Most of us don’t get offered stock options. But some companies do offer them, even if offered primarily to executives. The question is how to account for the costs.

A stock option is an option buy company stock at a certain price. You don’t have to buy the stock today (in fact some plans require you to wait a certain number of years before exercising the option). If the stock price increases between the time you were awarded the option and the time you exercise the option, then you make money. The idea is that if you stand to make money, you’ll put the best interests of the company foremost in your decision-making. The better the company does—at least in the eyes of the market—then the better you will do.

How does a company measure the cost of such options? If the option price is equal to today’s market price, then there is no cost to the company. It is providing shares at market price and there is nothing to account for. It can take shares from its treasury shares and put them away, and that’s the end of the story.

But that’s not the end of the story. A commonsense approach to this topic ignores all the complexities.

First, just because an employee has an option doesn’t mean that employee will exercise that option. The stock price could fall; and who would want to pay $10.00 per share for something that’s worth $5.00 per share. Further, the employee could leave the company and forfeit the right to acquire stock. For those reasons, if no others, a company will not set aside stock today to cover options that might be exercise tomorrow.

What remains is deferred compensation. Employees may exercise options at some point in the future, and the price of the stock may be different from what it is today, and so the company may have to “acquire” stock from treasury (or from the open market) at a price higher than the employee will pay for that stock. The company won’t know the quantity of shares it will issue, or the price it will pay, until the employees actually exercise their options.

Generally Accepted Accounting Principles (GAAP) requires a company to expense some amount today, as an estimate of what it expects to pay later.

The FAR does not permit government contractors to comply with GAAP requirements.

But before we get into that issue, let's acknowledge that there are several legal cases that discuss the allowability of Employee Stock Ownership Plans (ESOPs) and Stock Employee Compensation Trusts (SECTs). If you are dealing with those issues, then you will want to research those cases (*e.g.*, Ball Corp., ASBCA No 49118, and Newport News Shipbuilding, 57 Fed.Cl. 734, 2003). What we are discussing today is neither of those things: we are talking about employee stock options and how to value them for purposes of determining allowable costs.

Luna Innovations, Inc. was one company faced with that challenge. In June, 2006, Luna issued an Initial Public Offering (IPO) of its stock. It offered stock options to selected employees and corporate officers. Generally, the stock options had a 10-year term with a strike price set equal to the market price on the day the options were awarded.

Because Luna was a publicly traded company, it had to comply with FAS 123r. "The purpose of FAS 123r is to recognize, in the current period financial statements, the contingent financial liability represented by the employee stock option. … Thus, FAS 123r requires companies to recognize, at the time of award, the expected future liability, including possible appreciation, in the security price." In order to comply with FAS 123r, companies typically use the Black-Scholes Model to establish a value for the future stock price as well as to determine what that future stock price is worth today.. "In essence the model treats the stock option as a forward contract to deliver the stock at the end of the option period."

The problem with the Black-Scholes Model, from the point of view of a government contractor, is that one of its inputs is the volatility of the stock price, as measured from prior year price changes. Why is that a problem? It's a problem because the cost principle at FAR 31.205-6(i) states that "Any compensation which is calculated, or valued, based on changes in the price of corporate securities is unallowable." Because one of the Black-Scholes Model inputs was stock price volatility, Luna was going to have a problem with DCAA if it used the Model to measure the current period expense associated with its employee stock options.

Luna used the Black-Scholes Model to measure its current period stock option expense, and claimed $2,291,790 in allowable compensation in its FY 2007 proposal to establish final billing rates. DCAA questioned those costs and the administrative contracting officer (ACO) agreed. Further, the ACO slapped Luna with a demand for an additional $834,441 because the claimed compensation costs were "expressly unallowable"—plus the government demanded an additional $211,647 in interest. As part of the process, the ACO unilaterally established Luna's FY 2007 final billing rates without the disputed stock option expense included therein and, as a result, determined that Luna had previously overbilled the government in the amount of $95,333 (based on the difference between provisional billing rates and final billing rates). In total, the government demanded that Luna pay $1,141,421, calculated as $834,441 plus $211,647 plus $95,333. Luna **appealed** the ACO's COFD to the ASBCA.

(As you can see from the above, the amount associated with the unallowable compensation was rather insignificant. It was the penalty and interest that was the killer.)

Long story short, Judge D'Alessandris, writing for the Board, found that Luna's claimed stock option expense was indeed unallowable. ("Luna's employee stock option costs are unallowable under the plain language of the FAR….") However, the Board found that the costs were not expressly unallowable. Judge D'Alessandris wrote—

Given the complexity of the circumstances, the fact that the use of the Black-Scholes model is a question of first impression, the need to review the differential equations comprising the Black-Scholes model, and the fact that there could be a reasonable difference of opinion regarding the costs, we hold that it was not 'unreasonable under all the circumstances' for Luna to claim the employee stock option costs, and hold that the employee stock option costs are not expressly unallowable.

Therefore, it was rather a hollow victory for the government. The government will recover less than ten cents on the dollar.

To us, the more important question is "why are GAAP accounting requirements unacceptable for use in government contract cost accounting?" It's not as if Luna had much of a choice. As a publicly traded company, it was required to comply with FAS 123r. Why does the government reject required accounting treatment in favor of a unique approach to contract costing?

It's not enough to say that "public policy" requires a unique treatment. Nor is it sufficient to say that compensation based on stock price changes “does not represent work actually performed.” Those points should be irrelevant to the question of cost allowability, or at least should be superseded by the need to comply with GAAP.

The reason this question matters is because the Department of Defense has been attempting to woo non-traditional defense contractors. It has been actively working to attract Silicon Valley and other technology companies in an attempt to leverage the R&D budgets of those companies. It has been looking for start-ups and for innovators and for small businesses that are agile and flexible. It has created the Defense Innovation Board to help it change to better attract such companies.

And yet the Department of Defense and other government agencies create high barriers to market entry through onerous regulations that require deep expertise and which contain stiff penalties for non-compliance. This issue in particular is quite important to technology start-ups that base a large amount of compensation on employee stock options. If you make that aspect of their compensation plans unallowable, you significantly limit their ability to recover their costs. That limitation becomes a "toll" for doing business with the Federal government. Why should non-traditional defense contractors pay a “toll” for entering the defense marketplace, where the “toll” is measured not only in lost compensation recovery, but also in additional overhead costs associated with adjusting GAAP-compliant books to meet arcane government accounting regulations--and where the "toll" is also likely to include provision for contingent liabilities associated with the probability that those companies will not be able to comply with the rules and will end up before a Board of Contract Appeals.

It makes no sense.

It makes no sense to make companies adjust their GAAP-compliant books to meet arcane regulatory requirements, and then to penalize them for failing to do so satisfactorily.

It makes no sense if you want to attract non-traditional companies into the defense marketplace.

Meanwhile, “The Center for Strategic and International Studies study said the number of first-tier prime vendors declined by roughly 17,000 companies, or roughly 20 percent, between 2011 and 2015.” See **this article** at DefenseNews.com, citing the upcoming release of a formal study by CSIS.

So while the Federal government is busy penalizing contractors for following GAAP and for failing to follow the FAR, the defense industrial base is shrinking and companies are finding sales channels elsewhere.

Section 809 Panel – are you getting this picture?