



# GC Newsletter

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## IN THIS ISSUE:

**Cost Allowability- ESOP**

**Year-End Warning-Unallowable Costs**

**Risk Avoidance-DBA**

**DFARS Proposed Rule-FFP Contracts**

**Coso Request for Proposal**

**IRS Increases the Mileage Rate**

**Facilities Capital Cost of Money**

**When Small isn't Small Anymore**

**Coming Events**

**Thought for the Day**

We at Gaffey & Associates Government Contracting Services Group want to wish all of you the best this Holiday Season! We thank you for your kind words and business throughout 2006 and sincerely hope that your new year is prosperous. Please keep us in mind as government contracting and compliance issues arise. We continue to invite you to visit our website where you can access previous issues of the GCNewsletter, copies of our express notification bulletin GCAAlert, and White Papers and presentations on various subjects of government contracting interest. It can be found at:

[www.GaffeyCPA.com](http://www.GaffeyCPA.com)

If you have any questions or comments relative to our website or the articles included in this GCNewsletter please contact us.

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## **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.



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## 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 treated 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.

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## YEAR-END WARNING – BEWARE OF UNALLOWABLE COSTS

With year-end right around the corner many contractors are preparing to develop their annual indirect rate proposals or the actual billing rates to be used on cost reimbursable contracts. If your cost accounting system is not well suited to identify and segregate FAR Part 31 unallowable costs or those costs made expressly unallowable by contract you are open for the significant risk of penalties as specified in FAR 52.242-3, Penalties for Unallowable Costs. Generally, contracts that are covered by this clause are the ones that include: FAR 52.216-7, Allowable Cost and Payment; FAR 52.216-7, Allowable Cost and Payment – Facilities; FAR 52.216-16, Incentive Price Revision – Firm Target; and FAR 52.216-17, Incentive Price Revision – Successive Targets.

If unallowable costs are included in your year-end certified indirect rate proposal, and the inclusion of these costs are identified by the government, the penalty clause allows the government to recover a penalty equal to the value of the unallowable amount plus interest. In other words, if the government identifies the inclusion of \$100,000 of unallowable cost the contractor must reimburse the government not only the \$100,000, but also another \$100,000 in penalties, plus interest on the total amount. If the unallowable costs identified had been determined, in writing, by the contracting officer to be unallowable the penalty is twice the value of the unallowable cost identified.

The penalties clause may be applied even though the unallowable costs have not been billed or the indirect rate proposal has not been audited or the final indirect rates established. Once the certified indirect rate proposal is submitted to the contracting officer and/or the DCAA the penalties clause takes effect. The clause can also take effect even if it is determined that unallowable costs were included in final negotiated rates that were not caught in the audit process.

Conclusion! If any of the clauses above apply to your contracts make sure your cost accounting system has proper controls in place to ensure that unallowable costs captured and

segregated when incurred and not included in your cost claims at year-end.

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## RISK AVOIDANCE – COMPLIANCE WITH THE DEFENSE BASE ACT (DBA)

Federal law requires all U.S. government contractors and subcontractors to secure worker's compensation insurance for their employees working overseas. The Defense Base Act covers the following employment activities:

- Working for private employers on U.S. military bases or on any lands used by the U.S. for military purposes outside of the United States, including those U.S. Territories and possessions;
- Working on public work contracts with any U.S. government agency, including construction and service contracts in connection with national defense or with war activities outside the United States;
- Working on contracts approved and funded by the U.S. under the Foreign Assistance Act, generally providing for cash sale of military equipment, materials, and services to its allies, if the contract is performed outside of the United States;
- Working for American employers providing welfare or similar services outside of the United States for the benefit of the Armed Forces (e.g., the USO).

If any one of the above criteria is met, all employees engaged in such employment regardless of nationality, are covered under the Act.

The worker's compensation requirements for all overseas contracts are set out at FAR 28.305, Overseas workers' compensation and war-hazard insurance, FAR 52.228-3, Worker's Compensation Insurance (Defense Base Act), and FAR 52.228-4, Workers' Compensation and War-Hazard Insurance Overseas.

Section 38(a) of the DBA provides that an employer who fails to secure payment of compensation when required shall be guilty of a misdemeanor and, upon conviction thereof, shall be punished by

a fine of not more than \$11,000 or by imprisonment for not more than one year, or both. And if the employer is a corporation, the president, secretary, and treasurer shall be also severally liable for such fine and imprisonment.

Furthermore, if a corporation fails to secure the payment of compensation, the president, secretary, and treasurer shall be severally and personally liable, jointly with the corporation, for any compensation or other benefits payable under the Act in respect to any injury or death which may occur to any of its employees.

Are you covered? Now might be the time to obtain a copy of the Defense Base Act (<http://www.dol.gov/esa/owcp/dlhwc/dba.htm>) and call your insurance agent.

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## DFARS PROPOSED RULE– CONTRACTING METHODS AND CONTRACT TYPE (DFARS Case 2006-D018)

DoD is proposing to amend the Defense Federal Acquisition Regulation Supplement (DFARS) to add an exception to the requirement for a written determination before using a fixed-price type contract for a development program effort. The exception would apply to contracts for systems integration of commercial off-the-shelf information technology products under the DoD Enterprise Software Initiative. Comments on the proposed rule should be submitted in writing to the address shown below on or before January 8, 2007, to be considered in the formation of the final rule.

Federal Register: November 9, 2006 (Volume 71, Number 217)[Proposed Rules] [Page 65768-65769]

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## COSO REQUEST FOR PROPOSAL

The Committee of Sponsoring Organizations of the Treadway Commission (COSO) has issued a Request for Proposal to develop guidance designed to help organizations monitor the quality of their internal control systems in compliance with the Sarbanes-Oxley Act of 2002. To be completed in one year it is to meet the need for examples, guidance, and more information regarding the monitoring component of COSO's Internal Control – Integrated Framework (IC Framework).

COSO Chairman Larry Rittenberg stated "There is a tremendous gap between the value good monitoring brings to a system of internal control and management's understanding of that value. Not only does monitoring equip management with evidence of quality internal controls (or the lack thereof), but it also lays the groundwork for addressing SOX Section 404(a)."

For more information and to monitor the progress of this effort go to [www.coso.org](http://www.coso.org)

## IRS Increases the Mileage Reimbursement Rate

Like a bouncing ball the mileage reimbursement rate utilized by the GSA may be going back to where it was in September – December 2005. The Internal Revenue Service has increased the mileage reimbursement rate effective January 1, 2007 to 48.5 cents per mile. Historically GSA has not been far behind in raising its rate to match that of the IRS. We will keep you informed via our GCA alert when and if it happens. In the meantime if you are bidding in contracts with significant mileage reimbursement requirements you may want to keep the impact of this potential claim in mind.

## FACILITIES CAPITAL COST OF MONEY INTEREST RATE

The Facilities Capital Cost of Money, Prompt Payment Act and Contract Disputes Act interest rate applicable for the period July 1, 2006 through December 31, 2006 is 5.75% per annum. It was published in the Federal Register, Volume 71, Number 126, Pages 37638-37639 on Friday, June 30, 2006. The previous rate applicable for the period January 1, 2006 through June 30, 2006 was 5.125% per annum. Sorry we missed it in our July issue and hope it did not cause too much of an inconvenience to you.

## WHEN SMALL ISN'T SMALL ANYMORE

The Small Business Administration (SBA) has issued a new rule that requires small businesses to recertify their size status at the end of the first five years of a contract, when a contract option is exercised or when the business is purchased or merged with another company.

This change was driven by the current system that allows the contract to continue as a "small business set-aside" even if the recipient outgrows the small business criteria or is acquired by a larger company.

This new rule will not require automatic contract termination but would require the company to reclassify itself as other than small and prohibit large companies from using these reclassified businesses to meet their small business contracting goals.

## COMING EVENTS

### 3rd Quarterly Small Business Forum

The Coalition for Government Procurement and Patton Boggs, LLP are presenting the 3rd Quarterly Small Business Forum on Thursday, December 7, 2006 from 9:00 a.m. to 12:00 p.m. at the Patton Boggs offices, 2550 M Street, NW, Washington, D.C. 20037. Topics include: a panel discussion on the SBA's New Size re-Certification Rule and a presentation by Patton Boggs on how the new rule will affect your business. Fee is \$75.00 for CGP members and \$100.00 for non-members. Contact Adrian Tucker at [atucker@thecgp.org](mailto:atucker@thecgp.org).

### Establishing Pricing and Costing Rates

Gaffey & Associates will be presenting an executive-series seminar on the establishment of pricing and costing rates that:

- (1) facilitate the management decision making process;
- (2) maximize cost recovery;
- (3) improve your competitive position; and
- (4) satisfy the requirements of regulatory compliance.

This seminar is directed towards small to mid-size companies dealing in the federal marketplace. It will be presented at the Gaffey & Associates offices at 7918 Jones Branch Drive, McLean, VA 22102 on January 22, 2007 from 9:00 a.m. to 3:00 p.m.. Lunch will be provided. The registration fee is \$50.00. Contact Sam Davidson at [samuel.davidson@gaffeycpa.com](mailto:samuel.davidson@gaffeycpa.com)

## Thought for the Day

"The world is round and the place which may seem like the end may also be the beginning" - **Ivy Baker Priest, Former U.S. Treasurer**