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PLAN SPONSOR ESOP ACCOUNTING – AN OVERVIEW
September 26, 2018
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## INTRODUCTION

# OBJECTIVES

- Brief introduction of employee stock ownership plans (ESOPs)
- Understand accounting for both leveraged & nonleveraged ESOPs for plan sponsors
- Understand basics of repurchase obligation on plan sponsor's financial statements
- Prepare 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)

## TWO FORMS OF 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 is 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





## TWO FORMS OF 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 is transferred to broad-based employees

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# TWO FORMS OF 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





# 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

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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

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# INITIAL TRANSACTION


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# BALANCE SHEET (ASSETS)

| | Pre-Transaction | External Loan | Internal Loan | Post-Transaction |
|---|---|---|---|---|
| **Current Assets** | | | | |
| Cash | $ 50,000 | 15,000,000 | (15,000,000) | $ 50,000 |
| Accounts receivable | 3,000,000 | | | 3,000,000 |
| Inventory | 5,000,000 | | | 5,000,000 |
| Other current assets | 300,000 | | | 300,000 |
| **Total Current Assets** | 8,350,000 | | | 8,350,000 |
| Property & equipment, net | 10,000,000 | | | 10,000,000 |
| Other long term assets | 1,650,000 | | | 1,650,000 |
| **Total Assets** | $ 20,000,000 | | | $ 20,000,000 |

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# BALANCE SHEET (LIABILITIES & STOCKHOLDERS' EQUITY)

| | Pre-Transaction | External Loan | Internal Loan | Post-Transaction |
|---|---|---|---|---|
| **Current Liabilities** | | | | |
| Accounts payable | $ 2,500,000 | | | 2,500,000 |
| Accrued expenses | 1,500,000 | | | 1,500,000 |
| Notes payable, bank | 500,000 | | | 500,000 |
| **Total Current Liabilities** | 4,500,000 | | | 4,500,000 |
| **Long Term Debt** | 3,000,000 | 15,000,000 | | 18,000,000 |
| **Stockholders' Equity** | | | | |
| Common stock | 100,000 | | | 100,000 |
| Additional paid-in capital | 5,000,000 | | | 5,000,000 |
| Retained earnings | 7,400,000 | | | 7,400,000 |
| Unearned ESOP shares | - | | (15,000,000) | (15,000,000) |
| **Total Stockholders' Equity** | 12,500,000 | | | (2,500,000) |
| **Total Liabilities & Stockholders' Equity** | $ 20,000,000 | | | $ 20,000,000 |

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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)



## INTERNAL LOAN CONSIDERATIONS

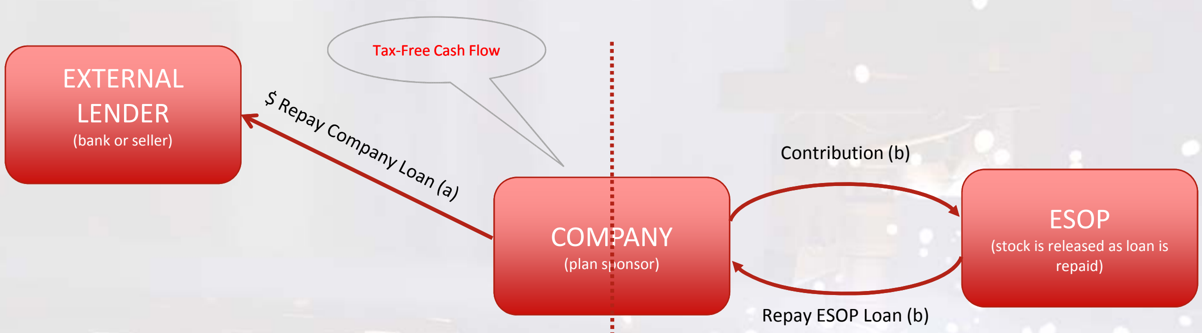
- Shares are released & allocated to participant accounts annually as loan is repaid
  - The faster the internal loan is repaid, the more benefit is allocated to participants annually
  - The slower the internal loan is repaid, less benefit is allocated to participants annually
- Internal loans typically have a minimum of 20 years
- The ESOP internal loan has no connection to the external loan due to third party or seller

## VARIATIONS OF INITIAL TRANSACTION

- Could be less than 100% of outstanding stock (partial sale)
- Could have a mix of third-party & seller financing
- ESOP loan can be: internal, direct or indirect
- If excess liquid assets on the balance sheet, company could use liquid assets to repurchase shares into treasury before ESOP transaction is executed
- Could distribute illiquid noncore assets to seller, *i.e.*, buildings & land, prior to ESOP transaction



## HOW DOES REPAYMENT OF A 100% LEVERAGED ESOP WORK?




(a) Generally 5 –7 year amortization
(b) ESOP loan generally repaid over 20 years or longer (no cash outlay)

## SUBSEQUENT TRANSACTIONS

- ESOP needs cash to fund its debt service on the internal loan with plan sponsor & later to fund repurchase obligations
- Cash comes in two forms
  - Company contributions (limited by the IRS to amounts up to 25% of eligible compensation)
  - Distributions & dividends
- Company sends cash to ESOP & the ESOP sends money back to company for internal debt service. Cash flow associated with the internal loan is cash neutral
- Even though cash neutral, cash should change hands, *i.e.*, do not just record journal entries

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## COMPENSATION EXPENSE

- Company records compensation expense, annually, equal to number of shares released from suspense (collateral) times the average price of the shares during the period
  - Compensation expense should presented as an above-the-line operating expense

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## COMPENSATION EXPENSE

- Example
  - 100,000 shares in suspense
  - 2,000 shares released based on internal loan debt service payments
  - Price at the beginning of the period $150
  - Price at the end of the period $165

**Journal Entry**

| | | | |
|---|---|---|---|
| Debit | Compensation Expense | $315,000 (($165+150)/2*2,000) | |
| Credit | Additional Paid in Capital | | $315,000 |





## 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 <u>NOT</u> 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

## UNEARNED ESOP COMPENSATION ACCOUNT

- Example
  - 2,000 shares released from suspense out of the 100,000 initially in suspense
  - Historical purchase price $150/share

**Journal Entry**

| | | | |
|---|---|---|---|
| Debit | Additional Paid in Capital | $300,000 | |
| Credit | Unearned ESOP Compensation Account | | $300,000 (2,000*$150/share) |





## 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

## 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

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## 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*



## 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

## 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



## 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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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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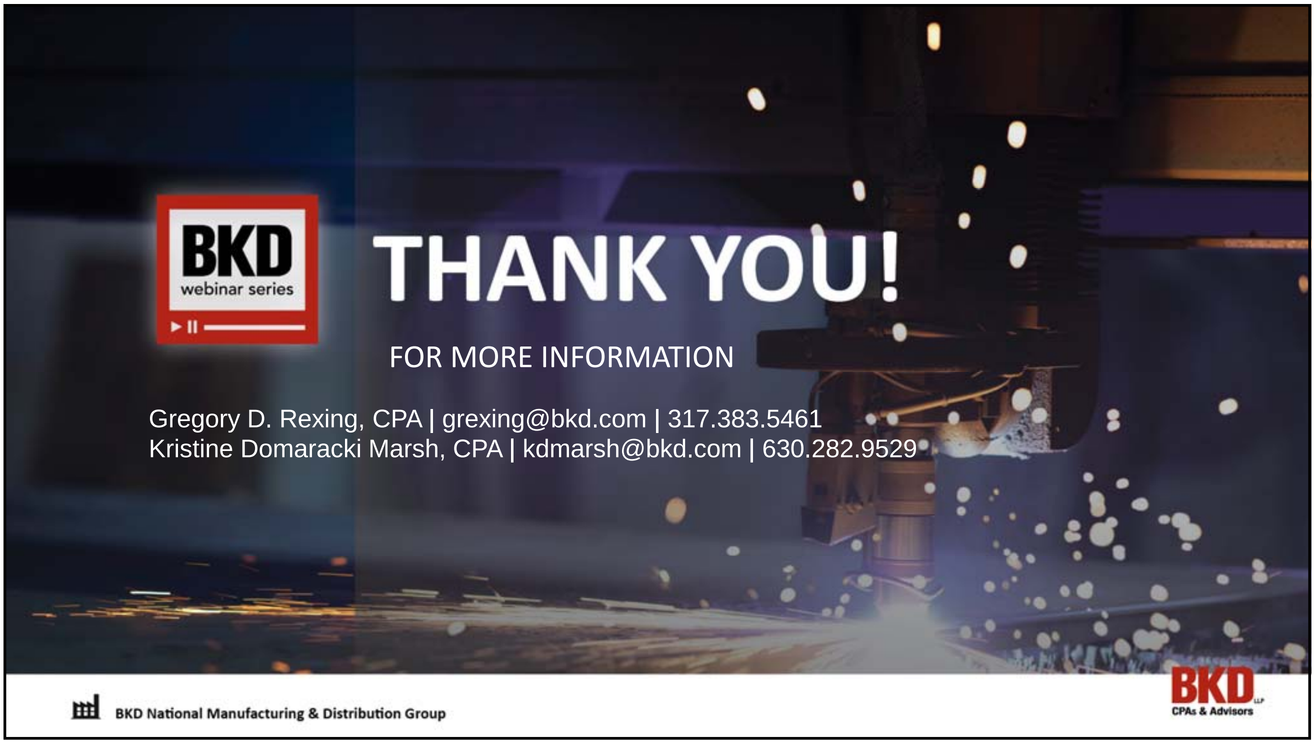
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