Chapter 23 – Employee Stock Ownership Plans (ESOPs)

Authoritative Sources
FAR 31.205-6(q), Employee Stock Ownership Plans (ESOP)

This chapter addresses the following topics:

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23-1 General

An Employee Stock Ownership Plan (ESOP) is an individual stock bonus plan designed specifically to invest in the stock of the employer corporation. An ESOP may be either nonleveraged or leveraged.

An Employee Stock Ownership Trust (ESOT) is the entity responsible for administering the ESOP. The contractor's contributions to the ESOT may be in the form of cash, stock, or property.

Under a nonleveraged ESOP, annual contributions are made by the corporation to the ESOT in the form of stock, property, or cash. If the contribution is in the form of cash, the ESOT uses this cash to acquire company stock. The ESOT holds the stock for the employees and periodically notifies them of how much they own and how much it is worth. The employees receive the stock (or the cash equivalent) when they retire or otherwise leave the company (depending upon the provisions of the ESOP).

Under a leveraged ESOP, the ESOT borrows money, usually from a bank, and then uses these funds to make a large purchase of company stock, either from the shareholders or from the company, e.g., treasury stock. This stock then becomes collateral for the bank loan. Each year the company makes a contribution to the ESOT equal to the total amount of the principal and interest on the loan. The ESOT then uses this money to make its annual payment to the bank. Upon receipt of the ESOT loan payment the bank releases an amount of stock in proportion to the loan principal paid by the ESOT. The released stock is then distributed by the ESOT to the accounts of the plan participants in accordance with the provisions of the plan. The employees receive the stock (or the cash equivalent) when they retire or otherwise leave the company (depending upon the provisions of the ESOP).
23-2 Applicable FAR/CAS

The reasonableness of all ESOP costs must be determined in accordance with FAR 31.205-6(a) and (b). In assessing the reasonableness, the auditor should review the terms of the ESOP to determine if the plan design provides unreasonable compensation to certain employees or groups of employees. In addition, the reasonableness of the amount of stock distributed to employees’ ESOP accounts should be reviewed in conjunction with a review of the employees’ total compensation (see CAM 5-800).

ESOP contributions are subject to the requirements of FAR 31.205-6(q). Contractor ESOP contributions must be measured and assigned in accordance with CAS 415. CAS 415 requires that ESOP contributions be awarded to the employees and allocated to the individual employee ESOP accounts by the Federal income tax deadline. Any amount funded in excess of the cost assigned to the current period is to be assigned to a future cost accounting period when the remaining portion is awarded and allocated to the individual employee accounts (CAS 415.50(f)(2)).

FAR 31.205-6(q)(2)(ii) – (v) provides that:

(1) The contractor’s annual ESOP contributions in excess of the Internal Revenue Code deductibility limits are unallowable (see FAR 31.205-6(q)(2)(ii)).

(2) The price paid by the ESOT for the stock in excess of its fair value is unallowable. If the ESOT purchases the stock with borrowed funds, the contractor’s cash contributions necessary to cover the ESOT loan (principal and interest) that are attributable to the excess price should be questioned pro rata during the loan repayment period (see FAR 31.205-6(q)(2)(iv)(B)).

(3) When contributions are made in the form of stock, the value of that stock is limited to the fair market value on the date the stock is transferred to the ESOT (see FAR 31.205-6(q)(2)(iii)). Therefore, ESOP costs assignable to a cost accounting period will be the fair market value of the stock on the date the contractor transfers the stock to the ESOT, multiplied by the total number of shares actually earned by employees and allocated to individual employee accounts for that period.

(4) FAR 31.205-6(q)(2)(v) provides that when the fair market value of stock is not readily determinable, the IRS guidelines for valuation will be used on a case by case basis (see 7-2114.4).

Under leveraged ESOPs, the contractor’s irrevocable cash contribution to the Trust, which is used by the ESOT to service its debt (including principal and interest), is the amount assignable to the cost accounting period, provided that an equivalent amount of shares are released and allocated to the individual participants’ accounts in accordance with the terms of the ESOP plan. For any given period, the shares released from collateral under the terms of the loan may exceed the number of shares
to be allocated under the terms of the plan. The auditor should be alert to excess shares that might be awarded to ESOP participants and claimed by the contractor. In the absence of the Contracting Officer's prior approval, the award of excess shares to ESOP participants should be questioned, since the excess shares are not awarded according to the established compensation plan.

23-3 ESOP Stock Valuations

The auditor should perform audit tests to determine that the contractor is not reimbursed an amount exceeding the fair market value of the stock on the measurement date. For stock that is publicly traded in substantial quantities, the published trading price on the measurement date should reflect the fair market value of the stock. For companies where the stock is not publicly traded in substantial quantities, a valuation is required. The annual appraisal of the ESOP stock should serve as the baseline for the auditor's review.

Valuation of stock for a company that is not publicly traded in substantial quantities is a complex process. While there is no formula that can be applied to all circumstances, the auditor should determine if the data used in making the valuation is current, accurate, and complete, and if the assumptions underlying the valuation are reasonable. In addition, the auditor should determine if appropriate adjustments have been made to reflect minority interests and/or lack of marketability.

Discount for Minority Interest

The discount for minority interest represents the additional cost per share needed to obtain a majority (control) interest, divided by the majority cost per share. The fair market value of the ESOP stock should include a discount to reflect a minority interest whenever the ESOT has not purchased a controlling interest in the company, i.e., the ESOT cannot exercise control over company decisions. A discount may also be appropriate even when the ESOT has purchased a majority of the company stock, if circumstances are present which prevent the ESOT from effectively exercising meaningful control, e.g., the ESOP trustee exercises significant voting rights and is not independent of the company. The decision to apply a minority discount in such situations must be made on a case-by-case basis. The decision should consider all relevant factors including the fiduciary responsibility of the trustee which may mitigate the lack of independence.

Where the ESOP stock has been obtained as part of a buyout, the additional cost can generally be computed by taking the difference between the actual cost paid per share and the value of the stock prior to any knowledge or speculation (e.g., leaks or rumors) of the upcoming buyout. This value must be close enough in time to be relevant to the buyout (preferably one or two months) but should not be a time period in which there were significant events that led to changing market conditions (e.g., stock market crash or product boycott).
Where a leveraged buyout is not involved, the discount should be based on historical data regarding similar companies that have been bought or sold within a relevant time period. If no such data exists, then overall market information may be used.

**Discount for Lack of Marketability**

Where the stock is not publicly traded, it should generally be discounted to reflect its lack of marketability. A marketability discount reflects the fact that the stock of a closely held company is generally less attractive to potential investors than publicly traded stock.

Even when the company has always exercised its option to repurchase the stock, or where the plan requires the company to repurchase the stock (called "put" rights), some discount will usually apply. While the amount of the marketability discount will differ depending upon the specific circumstances involved, such discounts have generally ranged from 5 to 20 percent.

Factors that influence the amount of the marketability discount include the extent to which "put" rights are enforceable, the company’s ability to meet its obligations with respect to these "put" rights (taking into account the company’s financial strength and liquidity), the company’s history of redeeming its ESOP shares for cash when tendered, and the establishment of a funding program for the repurchase liability.

**23-4 Dividends Used To Satisfy ESOP Contribution Requirements for Leveraged ESOPs**

Tax regulations allow companies with leveraged ESOPs to deduct dividend payments used to service ESOP debt, including dividend payments applicable to stock that has been allocated to employee accounts (allocated stock), as well as dividend payments applicable to stock held by the employee stock ownership trust (unallocated stock). As a result, some companies use the dividends applicable to allocated, unallocated, or both allocated and unallocated stock to satisfy their annual ESOP contribution requirements.

Dividend payments are expressly unallowable in accordance with FAR 31.205-6(i)(2). This is the case regardless of whether the dividends are paid directly to the employees, credited to employee accounts, used to service the ESOP debt, or used to acquire additional shares.