguous or conflicting instructions.
- *Records of how any received funds are used.* Best practices would segregate PPP loan proceeds into a separate account or accounting categories so the company can easily demonstrate that the funds were applied to appropriate, covered expenses.

2. Monitor Corporate Spending of PPP Loan Proceeds

Companies should be mindful of all corporate activity after receiving any federal assistance. Following the financial crisis of 2007–2008, several firms that received federal assistance came under scrutiny for throwing “lavish” parties and other activities. Company spending, pay increases, outsourcing, and other activities will all be closely scrutinized.

PPP loans are intended to assist businesses in covering specific categories of expenses during the COVID-19 crisis. While segregation of funds is not required by the SBA regulations or guidance, as a best practice, companies should separate their PPP loan proceeds either by account or category, and be able to trace how and when those funds were used for the designated business expenses.

3. Treat Your PPP Loan Like a Government Contract (Because It Is)

Companies should document any government modifications or waivers of requirements and ensure they are authorized in writing by a government official or agency with sufficient authority to act. Have effective reporting systems in place to receive notice of potential compliance issues and then investigate them appropriately. Put in place mechanisms to implement any new guidance issued by the government (such as the SBA's guidance related to the forgiveness of PPP loans related to payroll and non-payroll expenses). A robust compliance program is a crucial part of preparing for and responding to any government scrutiny of the receipt and use of government funds.

CONCLUSION

Notwithstanding all of the activity around the PPP over the last year, audit and enforcement activity is in its infancy and the government's approach is evolving. For example, while the SBA has said that, if it reviews a PPP loan and finds that the borrower was ineligible based on its necessity certification, it will not refer the matter for enforcement if the borrower repays the loan. On the other hand, even where a borrower paid back a loan in full, DOJ still pursued FIRREA and FCA penalties.

Because so much uncertainty still exists, diligent borrowers are advised to remain vigilant about creating and maintaining contemporaneous notes and records that can assist in responding to any government audit or inquiry that may be on the horizon.