



APR 14 2003

GSA Office of Governmentwide Policy

MEMORANDUM FOR RONALD POUSSARD
DIRECTOR
DEFENSE ACQUISITION REGULATIONS COUNCIL

FROM: RODNEY P. LANTIER, DIRECTOR 
REGULATORY AND FEDERAL ASSISTANCE
PUBLICATIONS DIVISION

SUBJECT: FAR Case 2002-037, Insurance and Pension Costs

Attached are comments received on the subject FAR case published at 68 FR 4880;
January 30, 2003.

<u>Response Number</u>	<u>Date Received</u>	<u>Comment Date</u>	<u>Commenter</u>
2001-037-1	03/24/03	03/24/03	DoD/IG
2001-037-2	03/31/03	03/28/03	Lockheed Martin
2001-037-3	03/31/03	03/31/03	AIA
2002-037-4	03/31/03	03/31/03	ESOP Association

Attachments



INSPECTOR GENERAL
DEPARTMENT OF DEFENSE
400 ARMY NAVY DRIVE
ARLINGTON, VIRGINIA 22202-4704

2001-037-01

MAR 24 2003

Ms. Laurie Duarte
General Services Administration
FAR Secretariat (MVA)
1800 F Street, NW, Room 4035
Washington, DC 20405

Dear Ms. Duarte:

We have reviewed the proposed Federal Acquisition Regulations (FAR) Case No. 2001-037, "Insurance and Pension Costs." The case would amend the insurance and indemnification cost principle and the portion of the compensation principle relating to pension costs. We generally agree with the proposed revisions that achieve consistency between the language in the cost accounting standards and the cost principle. However, we recommend that the current language at FAR subpart 31.205-6(j)(1) be retained, as follows:

A pension plan, as defined in 31.001, is a deferred compensation plan. Additional benefits such as permanent and total disability and death payments and survivorship payments to beneficiaries of deceased employees, may be treated as pension costs, provided the benefits are an integral part of the pension plan and meet all the criteria pertaining to pension costs (Emphasis added)

The current cost principle does not redefine pension plan but cross-references to the definition at FAR 31.001. If the current language is removed, the criteria for allowing additional benefit costs are eliminated. The underlined text, which defines allowability, is not a part of the *pension plan* definition at FAR 31.001. The current definition merely states that additional benefits may be an integral part of a pension plan. Therefore, there is no duplicate language.

Thank you for the opportunity to comment on the proposed rule. If you have any questions, please contact Ms. Madelaine E. Fusfield at (703) 604-8739.

A handwritten signature in cursive script, reading "Patricia A. Brannin".

Patricia A. Brannin
Deputy Assistant Inspector General
for Audit Policy and Oversight

Anthony M. DiPasquale
Vice President
Government Financial Management

March 28, 2003

General Services Administration
FAR Secretariat (MVA)
1800 F Street N.W., Rm. 4035
Washington, D.C. 20405

Attn: Laurie Duarte

Subject: FAR Case 2001-037

Dear Ms. Duarte:

Lockheed Martin Corporation (LMC) appreciates the opportunity to submit comments concerning the proposed revisions to the FAR Insurance, Employee Stock Ownership Plans (ESOP) and Pension Cost Principles. In addition, as the industry representative on the Cost Accounting Standards (CAS) Board, my comments reflect industry's perspective regarding CAS in FAR Cost Principles.

General

The effort to streamline Cost Principles is supported by LMC and industry. However, the streamlining process could benefit from joint Government – industry working groups rather than the sequential process that we have before us. This is especially true when modifying the subject Cost Principles which are both complex and also covered in CAS. Absent joint working groups, the following significant issues need to be addressed before establishing a final rule.

CAS In FAR Cost Principles

Incorporating substantial CAS provisions into the FAR Cost Principles creates de facto CAS coverage when, by law, promulgation of regulations covering the measurement, assignment and allocation of costs to cost objectives is assigned to the CAS Board. This includes applicable threshold levels that were raised reflecting Congressional desire and suggestions by the GAO (see report dated April 2, 1999, "*Future Role of the Cost Accounting Standards Board*"). In addition, requiring CAS at lower thresholds is directly contrary to progressive efforts such as the current DFARS Transformation and is a barrier to smaller commercial companies and commercial units of large defense contractors from performing Government Contracts.

*David
3/31/03*

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If the Councils elect to continue and/or expand CAS clauses in the Cost Principles, then it should be done with either direct references or direct quotes. The practice of paraphrasing CAS language results in unintended differences of interpretation. For example, auditors have used the FAR version of a CAS clause to create another meaning when the two clauses are not identical. The auditors defend their position by saying, “If FAR were intended to be exactly like CAS there would be a direct quote. Since there is a difference, then FAR must have a different meaning.” The fix for this type of problem is easy and it can start right now with this FAR case.

Proposed ESOP Revision

The CAS Board is currently addressing accounting for ESOPs. An ANPRM is expected to be issued in the near term. Since I cannot comment on any potential differences that might exist between CAS and FAR, I recommend that further FAR action be deferred until the CAS Board proposal can be reviewed for consistency. Industry is unaware of any significant issues regarding ESOP costs. Therefore, we see no urgency to expedite a FAR rule change and would like to suggest either dropping ESOP coverage in FAR or, as mentioned above, referencing the CAS rule.

Proposed Pension Revision

The proposed language at 31.205-6 (j)(3)(v)(C) addressing refunds for segment closings is more restrictive than CAS. There are optional settlement methods that are provided for in CAS 413-50(c)(12)(vii); specifically amortization. In addition, the proposed FAR language does not address charges (when the settlement requires additional Government funding), as does CAS. As previously stated, there should be no duplication of CAS in FAR and if there is, it must be either by reference or exact quote.

Proposed Insurance Revision

The proposed language at 31.205-19(c)(4) introduces a definition for “catastrophic losses” as “large dollar coverage with a very low frequency of loss.” The measurement of cost is a CAS issue, not FAR. The expanded definition could be interpreted to include deductibles or over ceiling amounts for property insurance policies, and other high dollar policies. Also, “coverage” refers to an insurance policy cost, not self-insurance. Lastly, there is a missed opportunity to make such self-insurance charges allowable. How is a contractor to be treated equitably when a catastrophic loss occurs such as an earthquake or as illustrated at CAS 416-60(g)? Catastrophic self-insurance losses should be allowable, especially if insurance is either unavailable or excessively priced.

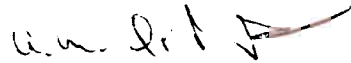
2001-037-2

Summary

As proposed streamlining changes to FAR Cost Principles make their way through the system, we collectively have the opportunity to make substantial improvements consistent with the spirit of DFARS Transformation. Specifically, in order of preference, we can eliminate CAS language in FAR, reference CAS clauses or exactly quote CAS if necessary. Each of the proposed Cost Principles being considered (ESOPs, pensions, and insurance) could be further streamlined or at least made exactly consistent with CAS. Lastly, self-insurance charges for catastrophic losses should be made allowable.

Lockheed Martin Corporation appreciates any consideration that the Councils will give to our comments. We also would be pleased to participate in streamlining working groups if they are formed. If there are any questions concerning our suggestion, please call me at 301-897-6781.

Sincerely,



Anthony M. DiPasquale

2001-037-03

**AEROSPACE INDUSTRIES ASSOCIATION
NATIONAL DEFENSE INDUSTRIAL ASSOCIATION**

March 31, 2003

General Services Administration
FAR Secretariat (MVA)
1800 F Street, NW
Room 4035
Washington DC 20405

ATTN: Ms. Laurie Duarte

Subject: FAR Case 2001-037, Insurance and Pension Costs

Dear Ms. Duarte:

The Aerospace Industries Association (AIA) and the National Defense Industrial Association (NDIA) are pleased to submit comments on the proposed rule to amend the Pension and Employee Stock Option Plans (ESOPs) portions of the Compensation cost principle and the Insurance cost principle.

In general, our members believe that the proposed changes reduce redundant language and provide increased clarity through reorganization. However, we would like to highlight, by topic area, several concerns with the proposed rule amendments.

Pensions

We have significant concerns with the proposed changes in the treatment of pension costs related to credits to the Government for segment closings and to early retirement incentives. The proposed segment closing credits language is not necessary because comparable language is already included in Cost Accounting Standards (CAS).

The proposed language dealing with early retirement incentives could have a major impact on the cost allowability of existing plans. The current provision, FAR 31.205-6 (j)(7), clearly states that plans based upon life income settlements are not, and should not be, treated as early retirement incentive plans. It is unclear why the proposed rule deletes this statement. This is particularly important since this deletion could impact the cost allowability of those plans that are based upon life income settlements.

Insurance

The proposed change to the Insurance cost principle introduces a new definition of catastrophic losses that could have a considerable negative effect. In particular, draft paragraph 31.205-19(c)(4) includes a definition of "catastrophic losses" that may cause contention and uncertainty in the field. The proposed language does not account for the relativity of "large losses" among different sized contractors. The phrase "very low frequency of loss" in the

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proposed definition also adds confusion. We are not sure why this definition was added as we are unaware of any problems in the field in the application of 31.205-19 (c)(4). We believe this proposed provision, if implemented, will be subject to misinterpretation and confusion, thus making it difficult to apply in the field. Established practices for determining thresholds of catastrophic loss based on individual circumstances and the general reasonableness provision in the FAR provide more than sufficient guidance; therefore, we recommend that the proposed definition be deleted.

ESOPs

We believe that no actions should be taken to revise the provisions of FAR 31.205-6 that deal with ESOPs until after the Cost Accounting Standards Board (CASB) releases for public comment an Advanced Notice of Proposed Rulemaking (ANPRM) on ESOPs. The CASB proposal could provide clarification, result in a more streamlined ESOPs format, and establish a useful framework for a future streamlining or elimination of this cost principle. Notwithstanding the above, the Councils must recognize that placing CAS requirements into the Cost Principles is counter to Government goals of attracting and retaining commercial companies in the government contracting arena.

For a more complete listing and description of concerns regarding the proposed rule, please refer to the Attachment to this letter.

Common Cost Principle Format

The proposal to revise the Compensation and Insurance cost principles, while removing some redundant language, does not achieve the overall goals of streamlining. For example, the proposed rule reorganizes the Insurance cost principle by source of coverage (i.e., self-insurance, purchased insurance, and all insurance), but we believe that the use of the common format recommended in our letters on FAR Cases 2001-024 (dated 10/25/02) and 2002-001 (dated 10/25/02) would be a better approach to streamlining the principle. Adoption of such a format would clarify or eliminate confusing, redundant, and unnecessary language and the user-friendly format for all cost principles will facilitate application of the principles in the field.

Another improvement to the streamlining effort we recommend is a greater focus on identifying and removing language not required by statute — an effort we believe to be consistent with the current DFARS transformation initiative. While resource constraints may preclude reformatting all cost principles at once, we believe the current FAR case provides an excellent opportunity to reformat, streamline and clarify the existing language and exclude non-statutory requirements.

Summary

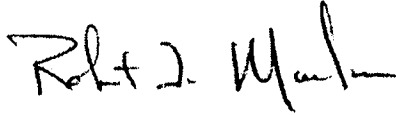
Several significant changes proposed in this rule go beyond simple clarification and streamlining. They represent major changes that we believe are contrary to Government Acquisition policy.

We would appreciate the opportunity to meet with the Councils to discuss our ideas for improving the process for reformatting the cost principles.

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If you have any questions concerning our recommendations for changes to the coverage or arrange for a meeting, please contact Dick Powers of AIA or Ruth Franklin of NDIA. Dick can be reached on 703 358-1042, or at powers@aia-aerospace.org. Ruth can be reached at (703) 247-2598 or rfranklin@ndia.org. Thank you for your consideration.

Sincerely,



Robert T. Marlow
Vice President, Government Division
Aerospace Industries Association



Peter M. Steffes
Vice President, Government Policy
National Defense Industrial Association

Attachment
Specific Statements on Proposed Rule



The ESOP Association

2001-037-04

The ESOP Association
1726 M Street, NW
Suite 501
Washington, D.C. 20036
202-293-2971
FAX 202-293-7583

E-Mail:
esop@esopassociation.org

Web Page:
www.esopassociation.org

President
J. Michael Keeling, CAE

BOARD OF DIRECTORS:

Chair
Joseph Cabral
President and Chairman of the Board
Chatsworth Products, Inc.
31425 Agoura Road
Westlake Village, California 91361-4614
818-735-6100 Fax: 818-735-6199
E-mail: jcabral@chatsworth.com
www.chatsworth.com

Vice Chair
George A. Ray
President & CEO
Lefell Manufacturing Co.
13700 Firestone Boulevard
Santa Fe Springs, California 90670
562-921-3411 Fax: 562-921-5480
E-mail: gray@lefell.com
www.lefell.com

Secretary/Treasurer
John J. Harlander
CFO/Treasurer
Precise Products Corporation
1201 Plymouth Avenue North
Minneapolis, Minnesota 55411-4052
612-522-2141 Fax: 612-522-0939
E-mail: jharlander@preciseproducts.com
www.preciseproducts.com

Immediate Past Chair
Delores L. Thomas
Vice President
Ewing & Thomas, Inc.
5311 Grand Boulevard
New Fort Richey, Florida 34652
727-949-3962 Fax: 727-949-7028
E-mail: earlardp@net.net

AT-LARGE BOARD MEMBERS

Waite Dalrymple
Founder
Parametrix, Inc.
P.O. Box 490
Sumner, Washington 98390
253-863-5128 Fax: 253-863-0946
E-mail: wdalrymple@parametrix.com
www.parametrix.com

Judith L. Kornfeld
President
ESOP Economics, Inc.
2221 Delancey Place
Philadelphia, Pennsylvania 19103-6501
215-546-6550 FAX: 215-546-6591
E-mail: jkornfeld@esopeconomics.com
www.esopeconomics.com

Cindy Turcot
Chief Financial Officer
Gardener's Supply Company
128 Intervale Road
Burlington, Vermont 05401
802-660-3500 Fax: 802-660-3501
E-mail: cindy@gardeners.com
www.gardeners.com

State & Regional Chapter Council Chair
Joseph Elphick
President/CEO
Colonial Carton Company
1000 CCC Drive
Clayton, North Carolina 27520
919-553-4113 Fax: 919-553-2591
jelphick@colonialcarton.com
www.colonialcarton.com

Advisory Committees' Chairs' Council Chair
E.W. ("Sandy") Purcell
Houlihan, Lokay, Howard & Zukin
123 N. Wacker Drive, 4th Floor
Chicago, Illinois 60605
312-458-4756 Fax: 312-346-0851
E-mail: epurcell@hlhz.com
www.hlhz.com

March 31, 2003

General Services Administration
FAR Secretariat (MVA)
1800 F Street, N.W.
Room 4035
Washington, DC 20405

Attn. Ms. Laurie Duarte

RE: Federal Acquisition Regulation (FAR) Case 2001-037 Response to Request for Public Comment on Proposed FAR New 31.205-6(q)

Dear Ladies and Gentlemen:

Following are the comments of The ESOP Association in response to proposed Federal Acquisition Regulation new paragraph 31.205-6(q) [FAR Case 2001-037].

I. EXECUTIVE SUMMARY

The ESOP Association is a national, non-profit association of approximately 1,300 corporations that sponsor employee stock ownership plans (ESOPs) and over 1,000 service providers with a professional commitment to ESOPs. The ESOP Association is the source of educational and informational materials necessary for successful administration and management of ESOP companies. The ESOP Association sponsors national, regional and local meetings for the business community, as well as two conferences per year which are the largest gathering of persons interested in employee ownership in the world.

The ESOP Association states that the proposed new paragraph FAR 31.205-6(q) is puzzling, as The ESOP Association does not know whether to welcome the proposed paragraph 6(q) as a needed clarification, or to protest the new proposed paragraph. To know what to convey in comments depends on the intent and interpretations of the words of clauses iii, v, and vi.

After setting forth potential concerns with the meaning, and thus the potential real world impact of these clauses, The ESOP Association asks that before proposed paragraph 6(q) is finalized, the issues raised in these comments be reviewed by interested parties and authors of 6(q) in order to understand how affected parties, government contractors sponsoring broad base employee ownership through ESOPs, may be impacted.

Serving America By Serving Our Members

II. BACKGROUND

A. The Basic Structure of ESOPs

An ESOP is an employee benefit plan authorized by federal law to provide employees with an ownership stake in their company of employees by investing the assets of an employee trust primarily in the stock of the sponsoring employer. A company establishes an ESOP by setting up an employee trust and making contributions to the trust of company stock or cash that can be used to purchase company stock. Stock contributed to the trust and/or stock purchased from the company or its shareholders is allocated to individual employee accounts.

It is important to understand an ESOP, like the more common and popular 401(k) plans, is a defined contribution plan.

It is important to recognize the differences between a defined contribution plan, such as an ESOP, and a defined benefit plan, or the traditional "pension" plan. Often representations made by Federal personnel reviewing how to determine allowable costs for an ESOP contribution state that the measure of cost is the value of the benefit for the employee. Such a statement is relevant in determining the contractor's costs for contributions to a defined benefit plan as the contribution is determined by what the future value of the employee's benefit is. But such a statement has no meaning for determining the costs of contributions, to an ESOP, 401(k), or other defined contribution plans as no one, no where, can determine the future value of a defined contribution plan benefit that depends on the value of assets such as equities, for which future value is unpredictable.

This point is made as it is relevant to the discussion as to what is the true cost of making contributions to an ESOP.

B. Leveraged and Non-Leveraged ESOPs

Federal law authorizes and promotes through tax incentives two basic types of ESOPs: leveraged and non-leveraged. An ESOP is a stock bonus plan or a combination of a stock bonus plan and a money-purchase pension plan that has received contributions of stock or purchased stock, using money that is not borrowed. Employer contributions to a stock bonus plan may be based on a formula, such as profits, or left to the reasonable discretion of the employer. Under a stock bonus ESOP an employer may deduct from taxes contributions equivalent to a maximum of 25% of annual covered payroll.

A leveraged ESOP is designated by law to establish employee ownership, and in practice does so at a faster rate than a non-leveraged ESOPs – which is exactly why Congress enacted incentives for employers to create leveraged ESOP. A leveraged ESOP is authorized to borrow money from a lender, directly or through the sponsoring employer, in order to purchase employer stock, often with the employer serving as guarantor for the loan. Shares purchased with the loan are held by the ESOP trust in a "suspense account" and released to individual employee accounts on a pro-rata basis as the loan is repaid. Employer contributions are tax deductible to the ESOP up to a maximum of a 25% of covered payroll plus the interest on the loan incurred to acquire the ESOP's stock, if the ESOP sponsor is a C corporation. (If the leveraged ESOP is sponsored by an S corporation, the Internal Revenue Code permits a deductible contribution up to 25% of

payroll.) In addition, dividends paid on ESOP stock may be deductible, including those used to pay the ESOP loan, if the ESOP sponsor is a C corporation. (Again, this tax incentive is not available to an S corporation sponsoring an ESOP.)

The net effect of leveraged ESOPs is to offer companies incentives for employee ownership above and beyond those of a non-leveraged ESOP. Because they reduce the costs of borrowing and enhance cash-flow, leveraged ESOPs can facilitate corporate financial transactions, such as buying out retiring shareholders of a closely-held corporation and outside shareholders, financing capital expansion, taking public companies private through ESOP-leveraged-buyouts, spinning off subsidiaries and acquiring new divisions.

In fact, Federal agency consideration of this aspect of ESOPs is well documented. For example, in testimony before Congress in 1978, NASA commented on a prior Defense Department proposal on cost allocation and ESOPs as follows: “[We] believe that it is clear the intent of this legislation [ERISA] is to foster ESOPs as a financial tool as well as a means of acquiring employee ownership in a corporation.”¹ The ASPR regulations on ESOPs developed thereafter were consistent with NASA’s understanding of leveraged ESOPs.

C. Advantages of ESOPs

The Employee Retirement Income Security Act of 1974 (ERISA) was the first major bill to facilitate establishment of ESOPs, and numerous other legislative and regulatory initiatives have created incentives for their use, including provisions of law enacted by Congress and agreed to by President Bush as evidenced by sections 656 and 662 of Economic Growth, and Tax Relief Reconciliation Act of 2001, Pub.L.107-16. Vigorous legislative promotion of ESOPs by the U.S. Congress over twenty-six years has increased the number of ESOPs nationwide from several hundred in 1974 to an estimated 11,000 by 2003. The rationale behind such unequivocal Congressional support continues to be that, unlike employee benefit plans which typically diversify their holdings by investing in a variety of assets, a company’s ESOP will, by law and design, invest primarily in the stock of the company, thereby making employees beneficial owners of the company where they work. Employees with an ownership stake in their companies have been shown to be more motivated to improve corporate performance because they stand to benefit directly from company profitability and growth.²

DISCUSSION

1. Proposed clause (q)(2)(iii). This clause limits allowable reimbursement for contributions to an ESOP by a contractor to 25% of salaries and wages, claiming in the background explanation to the proposed regulations that this percentage is consistent with the Internal Revenue Code. Federal Register, Vol. 68, 20, p. 4880. Not correct. Internal Revenue Code Section 404(a)(9)(A), permits contributions up to 25% of pay to a leveraged ESOP to be deductible, and IRC 404(a)(9)(B) permits tax deductible contributions to a leveraged ESOP to pay interest on the

¹ Senate Finance Comm. Hearing (1978).

² See, e.g., Annual Employee Ownership Foundation Survey on Economic Performance; Washington State Employee Ownership Program (1994); Northwest Ohio Center on Employee Ownership (1993); Research conducted by Professors Dr. Joseph Blasi and Dr. Douglas Kruse, School of Management and Labor Relations, Rutgers University, New Brunswick, New Jersey 20001.

037-4

loan incurred by the ESOP to acquire employer securities in addition to the 25% level set forth in subparagraph 404(k)(9)(A). These subparagraphs apply only to ESOP sponsors structured as a C corporation. Thus not only is (q)(2)(iii) inconsistent with the Internal Revenue Code, but also it is inconsistent with long standing positions of the Federal government for what the Defense Contract Audit Agency labels "pension" ESOPs, as set forth in a policy advisory document issued by the DCAA in 1993. Also, Internal Revenue Code Section 404(k) permits a C corporation to contribute dividends paid on ESOP stock to be deductible if paid in cash to employees, if reinvested voluntarily by employees for more company stock, or if use to pay ESOP debt.

2. Proposed Subclause (q)(2)(v)(A) and (B). These two clauses provide that contributions of cash to acquire stock for the benefit of employees are not allowed if in excess of fair market value, and contributions of such a nature will have the amounts in excess of fair market value credited to the indirect cost pools.

These provisions are not readily understood.

Any sponsor of an ESOP that acquires stock for the ESOP at a value in excess of fair market value has engaged in a prohibited transaction under ERISA, and the agencies responsible for regulating ESOPs should take appropriate action.

There may be two possible intents embedded in subclauses (A) and (B), which if either is correct, each would trigger protests from the ESOP community as either possible intent would undermine the law's purpose to promote employee ownership.

One interpretation of what (q)(2)(v)(A) and (B) mean is the intent is to impose on contractors a method of valuation that creates a false, and as a result discredited, value on the contractor's costs of acquiring stock for an ESOP. And ironically, if the intent of the authors of the proposed regulation is as described below, the result over time will be more costly for government agencies, unless the intent is to freeze forever a false value for the shares of stock in a leveraged or formerly leveraged ESOP.

To explain, in the withdrawn FAR proposed ESOP regulations of November 7, 1995, withdrawn March 14, 1996, there was a provision that limited the allowable reimbursement of a contractor's costs arising from the acquisition by debt of stock for the benefit of employees to the value of that stock the "day" after the acquisition of the stock, not at the value paid by a willing buyer, the ESOP, to a willing seller of stock to the ESOP. (Because the price paid for stock by the ESOP sponsor, and in turn by the ESOP, represents a price set by the willing buyer and willing seller, that price does not take into consideration the debt that attaches to the stock after the transaction closes. It is analogous to the price paid by a home buyer using a mortgage, and the equity the home buyer has in the house after the settlement of the transaction.)

The theory that the "real" value of ESOP stock is the value after the transaction closes is known as the "Farnum" theory, after a court case brought by the Department of Labor in 1990, suing an ESOP trustee named Farnum. The case was quickly withdrawn after top officials of the Department realized that it would enforce a policy that would completely reverse the many laws promoting employee ownership through ESOPs, as such a requirement on what would be paid for stock for an ESOP would eliminate anyone willing to sell stock to an ESOP. (See attached

sections from The ESOP Association's comments on the November 7, 1995 proposed FAR 31.205-6(p) addressing the very much opposed position of those proposed regulations on what the correct value of ESOP stock was for measuring costs of ESOP plan sponsors contributing cash to the leveraged ESOP.)

In other words, proposed subclauses (q)(2)(v)(A) and (B) may make sense if the drafters believe that the Internal Revenue Service and the Department of Labor are wrong in not imposing the Farnum theory of valuation on ESOP companies and that these ESOP sponsors are therefore being permitted by the IRS and DOL to pay more than fair market value for the stock in the ESOP, and thus contribute money to the ESOP beyond the fair market value of the shares. Of course, if this position is correct – i.e. IRS and DOL permit contributions above fair market value – then the two agencies are aiding and abetting violation of law.

If the above interpretation of subclauses (A) and (B) is correct, the ESOP Association urges a redrafting or withdrawal of subclauses (A) and (B).

Another possible reading of subclauses (q)(2)(v)(A) and (B) is that when economic fortunes of an ESOP sponsor are not positive, with the result the ESOP share value declines, the allowed cost will be the current value, not the acquisition value of the shares.

If this is the intent, i.e. to impose the latest valuation of the share value then proposed (q)(2)(v)(A) and (B) will not reflect the true cost of the contractor with a leveraged ESOP in providing the ESOP benefit to employees. Furthermore based on years of experience with thousands of ESOP companies, over any time frame the result of any measure other than the acquisition cost of the ESOP stock, which is exactly what the contractor contributes to the ESOP plus interest on the ESOP loan, will result in reimbursements to the contractor greater than its true costs of compensation through an ESOP.

To explain, assume that a contractor acquires stock for the ESOP at \$10 a share with a 10-year note at 10% interest, amortized with level payments. Over the ten-year period, the share value can do one of three things: Go up, go down, remain the same. Under current practices, the contractor will have allowable costs of \$10 plus \$1 interest each year, in order to release shares to the employee's accounts in the ESOP. This level of cost will remain constant to the contractor.

If in year two the statutorily required independent valuation establishes that the share value is now \$12 per share, subclauses (A) and (B) can be interpreted to provide that the contractor will be reimbursed not its \$11 costs in cash payment to the lender, but \$13, representing current \$12 per share plus \$1 interest, or \$2 more than actual costs.

If in year two, however, the statutorily required independent valuation establishes that the share value is now \$8 per share, subclauses (A) and (B) may be interpreted to provide that the contractor will be reimbursed not its \$11 costs in cash payments to the lender, but \$9, representing the current \$8 per share plus \$1 interest, or \$2 less than actual costs.

(Both general examples assume that the proposed regulations, as is current practice, permits reimbursement for interest costs paid by the contractor to service ESOP debt.)

If ESOPs were primarily bad deals for employees, and that ESOP companies always decline in value, this possible interpretation of the proposed subclauses (A) and (B) could be defended as a real money saver for the federal government. *But, the evidence is overwhelming, in numerous studies, that ESOP companies outperform their non-ESOP competitors and therefore provide significant value to employees as the value of shares that were acquired with debt in the vast majority of times quickly appreciate to levels beyond the share price at which the shares were acquired.*

Those doubting this statement can refer to a survey by The ESOP Association of its members that in 1989 the averaged account balance in the members' ESOPs was approximately \$17,000, but was over \$173,000 in 2000. A close study of the amazing increase in average account balance correlates to the age of the ESOP, the point made above that as the ESOP ages, share value increases in the vast majority of instances.

Outside the perhaps biased confines of the Association members, note should be taken by a study done by the Washington State's Department of Community, Trade and Economic Development which indicated that the value of ESOP accounts balances on average in that state compared to balances of retirement plans other than ESOPs were 2 and one-half times better than the balances in non-ESOP companies.

Research done by the State of Ohio sponsored Employee Ownership Center, which is part of Kent State University, showed Ohio's closely-held ESOP companies significantly outperformed non-ESOP companies in their industries.

There is no reason to believe that Washington State's and Ohio's closely-held ESOP companies are significantly different than closely-held companies in the other 48 states.

The collection of research and data on the success of ESOP companies, which translate into increasing share value can go on and on. For example, the most comprehensive review of closely-held ESOP companies' performances was done by researchers from Rutgers University. Reviewing data from over 1,000 private ESOP companies paired against 1,000 non-ESOP private companies for an eleven-year period, the Rutgers researchers (Dr.'s Joseph Blasi and Douglas Kruse), the research found that the ESOP companies had on average, on an annual basis, sales over 2.3% better than the non-ESOP companies, and had sales, on an annual basis 2.4% per employee greater than the non-ESOP companies. (The research had other impressive results for the ESOP companies, such as they were more likely to remain in business than the non-ESOP companies by a factor of 15%, and had greater employment growth.)

In fact, Dr. Blasi and Kruse have written that over 70 studies since 1975 indicate more growth, more productive, and more survivalability by ESOP companies compared to their non-ESOP counterparts. (In fairness, a lesser number of studies indicate that ESOPs and employee ownership have a "neutral" impact on the success of the ESOP sponsors; but note, these minority studies do not conclude that ESOP companies on average perform "worse", and thus, on average are declining in value.)

The key point is that the true measure of the contractor's costs in sponsoring an ESOP when the ESOP is leveraged is the annual payment to the lender, which represents the acquisition

cost of the ESOP stock plus interest. Any other measure is a false measure of costs, and can result in either unfairness to the ESOP sponsor or unfairness to the contracting agency.

In other words, the actual cost to the employer sponsoring a defined contribution plan versus a defined benefit plan is the current value of the actual contribution versus the future value of the benefit paid by the plan.

3. Proposed clause (vi). This clause of proposed paragraph (q) provides that when the ESOP sponsor's stock is not publicly traded, the value will be determined on a case-by-case basis taking into consideration guidelines used by the IRS. On its face, there is no concern with this clause, as all valuations of ESOP sponsors which are closely held, which account for approximately 95% of the ESOPs in the United States, must comply with IRS guidelines on valuing stock that is not publicly traded. In fact, the ESOP community welcomes the statement that reviews of contractor's costs arising from contributions to an ESOP are to comport with the long standing practice of following the guidelines from the IRS, which coupled with guidance from the Department of Labor, governs the operations of an ESOP. (The assumption of this welcoming view is the reference to IRS guidelines is to Rev. Ruling 59-60, which has been the basis for ESOP valuations for over 40 years.)

On the other hand, in the real world, at times, it seems that personnel of the agencies determining allowable costs of Federal contractors take it upon themselves to consider that the valuation of ESOP share value that follow IRS and DOL guidance is to be ignored, and the valuation is to be done de novo by the auditors, or someone hired by the auditing agency. This practice makes the use of the words "case-by-case basis" in clause (vi) fraught with uncertainty.

No one denies that anytime any appropriate government authority feels that the valuation of ESOP shares is wrong, or even suspect, that authority has an obligation to put the burden on the ESOP plan sponsor and its fiduciaries to demonstrate that the private valuation is valid. But where a competent valuation expert has done a valuation, the presumption should be that IRS and DOL guidance, plus accepted valuation process and procedures, were followed, and there is no need for the auditing agency to reinvent the wheel, so to speak, by starting with a valuation from scratch under the control and command of the auditing agency.

To use a legal analogy, the annual valuation, if done by competent independent valuation experts, should be presumed in accordance with IRS and DOL guidance; but, the burden to prove its validity can shift to the contractor should the agency auditors have reason to believe that the valuation is not in accord with IRS and DOL policies and procedures for valuations and/or acceptable practices and procedures followed by qualified valuation professionals.

CONCLUSION

As noted in the opening comments on proposed new paragraph FAR 31.205—6(q) The ESOP Association, writing for its over 2,400 members, does not know whether to welcome new proposed paragraph 6(q) or to protest the specific provisions of the proposed paragraph strongly, mildly, or not at all. The ESOP Association always welcomes more guidance from its regulating agencies, and feels both government and the private sector are well served with regulations that match the intent of Congress.

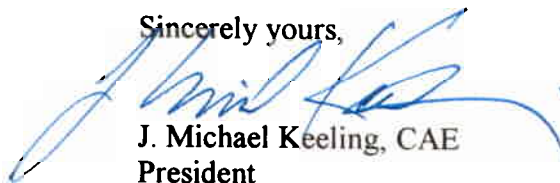
On the other hand, there are provisions that are worded in the proposed paragraph (q) that are not clear, especially in trying to discern how the words would be applied in real world audits of contractors.

Citing just one example in this conclusion, it is a puzzle that regulations would be issued that assume that ESOP sponsors are routinely engaged in illegal prohibited transactions by purchasing company stock for the benefit of employees at levels greater than fair market value, when such an action disqualifies the plan.

Thus, in a position of caution, The ESOP Association respectfully asks that proposed paragraph 6(q) not be adopted as a final regulation until there is more clarity on the issues raised in these comments, so that a firm understanding of their potential impact can be analyzed. Again, the Association does not endorse a "no" regulation outcome, and wants to interpret the proposed paragraph 6(q) as welcomed addition to FAR.

After filing these comments and before the regulations are finalized, The ESOP Association would respectfully request and welcome opportunities to discuss issues raised in these comments.

Sincerely yours,



J. Michael Keeling, CAE
President

JMK:sgs

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January 31, 1996
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and deferred compensation plans, as well as salary and wages. There is no reasonable basis for singling out ESOPs for adverse treatment under government contracts and, in fact, to do so is to frustrate overriding statutory intent.

2. **Proposed FAR 31.205-6(p)(6) Adopts The Discredited Farnum Theory As The Method of Valuation for Leveraged ESOPs**

Under proposed FAR 31.205-6(p)(6)(i), ESOP costs (excluding interest) are allowable up to the lesser of 15% of the salary and wages of participant employees and the fair market value of stock credited to employee accounts, minus forfeitures and dividends. Under proposed FAR 31.205-6(p)(3)(i), "fair market value" of the stock or noncash assets is to be determined "as of the close of business on the next business day after the transaction date."

In effect, this FAR provision would hold that, for government contractors only, the value of asset purchases financed through a loan is limited to the principal interest in the asset, regardless of their actual purchase price. Valuation of a leveraged ESOP trust on the date after the day of initial purchase by the ESOP is contrary to basic principles of corporate finance, ERISA and the IRC. Incredibly, it revives the widely discredited and federally repudiated "Farnum Theory," which arose in a case brought by the Department of Labor and withdrawn immediately thereafter.

The Farnum case dealt with whether the impact on corporate finances caused by servicing the ESOP debt through employer contributions must be taken into account in valuing company stock purchased by an ESOP.^{3/} DOL initially argued a theory of valuation analogous to that put forth in the proposed FAR -- that the cash used to pay the debt must be taken into account in determining whether the ESOP complied with the requirement that it pay no more than "adequate consideration" for the stock. Upon closer review of the issue, however, DOL quickly withdrew its complaint and stated publicly that it was backing away from the position taken in the suit.^{4/}

^{3/} Dole v. Farnum, Civil Action No. 90-0371 (D.R.I. July 30, 1990).

^{4/} See Joel Chernoff, "Withdrawal of Suit Hurts Labor Department," Pensions & Investments (Oct. 29, 1990); see also, Letter from Alan B. Lebowitz, Deputy Assistant Secretary for Program Operations, U.S. Dept. of Labor, to Martin I. Slate, Director of Employee Plans Technical and Actuarial Division, Internal Revenue Service (July 17, 1992).

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According to the repudiated Farnum Theory, if a couple purchased a home for \$200,000 with a \$100,000 mortgage, the value of the house would be only \$100,000 -- i.e., the equity holding of the couple the day after the close of the transaction rather than the \$200,000 fair market value as established between a willing buyer and a willing seller. Carried one step farther, as it is in the proposed FAR, the faulty logic of the Farnum Theory would conclude that the actual cost to the couple must therefore be only \$100,000, effectively ignoring the \$200,000 selling price.

In the Farnum case, as in the proposed FAR provision, the fundamental issue is how one values an asset. Basic principles of corporate finance hold that the value of an asset is the market value as established between a willing buyer and willing seller at the time of acquisition. On any given day after the original transaction of a leveraged ESOP, the fair market value will not necessarily reflect the employer's actual contribution costs, which are determined by the loan repayment obligations of the original transaction. Yet, the employees receive stock, or value, only if the ESOP pays the lender an amount of money equal to the acquisition cost of the stock, plus interest, as purchased with the loan proceeds. Using any other value to determine the allowability of ESOP-related compensation costs ignores the true cost of the ESOP deferred compensation arrangement.

On the day immediately following the transaction date, the fair market value may drop to reflect the debt obligation. On the date of each annual contribution, the fair market value will be affected by many factors, not the least of which are events determining the overall financial well-being of the ESOP sponsoring corporation. Consistent with the IRC, the allowed value for ESOP contractors must be that of the actual contribution or acquisition cost. No existing law requires valuation the day after the close of ESOP stock acquisition. The proposed FAR would mandate such a valuation above and beyond that mandated by Congress under IRC § 409, which also has been endorsed by DOL its proposed "adequate consideration" regulations.^{5/} It is difficult to fathom the FAR Council's requiring an additional valuation that will impose significant costs on the ESOP sponsor.

In sum, the proposed FAR applies a discredited and unworkable valuation scheme on ESOP stock. As Senator Robert Byrd pointed out in criticizing the Farnum Theory on the Senate Floor on October 27, 1990, this approach effectively prohibits ESOPs from using debt to buy stock in their sponsoring companies, despite express statutory language and longstanding federal

^{5/} Proposed Regulation: Definition of Adequate Consideration, U.S. Dept. Of Labor, Pension and Welfare Benefits Admin., 53 Fed. Reg. 17,632 (May 17, 1988).



Federal Register

Thursday,
January 30, 2003

Part VII

**Department of Defense
General Services
Administration**

**National Aeronautics and
Space Administration**

48 CFR Parts 31 and 52

**Federal Acquisition Regulation; Insurance
and Pension Costs; Proposed Rule**

DEPARTMENT OF DEFENSE**GENERAL SERVICES
ADMINISTRATION****NATIONAL AERONAUTICS AND
SPACE ADMINISTRATION****48 CFR Parts 31 and 52**

[FAR Case 2001-037]

RIN 9000-AJ57

**Federal Acquisition Regulation;
Insurance and Pension Costs**

AGENCIES: Department of Defense (DoD), General Services Administration (GSA), and National Aeronautics and Space Administration (NASA).

ACTION: Proposed rule.

SUMMARY: The Civilian Agency Acquisition Council and the Defense Acquisition Regulations Council (Councils) are proposing to amend the Federal Acquisition Regulation (FAR) to amend the insurance and indemnification cost principle and the portion of the compensation cost principle relating to pension costs.

DATES: Interested parties should submit comments in writing on or before March 31, 2003 to be considered in the formulation of a final rule.

ADDRESSES: Submit written comments to—General Services Administration, FAR Secretariat (MVA), 1800 F Street, NW., Room 4035, Attn: Laurie Duarte, Washington, DC 20405.

Submit electronic comments via the Internet to—farcase.2001-037@gsa.gov.

Please submit comments only and cite FAR case 2001-037 in all correspondence related to this case.

FOR FURTHER INFORMATION CONTACT: The FAR Secretariat, Room 4035, GS Building, Washington, DC 20405, at (202) 501-4755 for information pertaining to status or publication schedules. For clarification of content, contact Mr. Ralph De Stefano at (202) 501-1758. Please cite FAR case 2001-037.

SUPPLEMENTARY INFORMATION:**A. Background**

The Councils have performed an analysis of FAR 31.205-6(j), Pension costs, and FAR 31.205-19, Insurance and indemnification, and propose the following revisions:

1. Substitute the term "assign" for the term "account" in the newly renumbered paragraphs (j)(1) and (j)(5) of FAR 31.205-6 in order to be consistent with the terminology used in 48 CFR 9904.412, Cost Accounting

Standard for Composition and Measurement of Pension Cost (CAS 412), and 48 CFR 9904.413, Adjustment and Allocation of Pension Cost (CAS 413).

2. Revise the current paragraph (j)(4)(i) (renumbered as (j)(3)(i)) at FAR 31.205-6 and the contract clause at FAR 52.215-15 to specifically address how the Government will receive the pension cost adjustment amount when there is a segment closing, a pension plan termination, or a curtailment of benefits for CAS-covered and non-CAS-covered contracts.

3. Move and revise the current paragraph FAR 31.205-6(j)(8) that addresses employee stock ownership plans (ESOPs).

a. Move the discussion of ESOPs out of the current paragraph FAR 31.205-6(j) that addresses pension plans to a new paragraph FAR 31.205-6(q) so that the discussion of ESOPs is included in the coverage addressing all deferred compensation plans, both pension and nonpension.

b. Delete the term "individual" from the phrase "individual stock bonus plan" to preclude misinterpretation that a separate plan is required for each employee.

c. Add the term "primarily" to the phrase "invest in the stock of the employer corporation" to clarify that an ESOP does not have to invest 100 percent in the stock of the employer corporation.

d. Consistent with current policies and recent developments in applicable case law, clarify that ESOP costs are to be measured, assigned and allocated in accordance with 48 CFR 9904.412 for ESOPs that meet the definition of a pension plan, and in accordance with 48 CFR 9904.415, Accounting for the Cost of Deferred Compensation, for all other ESOPs. As ESOP accounting techniques continue to evolve, this FAR provision may require further modifications, e.g., if the present CAS treatment of this topic is changed as a result of the current ESOP project being pursued by the CAS Board.

e. Increase the limitation of ESOP contributions in any one year from 15 percent to 25 percent, which is consistent with the Internal Revenue Code limitation on ESOP contributions for corporations.

f. Remove the requirement for the contracting officer to approve the contribution rate in order to be consistent with the requirements for defined contribution pension and deferred compensation plans that are not ESOPs.

4. Eliminate the discount rate provision at the current paragraph FAR

31.205-19(a)(3)(i). The CAS Board revised 48 CFR 9904.416, Accounting for Insurance Costs, to use the Treasury Rate, which is the same rate currently contained in the insurance and indemnification cost principle. Therefore, it is no longer necessary for the cost principle to specify the discount rate.

5. Other editorial changes. The rule makes other editorial changes, including deleting—

a. The current paragraph FAR 31.205-6(j)(1) since FAR 31.001 already has a definition of "pension plan" that is the same as the definition in CAS 412 and 413;

b. The descriptions of defined-benefit pension plans at FAR 31.205-6(j)(3) and defined-contribution pension plans at FAR 31.205-6(j)(5) since the definitions of these terms are currently at FAR 31.001.

c. References to "reasonableness" and "allocability" currently found at FAR 31.205-6(j)(2)(ii) and (j)(3)(ii) because these general allowability standards are already addressed at FAR 31.201-2 and FAR 31.201-3. The Councils do not intend to make these changes to alter any current policy.

This is not a significant regulatory action and, therefore, was not subject to review under section 6(b) of Executive Order 12866, Regulatory Planning and Review, dated September 30, 1993. This rule is not a major rule under 5 U.S.C. 804.

B. Regulatory Flexibility Act

The Councils do not expect this proposed rule to have a significant economic impact on a substantial number of small entities within the meaning of the Regulatory Flexibility Act, 5 U.S.C. 601, *et seq.*, because most contracts awarded to small entities use simplified acquisition procedures or are awarded on a competitive, fixed-price basis, and do not require application of the cost principles that are discussed in this rule. An Initial Regulatory Flexibility Analysis has, therefore, not been performed. We invite comments from small businesses and other interested parties. The Councils will consider comments from small entities concerning the affected FAR parts in accordance with 5 U.S.C. 610. Interested parties must submit such comments separately and should cite 5 U.S.C. 601, *et seq.* (FAR case 2001-037), in correspondence.

C. Paperwork Reduction Act

The Paperwork Reduction Act does not apply because the proposed changes to the FAR do not impose information collection requirements that require the

approval of the Office of Management and Budget under 44 U.S.C. 3501, *et seq.*

List of Subjects in 48 CFR Parts 31 and 52

Government procurement.

Dated: January 23, 2003.

Al Matera,

Director, Acquisition Policy Division.

Therefore, DoD, GSA, and NASA propose amending 48 CFR parts 31 and 52 as set forth below:

1. The authority citation for 48 CFR parts 31 and 52 continues to read as follows:

Authority: 40 U.S.C. 486(c); 10 U.S.C. chapter 137; and 42 U.S.C. 2473(c).

PART 31—CONTRACT COST PRINCIPLES AND PROCEDURES

2. Amend section 31.205–6 by—

a. Removing from the second sentence of paragraph (g)(1) “(j)(7)” and adding “(j)(6)” in its place;

b. Revising paragraph (j);

c. Removing from the second parenthetical in paragraph (p)(2)(i) “paragraphs (j)(5) and (j)(8)” and adding “paragraphs (j)(4) and (q)” in its place; and

d. Adding paragraph (q) to read as follows:

31.205–6 Compensation for personal services.

* * * * *

(j) *Pension costs.* (1) Pension plans are normally segregated into two types of plans: defined-benefit and defined-contribution pension plans. The contractor shall measure, assign, and allocate the costs of all defined-benefit pension plans and the costs of all defined-contribution pension plans in compliance with 48 CFR 9904.412—Cost Accounting Standard for Composition and Measurement of Pension Cost, and 48 CFR 9904.413—Adjustment and Allocation of Pension Cost. Pension costs are allowable subject to the referenced standards and the cost limitations and exclusions set forth in paragraph (j)(1)(i) and in paragraphs (j)(2) through (j)(6) of this section.

(i) Except for nonqualified pension plans using the pay-as-you-go cost method, to be allowable in the current year, the contractor shall fund pension costs by the time set for filing of the Federal income tax return or any extension. Pension costs assigned to the current year, but not funded by the tax return time, are not allowable in any subsequent year. For nonqualified pension plans using the pay-as-you-go method, to be allowable in the current year, the contractor shall allocate

pension costs in the cost accounting period that the pension costs are assigned.

(ii) Pension payments must be paid pursuant to an agreement entered into in good faith between the contractor and employees before the work or services are performed; and the terms and conditions of the established plan. The cost of changes in pension plans are not allowable if the changes are discriminatory to the Government or are not intended to be applied consistently for all employees under similar circumstances in the future.

(iii) Except as provided for early retirement benefits in paragraph (j)(6) of this subsection, one-time-only pension supplements not available to all participants of the basic plan are not allowable as pension costs, unless the supplemental benefits represent a separate pension plan and the benefits are payable for life at the option of the employee.

(iv) Increases in payments to previously retired plan participants covering cost-of-living adjustments are allowable if paid in accordance with a policy or practice consistently followed.

(2) *Defined-benefit pension plans.* The cost limitations and exclusions pertaining to defined-benefit plans are as follows:

(i)(A) Except for nonqualified pension plans, pension costs (see 48 CFR 9904.412–40(a)(1)) assigned to the current accounting period, but not funded during it, are not allowable in subsequent years (except that a payment made to a fund by the time set for filing the Federal income tax return or any extension thereof is considered to have been made during such taxable year). However, any portion of pension cost computed for a cost accounting period, that exceeds the amount required to be funded pursuant to a waiver granted under the provisions of the Employee Retirement Income Security Act of 1974 (ERISA), will be allowable in those future accounting periods in which the funding of such excess amounts occurs (see 48 CFR 9904.412–50(c)(5)).

(B) For nonqualified pension plans, except those using the pay-as-you-go cost method, allowable costs are limited to the amount allocable in accordance with 48 CFR 9904.412–50(d)(2).

(C) For nonqualified pension plans using the pay-as-you-go cost method, allowable costs are limited to the amounts allocable in accordance with 48 CFR 9904.412–50(d)(3).

(ii) Any amount funded in excess of the pension cost assigned to a cost accounting period is not allowable in that period and shall be accounted for as set forth at 48 CFR 9904.412–50(a)(4).

The excess amount is allowable in the future period to which it is assigned, to the extent it is not otherwise unallowable.

(iii) Increased pension costs are unallowable if the increase is caused by a delay in funding beyond 30 days after each quarter of the year to which they are assignable. If a composite rate is used for allocating pension costs between the segments of a company and if, because of differences in the timing of the funding by the segments, an inequity exists, allowable pension costs for each segment will be limited to that particular segment's calculation of pension costs as provided for in 48 CFR 9904.413–50(c). The contractor shall make determinations of unallowable costs in accordance with the actuarial method used in calculating pension costs.

(iv) The contracting officer will consider the allowability of the cost of indemnifying the Pension Benefit Guaranty Corporation (PBGC) under ERISA section 4062 or 4064 arising from terminating an employee deferred compensation plan on a case-by-case basis, provided that if insurance was required by the PBGC under ERISA section 4023, it was so obtained and the indemnification payment is not recoverable under the insurance. Consideration under the foregoing circumstances will be primarily for the purpose of appraising the extent to which the indemnification payment is allocable to Government work. If a beneficial or other equitable relationship exists, the Government will participate, despite the requirements of 31.205–19(c)(3) and (d)(3), in the indemnification payment to the extent of its fair share.

(v) Increased pension costs resulting from the withdrawal of assets from a pension fund and transfer to another employee benefit plan fund, or transfer of assets to another account within the same fund, are unallowable except to the extent authorized by an advance agreement. If the withdrawal of assets from a pension fund is a plan termination under ERISA, the provisions of paragraph (j)(3) of this subsection apply. The advance agreement shall—

(A) State the amount of the Government's equitable share in the gross amount withdrawn or transferred; and

(B) Provide that the Government receive a credit equal to the amount of the Government's equitable share of the gross withdrawal or transfer.

(3) *Pension adjustments and asset reversions.* (i) For segment closings, pension plan terminations, or

curtailment of benefits, the amount of the adjustment shall be—

(A) For contracts and subcontracts that are subject to full coverage under the Cost Accounting Standards (CAS) Board rules and regulations, the amount measured, assigned, and allocated in accordance with 48 CFR 9904.413–50(c)(12);

(B) For contracts and subcontracts that are not subject to full coverage under the CAS, the amount measured, assigned, and allocated in accordance with 48 CFR 9904.413–50(c)(12), except the numerator of the fraction at 48 CFR 9904.413–50(c)(12)(vi) is the sum of the pension plan costs allocated to all non-CAS-covered contracts and subcontracts that are subject to Subpart 31.2 or for which cost or pricing data were submitted; and

(C) Credited to the Government either as a cost reduction or by cash refund, at the option of the Government.

(ii) For all other situations where assets revert to the contractor, or such assets are constructively received by it for any reason, the contractor shall, at the Government's option, make a refund or give a credit to the Government for its equitable share of the gross amount withdrawn. The Government's equitable share shall reflect the Government's participation in pension costs through those contracts for which cost or pricing data were submitted or that are subject to Subpart 31.2. Excise taxes on pension plan asset reversions or withdrawals under this paragraph (j)(3)(ii) are unallowable in accordance with 31.205–41(b)(6).

(4) *Defined-Contribution Pension Plans.* In addition to defined-contribution pension plans, this paragraph also covers profit sharing, savings plans, and other such plans, provided the plans fall within the definition of a pension plan at 31.001.

(i) Allowable pension cost is limited to the net contribution required to be made for a cost accounting period after taking into account dividends and other credits, where applicable. However, any portion of pension cost computed for a cost accounting period that exceeds the amount required to be funded pursuant to a waiver granted under the provisions of ERISA will be allowable in those future accounting periods in which the funding of such excess amounts occurs (see 48 CFR 9904.412–50(c)(5)).

(ii) The provisions of paragraphs (j)(2)(ii) and (iv) of this subsection apply to defined-contribution plans.

(5) *Pension plans using the pay-as-you-go cost method.* When using the pay-as-you-go cost method, the contractor shall measure, assign, and allocate the cost of pension plans in

accordance with 48 CFR 9904.412 and 9904.413. Pension costs for a pension plan using the pay-as-you-go cost method are allowable to the extent they are not otherwise unallowable.

(6) *Early Retirement Incentives.* An early retirement incentive is an incentive given to an employee to retire early. For contract costing purposes, costs of early retirement incentives are allowable subject to the pension cost criteria contained in paragraphs (j)(2)(i) through (iv) of this section provided—

(i) The contractor measures, assigns, and allocates the costs in accordance with the contractor's accounting practices for pension costs;

(ii) The incentives are in accordance with the terms and conditions of an early retirement incentive plan;

(iii) The contractor applies the plan only to active employees. The cost of extending the plan to employees who retired or were terminated before the adoption of the plan is unallowable; and

(iv) The present value of the total incentives given to any employee in excess of the amount of the employee's annual salary for the previous fiscal year before the employee's retirement is unallowable. The contractor shall compute the present value in accordance with its accounting practices for pension costs. The contractor shall account for any unallowable costs in accordance with 48 CFR 9904.412–50(a)(2).

* * * * *

(q) *Employee stock ownership plans (ESOP).* (1) An ESOP is a stock bonus plan designed to invest primarily in the stock of the employer corporation. The contractor's contributions to an Employee Stock Ownership Trust (ESOT) may be in the form of cash, stock, or property.

(2) Costs of ESOPs are allowable subject to the following conditions:

(i) For ESOPs that meet the definition of a pension plan at 31.001, the contractor—

(A) Measures, assigns, and allocates the costs in accordance with 48 CFR 9904.412;

(B) Funds the pension costs by the time set for filing of the Federal income tax return or any extension. Pension costs assigned to the current year, but not funded by the tax return time, are not allowable in any subsequent year; and

(C) Meets the requirements of paragraph (j)(2)(ii) of this section.

(ii) For ESOPs that do not meet the definition of a pension plan at 31.001, the contractor measures, assigns, and allocates costs in accordance with 48 CFR 9904.415.

(iii) Contributions by the contractor in any one year that exceed 25 percent of salaries and wages of employees participating in the plan in that year are unallowable.

(iv) When the contribution is in the form of stock, the value of the stock contribution is limited to the fair market value of the stock on the date that title is effectively transferred to the trust.

(v) When the contribution is in the form of cash—

(A) Stock purchases by the ESOT in excess of fair market value are unallowable; and

(B) When stock purchases are in excess of fair market value, the contractor shall credit the amount of the excess to the same indirect cost pools that were charged for the ESOP contributions in the year in which the stock purchase occurs. However, when the trust purchases the stock with borrowed funds which will be repaid over a period of years by cash contributions from the contractor to the trust, the contractor shall credit the excess price over fair market value to the indirect cost pools pro rata over the period of years during which the contractor contributes the cash used by the trust to repay the loan.

(vi) When the fair market value of unissued stock or stock of a closely held corporation is not readily determinable, the valuation will be made on a case-by-case basis taking into consideration the guidelines for valuation used by the IRS.

* * * * *

3. Revise section 31.205–19 to read as follows:

31.205–19 Insurance and Indemnification.

(a) Insurance by purchase or by self-insuring includes—

(1) Coverage the contractor is required to carry or to have approved, under the terms of the contract; and

(2) Any other coverage the contractor maintains in connection with the general conduct of its business.

(b) For purposes of applying the provisions of this subsection, the Government considers insurance provided by captive insurers (insurers owned by or under control of the contractor) as self-insurance, and charges for it shall comply with the provisions applicable to self-insurance costs in this subsection. However, if the captive insurer also sells insurance to the general public in substantial quantities and it can be demonstrated that the charge to the contractor is based on competitive market forces, the Government will consider the insurance as purchased insurance.

(c) Whether or not the contract is subject to CAS, self-insurance charges

are allowable subject to paragraph (e) of this subsection and the following limitations:

(1) The contractor shall measure, assign, and allocate costs in accordance with 48 CFR 9904.416, Accounting for Insurance Costs.

(2) The contractor shall comply with FAR Part 28. However, approval of a contractor's insurance program in accordance with FAR Part 28 does not constitute a determination as to the allowability of the program's cost.

(3) If purchased insurance is available, any self-insurance charge plus insurance administration expenses in excess of the cost of comparable purchased insurance plus associated insurance administration expenses is unallowable.

(4) Self-insurance charges for risks of catastrophic losses (large dollar coverage with a very low frequency of loss) are unallowable (see 48 CFR 28.308(e)).

(d) Purchased insurance costs are allowable, subject to paragraph (e) of this subsection and the following limitations:

(1) For contracts subject to full CAS coverage, the contractor shall measure, assign, and allocate costs in accordance with 48 CFR 9904.416.

(2) For all contracts, premiums for insurance purchased from fronting insurance companies (insurance companies not related to the contractor but who reinsure with a captive insurer of the contractor) are unallowable to the extent they exceed the sum of—

(i) The amount that would have been allowed had the contractor insured directly with the captive insurer; and

(ii) Reasonable fronting company charges for services rendered.

(3) Actual losses are unallowable unless expressly provided for in the contract, except—

(i) Losses incurred under the nominal deductible provisions of purchased insurance, in keeping with sound business practice, are allowable; and

(ii) Minor losses, such as spoilage, breakage, and disappearance of small hand tools that occur in the ordinary course of business and that are not covered by insurance are allowable.

(e) Self-insurance and purchased insurance costs are subject to the cost limitations in the following paragraphs:

(1) Costs of insurance required or approved pursuant to the contract are allowable.

(2) Costs of insurance maintained by the contractor in connection with the general conduct of its business are allowable subject to the following limitations:

(i) Types and extent of coverage shall follow sound business practice, and the rates and premiums shall be reasonable.

(ii) Costs allowed for business interruption or other similar insurance shall be limited to exclude coverage of profit.

(iii) The cost of property insurance premiums for insurance coverage in excess of the acquisition cost of the insured assets is allowable only when the contractor has a formal written policy assuring that in the event the insured property is involuntarily converted, the new asset shall be valued at the book value of the replaced asset plus or minus adjustments for differences between insurance proceeds and actual replacement cost. If the contractor does not have such a formal written policy, the cost of premiums for insurance coverage in excess of the acquisition cost of the insured asset is unallowable.

(iv) Costs of insurance for the risk of loss of, or damage to, Government property are allowable only to the extent that the contractor is liable for such loss or damage and such insurance does not cover loss or damage which results from willful misconduct or lack of good faith on the part of any of the contractor's directors or officers, or other equivalent representatives.

(v) Costs of insurance on the lives of officers, partners, proprietors, or employees are allowable only to the extent that the insurance represents additional compensation (see 31.205-6).

(3) The cost of insurance to protect the contractor against the costs of correcting its own defects in materials and workmanship is unallowable. However, insurance costs to cover fortuitous or casualty losses resulting from defects in materials or workmanship are allowable as a normal business expense.

(4) Premiums for retroactive or backdated insurance written to cover losses that have occurred and are known are unallowable.

(5) The Government is obligated to indemnify the contractor only to the extent authorized by law, as expressly provided for in the contract, except as provided in paragraph (d)(3) of this subsection.

(6) Late premium payment charges related to employee deferred compensation plan insurance incurred pursuant to Section 4007 (29 U.S.C. 1307) or Section 4023 (29 U.S.C. 1323) of the Employee Retirement Income Security Act of 1974 are unallowable.

PART 52—SOLICITATION PROVISIONS AND CONTRACT CLAUSES

4. Amend section 52.215-15 by revising the date of the clause and paragraph (b) to read as follows:

52.215-15 Pension Adjustments and Asset Reversions.

* * * * *

Pension Adjustments and Asset Reversions (Date)

* * * * *

(b) For segment closings, pension plan terminations, or curtailment of benefits, the amount of the adjustment shall be—

(1) For contracts and subcontracts that are subject to full coverage under the Cost Accounting Standards (CAS) Board rules and regulations (48 CFR Chapter 99), the amount measured, assigned, and allocated in accordance with 48 CFR 9904.413-50(c)(12);

(2) For contracts and subcontracts that are not subject to full coverage under the CAS, the amount measured, assigned, and allocated in accordance with 48 CFR 9904.413-50(c)(12), except the numerator of the fraction at 48 CFR 904.413-50(c)(12)(vi) shall be the sum of the pension plan costs allocated to all non-CAS covered contracts and subcontracts that are subject to Federal Acquisition Regulation (FAR) Subpart 31.2 or for which cost or pricing data were submitted; and

(3) Credited to the Government either as a cost reduction or by cash refund, at the option of the Government.

* * * * *

(End of Clause)

[FR Doc. 03-1963 Filed 1-29-03; 8:45 am]

BILLING CODE 6820-EP-P



APR 4 2003

GSA Office of Governmentwide Policy

MEMORANDUM FOR RONALD POUSSARD

DIRECTOR
DEFENSE ACQUISITION REGULATIONS COUNCIL

FROM:

RODNEY P. LANTIER, DIRECTOR
REGULATORY AND FEDERAL ASSISTANCE
PUBLICATIONS DIVISION

SUBJECT:

FAR Case 2002-012, Section 508 Micro-Purchase
Exception Sunset Provision

Attached are comments received on the subject FAR case published at 67 FR 80321;
December 31, 2002.

<u>Response Number</u>	<u>Date Received</u>	<u>Comment Date</u>	<u>Commenter</u>
2002-012-1	02/07/02	02/07/03	Hattie Hearne
2002-012-2	03/03/03	03/03/03	ITAA
2002-012-3	03/03/03	03/03/03	Information Technology Industry Council
2002-013-4	03/04/03	03/04/03	Barbara Jackson LeMoine

Attachments

2002-012-1



"HATTIE HEARNE"
<COOKHATTIE1234@A
OL.COM>

To: "General Services Administration Attn: Laurie Duarte "
<farcase.2002-012@gsa.gov>
cc:
Subject: SMALL BUSINESS OWNED

02/07/2003 02:42 AM

HATTIE HEARNE
1427 FARRELL ST.
VALLEJO, CA 04590

February 7, 2003

General Services Administration Attn: Laurie Duarte
Attn: FAC 2001-11, FAR case 2002-012
1800 F St NW, Rm 4035
Washington, DC 20405

Dear FAR Secretariat (MVA) Duarte:

TO WHOM IT MAY CONCERN:MY NAME IS HATTIE HEARNE I HAVE BEEN WAITING 4 YRS
TO OPEN MY BUSINMESS OF DISABLED ADULTS, I WAS APPROVED BY THE STATE, MY
HOME WAS APPROVED, NOW I AM A BLACK 52 YR OLD WOMAN WHO HAS HAD A TUFF
DEAL WITH THE SYSTEM,THE REGENCY WILL AND HAS DYNIED ME FROM GETTING
CLIENTS IN MY HOME, I BEEN THRU ALL THE RED TAPE THIER IS AND I HAVE BEEN
DENIED MY RIGHTS OF HAVING CLIENTS FROM THIER REGENCY, NOW I AM AWARE THAT
WOMEN WITH A BUSINESS COULD GET A GRANT TO HELP THEM BUT I WAS TOLD
BECAUSE I LIVE IN A PRODONENTLY BLACK NEIGHBORHOOD I DO NOT QULIFY

Sincerely, HATTIE HEARNE

HATTIE HEARNE

2002-012-2



March 3, 2003

General Services Administration
FAR Secretariat (MVA)
1800 F Street, NW, Room 4035
Washington, DC 20405

ATTN: Ms. Laurie Duarte

**Re: FAC 2001-11, FAR case 2002-012, Section 508 Micro-Purchase
Exception (Interim Rule)**

Dear Ms. Duarte:

The Information Technology Association of America (ITAA) submits these comments in response to the interim rule extending the electronic and information technology "micro-purchase" exception to October 1, 2004. As discussed in more detail below, the ITAA believes that the decision by the Civilian Agency Acquisition Council and the Defense Acquisition Regulations Council ("the Councils") to extend the expiration date of the micro-purchase exception is reasonable considering the practicalities of the matter.

As to the Councils' request for comments on product labeling, we believe that including statements of Section 508 conformance on product labeling would impose significant burdens on IT vendors while providing very little value for purchasers.

The ITAA provides global public policy, business networking, and national leadership to promote the continued rapid growth of the information technology (IT) industry. The ITAA consists of over 500 corporate members throughout the United States and a global network of 47 countries' IT associations. The Association plays a leading role in issues of IT industry concern, including information security, finance policy, digital intellectual property protection, telecommunications competition, workforce and education matters, immigration, online privacy, *consumer protection*, *government IT* procurement, human resources, and e-commerce policy. ITAA members range from the smallest IT start-ups to industry leaders in the Internet, software, IT services, ASP, digital content, systems integration, telecommunications, and enterprise solution fields. (More information on the ITAA may be found at www.ITAA.org.)

The ITAA greatly appreciates this opportunity to provide our comments.

A. The ITAA Supports the Councils' Interim Rule Extending the Section 508 Micro-purchase Exception to October 1, 2004.

The ITAA supports the Councils' interim rule extending the Section 508 micro-purchase exception to October 1, 2004. We agree with the Councils that eliminating the micro-purchase exception at this time is not feasible.

The ITAA continues to believe that the micro-purchase exception is a common-sense *approach for addressing small acquisitions made by government employees using a purchase*

Information Technology Association of America

1401 Wilson Blvd. - Suite 1100, Arlington, Virginia 22209-2318 ■ Phone: (703) 522-5055 Fax: (703) 525-2279

card. Most users of government purchase cards are not contracting officers or members of the procurement workforce and do not possess the training to assess whether a product supports the applicable accessibility standards. Without an extension of the micro-purchase exception, each procuring agency would be required to forward proposed electronic and information technology micro-purchases to agency procurement officers who have received proper training. This process would significantly burden contracting offices with numerous additional transactions needing review, although the dollar amounts of the transactions themselves account for a very small part of the Government's procurement budget. In sum, the situation would unduly delay and burden Government procurements.

B. Product Labeling Is Not Feasible.

Members of the ITAA have expended tremendous financial resources to build accessibility features into their products. ITAA members make information about these product features available to federal agencies by completing Voluntary Product Accessibility Templates (VPATs) that are placed either on the vendor's website (and on the government's www.Section508.gov website) or provided in response to an agency's request. The VPAT process provides a useful mechanism for companies to provide full accessibility information about their products to purchasing officials, including any qualifying statements that the company deems the purchaser should know.

Regarding Section 508 product labeling, however, the ITAA believes that product labeling would raise significant legal and practical concerns for the IT industry without providing any real benefit to government purchasers or consumers.

An important issue for industry is that inaccurate product labeling exposes vendors to risks associated with class action lawsuits under state deceptive trade practices statutes. (This is in addition to the risks associated with the False Claims Act for government purchases.) As such, it is especially important that vendors take enormous pains to ensure that statements included on product labels are 100% accurate. That is one reason why product labeling is a very significant cost item for vendors. With respect to how these concerns relate to Section 508, we believe that everyone would agree that there are varying degrees of accessibility and that reasonable minds may differ regarding the extent to which a product is accessible. In our view, most companies would be unwilling to make blanket statements on a product label regarding Section 508 because of the risk that someone with a different interpretation may impose litigation.

Also, a vendor's blanket statement regarding Section 508 conformance on a product label would provide very little value to purchasers. A product label is read only by those purchasers who buy the product off of a store shelf. However, we understand that a majority of micro-purchases are made over the telephone or the Internet. These purchasers would not be in a position to view the product prior to purchase.

A Section 508 conformance statement on a product label also would not absolve a Federal agency of the responsibility of doing its own market research under the Federal Acquisition Regulations to determine such things as the extent to which the applicable accessibility standards are satisfied by commercially available products and whether an exception to Section 508 should be applied. A Section 508 statement on a product label also would not ensure that the product would be compatible with the agency's existing infrastructure and technology.

Accordingly, it is ITAA's view that Section 508 product labeling is neither a desirable nor feasible option.

012-2

C. Internal Education and Training.

ITAA member companies are employing tremendous resources to design and manufacture accessible products. A key component of this process is training and putting systems in place to ensure that the engineers have accessibility as a key design requirement. ITAA members are also focusing on training their sale forces on accessibility requirements so that they may assist purchasers by providing helpful information when purchasers make their accessibility determinations.

It is difficult to summarize the wide variety of means that IT companies are using to educate and train their hardware and software developers and salespersons regarding accessibility issues. We will leave it up to the individual companies to provide the specific details. If the Councils would like our detailed views on this issue, however, we would gladly provide them.

* * * *

The ITAA and its membership strongly support the goal of making IT fully accessible to individuals who have disabilities. As always, we appreciate the opportunity to comment on accessibility issues pertaining to Federal Government purchases of IT products and services and look forward to our continuing dialogue with the Councils on this important subject.

Respectfully submitted,



Harris N. Miller
President
Information Technology Association of America

2002-012-3



1250 Eye Street NW Suite 200
Washington, DC 20005
202-737-8888 www.itic.org

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Vice President

March 3, 2003

General Services Administration
FAR Secretariat (MVA)
1800 F Street, NW Room 4035
Attn: Laurie Duarte
Washington, DC 20405

REF: FAC 2001-11, FAR case 2002-12

Dear Ms. Duarte:

I am pleased to submit these comments electronically on behalf of ITI, the Information Technology Industry Council, in response to the request for comments published in the December 31, 2002 edition of the Federal Register (67FR 251), on the Interim Rule to extend the Section 508 Micro-Purchase exception to October 1, 2004. In particular, we wish to respond to the question regarding the labeling of accessible products.

We support the extension of the micro-purchase exception. We recognize the challenges facing the General Services Administration (GSA) and other agencies in educating government personnel regarding their Section 508 obligations, whether purchasing one or 10,000 "electronic and information technology" (EIT) products. Accordingly, an extension makes sense. Nevertheless, we were surprised to learn that the Civilian Agency Acquisition Council and the Defense Acquisition Regulations Council (together, the Councils) had anticipated that commercial manufacturers would apply some form of a label or logo to their product packaging to provide Section 508 "conformance information." We believe such a label would not serve nor achieve the desired intent.

One Size Does Not Fit All

The EIT Accessibility Standards, published by the Access Board in December 2000, are not a single monolithic requirement, rather a series of subjective criteria that apply to various products or services. In some instances, similar products could be associated with different sections of the Standards, depending on their features and relative functionality. It would be very difficult and unwieldy to create a label that could provide sufficient information to federal buyers, including those using government purchasing

cards, regarding a product's conformance with a particular section or sections of the Standards. In addition, we do not believe that it would meet the requirements of 48 CFR Part 10, which outline an agency's duties regarding acquisition planning and market research.

A Label Would Lack Utility

A principle objective of commercial EIT manufacturers is to design products that can be successful in multiple markets, including government markets. Section 508 has succeeded in that regard, spurring research and development of more accessible EIT products, which are now being offered in consumer, commercial and government markets worldwide. Accordingly, the commercial EIT inventory of an Internet or retail office supply store is unlikely to be any different than those products being offered via federal contracts or acquisition programs, such as "GSA Advantage!". Government agencies have been identifying and buying accessible EIT with increasing ease, as manufacturers continue to design accessibility into each new generation of products. Given current experience and design trends, we submit that product labeling would ultimately be of little real value or utility to federal purchasers.

Costs Would Far Outweigh the Benefits

As the Interim Rule points out, the U.S. Government spends an estimated \$52 billion per year on EIT products and services, and only a "very small percentage" of that total is acquired "through the micro-purchase process with [government] credit cards." Typically, EIT hardware and software products are acquired via other federal contract vehicles, where the government has been able to take advantage of its purchasing power to obtain more favorable pricing. For most EIT manufacturers, government sales in general represent a very small percentage of their overall business – two to five percent for most ITI members – with government credit card percentages barely registering at all.

Assuming a meaningful label could be designed, the challenge of competing for space on the packaging and the cost of applying the label to packaging is *not* insignificant, and would be extremely difficult to justify the expense given that it is unlikely to generate additional sales. In addition, since government credit card purchases are typically made using the Internet, by phone or in person at retail establishments, it is very likely that government buyers would not even *see* the label until *after* the purchase.

Business Solutions for Government Challenges

Rather than relying on labeling schemes or similar means, ITI recommends greater government and contractor utilization of market-oriented tools, such as the Voluntary Product Accessibility Template, better known as the VPAT (available for download via the ITI web site at www.itic.org/policy/508/Sec508.html). Developed by ITI in partnership with GSA, the VPAT provides a simple mechanism for manufacturers to highlight the accessibility features of their EIT products relative to the Accessibility

Ms. Duarte
March 3, 2003
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2002-012-3

Standards. This in turn helps government buyers meet their obligations under the law and survey the commercial marketplace for accessible products that will meet the requirements of a given acquisition.

As part of an ongoing effort to support Section 508, ITI has posted "best practice" recommendations on our web site, which include a listing of suggested terms to use when filling out VPATs. We will soon publish additional guidance for businesses to help ensure more consistent reporting of accessibility information within product categories. We believe that this will make the VPAT an even more effective tool in helping federal agencies fulfill their responsibilities under Section 508.

ITI and its members remain committed to working with the government and other interested parties to increase the availability of accessible EIT for employees with disabilities. Thank you for the opportunity to submit these comments. We would be happy to respond to any questions the Councils may have.

Sincerely,

Rhett B. Dawson
President

2002-012-4



"Barbara Jackson
LeMoine"
<blemoine@afb.net>

To: farcase.2002-012@gsa.gov
cc:
Subject: FAC 2001-11, FAR Case 2002-012

03/04/2003 03:15 PM

General Services Administration
FAR Secretariat (MVA),
1800 F Street, NW., Room 4035,
Washington, DC 20405.

ATTN: Laurie Duarte

The American Foundation for the Blind is please to submit comments on the extension of the small-purchase exception until 2004. The American Foundation for the Blind has been closely involved in advocacy for Section 508 from participation in the drafting of the amendment to participation as a member of the Electronic and Information Technology Advisory Committee established to develop recommendations resulting in the Architectural and Transportation Barriers Compliance Board's final standards. We offer the following comments based on our experiences in this process as well as our long history in advocacy and leadership undertaken to assure that individuals who are blind or visually impaired will have full access to the information they need to lead independent and productive lives.

We are concerned that it has already been two years since the standards were published and there appears to be little formal training for federal employees with credit cards. What limits are there going to be set to the number of times this exception can be extended? We do not see an incentive for the government to resolve this problem so that the exception is not needed. Perhaps, the small purchase itself is the problem. What research has been done to eliminate this method of purchasing? It seems to us that 52 Billion dollars is a lot of money. It appears by the questions being asked that the government is depending on the industry to provide the information. It seems incongruous to rely on the producers of the products to ensure that the products themselves are compliant. The real losers here are the disabled persons themselves when they are employed in an office, which uses incompliant software, or hardware purchased under the exception and, because of this, the individual cannot perform certain tasks thus impeding career opportunities. The reason that section 508 was passed is that we needed to establish a right to have access to electronic and information and technology on an equal grounds with nondisabled persons. Furthermore, as prices go down for products it is possible to purchase more and more sophisticated EIT for less money, which means that they could be purchased under the small-purchase exception.

In response to your questions:

a. What mechanisms or approaches should the Government consider to ensure EIT micro-purchases (products and services) are accessible?

The government should create tools with questions and measurements for the purchaser to utilize in determining accessibility.

b. Currently, what type of training is being employed by your organization to educate purchasers and users regarding the Section 508 requirements? Is any training specifically geared towards cardholders and micro-purchases? If so, how do you explain and communicate the Section 508 requirements?

Our organization doesn't currently train anyone on small-purchases or cardholders. WE do have the ability to develop training modules to train cardholders if this is helpful.

2002-0124

We would appreciate responses to our questions. Please address them to:

Joy L. Relton
American Foundation for the Blind
Governmental Relations Group
820 1st Street Suite 400
Washington, DC 2002

Sincerely,
Joy L. Relton
Governmental Relations Representative
American Foundation for the Blind
Phone: 202-408-8170
Fax: 202-289-7880
Email: jrelton@afb.net

CC: FAR Desk Officer
Office of Information and Regulatory Affairs
Room 10236
New Executive Office Building
Washington, DC 20503
Subject: FAC 2001-11, FAR Case 2002-012

=====
Barbara Jackson LeMoine
Legislative Assistant
Governmental Relations Group
American Foundation for the Blind
Washington, DC
202-408-8169 <mailto:blemoine@afb.net>
Visit GRG's web site at <http://www.afb.org/gov.asp>
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