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November 17, 2003

Via Hand Delivery and Electronic Mail

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

**Re: CASB Docket No. 00-03A
Accounting for the Costs of Employee Stock Ownership Plans
("ESOPs") Sponsored by Government Contractors,
68 Fed. Reg. 50111 (August 20, 2003)**

Dear Sirs:

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. 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 ABA'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.

Introduction

The Cost Accounting Standards Board (“CASB” or “CAS Board”) has proposed in this Advance Notice of Proposed Rulemaking (“ANPRM”) to place the cost accounting rules for ESOP costs in CAS 415, Accounting for the Costs of Deferred Compensation. Under these rules, the contractor’s ESOP cost would be measured by the amount of the contractor’s contribution to the ESOP, regardless of whether the ESOP is leveraged or non-leveraged. The ESOP cost thus measured will be assigned to the cost accounting period to the extent that shares, cash, or both resulting from the contribution are awarded to individual employees in the accounting period. Any excess contribution will be carried forward to future accounting periods. The new rule is proposed to be applied only to the costs of ESOPs established after the effective date of the new rule.

Background

In September 2000, the CAS Board published a Staff Discussion Paper on the topic of accounting for ESOP costs. 65 Fed. Reg. 56008 (Sept. 15, 2000). In that publication, the CAS Board posed a number of issues for comment, most importantly the following:

Do generally accepted accounting principles (“GAAP”), as embodied in American Institute of Certified Public Accountants (“AICPA”) Statement of Position 93-6 (“SOP 93-6”), provide sufficient guidance for accounting for costs of ESOPs for government contracting costing purposes?

The significance of the issue lies in the distinction between leveraged and non-leveraged ESOPs. In leveraged ESOPs, the Employee Stock Ownership Trust (“ESOT”) borrows funds, which it uses to buy shares of the employer’s stock. The ESOT holds the purchased shares in a suspense account. It uses employer contributions to repay the debt; as the debt is paid, it releases shares from the suspense account and allocates them to individual employee accounts. In a non-leveraged ESOP, the employer contributes stock or cash or a combination thereof, which the ESOT allocates to employee accounts by fiscal year-end. In a non-leveraged ESOP, the ESOT allocates the entire amount of the employer’s contribution to employees; in a leveraged ESOP, the ESOT uses part of the employer’s contribution to pay interest on the debt (what SOP 93-6 calls the “financing” element), and allocates the remainder to employee accounts (what SOP 93-6 calls the “defined contribution” element).

SOP 93-6 reflects the view that employers' accounting for the "financing" element should be separate from their accounting for the "defined contribution" element. This view flows from the conclusion that it is the release of shares to individual employee accounts, not the employer's cash contribution, that represents the compensation of participants in the plan. Thus, SOP 93-6 provides that the employer's compensation cost is to be measured by the fair value of the shares at the time the ESOT releases them to employee accounts.

To adopt SOP 93-6 in the context of government contract cost accounting would mean that the portion of the employer's contribution to a leveraged ESOP that is used to pay interest on the debt would not be recognized as a contract cost. The Section of Public Contract Law, in its comments on the September 2000 Staff Discussion Paper, recommended that the CAS Board not adopt an approach that would result in the nonrecognition of a portion of the contractor's cost. The Section noted that the CAS Board's Statement of Objectives, Policies and Concepts (May 1992) defines "cost" as the "monetary value of the resources used." The Section said:

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.

The Section also noted that to exclude part of the contractor's contribution from the measurement of the cost would violate the fundamental concept of "full costing" in contract cost accounting, as the ASBCA had observed in *Ball Corporation*, ASBCA No. 49118, 00-1 BCA ¶ 30,864.

Discussion

The Section believes that the approach the CAS Board has proposed in the subject ANPRM is fair and in accord with principles of contract cost accounting. The Section confines its comments below to those areas in which it believes the proposal may be further improved.

1. Definition of "ESOP." The Section is concerned that the proposed definition of an ESOP is overbroad and could sweep within its reach other types of defined contribution plans that should not be subject to the ESOP accounting rules. The proposed definition is:

Employee Stock Ownership Plan (ESOP) means any deferred compensation plan designed to invest primarily in the stock of the contractor's corporation including, but not limited to, plans covered by the Employee Retirement Income Security Act (ERISA).

The proposed definition is broader than the definitions used by the Internal Revenue Code, ERISA, or GAAP. The reason to use such a broad definition is not apparent. The definition is so broad that it could be argued to encompass "thrift plans" or other 401(k) defined contribution plans such as the plan at issue in a recent case decided by the U.S. Court of Federal Claims, *Newport News Shipbuilding and Drydock Co. v. United States*, 2003 U.S. Claims LEXIS 255 (Sept. 10, 2003). In that case, the parties disputed whether the plan was a deferred compensation plan under CAS 415 or a defined contribution pension plan under CAS 412. Nevertheless, the plan was clearly designed to invest in the stock of the employer through contributions of company stock that matched employee contributions to the plan. It thus could be considered an ESOP subject to CAS 415 under the subject proposal.

The GAAP definition of ESOP is "an employee benefit plan that is described by [ERISA] and the Internal Revenue Code (IRC) of 1986 as a stock bonus plan, or combination stock bonus plan and money purchase plan, designed to invest primarily in employer stock." SOP 93-6. ERISA defines an ESOP as an individual account plan "which [sic] is a stock bonus plan which [sic] is qualified, or a stock bonus plan and money purchase plan both of which are qualified, under section 401 of title 26, and which [sic] is designed to invest primarily in qualifying employer securities." ERISA, sec. 407(d)(6).

We recommend that the Board align its definition with these established definitions or explain why it believes a broader definition is necessary or desirable.

2. Assignment of Cost to Accounting Periods. The proposal provides that the cost measured for an accounting period (the employer's contribution) will be assigned to that period "only to the extent that the number of shares, cash, or any combination thereof resulting from the contribution are awarded to individual employees in the accounting period." Several illustrations flesh out this requirement.

We recognize that the Board must propose provisions consistent with the definition of "deferred compensation" contained in CAS 415. This definition states that deferred compensation is "an award made by a contractor to compensate an

employee in a future cost accounting period or periods for services rendered in one or more cost accounting periods prior to the date of the receipt of compensation by the employee.” Nevertheless, because the contractor incurs the cost when it makes the contribution, and because the contribution is irrevocable, we question the necessity to tie the assignment of the cost to the period in which the ESOT makes an “award” to an individual employee. Not only does this seem to be an unnecessary remnant of the SOP 93-6 approach, but the term “award” may have little relevance to the operation of ESOPs. IRC rules require that the entire contribution to an ESOP, to the extent not used to service debt, be allocated to employee accounts in accordance with a definite formula. See, e.g., Treas. Regs. 1.401-1(b) and 54.4975-11(c) and (d). This being the case, there would be no excess to assign to future years.

3. Transition. The Section believes the CAS Board’s proposed transition rules unnecessarily complicate ESOP accounting and do not achieve the uniformity and consistency in cost accounting that is the Board’s goal. The rules would create three classes of ESOPs: (1) ESOPs created after the effective date of the new provision, to which the new rules would apply; (2) pre-existing ESOPs with an advance agreement, in which case the parties “shall comply” with the advance agreement; and (3) pre-existing ESOPs without an advance agreement, which “shall remain subject to the Cost Accounting Standard(s) that were applicable to such plans prior to” the applicability date of the new rule.

As is evident from the *Ball Corporation* and *Newport News* decisions, there has been plenty of room for disagreement on whether ESOP costs are governed by CAS 412 or CAS 415, and the Section does not believe this sort of uncertainty needs to be perpetuated for existing plans. The Defense Contract Audit Agency has consistently taken the position that ESOP costs are subject to CAS 415.50(e) because under this provision, the interest portion of the employer’s contribution to a leveraged ESOP is not recognized. Contractors have argued that CAS 412 applies, since under CAS 412.40(a)(2), the pension cost for a period is the contribution made for that period. The Section does not believe this sort of uncertainty needs to be perpetuated for existing plans. The Section also believes that more flexibility is required where ESOP costs are governed by advance agreements, and that the parties should be free to adopt the new ESOP accounting provisions. Therefore, the Section proposes the following as a substitution for the ANPRM transition provisions:

9904.415-64 Transition method:

(a) For contractors and subcontractors that were subject to Standard 9904.415 in effect prior

to [effective date of final rule], the requirements of this Standard, as amended, shall apply to the costs of pre-existing ESOPs and the costs of ESOPs that are established after the effective date of this Standard.

(b) For pre-existing ESOPs, the requirements of this Standard shall apply as of the beginning of the contractor's next full fiscal year following the Standard's effective date. The parties may mutually agree to apply the requirements of this Standard earlier if they so desire.

(c) Where ESOP costs are subject to the terms of an advance agreement, the parties shall comply with the provisions of such advance agreement, which may be modified by mutual agreement to incorporate the requirements of this Standard.

Conclusion

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

Sincerely,



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Chair, Section of Public Contract Law

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