November 14, 2000

VIA HAND DELIVERY

Dr. Rein Abel
Director of Research
Cost Accounting Standards Board
Office of Federal Procurement Policy
Room 9013
725 17th Street, N.W.
Washington, D.C. 20503

Re: CASB Docket No. 00-03, Accounting for the Cost of Employee Stock Ownership Plans, 65 Fed. Reg. 56008 (September 15, 2000)

Dear Dr. Abel:

On behalf of the Section of Public Contract Law of the American Bar Association (the “Section”), I am submitting comments on the above-referenced matter regarding the Cost Accounting Standards Board’s publication of a Staff Discussion Paper on accounting for the cost of employee stock ownership plans (“ESOPs”). The Section consists of attorneys and associated professionals in private practice, industry, and Government service. The Section’s governing Council and substantive committees contain members representing these three segments to ensure that all points of view are considered. In this manner, the Section seeks to improve the process of public contracting for needed supplies, services, and public works.

The Section is authorized to submit comments on acquisition regulations under special authority granted by the Association’s Board of Governors. The views expressed herein have not been approved by the House of Delegates or the Board of Governors of the American Bar Association and, therefore, should not be construed as representing the policy of the American Bar Association.

Discussion

After review of the Staff Discussion Paper, consideration of the issues posed therein, and review of AICPA Statement of Position (“SOP”) 93–6, which sets forth financial accounting practices for the costs of ESOPs, the Section is of the opinion that ESOP costs for both leveraged and non-leveraged plans should be measured, at the date of the employer’s contribution, by the amount of that contribution. This result can be achieved by relatively minor changes to CAS 415, which should serve to resolve any remaining difficulties in accounting for ESOP costs. For the reasons stated herein, the Section does not believe that SOP 93–6 provides useful guidance for purposes of contract cost accounting.

The Staff Discussion Paper poses specific questions with respect to what it considers to be among the more prominent issues in accounting for ESOP costs. These comments will first set forth the Section’s views on the appropriate accounting for ESOP costs and will then turn to any specific questions that remain unaddressed.

Our understanding is that there are two primary issues that have engendered disputes over the proper accounting for...
ESOP costs. Both issues arise only with leveraged ESOPs. In a leveraged ESOP, the Employee Stock Ownership Trust (“ESOT” or “trust”) borrows funds, which it then uses to purchase shares of the employer’s stock. The purchased shares are held in a suspense account. Employer contributions to the trust are used to repay the debt, and, as the debt is paid, shares are released from the suspense account and allocated to individual employee accounts. In a non-leveraged ESOP, the employer contributes stock or cash which is used to buy stock, and the entire amount of the contribution is allocated to employee accounts by fiscal year-end. The two issues are:

1. “Pension” vs. “Non-Pension” ESOPs. 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’ 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.

2. Distribution in Cash vs. Distribution in Stock. This issue was at the heart of the recent decision in Ball Corp., ASBCA No. 49118, 00 1 BCA ¶ 30,864, 2000 ASBCA LEXIS 57. The Government argued that CAS 415-50(e)(1) applied. This provision states that, if the award is made in the stock of the contractor, the cost of deferred compensation shall be based on the market value of the stock on the measurement date (i.e., the first date on which the number of shares awarded is known). This measurement effectively excludes the portion of the employer’s contribution used by the trust to make interest payments on the loan. The contractor argued that CAS 415-50(d)(6) applied. This provision applies when the award is to be paid in money. It states that, if the award is made under a plan that requires irrevocable funding for payment to the employee in a future cost accounting period together with all interest earned thereon, the amount assignable to the period of award shall be the amount irrevocably funded. This measure includes any component ultimately used by the trust to pay interest on the loan. Under Ball Corporation’s plan, employees could elect to receive distributions from their accounts in either stock or cash. The ASBCA held that, due to this fact, neither provision was applicable by its terms. The Board concluded that the Government had not shown that the contractor was incorrect in measuring its cost by the amount of its contribution to the trust.

The Section is of the opinion that the ASBCA in Ball Corporation reached the right result. The Cost Accounting Standards Board, in its Statement of Objectives, Policies and Concepts (May 1992) defines “cost” as the “monetary value of the resources used.” In our view, the only measure appropriate for a contractor’s ESOP costs is the amount of the contractor’s irrevocable contribution to the ESOT, whether that contribution be in cash or stock. The contractor has given up irrevocably the resources represented by the contribution and, therefore, has incurred a cost in the amount of the contribution. To attempt to measure the contractor’s cost in such a way as to exclude part of the contractor’s contribution from the measurement would be contrary to another fundamental concept of contract cost accounting, “full costing.” It would, as the ASBCA observed, fail to measure and, ultimately, to allocate a portion of the amount funded. Ball Corp., 2000 ASBCA LEXIS 57, at 33.

Indeed, exclusion of a deemed interest component from measurement of a contractor’s ESOP costs serves no legitimate government contract costing purpose. The only purpose we can see that would be served would be separate identification of the deemed interest component to facilitate disallowance of that portion of the contractor’s cost. Such disallowance would be contrary to Congressional policy to encourage the use of leveraged ESOPs. See generally Ball Corp., 2000 ASBCA LEXIS 57. Several attempts to amend the FAR to disallow the deemed interest portion of employer contributions to leveraged ESOPs have been abandoned (most recently in 1996) in the face of Congressional and public opposition. It is our understanding that there is no intent to revive them. In addition, we must point out that, even if the trust’s borrowing could be attributed to the contractor, which we do not think is the case, the borrowing is not of the sort (i.e., to finance the operations of the contractor) that was within the original contemplation of the cost principle, FAR 31.205-20, disallowing interest on borrowings.

To the extent not covered above, we now address four specific questions raised by the Staff Discussion Paper.

1. Is the distinction between “pension” and “deferred compensation” ESOPs useful? No. This distinction arose primarily as a result of the “interest” issue. Under the Section’s recommended solution, which recognizes the amount of
the contractor’s irrevocable contribution as the contractor’s cost, such a distinction serves no purpose.

2. **What should be the measurement date?** The Section’s recommendation makes the measurement date the date of the contractor’s contribution. This solution avoids the difficulties inherent in rising and falling stock values and avoids the Government’s participation in fluctuations in stock values. For this reason, the CAS Board should not adopt the measurement date used in SOP 93-6, which is the date the shares are released from the suspense account for allocation to individual employee accounts.

3. **For contract costing purposes, should a distinction be made between costs to the company and compensation received by the employee?** Yes. 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.

4. **Should the form of payment of ESOP benefits to the employee make a difference in measuring the cost allocable to government contracts?** No. The form of payment is irrelevant in the ESOP context. The appropriate focus is on the contractor’s contribution.

The Section appreciates the opportunity to provide these comments and is available to provide additional information or assistance as you may require.

Very truly yours,

Gregory A. Smith
Chair

cc: Norman R. Thorpe
Mary Ellen Coster Williams
Hubert J. Bell, Jr.
Patricia A. Meagher
Marshall J. Doke, Jr.
Rand L. Allen
David A. Churchill
Council Members
Robert A. Burton
Karen L. Manos
Vice Chairs of the Accounting, Cost and Pricing Committee
Richard P. Rector

[1] Mary Ellen Coster Williams, an Officer of the Public Contract Law Section, did not participate in the Section’s consideration of these comments, and she abstained from voting to approve and send this letter.