Accounting for ESOPs: Impact on Financial Statements of Plan Sponsors

Presented by

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Goals of the Session

- Refresher on definitions of specific terms
- Understand how to account for ESOP transactions
- Review accounting for ESOP loan payments
- Review accounting for issuance of dividends
Citations and Resources

- SOP 93-6 is no longer applicable
- ASC 718-40: ESOP Stock Ownership Plans
- NCEO publications
Definitions and Basics

- Unearned or ESOP shares held in suspense
- Allocated shares
- Direct loan
- Indirect loan
- Compensation cost
- Contributions
- Dividends on C-corporation shares
- Release of shares
- Shares committed-to-be released
Types of ESOPs

- Non-Leveraged
  - Cash Warehouse
  - Creeping ESOP
- Leveraged – Bank Financed
- Leveraged – Seller Financed
- Leveraged – Internally Financed
- Leveraged – Blended Financing
Non-Leveraged ESOP

Company → ESOP

ESOP Contributions $$$

$$$

Company Stock

Selling Shareholder
Case Study 1 – Non-Leverage

- Contributions of cash or stock to an ESOP are reported as compensation expense equal to the fair value of the contribution.
- For stock contributions, the stock is valued effective as of the date of transfer.
Illustration

- Cash Contributions – The Company contributes cash to the ESOP. The Company issues fresh shares of corporate stock to the ESOP in exchange for cash.

- Stock Contributions – The Company issues stock directly to the ESOP.

- Dilutive
## Journal Entries

### Transaction – Cash Contribution

<table>
<thead>
<tr>
<th>Debit</th>
<th>Credit</th>
<th>Amount</th>
</tr>
</thead>
<tbody>
<tr>
<td>DR Compensation expense</td>
<td>CR Cash</td>
<td>$200,000</td>
</tr>
<tr>
<td>CR Cash</td>
<td>DR Cash</td>
<td>$200,000</td>
</tr>
<tr>
<td>CR Common stock (par value $5)</td>
<td>DR Cash</td>
<td>$50,000</td>
</tr>
<tr>
<td>CR Additional paid-in capital</td>
<td></td>
<td>$150,000</td>
</tr>
</tbody>
</table>
Journal Entries

Transaction – Stock Contribution

DR Compensation expense $200,000
CR Common stock (par value $5) $ 50,000
CR Additional paid-in capital $150,000
Tax Impact

- Tax deduction of $200,000
- No book/tax timing differences
Key Ideas

- The book expense will equal the tax deduction.
- If the ESOP acquires stock from the shareholder with cash, it will be outside the Company’s books because there is no debt.
- There are no suspended shares; all shares are allocated to participants.
Case Study 2 – Leveraged – Bank

- The Company obtains a loan from a bank.
- The Company lends the funds to the ESOP.
- The ESOP pays the selling shareholder(s) in exchange for stock.
ESOP Case 2; Bank Financed Leveraged Purchase “Non-Mirror Loans”

- Company
- Bank Loan “Outside Loan” $$$
- Note
- ESOP Loan “Inside Loan” $$$$$
- Note
- ESOP
- $$$$$ Company Stock
- Selling Shareholder
Bank Relations Post Deal: Impaired Balance Sheet

- They should be brought in early.
- Clear communication on issues that must be addressed when calculating bank covenants and ratios.
  - Non cash charge to operations
  - ESOP compensation needs to be an add back to EBITDA
  - If you have a pricing matrix on lending, make sure anything based on EBITDA, that the ESOP compensation expense is an add back to EBITDA calculation.
- Communicate an understanding with the bank that the compensation expense trajectory will be considered in the valuation and repurchase liability estimates.
Illustration

- Company borrows $900,000 from a bank for 5.5% for 7 years.
- ESOP borrows $1,280,000 from the Company for 4.0% for 10 years consisting of the proceeds from the bank loan and $380,000 from existing cash.
- The ESOP purchases 100,000 shares from the Seller.
- Appraised value of stock is:
  - Transaction Date = $12.80 per share
  - Year 1 = $14.00 per share
  - Year 2 = $16.00 per share
Case Study 2 Journal Entries
Funding and Transaction

<table>
<thead>
<tr>
<th>Description</th>
<th>Debit</th>
<th>Credit</th>
</tr>
</thead>
<tbody>
<tr>
<td>DR Cash</td>
<td>$900,000</td>
<td></td>
</tr>
<tr>
<td>CR Note payable, bank</td>
<td></td>
<td>$900,000</td>
</tr>
<tr>
<td>DR Unearned ESOP shares</td>
<td></td>
<td>$1,280,000</td>
</tr>
<tr>
<td>($12.80/sh. x 100,000 sh.)</td>
<td></td>
<td></td>
</tr>
<tr>
<td>CR Cash</td>
<td></td>
<td>$1,280,000</td>
</tr>
</tbody>
</table>
Case 2 Journal Entries
Bank “Outside” Loan Payment

DR Note payable, bank $108,000
DR Interest expense $  49,500
CR Cash $158,368
Management is responsible for corporate GAAP financial statements including any estimates that are made. As contributions are made to the plan to pay down ESOP debt, shares are released at “fair market value” triggering the booking of compensation expense.

This presents a circular problem as the appraiser wants the financial statements before determining FMV. Management must estimate FMV based on prior appraisal methodology incorporating current financial performance and other pertinent factors. The estimate could be substantial.

Management must be well versed in the methodology the appraiser uses to run cash flow models etc. to estimate FMV.
Journal Entries

“Inside” Loan Financial Statement Impact

Corporate auditors will test the estimate of value and may present adjusting entries.

Significant changes could produce an adjustment which can be a large unbudgeted expense and cause a default in a bank covenant.

Significant waivers in budget versus actual will cause the appraiser to pause and judge negatively if management is also presenting financial forecasts that are relied on in the appraisal process.
Journal Entries
“Inside” Loan

After the Company makes a contribution to the ESOP in the amount of $157,000 the ESOP makes a debt service payment to the Company in the amount of $157,812 consisting of $106,612 in principal and $51,200 in interest. As a result, 8,300 shares are released from the suspense account for allocation to participants. The compensation expense is based on an estimate of fair market value of shares released:

DR Compensation expense
(Avg. FMV $13.40/sh. x 8,300 sh.) $111,220
CR Additional paid-in capital
($0.60/sh. x 8,300 sh.) $ 4,980
CR Unearned ESOP shares
(Cost $12.80/sh. x 8,300 sh.) $106,240
Key Ideas

• Unearned shares are a **contra-equity account**.
• For GAAP purposes, the interest income from the “inside loan” is **not recognized**.
• Compensation expense is based on an estimate of the fair value of the stock being released.
• How can you determine the FMV and book the entry for release prior to the financial statements being final and the appraisal being completed?
Case Study 2-Dividends

- A Dividend to a C-corporation ESOP is tax deductible as long as the dividend is used to either service the ESOP debt or it is passed through to the participants.
- Dividend rate must be reasonable.
- An S-corporation distribution of earnings/dividend is not deductible.
Dividend Illustration – Year 1

- At the end of Year 1, the Company issues a dividend that will be used to pay down debt. The dividend is $0.45 per share (for a total of $45,000 = $0.45 \times 100,000$ shares) and the debt repayment releases 3,515 shares.
- The Company writes a check to the ESOP for $45,000 and the ESOP writes a check to the Company for $45,000.
Case 2 Dividend Journal Entry

DR Compensation expense
(Avg. FMV $13.40/sh. x 3,515 sh.) $47,101

CR Additional paid-in capital
($0.60/sh. x 3,515 sh.) $ 2,096

CR ESOP unearned shares
(Cost $12.80/sh. x 3,515 sh.) $45,005
Tax Impact

Tax Deduction

• Cash contribution of $157,000 plus
• Dividend used for debt repayment of $45,000
Dividends to Allocated and Unearned Shares

- Dividends to allocated shares are charged to retained earnings.
- Dividends to unearned shares are charged to compensation expense.
Dividend Illustration – Year 2

- At the end of Year 2, the Company issues a dividend that will be used to pay down debt. The dividend is $0.45 per share (for a total of $45,000 = $0.45 \times 100,000\) shares) and the debt repayment releases 3,515 shares.
- The Company writes a check to the ESOP for $45,000 and the ESOP writes a check to the Company for $45,000.
Unearned Shares

In Year 2, the dividend is allocated between allocated and unearned shares. According to the third-party administrator, 83% of the shares are unearned:

DR Compensation expense
(Avg. FMV $15/sh. x 83% x 3,515 sh.) $43,762

CR Additional paid-in capital
($2.20/sh. x 83% x 3,515 sh.) $ 6,419

CR ESOP unearned shares
(Cost $12.80/sh. x 83% x 3,515 sh.) $37,343
Allocated Shares

In Year 2, the dividend is allocated between allocated and unearned shares. According to the third-party administrator, 17% of the shares are unearned:

DR Retained Earnings
(Avg. FMV $15/sh. x 17% x 3,515 sh.) $8,963

CR Additional paid-in capital
($2.20/sh. x 17% x 3,515 sh.) $1,314

CR ESOP unearned shares
(Cost $12.80/sh. x 17% x 3,515 sh.) $7,649
Key Ideas

- In a C-Corporation, dividends on unearned shares are compensation expense at the estimated fair value.
- Dividends on allocated shares are dividends.
Case Study 3 – Leverage – Seller Note

• The Seller takes back a note from the ESOP in exchange for stock.
Case Study 3 – Leverage – Seller Note

Company → ESOP

ESOP Contributions $$$

Note $$$ Company Stock

Selling Shareholder
Illustration – Seller Financed Note

- Company purchases 100,000 shares from Seller for $1,000,000.
- Seller receives a note for $1,000,000 at 5.0% for 15 years.
- Appraised value of stock is:
  - Transaction Date = $10.00 per share
  - Year 1 = $10.50 per share
  - Year 2 = $11.00 per share
Journal Entries - Transaction

DR ESOP unearned shares $1,000,000
CR Note payable, seller $1,000,000
Journal Entries - Repayment

<table>
<thead>
<tr>
<th>Debit (DR)</th>
<th>Credit (CR)</th>
<th>Amount</th>
</tr>
</thead>
<tbody>
<tr>
<td>DR Interest expense</td>
<td></td>
<td>$50,000</td>
</tr>
<tr>
<td>DR Note payable, seller</td>
<td></td>
<td>$46,342</td>
</tr>
<tr>
<td>CR Cash</td>
<td></td>
<td>$96,342</td>
</tr>
<tr>
<td>DR Compensation expense</td>
<td></td>
<td></td>
</tr>
<tr>
<td>(Avg. FMV $10.25/sh. x 6,667 sh.)</td>
<td></td>
<td>$68,337</td>
</tr>
<tr>
<td>CR Additional paid-in capital</td>
<td></td>
<td></td>
</tr>
<tr>
<td>($0.25/sh. x 6,667 sh.)</td>
<td></td>
<td>$1,667</td>
</tr>
<tr>
<td>CR ESOP unearned shares</td>
<td></td>
<td></td>
</tr>
<tr>
<td>(Cost $10/sh. x 6,667 sh.)</td>
<td></td>
<td>$66,670</td>
</tr>
</tbody>
</table>
Financial Footnotes

• Significant Accounting Policies
  • External (direct loan) versus Internal (indirect) ESOP Debt
  • FASB ASC 718
  • Recognition of compensation costs

• Employee Stock Ownership Plan
  • Details of plan
  • History of stock purchases
  • Current contributions
  • Current released and unreleased shares
  • Estimated current FMV of shares
  • Schedule of future share releases
Key Takeaways

- Accounting for ESOPs is not rocket science nor is it intuitive
- Unearned ESOP shares are a contra-equity account
- Stock is released from suspense and allocated to plan participants as debt is paid down
- Compensation costs are measured by the fair value of the shares released
- Interest income from “inside” loan is not reported
Disclosure

- This presentation is designed to provide accurate and authoritative information in regard to the subject matter covered. This information is provided solely as a teaching tool, with the understanding that the instructors are not engaged in rendering legal, accounting or other professional opinions and that they are not offering advice in this presentation and these accompanying materials.
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Questions?

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