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Coronavirus Update

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Borrower's Accounting for Paycheck Protection Program Loans

Background

On March 27, 2020, President Trump signed into law the Coronavirus Aid, Relief, and Economic Security (CARES) Act, which provides relief to taxpayers affected by the novel coronavirus (COVID-19). The CARES Act provides opportunities for certain businesses to receive emergency grants and loans to pay qualifying expenses. Grants do not need to be repaid and certain loans can be forgiven if specified conditions are met. In addition, President Trump signed into law the Paycheck Protection Program and Health Care Enhancement Act on April 24, 2020, which increased funding provided by the CARES Act.
The Paycheck Protection Program ("PPP") authorized two rounds of up to $660 billion in federally guaranteed forgivable loans to qualifying small businesses to pay their employees during the COVID-19 crisis. On June 5, 2020 the Paycheck Protection Program Flexibility Act was signed into law and extended the program until December 31, 2020.

Eligibility

Small businesses may apply for these loans if they either:

- Employ no more than 500 employees, or
- Are a business in an industry that has an employee-based size standard established by the Small Business Administration (SBA) that is higher than 500 employees.

Eligible small businesses can borrow an amount equal to 250% of their average monthly payroll expenses incurred during the year prior to the loan date, up to a total of $10 million. The loan is due in five years and carries a 1% fixed interest rate. Loan payments will be deferred until the date on which the amount of forgiveness determined under the CARES ACT is remitted to the lender. The borrower must apply for forgiveness within 10 months after the last day of the covered period. No collateral or personal guarantees are required.

Borrowers are eligible for loan forgiveness equal to the amount they spend on the following items during the 24-week period beginning on the loan origination date:

- Payroll costs, including benefits
- Interest on mortgage obligations entered into before February 15, 2020
- Rent, under lease agreements in force before February 15, 2020
- Utilities, for which service began before February 15, 2020.

The portion of payroll costs associated with wages are capped at $100,000 on an annualized basis for each employee and at least 60% of the forgiven amount must be used for payroll costs, including benefits. Entities should remain alert to potential changes in this program, such as the payroll calculations associated with the loan forgiveness

The forgivable amount is reduced if:

- The employer decreases full-time employee (FTE) headcount
- The employer decreases salaries and wages by more than 25% for any employee that has made less than $100,000 (annualized) in 2019
- The employer does not restore full-time employment and salary levels for any changes made between February 15, 2020 and April 26, 2020.

The Paycheck Protection Program Flexibility Act of 2020 provides an exemption from the FTE maintenance requirement for companies who are able to document inability to rehire similarly qualified employees or are unable to return to same levels of business activity due to compliance requirements established by the Secretary of Health and Human Services.

Certification of Eligibility

While the PPP is intended to assist small entities, some large companies, including public companies with access to other capital, have applied and received PPP loans. Subsequently, U.S. Secretary of the Treasury Steven Mnuchin announced that relief loans over $2 million will be subject to audit by the SBA to ensure they were eligible and advised large entities with access to capital to refrain from applying for this assistance. In addition, the SBA has published guidelines about certification of the PPP loans.

Upon application, borrowers must certify in good faith that they were affected by the pandemic and that current economic uncertainty makes the PPP loan request necessary to support their ongoing operations. Borrowers are not required to demonstrate that they are unable to obtain credit elsewhere, however the certification must consider the borrower's current business activity and its ability to access other resources of liquidity sufficient to support ongoing operations. As a safe harbor for SBA's review, loans with an original principal amount of less than $2 million are deemed to have appropriately made the required certification. This is because borrowers with loans below this threshold are generally less likely to have had access to adequate sources of liquidity in the current economic environment than borrowers that obtained larger loans.

Accounting Treatment

There are no specific US GAAP standards on accounting by business entities for government assistance. Therefore, in order to determine the relevant accounting treatment, entities should analyze the nature and form of the assistance as well as the related conditions required to be met.

ASC 105, Generally Accepted Accounting Principles, states that if the guidance for a transaction or event is not specified within a source of authoritative GAAP for that entity, an entity shall first consider accounting principles for similar transactions or events within a source of authoritative GAAP for that entity and then consider nonauthoritative guidance from other sources.

The following guidance is included in US GAAP:

- ASC 470 – guidance on accounting for debt
- ASC 740 – guidance about tax credits that are based on taxable income
- ASC 958-605 - contribution accounting by not-for-profit entities. This guidance excludes from its scope transfers of assets from a government entity to business entities.

PPP loans are not in the scope of ASC 740, Income Taxes or ASC 958-605, Not-for-Profit Entities—Revenue Recognition for business entities. In contrast to business entities, ASC 958-605 applies to government grants received by not-for-profit entities. Therefore, no analogy to IAS 20 would be made by NFPs.

As PPP loans are considered legal-form debt, it is appropriate to account for them as such under ASC 470, Debt. Under this model, the liability would only be derecognized upon repayment to the creditor or upon legal release under ASC 405-20, Extinguishments of Liabilities. In this context, we note some entities may repay the PPP loan at the end of five years upon maturity, or earlier because they have reconsidered their eligibility. In those cases, debt accounting must be applied.

In contrast, other entities intend to apply for debt forgiveness. In that scenario, the entity could still elect to account for the PPP loan as debt pursuant to the guidance in ASC 470. However, legal release would only occur upon confirmation of forgiveness from the SBA under ASC 405-20-40-1(b). Such forgiveness would be presented as a non-cash financing activity on the statement of cash flows. Further, interest imputation does not apply to this government loan program under ASC 835-30-15-3(e), even if the interest rate being charged is deemed to be below market.

Alternatively, it may be acceptable in limited circumstances to analogize to IAS 20, Accounting for Government Grants and Disclosure of Government Assistance. This analogy is only acceptable if:

1. The entity met the eligibility requirements to participate in the PPP, which may require legal analysis. As noted above, entities with loans under the $2 million safe harbor may be eligible, absent evidence to the contrary.
2. At inception, it is probable the borrower will qualify for forgiveness. In practice, “probable” is commonly understood to mean 75% - 80% likely to occur.

Under an analogy to IAS 20, a deferred income liability would be recognized upon receipt of the forgivable loan if at the time of receiving the loan the entity has determined that it is probable that it would meet the conditions for forgiveness, i.e., the loan will be used to pay for qualifying salaries, rent, mortgage interest, and utilities. Similarly, no interest would be accrued due to the expectation of forgiveness.

The deferred income liability would be derecognized on a systematic basis over the periods in which the entity incurs the related expenses (e.g., payroll). That is, the deferred income would be recognized in the income statement as qualified expenses are paid and presented as either (1) other income or (2) a reduction of the related expenses. This approach will result in the recognition of the proceeds as a grant for the amount expected to be forgiven prior to legal release; the remainder (if any) would be recognized as a loan consistent with ASC 470 and derecognized upon repayment or legal release in accordance with ASC 405-20.

On the cash flow statement, grant proceeds expected to be forgiven would generally be classified within the operating section since they relate to operating costs such as payroll, rent and utilities.

Disclosure

All reporting entities should disclose the applicable accounting policy in the footnotes and where the loan amounts are presented in the financial statements.

In addition, SEC registrants should provide appropriate disclosures throughout their filings. Specifically, a risk factor may be appropriate to address eligibility considerations for the PPP loans as well as uncertainties about forgiveness. MD&A liquidity disclosures should discuss the borrower's intent and ability to repay the loan. When a registrant's operations are only viable due to the receipt of the PPP loan, that fact should also be disclosed.