

ESOPs is clearly reflected on financial statements as such.”

However, POGO characterized its opinion that contractors should be required to account for ESOP costs using SOP 93-6, as “tentative.” POGO stated:

POGO is pleased to see that the Board is addressing an important Government contract accounting topic. This may be an area where the use of GAAP is appropriate; something we understand that some Government contractors have urged upon the Board for some time (although apparently not with respect to ESOPs). We would strongly recommend that the CAS Board, whatever its ultimate decision, consider the need to promote greater uniformity among Government contractors in this area, and to place greater importance on the financial implications for taxpayers, rather than those of contractors.

Response: The CAS Board recognizes that there are instances when GAAP is not appropriate for measuring costs on Government contracts. This is due, in part, to significant differences between the objectives of CAS and those of GAAP. CAS seeks to promote consistency and uniformity in the measurement, assignment and allocation of costs on Government contracts, while the broad objectives of GAAP relate to the fair presentation of income, cash flows, assets, liabilities and stockholders’ equity in financial statements. GAAP does not embrace the CAS concern for appropriate accumulation and estimating of costs to specific cost objectives. The CAS Board believes that ESOPs are an instance where GAAP would be inappropriate for determining costs on Government contracts for the following reasons:

1. For contract costing purposes, the Government recognizes and reimburses a contractor’s actual costs, as defined at 48 CFR 9904.401-30(a)(2). As stated in the May 1992 CASB “Restatement of Objectives, Policies and Concepts” (57 FR 31036), the Standards are intended to “provide criteria for the allocation to cost objectives of the costs of resources used.” In the case of ESOPs, the costs of resources used are the amount of the company’s contribution to the ESOP. The contribution represents the contractor’s actual total costs to acquire shares that are awarded to employees; that is, the amount of contractor resources used to provide the deferred compensation to the employee. The value of the stock at distribution to employee accounts generally does not reflect a contractor’s actual costs.

2. The cost for a leveraged ESOP measured using GAAP changes from period to period based on fluctuations in stock prices. The Government should

not share in fluctuations of stock prices, whether up or down, that occur during the period between the time when an ESOP trust originally acquires shares and when those shares are distributed to employee accounts. The policy that the Government should not participate in the fluctuation of stock prices is already embodied in CAS 9904.415 related to stock options. The Preamble to CAS 9904.415, states:

If the market price of the stock on the date of distribution is used, the Government, in effect, would be sharing in financial risk taking with the contractor. Subsequent fluctuations of the price of the stock should not influence the measurement of the award.

3. Congressional intent is to encourage the use of ESOPs. However, if the measurement date prescribed by GAAP were used for Government contracting purposes, it would significantly limit the use of leveraged ESOPs by Government contractors, particularly contractors whose stock is not widely traded. Government contractors could still use ESOPs, but would potentially suffer from financial disadvantages if leveraging caused a material effect on a company’s debt to equity ratio. Often the establishment of a leveraged ESOP adversely affects a company’s debt to equity ratio since the value of the company’s stock may drop significantly after the leveraged ESOP is established due to the ESOP debt recognized on a contractor’s books. Over a period of time, as the debt is paid off, the value of the stock can be expected to return to pre-ESOP levels. In the commercial marketplace, where the price a company receives for its product is not totally based on actual costs incurred, the company does not necessarily have to reduce the price of its products to reflect smaller deferred compensation awards resulting from the drop in stock value. This is not the case with Government cost-based contracting, since the contractor is only reimbursed for its actual costs incurred.

If GAAP were to be adopted for measuring the cost of a leveraged ESOP, the fair value of stock would become the basis for reimbursement of ESOP costs under Government contracts. Since the fair value of stock of Government contractors, whose stock is not widely traded, is lower after the initiation of a leveraged ESOP, the use of GAAP measurement requirements would impair those Government contractors’ ability to recover sufficient monies to cover the debt payment of the leveraged ESOP.

The CAS Board notes there was consensus among the respondents to its SDP that the cost of ESOPs should be

measured as the amount of the contractor’s total contribution.

Question 2

Do you believe that distinguishing between “pension” and “deferred compensation” ESOP type is useful in the Government contract costing environment and that this feature should be included in any future CAS promulgation on this topic? Please include the rationale for your answer to this question.

Comments: With one exception (the DOD Inspector General), all commenters agreed that the distinction between “pension” and “deferred compensation” ESOPs serves no useful purpose. They described such distinction as either irrelevant, confusing, meaningless, artificial, specious or not useful. McDermott, Will & Emery described the relevance of the distinction as follows:

ESOP companies are currently able to pick and choose whether they are better off being pension ESOPs or deferred compensation ESOPs by merely including or not including a meaningless provision in their plan documents offering participants distribution in the form of a life annuity. In practice, virtually no participants ever want a distribution in this form; and if they do, they are better off taking a lump sum distribution and purchasing their own annuity to fit their own needs than accepting the “one size fits all” annuity that the plan would provide. Whether this distribution form is present in the plan document has no logical connection whatsoever with the determination of the amount and timing of costs for government contracts purposes.

The Section of Public Contract Law of the American Bar Association (ABA) and Abt Associates Inc. attributed the concept of different types of ESOPs to a Government attempt to disallow interest costs related to ESOP financing. This view was expressed by the Public Contract Law Section of the ABA:

Disputes have arisen over whether an ESOP is more appropriately accounted for under CAS 412 or under CAS 415. The primary driver in these disputes is the so-called “interest component” of the employer’s contribution. In other words, should a portion of the employer’s contribution be disallowed because the trust uses it to repay interest on borrowings? Under CAS 412, pension cost is measured by the entirety of an employer’s contribution to the pension trust, even though the trustee may use it to repay borrowings. Under CAS 415, governing the costs of deferred compensation, the Government can argue that the portion of the employer’s contribution that the trust uses to pay interest should not be included in measuring the employer’s cost.

The DOD Inspector General (DOD IG) provided the following comments in