



COST ALLOWABILITY - EMPLOYEE STOCK OWNERSHIP PLANS (ESOP)

An Employee Stock Ownership Plan (ESOP) is a defined contribution employee benefit plan that allows employees to become owners of stock in the company where they work. As an equity based deferred compensation plan the ESOP is required by law to invest primarily in the securities of the employing company and has the ability to borrow money (e.g., leveraged ESOP).

The ESOP operates through a trust established by the company that accepts tax deductible contributions from the company to purchase company stock for distribution to the individual employee accounts within the trust. Employees receive the vested portion of the value of stock in their account either upon termination, disability, death, or retirement. These distributions are either made in a lump sum or over a period of years. If the employee becomes disabled or dies, they or their beneficiaries immediately receive the vested portion of their ESOP accounts.

FAR 31.205-6, Compensation, CAS 412, Compensation and Measurement of Pension Costs and CAS 415, Accounting for the Cost of Deferred Compensation, provide the cost allowability framework for ESOPs. Compliance with the governing rules of the ESOP will assure the allowability of the related costs.

There are two types of ESOP plans:

- (1) pensions (FAR 31.205-6 (j)) must comply with the provisions of CAS 412. These plan must offer benefit payments for life or benefits that are payable for life at the option of the participants; and
- (2) deferred compensation plans (FAR 31.205-6(q), that must comply with CAS 415 and provide future payments for current work and that are not pensions.

BASIC COST ALLOWABILITY REQUIREMENTS

The related cost must meet the reasonableness criteria spelled out in FAR 31.201-3, Determining reasonableness. While the reasonableness criteria applies to all elements of contract costs, FAR 31.205-6 Compensation, provides some specific requirements. It important to remember that once the government challenges the reasonableness of a cost, the burden of proof shifts to the contractor who must establish the reasonableness of that cost.

Some important requirement of FAR 31.205.6 are:

- The total compensation for individual employees or classes of employees must be reasonable for the work performed.
- In the case of ESOPs, the plan must be based upon and conform to the terms and conditions of an established plan or practices so consistently followed as to imply in effect, an agreement to make payment.



- No presumption of allowability exists where a new plan has been established and the contractor has not provided the ACO opportunity to review the allowability of the charges, either before implementation or with a reasonable period of it.
- The government has the right to closely examine costs related to owners of closely held corporations, members of limited liability companies, partners, sole proprietors, or members of immediate families or persons who are contractually committed to acquire a substantial financial interest in the contractor's enterprise. For such individuals, compensation must-
 - Be reasonable for the personal services rendered; and
 - Not be a distribution of profits (which is an unallowable contract cost)
 - For owners of closely held companies, compensation in excess of the cost that are deductible as compensation under Internal Revenue Service Code (26 U.S.C.) and regulations are unallowable.

ALLOWABILITY OF PAYMENTS MADE TO ESOP TRUSTS

The allowability criteria for contributions to the ESOP are the same for both leveraged and non-leveraged plans.

CAS 415.50(e)(1) requires that deferred compensation awards that are made in the stock of the contractor shall be based on the market value of the stock on the measurement date, i.e., the first date the number of shares are known. Costs assigned to an accounting period will be determined based on the fair market value of the stock on the date the contractor transfers the stock to the ESOT or pledges the stock as loan collateral on behalf of the ESOT, multiplied by the number of share actually earned for that period.

Should the shares released from collateral exceed the number of shares to be allocated under the terms of the plan, the cost of such excess shares will likely be disallowed, as such shares were not awarded under the terms of the established plan.

Tax regulations and government regulation differ with respect to the treatment of dividend payment used to service ESOP debt. Tax regulations allow deductions for dividend payments to both allocated and unallocated stock. In contrast for contract costing purposes, dividend payments that relate to stock that have been allocated to employee accounts on or before the dividend date of record are unallowable. Such dividends arise from ownership of stock rather than compensation for services rendered, thus they do not meet the requirements for compensation under CAS 415 or FAR 31.205-6.

ESOP STOCK VALUATIONS

The government has a keen interest in the subject of ESOP stock valuations. The primary areas of concern include:

- In situations involving leveraged buyouts, the price per share immediately after the buyout is considered to represent the value of stock to be distributed to contractor employees.
- Where the stock is publicly traded in substantial quantities, the published trading price on the measurement date is consider the fair market value of the stock.
- Where the stock is not publicly traded in substantial quantities, the government will look to the contractor's annual appraisal as the baseline for its detailed analysis of stock price.
- The government will require discounts of the stock value to reflect minority interest and lack of marketability.
- Where the ESOT has not purchased a controlling interesting the company, the government will expect a discount to reflect the additional cost per share to obtain a majority control interest.
- Where the stock is not publicly traded, the government may be expected to request the contractor to recognize it stock is less attractive to potential investors than publicly traded stock and provide a discount of the appraised value generally in the range from 5 to 20 percent.

PLANS FOR THE ESTABLISHMENT OF ESOPs

Companies planning to establish an ESOP should recognize the complex requirements of the related government contract and the IRS regulations. Consultations with recognized experts in such fields is generally viewed as an element of due diligence.