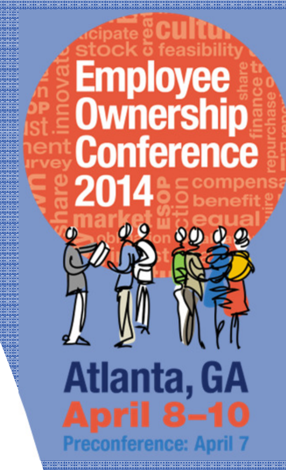

Accounting for ESOPs: Impact on Financial Statements of Plan Sponsors

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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- SOP 93-6 is no longer applicable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

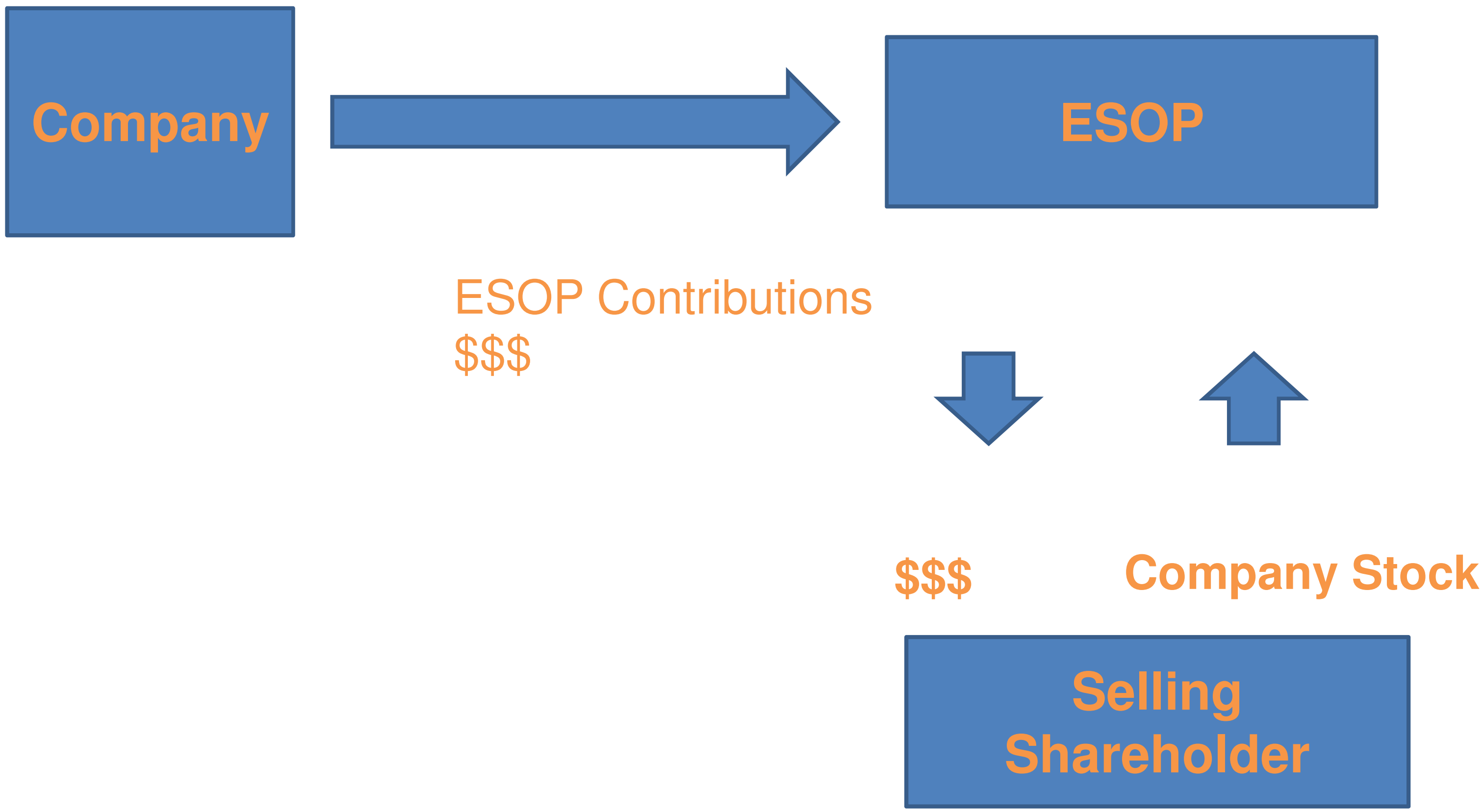
Definitions and Basics

- 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



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

Employee Ownership Conference

Journal Entries
Transaction – Cash Contribution

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

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

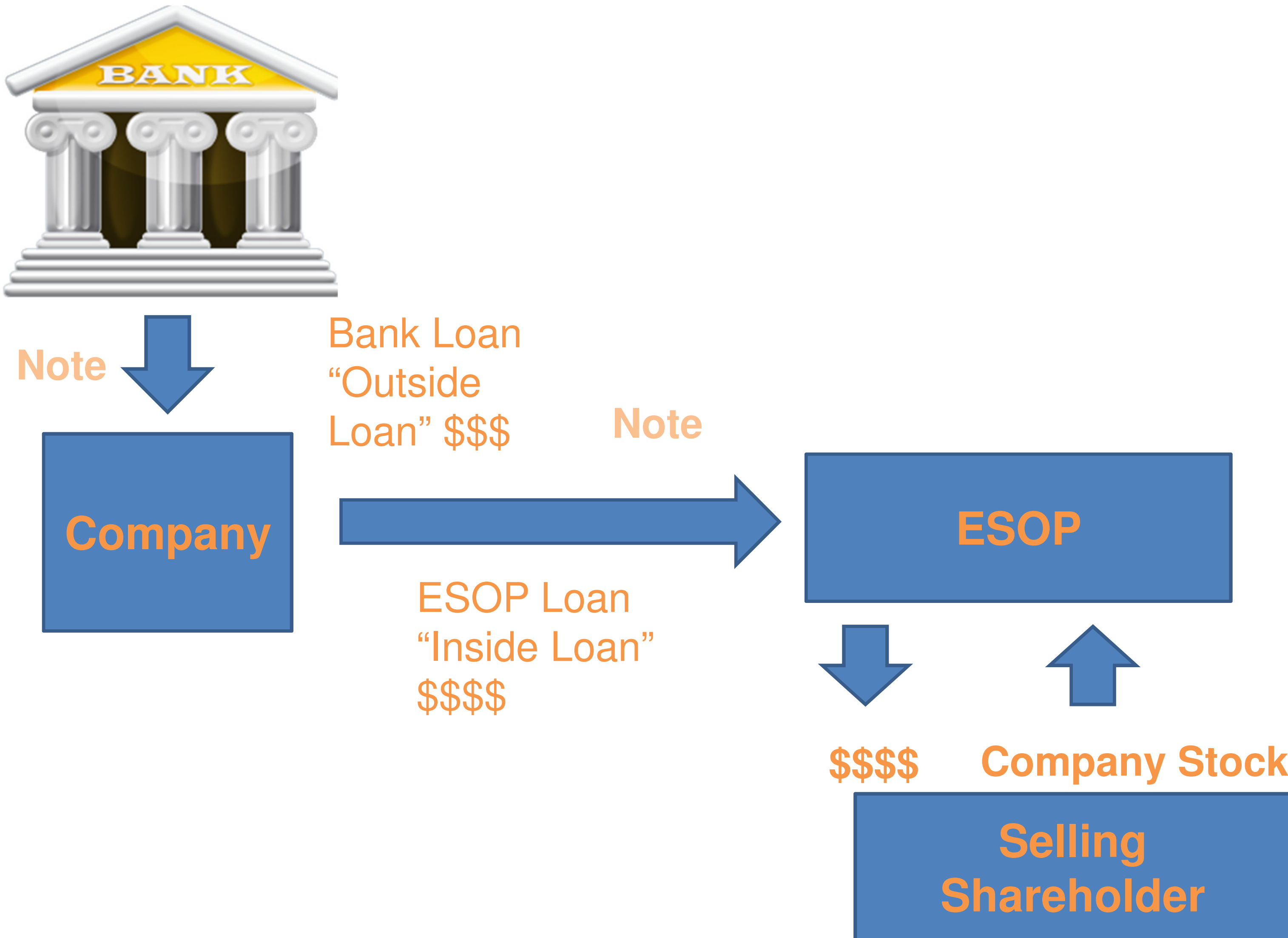
Key Ideas

- 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"



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

DR Cash	$ 900,000	
CR Note payable, bank		$ 900,000
DR Unearned ESOP shares		
($12.80/sh. x 100,000 sh.)	$1,280,000	
CR Cash		$1,280,000

Case 2 Journal Entries
Bank "Outside" Loan Payment

DR Note payable, bank		$108,000	
DR Interest expense	$ 49,500		
CR Cash			$158,368

Journal Entries
"Inside" Loan Financial Statement Impact

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?

Employee Ownership Conference

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 x 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 x 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:

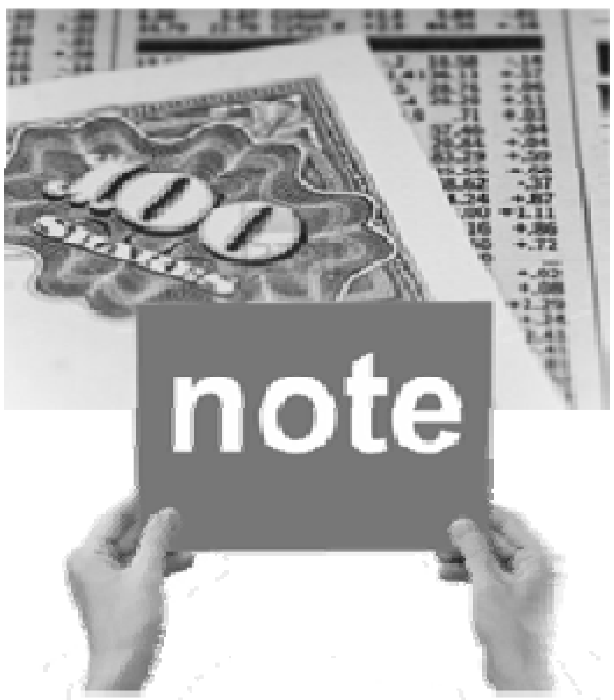
DR Retained Earnings	
(Avg. FMV $15/sh. x 17% x 3,515 sh.) $8,963	
CR Additional paid-in capital	
($2.20/sh. x 17% x 3,515 sh.)	$1,314
CR ESOP unearned shares	
(Cost $12.80/sh. x 17% x 3,515 sh.)	$7,649

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

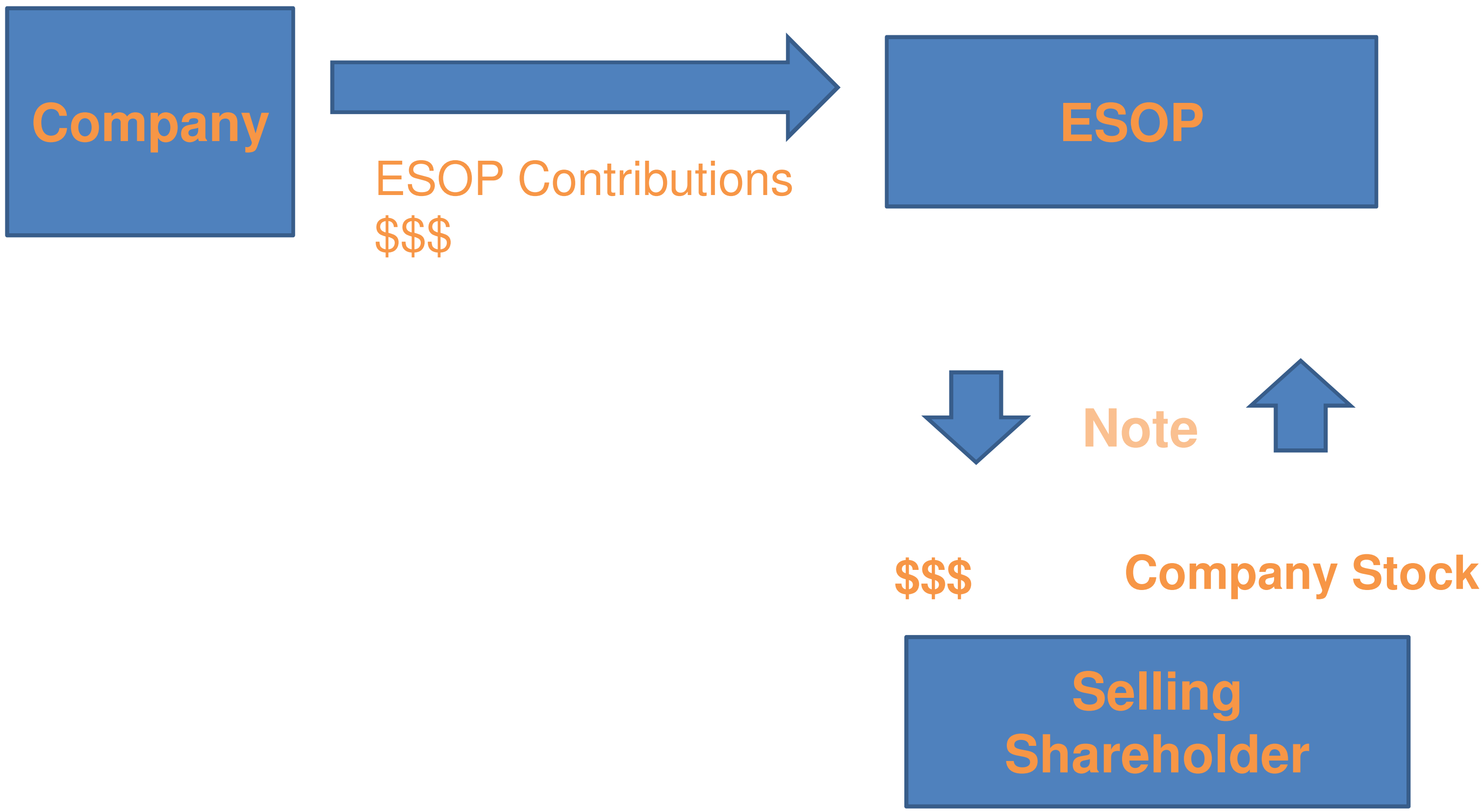


Illustration – Seller Financed Note

- 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

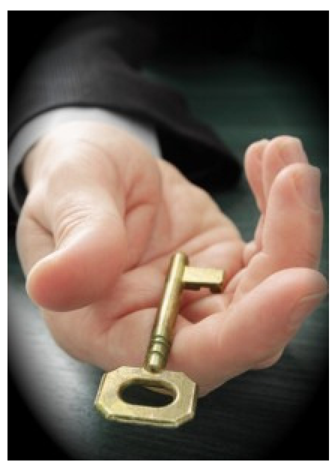
DR Interest expense	$50,000	
DR Note payable, seller	$46,342	
CR Cash		$96,342
DR Compensation expense		
(Avg. FMV $10.25/sh. x 6,667 sh.)	$68,337	
CR Additional paid-in capital		
($0.25/sh. x 6,667 sh.)		$ 1,667
CR ESOP unearned shares		
(Cost $10/sh. x 6,667 sh.)		$66,670

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



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Questions?

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