

Project On Government Oversight

Watchdog since 1981

November 14, 2000

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

ATTN: CASB Docket 00-03

Dear Dr. Abel:

Thank you for the opportunity to comment on the Cost Accounting Standards (CAS) Board's Staff Discussion Paper (SDP) on "Accounting for the Cost of Employee Stock Ownership Plans (ESOPs)" by government contractors. The Project on Government Oversight (POGO) is a non-partisan, non-profit organization that has, for almost 20 years, investigated, exposed and worked to remedy abuses of power, mismanagement and subservience to special interests by the Federal government. POGO has a keen interest in government contracting matters, especially those relating to the ongoing activities of the CAS Board.

In general, we believe that ESOPs should be accounted for in a uniform manner, without regard to the form of the ESOP (i.e., its classification as either a so-called "pension" or "deferred compensation" ESOP). The fact that under current government contracting rules, ESOP cost accounting may be accomplished in two different ways, with disparate results, illustrates the need for the CAS Board to act on this matter.

The second concern that POGO has about ESOP accounting relates to the issue of leveraged ESOPs. We believe that leveraged ESOPs are prone to accounting abuse in two areas: 1) valuation of shares at the time that they are purchased by the ESOP trust (the "ESOT"); and 2) failure to account for interest expense under leveraged ESOPs as interest.

Under Generally Accepted Accounting Principles (GAAP), valuation of stock shares may be theoretically done at either the time the shares are transferred to the ESOT, or alternatively, at the time the shares are transferred to individual employee accounts. It would seem to us that the principal distinction between these two methods relates to the risk associated with share value fluctuations while shares are held in the ESOT. It cannot be said in any objective manner, that one particular valuation date is preferable to another. However, POGO believes that valuing company

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shares just prior to their transfer to an ESOT may be an abusive practice for some government contractors whose stock share prices are not readily ascertainable in capital markets (e.g., closely held corporations). In such cases, especially where a leveraged ESOP is involved, share price valuations are almost wholly dependent on the opinions of appraisers engaged to facilitate such transactions, rather than on capital markets. POGO has serious concerns and questions about these practices, which we understand resulted in Congressional intervention on behalf of at least one defense contractor during 1998.

The second potentially abusive area relates to the classification of interest expense for leveraged ESOPs. Under SOP 93-6, interest expense incurred in financing leveraged ESOPs is clearly reflected on financial statements as such. Due to attempts to "force fit" government contract ESOP accounting under existing CAS (as the CAS Board's SDP notes there are no existing CAS which even make explicit reference to ESOPs), at least some agency Boards of Contract Appeals (BCAs) have determined that interest expense is not really contractor interest expense when incurred by an ESOT. Under such circumstances, the agency BCAs have found that interest expense may be passed on to contractors (and ultimately taxpayers) as a form of "employee compensation." We do not understand this logic except that it reveals the sorry state of ESOP accounting under government contracts. POGO believes that interest expense should be reflected as such under government contract accounting rules. An attempt to discuss whether such interest expense should be made an allowable cost under government contracts could then be conducted in a rational manner, rather than hiding behind legalisms as to whether "interest is actually interest expense incurred by contractors."

POGO's attempt to outline the basic contentious issues in government contract ESOP accounting leads us to the tentative conclusion that contractors should be required to account for ESOP costs – for both leveraged and non-leveraged ESOPs – in accordance with SOP 93-6. Accordingly, the CAS Board could specifically prohibit accounting for ESOP costs under either current CAS 9904.412 ("Composition and Measurement of Pension Cost") or CAS 9904.415 ("Accounting for the Cost of Deferred Compensation"), and require the use of SOP 93-6 ("Employers' Accounting for Employee Stock Ownership Plans"), regardless of the form of the ESOP (e.g., pension or deferred compensation).

Alternatively, another potential course of action for the CAS Board to consider is to revise CAS 9904.415 so that it specifically addresses ESOP accounting. If the CAS Board chooses this approach, then CAS 9904.415 should provide that ESOPs (regardless of form) are to be governed by the provisions of that Standard. CAS 9904.415 should then be revised to state that when an irrevocable contribution is made to an ESOT, the amount that shall be measured is the amount contributed to the ESOT by the contractor. We would recommend using the amount contributed to the ESOT by the contractor in this case, because it would have the effect of not recognizing interest expense for leveraged ESOPs. POGO believes that unless interest expense for leveraged ESOPs is properly classified as such, then no rational discussion as to the public policy implications of recognizing these costs under government contracts – and passing these costs on to taxpayers – will be engendered. Under this circumstance, we would strongly suggest that the costs not be measured.

POGO is pleased to see that the CAS Board is addressing an important government contract accounting topic. This may be an area where 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.

Sincerely,

A handwritten signature in cursive script that reads "Danielle Brian". The signature is written in black ink and is positioned above the typed name.

Danielle Brian
Executive Director



November 15, 2000

Dr. Rein Abel
Director of Research
Cost Accounting Standards Board
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725 17th Street, NW
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Washington, DC 20503

ATTN: CASB Docket 00-03

Dear Dr. Abel:

In reviewing our letter of November 14, 2000, it came to our attention that one sentence may be subject to being misconstrued. POGO did not mean to suggest that under current Generally Accepted Accounting Principles (GAAP) that employee stock ownership plan (ESOP) share valuation may be accomplished either at the time the shares are transferred to the ESOT or when they are transferred to individual employee accounts. American Institute of Certified Public Accountants Statement of Position (SOP 93-6) reversed the previously issued SOP 76-3 share valuation date requirement. POGO's only point was that from a theoretical standpoint, there is no advantage in choosing one date over the other. Absent a decision by the CAS Board to revise CAS 9904.415 as suggested in the "alternative approach" in our November 14, 2000 letter (or for some other equally compelling reason), there seems to be no rationale as to why government contractors may choose a share valuation date that is at variance with SOP 93-6.

Sincerely,

A handwritten signature in cursive script that reads 'Danielle Brian'.

Danielle Brian
Executive Director

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