

the trust either in cash or in stock. These commenters, including two Government agencies, probably would agree with the following, rather general, statement made by Parsons Brinkerhoff:

If the company's contribution is made in stock, we believe the fair value of shares should be as of the date the shares are transferred, or committed to be transferred, to the ESOP. The fair value of shares at any later time, e.g., at the time committed to be released to employee accounts, would not be relevant in determining allocability as a contract cost. If the company's contribution is made in cash, excluding payments made to the Trust to re-purchase shares from the Trust, then the entire amount of the payment, regardless of how characterized, e.g., contribution, loan principal, interest, or dividends on a qualified security, is allocable to the government.

McDermott, Will & Emery, however, does not agree with this type of response and indicated that the CAS Board should strive for conformance with GAAP and, in particular, with SOP 93-6. McDermott, Will & Emery believes that the proper valuation date should be the date when the shares are committed to be released to employee accounts. McDermott, Will & Emery stated:

The fair value of shares should be established in accordance with the GAAP rule of SOP 93-6, i.e., at the time the shares are committed to be released to employee accounts.

Establishing it at any other time would put the CAS out of synch with GAAP, creating a highly undesirable and unnecessary "two sets of books" environment for government contractors.

Response: The Board agrees with the majority of commenters and is proposing to adopt the "contribution" approach to ESOP cost accounting as the best measure of a contractor's cost to provide the ESOP benefit awarded to employees. Therefore, the value of shares transferred to an ESOP should be established as of the date when the title to the shares is transferred to the trust.

The Board also notes that in adopting this approach, risks associated with changes in the market value of stock or property subsequent to the date the title to such stock or property is transferred to the ESOP, either up or down, are borne by the ESOP trust. From this perspective, the government does not bear any risk or perceived conflict of interest associated with share price fluctuations after the contribution has been made as pointed out by Lockheed Martin. This is consistent with the current CAS 9904.415 provision regarding stock options.

The Board believes that any other measurement date, such as that suggested by McDermott, Will & Emery, would not reflect the contractor's cost in

providing the ESOP benefit and would, therefore, be inappropriate for the measurement of costs for government contracting purposes. McDermott, Will & Emery's rationale is based on its desire to avoid differences between financial accounting and contract cost accounting. As discussed in the Board's response to Question 1, GAAP are not appropriate for determining ESOP costs on Government contracts.

Question 5

For contract costing purposes, should a distinction be made between measurement of the "cost to the company" or measurement of compensation "received by the employee?" Please explain. If a distinction should be made, please also comment on the method that should be used to measure this amount.

Comments: All the commenters who responded to this question either stated directly or implied that a distinction should be made between measurement of "cost to the company" and the measurement of "compensation received by the employee." With one exception (McDermott, Will & Emery), they also all stated that the proper measurement should be the "cost to the company." The line of thought of this majority is exemplified by the following two quotes. First, NDIA stated:

We firmly believe that the only relevant date is the measurement date of the cost to the company. ESOPs are essentially a defined contribution plan. Thus when the company incurs the cost that is the measurement date. The measurement date based on "received by the employee" is irrelevant.

As a basic principle, no further contract cost or costing consideration exists after the date for the cost to the company. This approach accurately measures the cost to the company. Any attempt to impact contract costs after these events is inappropriate.

The same point of view, in different words, was also expressed by the Public Contract Law section of the ABA:

The purpose of the proposal is to measure the contractor's cost, not the amount of compensation received by the employee. In a leveraged ESOP, these two will hardly ever be the same. If the contractor contributes \$100, and by the time the shares are released the stock has doubled in value, should the contractor's "cost" be \$200? We think not.

McDermott, Will & Emery disagreed with the majority response stating that GAAP should prevail for the purpose of Government contract cost accounting in order to maintain consistency between financial and Government contract reporting and to increase contractors' profitability. At the same time, their comments cited a potential weakness in the GAAP methodology for financial

reporting purposes. The commenter's justification for this position is stated as follows:

* * * the GAAP rule, which measures compensation "received by the employee," should govern, so that there is no inconsistency between the GAAP reporting and the government contract cost reporting that is required of these companies. Arguably, the GAAP rule should be reformed, as users of corporate financial statements probably have more interest in what the corporation spent than in what the employees received.

However, so long as government contractors must use the GAAP rule in their audited statements and SEC reports, it is unfair and problematic to require them to use a completely different rule for contract costing purposes which could negatively impact their profitability and their access to working capital.

The scenario that could prove to be detrimental to a contractor under such circumstances is further described by the commenter in response to another question:

For example, in a leveraged ESOP where the price of a company's stock has *increased* since the time the shares were acquired, if the ESOP company reflects the cost of the shares at the time they were originally acquired in their indirect rates, then that company will have lower revenue from cost based government contracts, but higher pension expense under GAAP. This will both distort and negatively impact the company's profitability and, especially for a smaller business, its ability to obtain funding to support its business with the government.

Response: The Board agrees with the majority of commenters that a distinction exists between measurement of the "cost to the company" and the measurement of "compensation received by the employee." The Board has determined that the relevant concept in the measurement of ESOP costs for Government contracts is the "cost to the company." Therefore, the Board proposes adoption of the "contribution" approach to ESOP cost measurement.

Regarding the comments of McDermott, Will & Emery, the Board notes that the use of the "compensation received by the employee" as the measurement of ESOP costs could result in the reimbursements to contractors in excess of their actual costs as defined at CAS 9904.401-30(a)(2). The commenter would have the Board believe that failure to adopt GAAP will unfairly penalize contractors by reducing their revenues. However, under cost-type Government contracts it is intended that the contractor be reimbursed actual costs and, in addition, be paid a negotiated profit. In the commenter's example, the costs submitted by the