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PLAN SPONSOR ESOP ACCOUNTING – AN OVERVIEW

Angela Fisher & Corey Vincent / July 11, 2023

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Objectives

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- Describe accounting for both leveraged & nonleveraged ESOPs for plan sponsors
- Identify the types of leveraged ESOP loans
- Discuss the basics of repurchase obligation on plan sponsor's financial statements
- Identify required footnote disclosures for plan sponsor's financial statements

WHAT IS AN ESOP?

- Qualified retirement plan
- Similar to profit-sharing plan, except
  - Designed to invest primarily in company stock
  - ESOP can borrow money (leveraged ESOP) to purchase company stock
- Stock is held by ESOP trust
  - ESOP trust is legal shareholder
  - Employees are beneficial (not actual) owners in value of stock allocated to their account
  - Employees do not receive stock
- Governed by Internal Revenue Code (IRC) & Employee Retirement Income Security Act of 1974 (ERISA), with oversight by Internal Revenue Service (IRS) & Department of Labor (DOL)

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TWO FORMS OF ESOPS

Leveraged

Nonleveraged

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NONLEVERAGED ESOPS

- Nonleveraged
  - Does not borrow funds to buy company stock
  - ESOP trust/plan acquires shares over time either through cash contributions or stock contributions from plan sponsor
    - Stock contributions can be either new company stock or stock from treasury
  - Accounting relatively simple
    - As cash or stock is contributed by plan sponsor, the plan sponsor records compensation expense equal to the fair value of the asset transferred

LEVERAGED ESOPS

- Leveraged
  - ESOP borrows money to purchase stock from selling stockholder(s)
  - Similar to traditional leveraged buyouts, except
    - Allows owner to continue to manage business
    - Tax benefits to seller & company
    - Over time, wealth transferred to broad-based employees

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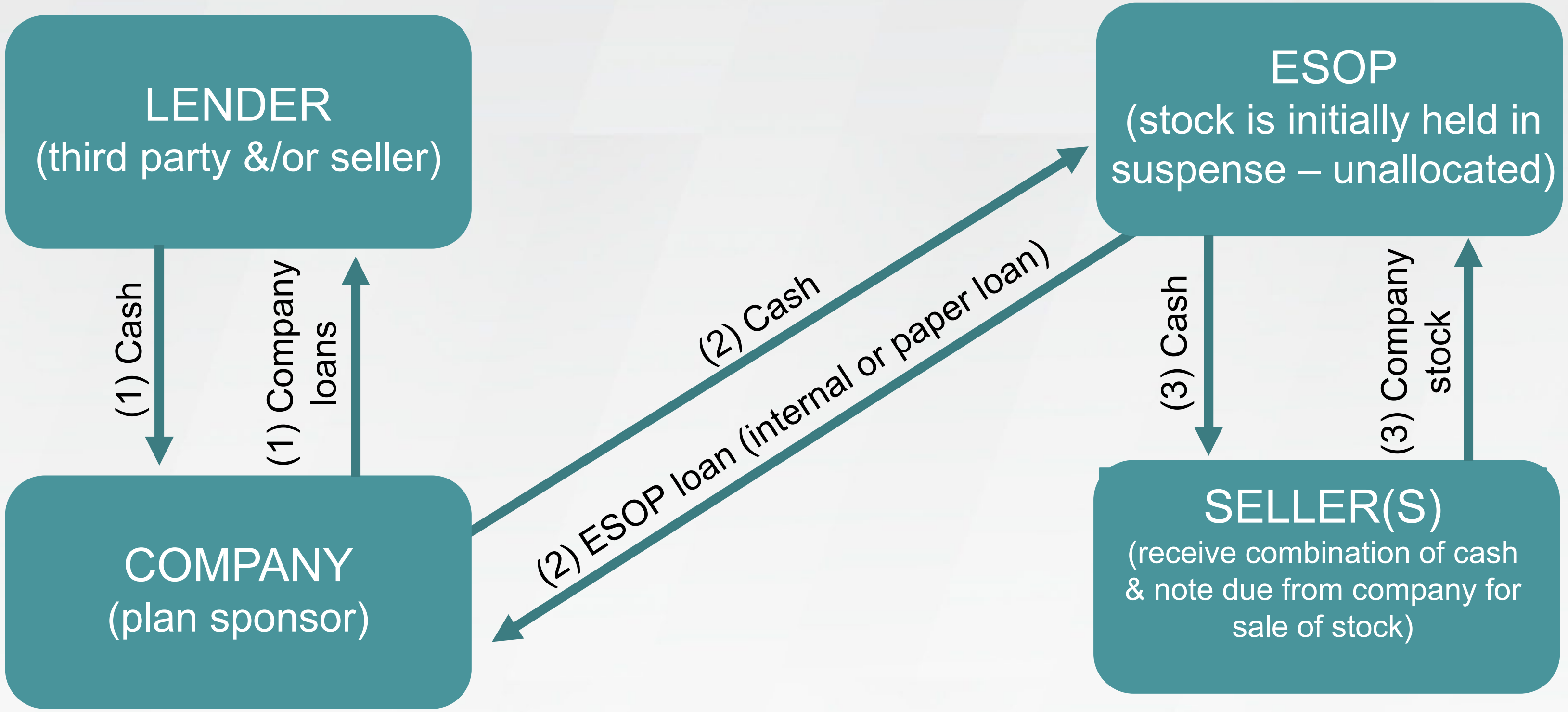
INITIAL TRANSACTION



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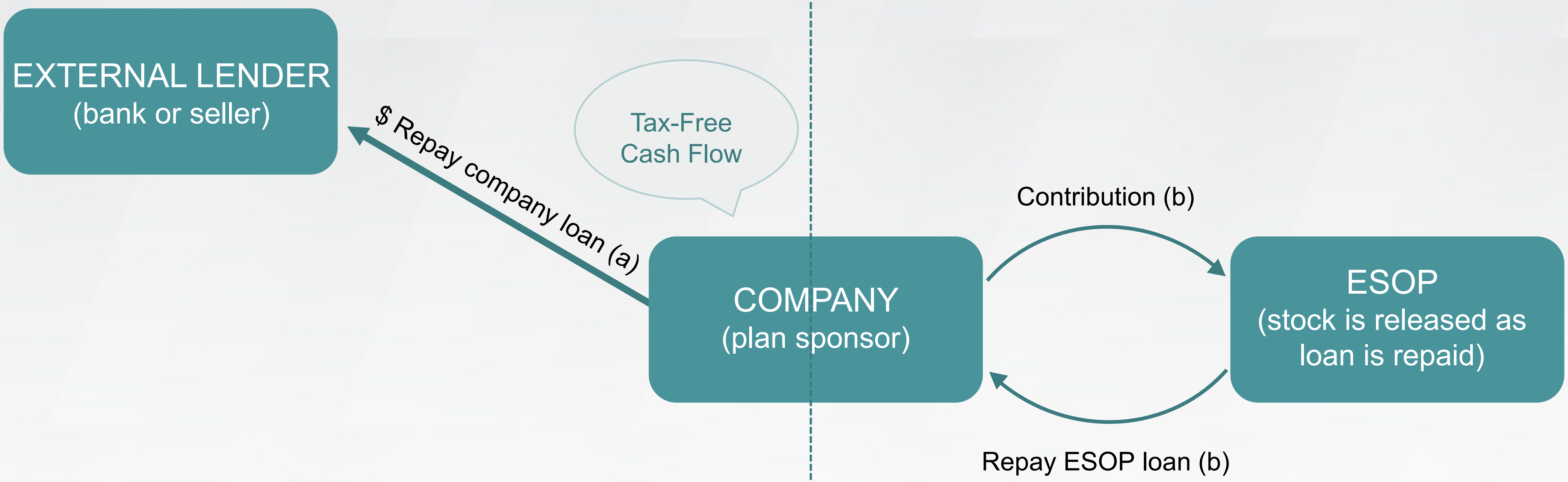
INITIAL TRANSACTION



(a) Generally, five- to seven-year amortization
(b) ESOP loan generally repaid over 20 years or longer
(no cash outlay)

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INTERNAL LOAN CONSIDERATIONS

- Has no cash flow impact
- Contributions & dividends/distributions can be used to repay ESOP loan
  - Contributions generally limited to 25% of compensation (IRS regulation)
- Acquired shares serve as collateral on the internal loan (unallocated)

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INTERNAL LOAN CONSIDERATIONS

Shares are released & allocated to participant accounts annually as loan is repaid

- The faster the internal loan is repaid, the more benefit is allocated to participants annually
- The slower the internal loan is repaid, less benefit is allocated to participants annually

Internal loans typically have a minimum of 30 years

The ESOP internal loan has no connection to the external loan due to third party or seller

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LEVERAGED ESOPS

- Leveraged
  - There are basically three types of ESOP loans
    - Internal loan – company directly makes loan to ESOP without any outside lenders
    - Indirect – lender/selling shareholder(s) makes loan to company, company then makes a loan to ESOP
    - Direct – lender/selling shareholder(s) makes loan directly to ESOP
  - Accounting can be complex & may significantly impact the company’s financial statements

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AUTHORITATIVE GUIDANCE

- Accounting Standards Codification (ASC) Subtopic 718-40 Employee Stock Ownership Plans
  - Formerly Statement of Position (SOP) 93-6 Accounting for Employee Stock Ownership Plans

UNEARNED ESOP COMPENSATION ACCOUNT

- This is a contra equity account & represents the initial purchase price of the shares by ESOP
- Often, on Day 1, this is the same as the internal loan. After Day 1, this account will **NOT** represent the internal loan balance
- On a go-forward basis, this account should always represent the number of unallocated shares times the historical purchase price of those shares

EXAMPLE

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- On January 1, 2023, the ESOP purchased 100,000 shares for $14,000,000 ($140/share)

	Opening 01/01/2023	Transaction	Post-Closing 01/01/2023
ASSETS			
Cash	700,000		700,000
Accounts receivable, net	2,000,000		2,000,000
Inventories	5,000,000		5,000,000
Prepaid expenses and other assets	100,000		100,000
Fixed assets	4,000,000		4,000,000
Total Assets	11,800,000		11,800,000
LIABILITIES AND STOCKHOLDERS' EQUITY			
Accounts payable	2,500,000		2,500,000
Accrued expenses	500,000		500,000
Acquisition Term Notes	-	14,000,000	14,000,000
Total Liabilities	3,000,000	14,000,000	17,000,000
Retained earnings	8,800,000		8,800,000
Unearned ESOP shares	-	(14,000,000)	(14,000,000)
Total Equity	8,800,000	(14,000,000)	(5,200,000)
Total Liabilities and Stockholders' Equity	11,800,000	-	11,800,000

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SHARES TERMINOLOGY

- Allocated shares
  - Shares that have been assigned to participant accounts
- Committed-to-be-released shares
  - Not legally released but will be released by a future scheduled & committed debt service payment & will be allocated to employees for service rendered in the current accounting period
- Suspense shares
  - Shares that have not been released, committed to be released, or allocated to participant accounts; & generally collateralize ESOP debt

COMPENSATION EXPENSE

- Company records compensation expense, annually, equal to number of shares committed to be released to employees for services performed during the accounting period times fair value
  - Fair value is generally determined based on the average stock value during the period
  - Compensation expense should be presented as an above-the-line operating expense

EXAMPLE

- On December 31, 2023, the ESOP makes a loan payment that releases 2,000 shares from suspense out of the 100,000 initially in suspense
- Price at the beginning of the year: $150/share
- Price at the end of the year: $165/share

Journal Entry

Debit	ESOP Compensation Exp.	$315,000 ($150+$165/2*2,000 shares)	
Credit	Additional Paid in Capital		$35,000
Credit	Unearned ESOP Shares		$280,000 ($140/share*2,000 shares)

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INCOME STATEMENT

	12/31/23
Revenues	28,600,000
Cost of revenues	23,500,000
Gross profit	5,100,000
General and administrative expense	1,500,000
ESOP compensation expense	315,000
Operating income	3,285,000
Other income (expense)	
Interest expense	(500,000)
Other income (expense)	200,000
Total other income (expense)	(300,000)
Net income	2,985,000

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BALANCE SHEET

	Post-Closing 01/01/2023	2023 Activity	Loan Payment	12/31/2023
ASSETS				
Cash	700,000	2,670,000		3,370,000
Accounts receivable, net	2,000,000			2,000,000
Inventories	5,000,000			5,000,000
Prepaid expenses and other assets	100,000			100,000
Fixed assets	4,000,000			4,000,000
Total Assets	11,800,000	2,670,000	-	14,470,000
LIABILITIES AND STOCKHOLDERS' EQUITY				
Accounts payable	2,500,000			2,500,000
Accrued expenses	500,000			500,000
Acquisition Term Notes	14,000,000			14,000,000
Total Liabilities	17,000,000	-	-	17,000,000
Retained earnings	8,800,000	2,670,000	(315,000)	11,155,000
APIC	-		35,000	35,000
Unearned ESOP shares	(14,000,000)		280,000	(13,720,000)
Total Equity	(5,200,000)	2,670,000	-	(2,530,000)
Total Liabilities and Stockholders' Equity	11,800,000	2,670,000	-	14,470,000

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DIVIDENDS & DISTRIBUTIONS

- Cash dividends & distributions on allocated shares are recorded as dividends
- Cash dividends & distributions on unallocated shares are recorded as compensation expense
- If cash from dividends on allocated shares is used to fund internal loan debt service, that cash has to be replaced with an asset of equal value which is typically more shares
  - This releases more shares & creates more compensation expense

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ADDITIONAL CONSIDERATIONS

- Cash contributed to ESOP that is not returned as part of debt service, *i.e.*, to be used for repurchase obligation, can either be
  - Contribution expense (subject to IRS regulations)
  - Dividend or distribution (see previous slide)
- Synthetic equity (warrants, options, SARs)
  - Often see these instruments issued to management to incentivize them to grow shareholder value
- Bank covenants, KPIs, & negative equity

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REPURCHASE OBLIGATION

- Participants are entitled to receive cash equal to the fair value of the stock allocated to their accounts upon a distributable event thus creating the repurchase obligation
  - Under IRC Section 409(h), the company—not the ESOP—is required to provide enough cash to the Plan so the ESOP can meet these distribution requirements

REPURCHASE OBLIGATION

- Company has the fiduciary responsibility to plan for & manage this repurchase liability
- Repurchase obligation is not required to be reflected as a liability on the plan sponsor’s balance sheet for **private companies***
- Plan sponsor should disclose in its financial statement footnotes the existence & nature of any repurchase obligation, including disclosure of fair value of shares allocated as of the balance sheet date

**Public companies that have effective put option do have to report their ESOP-related shares outside of permanent equity under the guidance of Accounting Series Release 268*

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FOOTNOTE DISCLOSURES

- ASC Subtopic 718-40 requires the following disclosures
  - Description of the plan, basis for determining contributions, & employee groups covered
  - Description of accounting policies followed for ESOP transactions, including method of measuring compensation, classification of dividends on ESOP shares, & treatment of ESOP shares for earnings-per-share computations

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FOOTNOTE DISCLOSURES

- ASC Subtopic 718-40 requires the following disclosures
  - Amount of compensation cost recognized during the period
  - Number of allocated, committed-to-be-released, & suspense shares held by ESOP as of balance sheet date
  - Fair value of unearned ESOP shares at balance sheet date
  - Existence & nature of any repurchase obligation, including the fair value of the shares allocated as of the balance sheet date, which are subject to the repurchase obligation

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CONCLUSION

- We continue to see many companies exploring ESOPs as a succession & legacy strategy
- Each transaction is unique & different
- Those differences can drive different accounting entries
- Consult with your legal & financial advisors

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Questions?

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DISCLAIMER

Information contained herein is intended to provide a general overview of certain ESOP structures/transactions & should not be acted upon without seeking professional guidance. ESOP laws & regulations are complex & specific recommendations & courses of action are dependent on a thorough review of facts & circumstances.

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