Too frequently, the accountant is called into the picture after a leveraged employee stock ownership plan (ESOP) transaction has been implemented and the financing obtained. To start educating the plan sponsor on the accounting treatment of leveraged ESOPs at that late date is likely to be an unhappy experience. By that time, the transaction may be too far down the road to be able to avoid or minimize any potentially adverse accounting treatment. Many people simply do not recognize the dramatic impact that a leveraged ESOP will have on the financial statements of the plan sponsor.

The purpose of this chapter is to describe the basics of accounting for leveraged ESOP transactions so that potential plan sponsors and their advisors can anticipate the accounting presentation and structure the transaction where possible to minimize any complications created by the accounting. This chapter is only a primer on the rules covering the accounting for leveraged ESOPs and will not cover all of the intricacies of very sophisticated ESOP applications. Nor will it go into much detail on the accounting for nonleveraged ESOPs.¹ ESOP sponsors or potential sponsors will still need to get their accounting firms involved in the early stages of planning, as the sophisticated equity structures of many ESOP transactions will create equally sophisticated financial reporting consequences beyond what is covered in this brief overview.

Background

Before describing the accounting rules in detail, it may help readers who are not accountants to understand how these rules are created. Most people have some understanding of how tax and Employee Retirement Security Act of 1974 (ERISA) regulations are written. If questioned on the accounting rules, however, those same people would have little idea of how an accounting principle is developed and what importance it has to their financial future.

Even after the Sarbanes–Oxley Act of 2002, the accounting profession remains a self-regulated professional group. In an attempt to achieve uniformity, the profession establishes Generally Accepted Accounting Principles (GAAP). Most accounting standards are issued by the Financial Accounting Standards Board (FASB). FASB issues Statements of Financial Accounting Standards, referred to as FASB Statements, and FASB Interpretations, referred to simply as Interpretations. Before 2002, the next level of accounting authority was issued by the Accounting Standards Executive Committee (AcSEC) of the American Institute of Certified Public Accountants (AICPA). This group issued Statements of Position, referred to as “SOPs.” An SOP does not depart from the general rules established by the FASB. Since 2002, AcSEC has only issued guidance on industry-specific accounting and auditing matters. In 2009, AcSEC was renamed as the Financial Reporting Executive Committee or FinREC. The last group authorized to issue accounting authority is the Emerging Issues Task Force (EITF) of the FASB. This group is the least formal and is authorized only to interpret current standards. Such interpretations, however, do have the standing of GAAP. These interpretations are referred to as EITF issues.

The FASB provides for a public comment period before they release a statement. When comments are received, the staff reviews them. Changes may be proposed in response to such comments. In any event, any standard passes in front of the applicable board or boards before final approval. If the public comments raise serious issues that result in major

¹ This chapter does not cover nonleveraged ESOPs because the financial reporting for such transactions is substantially similar to a profit sharing plans. Sponsors on nonleveraged ESOPs should, however, pay attention to the footnote requirements discussed later in this Chapter, as those requirements apply to all ESOPs, leveraged or not.
modifications in a proposal, a second comment period may be provided before finalizing a standard.

A FASB Interpretation can be released without any public comment but generally involves significant time in drafting. The EITF, on the other hand, can respond quite quickly. It holds approximately 10 meetings every year. If consensus can be reached at a single meeting, new GAAP may be created.

In 2009, all U.S. GAAP in whatever form (FASB, SOP, EITF, etc.) was combined into a single document. This is the Financial Accounting Standards Codification or ASC. Practitioners are gradually becoming familiar with this structure. To the person unfamiliar with U.S. accounting standards, this may be very helpful, as all literature on a specific topic is covered by a single section of the Codification. The user no longer has to search through the FASBs, SOPs, EITF consensus opinions, FASB Staff Interpretations, etc. to ascertain the governing provisions on that topic.

Besides these private entities, the Securities Exchange Commission (SEC) issues accounting pronouncements for public companies. These releases typically concern issues relevant to the public market. However, if there is no other GAAP pronouncement on the topic, an SEC Accounting Release may be considered to apply even to private companies. In addition, the SEC substantially influences GAAP through its participation with the FASB. These releases are, however, separate documents and are not found in the Codification.

It is rare for any other entity to become involved in drafting accounting rules for the public. Within regulated industries, the regulatory agencies may require deviations from GAAP or may supplement GAAP. However, the regulatory rules are applied only in preparing statements for the regulators, not for other users who request GAAP statements.

Today, the accounting standard setters are dealing with the concept of “convergence.” As more and more businesses compete in a global marketplace, the need for uniform standards across nations has become evident. To address this concept, the accounting community formed the International Accounting Standards Board (IASB). U.S. GAAP has been evolving in conjunction with the international standards. Where common principles exist, common standards are developed. However, U.S. GAAP continues to have a separate application to most ESOP sponsors.

Most users of financial statements (lenders, for example) will require that a “clean” opinion be provided by the auditor. A clean opinion is one that states that the financial statements have been subject to generally accepted auditing standards and are presented in accordance with generally accepted accounting principles with no exceptions. The failure to provide a clean opinion may reduce the amount of credence that the users will have for the statements. Because most leveraged ESOPs do involve a lender, it is important to understand how the ESOP will affect the financial statements of the plan sponsor.

It is possible to receive a “clean” opinion on financial statements which are prepared based upon an “other comprehensive basis of accounting.” This might be, for example, cash basis, modified cash basis or income tax basis. Commercial lenders, typically, require GAAP basis financial statements, so the remainder of this chapter focuses on that manner of presentation.

Specific ESOP accounting authority

From 1976 until 1989, the accounting for ESOP transactions was controlled by Statement of Position 76–3, “Accounting Practices for Certain Employee Stock Ownership Plans,” published by the AICPA in 1976. This was issued before the Internal Revenue Service (IRS) and the Department of Labor (DOL) had finalized their regulations governing the operation of leveraged ESOPs. This statement, referred to as SOP 76–3, was later affirmed as GAAP by Statement of Financial Accounting Standard No. 32.

At the time that SOP 76–3 was issued, because ESOPs were quite new, most of them were very simple arrangements. All of the later activity involving convertible preferred stock, debt service with deductible dividends, reduced interest loans, immediate allocation loans, and so on was not yet encouraged through special tax incentives. Therefore, most of the plans were straightforward financing and compensation devices.

In response to this, a simple accounting standard was developed. The upsurge in ESOP activity during the 1980s, however, highlighted inadequacies in the SOP. This caused a great deal of activity on the part of the FASB’s EITF during 1989 to amplify and apply the terms of the SOP to the creative ESOP applications that came about because of the 1984 and 1986 tax law changes. In 1989, the EITF dealt with only 20 accounting issues, four of which were ESOP-related.

This flurry of activity caused the accounting community to rethink the existing ESOP guidance. In fall 1989, the AcSEC formed a committee to address ESOP accounting. After more than three years of meetings, public comments and hearings, a revised model for the reporting of leveraged and nonleveraged ESOPs was approved. That standard applies to shares acquired on or after December 31, 1992. A plan sponsor may elect to apply it to earlier periods, but is not required to do so. The prior accounting rules under SOP 76–3 and the numerous EITF consensus opinions may continue to be applied.

Apart from this development, a significant controversy took place during 1991 and 1992 as a result of a proposed revision of Statement of Financial Accounting Standards No. 96 (SFAS 96) dealing with the reporting of income taxes. A portion of the changes in SFAS 96 also has a significant impact on sponsors of ESOPs. The revised statement, SFAS 109, effective for 1993 with no transition rule, interacts with the new ESOP accounting standard in critical ways for sponsors that use dividends for debt service.

In addition, in the spring of 1992, the EITF issued a clarification on the treatment of the tax benefit on common shares held by an ESOP for reporting earnings per share. This is EITF Consensus Opinion 92–3. This opinion was necessary to integrate the impact of SFAS 109 and prior EITF Consensus Opinion 90–4. (Note that Consensus Opinion 90–4 applied only to preferred
the kind of debt an ESOP might incur. Typically, the debt is the
Liabilities recorded as an asset; instead, it affects the equity section.

because internal financing was used, that note receivable is not
the event that the sponsor has a note receivable from the plan
assets of the plan are not reported as assets of the sponsor. In
has no direct affect on the asset side of the balance sheet. The
from the financing aspect of certain plan structures, an ESOP
Other than the obvious increase in cash or other assets resulting

The remainder of this chapter covers how a leveraged ESOP
affects the plan sponsor’s financial statements. The reader is
cautions to pay specific attention to the structure of the loan
discussed in each paragraph. In the 21st century, it is as common
for the ESOP to borrow funds indirectly, through the plan sponsor,
as directly from a lender or with seller financing. The financial
reporting by the plan sponsor is substantially similar in each case,
but the entries required to record the plan’s activity will vary. The
following discussion is for financial statement purposes only and
does not bear on the income tax treatment of ESOPs.

To best understand the financial reporting of leveraged ESOPs,
the reader should think of the transaction as being substantially
similar to a treasury stock acquisition. If a company purchased
shares from a current shareholder with debt, the company’s
financial statements would record the debt and a negative
carry to equity referred to as treasury stock. If the company
subsequently rewarded those shares to other employees as
compensation, the fair market value of the shares would be
recorded as compensation on the award date, treasury stock
would be reduced by the original cost of those shares and
additional paid in capital would be adjusted for the difference.
This is only a simplified view of the results but it sets an easily
recognized framework in which to understand the accounting
for a leveraged ESOP transaction.

Balance sheet

The first financial statement presented in any official set of
financial statements is the balance sheet. Generally, this has
three parts: assets, liabilities, and equity. For sponsors of certain
ESOPs, another section, temporary equity or mezzanine capital
also may be present. That is classified on the debt/equity side
of the balance sheet between long-term debt and equity.

Assets
Other than the obvious increase in cash or other assets resulting
from the financing aspect of certain plan structures, an ESOP
has no direct affect on the asset side of the balance sheet. The
assets of the plan are not reported as assets of the sponsor. In
the event that the sponsor has a note receivable from the plan
because internal financing was used, that note receivable is not
recorded as an asset; instead, it affects the equity section.

Liabilities
For purposes of this discussion, it is important to recognize
the kind of debt an ESOP might incur. Typically, the debt is the
original stock acquisition loan. The ESOP may have directly
borrowed funds from a commercial lender. But seller financing
is also considered a direct loan. Also, if the ESOP distributes
shares to a plan participant and then repurchases those shares
with a note, that is a stock acquisition note subject to these
accounting standards. Where the ESOP borrows funds from
the plan sponsor, it is an indirect or two-step loan. The ESOP
accounting does not change with respect to the structure of
the financing obtained by the plan sponsor to fund that loan.

Under ASC 718–40/SOP 93–6, all ESOP debt is reflected on the
financial statement of the plan sponsor. There is no potential for
off balance sheet financing under the current standards. This is
based upon the fact that the ESOP has no ability to repay this
debt except for funds provided by the plan sponsor through
contributions or dividend/S distribution payments on the
shares held by the ESOP.

One major, unanswered question remains after nearly 20
decades have passed: How is the debt to be reflected upon
the balance sheet of a subsidiary that participates in a single
plan that covers the parent corporation and some or all of
the subsidiaries? In the minutes from the June 19, 1989, EITF
meeting, there is a specific reference to the fact that the EITF
members did not discuss this matter. There is nothing specific
in the Codification regarding this. Common sense would argue
that if the subsidiary’s employees are covered by the plan, then
that subsidiary is, theoretically, benefiting from that portion of
the ESOP and obligated to fund its portion of the ESOP debt.
Thus, such subsidiary should reflect that portion of its debt.

In any event, the accounting practitioner might initially argue
that it makes no difference since GAAP requires a consolidated
balance sheet in the case of a parent/subsidiary group. In this
case, it is irrelevant where the debt is initially recorded, the
parent or the subsidiary, since it all ends up in the same place.
A problem arises in the case of separate financial statements of
regulated enterprises (banks or savings and loan institutions,
bonded warehouses, etc.) that are subsidiaries of holding
companies. In these cases, the regulators or bonding companies
frequently impose rigid financial ratio or other reporting
requirements. These requirements affect the way the enterprise
can conduct its business. Generally, however, the regulators
seem to look at GAAP financial statements of the operating
subsidiaries only. They may not look at any debt of the holding
company when analyzing the subsidiary’s ability to do business.
In the past, these entities have used leveraged ESOPs at the
parent company level. This has left the debt at that level and not
brought it down to the operating subsidiaries. To date, disparity
remains in accounting practice on whether to “push down”
this debt from the parent to one or more of the subsidiaries. As
discussed under ASC 718–40/SOP 93–6, the argument against
“push-down” accounting has been weakened for post–1992
transactions. If the debt is recorded by the employer because
they are the source of future debt service and the employees
are all at the subsidiary level, it makes sense that the subsidiary
is the entity who will be servicing the debt and recording the
debt. The only recommendation that can be made at this time
is to discuss the matter specifically with your accountant in
the event that any recording of the debt at the subsidiary level

3
could have an adverse effect on the plan sponsor’s ability to do business. This issue, however, has had less attention paid over recent years due to the dominance of indirect or two-step loans, rather than direct loans.

All of this discussion under “liabilities” has focused on the major issue of the recording of the ESOP loan by the sponsor. There is also an ancillary, though occasionally equally frustrating, issue. This is the recording of the current accrual for the current year’s contribution to the plan. Generally, any long-term obligation will be separated annually into two pieces: the short-term piece, the amount that is payable in the next 12 months; and the long-term piece, the amount not payable within 12 months. The first is recorded as a current liability. The second is recorded as a long-term liability.

In most cases, where the employer makes its qualified plan contribution after the end of the year, the balance sheet will show a current liability for any accrued plan contribution. If a sponsor has a leveraged ESOP with outside debt, the unfunded amount of the “accrued contribution” which is applicable to future debt service will already be recorded in current liabilities in the form of the current portion of the ESOP debt. Until the contribution/payment is actually made, that debt cannot be eliminated. If the current accrual for the contribution that is intended to make this payment is also recorded, that portion of current debt will be reflected twice in the current liabilities section of the plan sponsor’s balance sheet. This double counting of this obligation is avoided by the expense recognition methodology under ASC 718-40/SOP 93-6. No accrued contribution is recorded except for contributions that are not to be applied to debt service in the current period.

The above section covers the recording of a direct loan to the ESOP. In the more typical two-step or indirect loan transaction, the company borrows funds from another source and makes a second loan to the ESOP. Occasionally, the sponsor has the funds on hand and makes a direct loan to the ESOP. In such cases, the credit relationship between the ESOP and the sponsor is not recorded as an asset or a liability. Not only is the long-term debtor/creditor relationship not reflected, but there is also no payable to the ESOP for the accrued contribution or receivable from the ESOP for its requirement to return these funds to the sponsor for that year’s payment. Obviously, to the extent the sponsor borrowed funds from another party to finance this event, that loan would be recorded and any other accrued contribution to the ESOP to fund distributions or cover plan expenses would also be recorded.

Equity
Anyone who has had an introductory accounting course will remember that every credit entry must have an equal debit entry or the books will not balance. In booking the ESOP loan for a direct loan or the transfer of cash to the plan for an indirect loan, a credit is recorded. As stated earlier, the establishment of the ESOP has no impact on assets, where debits would normally show up on the balance sheet. That leaves us with only one other place to put this dangling debit, the equity section. At the same time that the debt is recorded or the cash is advanced, an equal and offsetting debit is recorded as a single line in the equity section. This reduces the net equity. This is referred to as the “ESOP Loan Contra Account” or “Unearned Compensation.” Under ASC 718-40/SOP 93-6, this contra account is called “Unearned ESOP Shares.”

This contra equity account is eliminated as the shares are allocated. The amount of reduction in the contra account for any year is measured by the amount of compensation expense recorded on the plan financial statements attributable to ESOP activity. The important point to recognize is that the unearned shares account will not necessarily be reduced at the same time or in the same amount that the ESOP loan balance is reduced. Where an ESOP loan applies the principal only method of collateral release, the number of shares released is always directly tied to the principal reduction. But for GAAP, the shares are released when the employer commits to make the payment. The actual principal payment may be several months after the financial statement date. For a loan which applies the principal and interest method of collateral release, you will see this same timing difference when shares are considered earned. There is an additional difference because the shares are released based upon both principal and interest payments. This means that shares are released and allocated at a different rate than principal is retired.

The ESOP’s impact on retained earnings is reflected in three entries: compensation cost, tax effect and dividends/S distributions. These are described in more detail in the discussion later regarding the income statement effect of a leveraged ESOP. However, a portion of this activity does not flow through the income statement. That arises where dividends/S distributions are paid on shares allocated to the accounts of the plan participant. These retain their character as true dividends.

The tax benefit from C corporation ESOP dividends paid on allocated shares is covered by ASC40-20-45-11(e)/SFAS 109. All of the tax benefit runs through the tax provision.

During 1989, another change was made in the manner that certain ESOPs may affect the equity section. This is described in ASC 480-10/EITF Issue 89-11, “Sponsor’s Balance Sheet Classification of Capital Stock with a Put Option Held by an Employee Stock Ownership Plan.” This issue is generally considered to apply only to publicly traded enterprises, as it is based on the interpretation of SEC Accounting Release No. 268, “Presentation in Financial Statements of Redeemable Preferred Stocks.” This release effectively provides that any stock held by an ESOP that is subject to a put option is to be classified outside of permanent capital. That is, it will be recorded into the portion on the right side of the balance sheet between debt and equity. This is frequently referred to as the “mezzanine” level. According to the EITF, the proportionate share of the contra equity account attributable to these shares will also be recorded at this mezzanine level. These shares can remain in permanent equity if the plan sponsor can issue stock for the puts and has expressed the intent to do so. Any plan sponsor who makes this representation must realize that in that case, the SEC is likely to hold that the ESOP shares are common stock equivalents for purposes of calculating
primary earnings per share. A key issue to understand about this mezzanine capital is that the stock is marked to market value. This is an area that may change as the FASB’s work on financial instruments progresses. Currently, the one standard that addresses this issue, ASC 480-10/FAS 150, does not apply to stock held in an ESOP. See ASC 480-10-15-8/FASB Staff Position 150-4.

Before leaving the discussion of the ESOP’s affect on the equity section, it is critical to note how inside loans, sometimes referred to as mirror loans, two-step loans or back-to-back loans, affect the equity section. A simple inside loan is one in which the plan sponsor makes the loan to the plan without obtaining any related financing from the outside. The other terms describe situations in which the plan sponsor receives financing from the outside, then in turn loans funds to the ESOP. As noted earlier, however, the note receivable represented by the inside note between the plan sponsor and the ESOP is not recorded as an asset. Instead, that note receivable is what is reflected in the contra equity account or Unearned ESOP Shares Account in the equity section of the balance sheet. As described above, it is not adjusted as collections are made on the note. Rather it is adjusted as the associated shares are released for the benefit of employees.

**Income statement and earnings per share**

When the original SOP was issued, there was as much controversy over the measurement of compensation expense as there was over the recording of the debt. Basically, both controversies revolved around the same issue: Is the ESOP a compensation device, a financing device or both? The accounting community is still wrestling with this issue. However, in publishing SOP 76–3, the AcSEC made the decision that it is both. That position has continued through the subsequent changes in ESOP accounting. Therefore, the income statement impact of an ESOP reflects a compensation cost and, if a direct loan is involved, an interest cost. (For purposes of this chapter, compensation expense and interest expense are discussed as though they are currently deductible. Any issues pertaining to whether some or all of one or the other need to be capitalized are outside of the scope of this discussion.)

There is no magic to the measurement of the interest expense. It is measured in the same manner as it would be for any other similar financial instrument.

The measurement of the compensation element is another story. Compensation cost is measured as shares are made available for allocation to plan participants. The dollar value of that compensation is based upon current value of the shares to be allocated.

In 1977, the IRS and DOL released final regulations that provided that the ESOP participants would receive an annual allocation as the shares were released from collateral. These regulations established two methods of collateral release: the principal–and–interest method and the principal–only method. In the first case, shares are released from collateral and allocated to participants on the basis of the ratio of the current year’s payment of principal and interest to the total of the current year’s payments plus all future year’s payments of principal and interest. The principal–only method is simply the ratio of the current year’s principal payment to the total original principal of the loan. The principal–only method is limited by three specific requirements of the regulations. The major limit is to ESOP loans that at all times have cumulative principal payments of no less than a normal 10–year amortization loan.

The IRC regulations governing debt service refer to debt payments made “for” the plan year. This raises questions associated with when the release of shares is recognized for expense measurement. The standard calls for compensation cost to be measured by the number of shares “allocated, released or committed to be released” with respect to the reporting period. This means shares for which the debt has been paid, the shares have been released from collateral and under the plan’s terms, they have been allocated to accounts of plan participants. It also covers shares where the loan payment has been made, the shares have been released but, perhaps due to a difference in the plan year end and the sponsor year end, the shares have not yet been allocated. Finally, consistent with accrual accounting, it includes shares which will be released from collateral where the sponsor has committed to make a contribution with respect to the current year, but such a contribution is to be paid in the subsequent year. The number of shares released for this purpose is controlled by the terms of the IRC regulations, the ESOP agreement and the ESOP loan agreements.

The other key component to the measurement of compensation cost is the value assigned to these shares that have been allocated, released or committed to be released. Under ASC 718–40–30–2/SOP 93–6 paragraph 16, compensation cost will be based on the average fair market value of the shares released or committed to be released with respect to any payments made on the ESOP debt for that year. This amount would be reduced for by the dollar value of any dividends paid on allocated shares which has been applied to debt service. Average value for the year is used as the stock is assumed to have been earned throughout the year. As of spring of 2012, the fair value concept for ESOPs was not based upon the evolving standard of fair value as defined in ASC 820/FAS 157. However, on October 14, 2011, the FASB announced a technical corrections project which proposed to replace the ESOP standard’s definition of fair value with that used throughout the rest of GAAP. In most situations, the ESOP concept of fair value under GAAP, whether ASC 820 or ASC 718–40 would match the ERISA standard. However, in limited circumstances, there may be a difference which would be significant for certain footnote disclosures. For example, consider an ESOP sponsored by a company whose stock is actively traded on the Over the Counter Bulletin Board. As defined in IRS Notice 2011–19, the IRS does not consider such shares to be traded in an established securities market and requires that the share value be based upon an appraisal. In those circumstances, GAAP (whether the new or old fair value standards) would likely conclude that the trading price is fair value. The ESOP trustee would consider the appraised price to be fair value. Where the financial statement reports the
expense, the GAAP standard would apply and the footnotes could explain any difference. However, where the footnotes describe rights of the participants, such as the put option, their rights would be based upon the trustee’s determination of value. In such circumstances, it would be critical to ensure that the correct fair value concept is used in the applicable accounting standard. Comments were filed with the FASB to make them aware of this issue as they consider the technical corrections project. The final conclusion of this project was not published at the time of this writing.

To illustrate how these rules apply to the measurement of ESOP compensation, consider the following example:

An employer sponsors a 401(k) plan with a match. The match for the current plan year is $100,000. That match could be satisfied with the fair market value of employer securities released by the current year’s contribution to the plan. Assume that the principal portion of the contribution required to release $100,000 of securities is only $80,000 (e.g., the company is using the principal-only method of collateral release, and the shares have increased in value by 25 percent). This is a direct ESOP loan so both the financing and the compensation aspects of the entry must be recognized. Interest expense for the period on the ESOP note was $14,000.

The journal entries would be:

<table>
<thead>
<tr>
<th>Compensation cost</th>
<th>$100,000</th>
</tr>
</thead>
<tbody>
<tr>
<td>Interest expense</td>
<td>$14,000</td>
</tr>
<tr>
<td>Accrued matching contribution</td>
<td>$100,000</td>
</tr>
<tr>
<td>Accrued interest payable</td>
<td>$14,000</td>
</tr>
</tbody>
</table>

To record the accrual of the matching contribution and interest. In this fact pattern, the accrued contribution is recorded because the employer could decide to satisfy it with a cash contribution, rather than shares from the ESOP.

<table>
<thead>
<tr>
<th>Accrued matching contribution</th>
<th>$100,000</th>
</tr>
</thead>
<tbody>
<tr>
<td>Accrued interest payable</td>
<td>$14,000</td>
</tr>
<tr>
<td>ESOP debt</td>
<td>$80,000</td>
</tr>
<tr>
<td>Unearned ESOP shares account</td>
<td>$80,000</td>
</tr>
<tr>
<td>Paid-in-capital</td>
<td>$20,000</td>
</tr>
</tbody>
</table>

To record the payment of the match and the ESOP principal and interest and contra account, the increase in the market value of the stock is added to paid-in-capital.

<table>
<thead>
<tr>
<th>Compensation cost</th>
<th>$100,000</th>
</tr>
</thead>
<tbody>
<tr>
<td>Interest expense</td>
<td>$14,000</td>
</tr>
<tr>
<td>Unearned ESOP shares account</td>
<td>$80,000</td>
</tr>
<tr>
<td>Paid-in-capital</td>
<td>$20,000</td>
</tr>
</tbody>
</table>

If it was known that the matching contribution was to be satisfied through a contribution to the ESOP and associated release of shares, the accrued matching contribution would not be recorded. Instead the following entries would have been made:

<table>
<thead>
<tr>
<th>Compensation cost</th>
<th>$100,000</th>
</tr>
</thead>
<tbody>
<tr>
<td>Interest expense</td>
<td>$14,000</td>
</tr>
<tr>
<td>Unearned ESOP shares account</td>
<td>$80,000</td>
</tr>
<tr>
<td>Paid-in-capital</td>
<td>$20,000</td>
</tr>
</tbody>
</table>

To record the accrued contribution/shares committed to be released and interest.

<table>
<thead>
<tr>
<th>ESOP debt</th>
<th>$80,000</th>
</tr>
</thead>
<tbody>
<tr>
<td>Accrued interest payable</td>
<td>$14,000</td>
</tr>
<tr>
<td>Cash</td>
<td>$94,000</td>
</tr>
</tbody>
</table>

To record the payment to the ESOP of the cash and the ESOP’s application of this cash to debt service.

### Dividends

Before leaving the discussion of the income statement, it is important to address the very unique treatment of dividends paid on employer securities held by a leveraged ESOP. (For the purpose of this discussion, distributions by an S corporation are included in the general concept “dividend.”)

Two provisions of the IRC have had significant influence on the design of ESOPs and thus, direct impact on the financial reporting for such plans. First, as long as the specific requirements of the IRC and associated regulations are satisfied, dividends paid on leveraged shares may be applied to debt service. Second, dividends applied to debt service, distributed to plan participants or subject to a cash-or-deferred election within the plan are tax deductible by a C Corporation plan sponsor. For purposes of the dividend deduction, this is limited to dividends paid during the year. Dividends accrued at year-end are not eligible for this deduction until the later period in which they are paid.

In understanding the accounting rules for ESOP dividends, it is important to remember that the plan sponsor retains significant control over the application of dividends through its control over the drafting of plan terms and the negotiation of the ESOP loan agreements.

The financial reporting implications of dividends paid on ESOP shares vary between shares that are allocated or released to plan participants and those shares that remain as collateral, including shares that are committed to be released, on the loan to be released and allocated in future financial periods. This is a technical nuance that primarily applies to those shares that are released but unallocated and those committed to be released for the current period. To simplify the remainder of this discussion, the distinction is going to be allocated versus unallocated shares. Shares that are released but unallocated are treated as allocated.
Shares committed to be released are classified as unallocated shares. See SOP 93–6 paragraph 77, because this comes from the basis for conclusions portion of the SOP; there is no equivalent paragraph in the ASC.

Dividends paid on allocated shares retain their character as true dividends. Where such dividends are applied to debt service, the compensation cost derived from the release of shares is reduced by the dollar amount of the dividends on allocated shares that we used to pay the debt. See ASC 718–40–25–16/SOP 93–6 paragraph 21. Where such dividends are tax deductible, the tax benefit goes to reduce the current year’s provision for taxes. See ASC 740–20–45–11(e).

Dividends paid on unallocated shares are always part of compensation cost. Where the cash attributable to such dividends is applied to debt service, these dividends become part of compensation through their impact on the number of shares released. Where such dividends are distributed to plan participants, part of the cash–or–deferred election or simply retained in the trust to increase participant account balances, they are included in compensation cost. To the extent such dividends create compensation cost, the associated tax benefit, if any, is part of the current year’s provision for taxes.

Earnings per share
For nonleveraged ESOPs, all shares are considered outstanding, whether common or convertible preferred. For leveraged ESOPs, only the shares allocated, released or committed to be released are considered outstanding. In all cases, convertible preferred stock is to be considered a common stock equivalent. This will reduce the number of shares considered outstanding until an ESOP loan is fully amortized. It is important to recognize that this result is for the GAAP reporting of earnings per share only. The shares still held as collateral remain outstanding for all other purposes—voting, determination of share value, etc.

Statements of shareholders’ equity
The third financial statement is the statements of stockholder’s Equity. Where the company sponsors a leveraged ESOP, a new column is added to this presentation to reflect the balance and changes in the balance of the Unearned ESOP Shares Account. This statement would include columns for common or preferred stock, par value, additional paid-in–capital, unearned ESOP shares and retained earnings. Only the columns applicable to the plan sponsor would be included. When ESOP shares are released from collateral and allocated to plan participants, each column is adjusted for the applicable effect. Unearned ESOP shares are reduced by the release and allocation or it is increased for additional leveraged purchases. Retained earnings is adjusted for net income, which includes the impact of the ESOP compensation cost and for any dividends attributable to allocated shares. Market value changes on shares allocated, released or committed to be released may adjust additional paid-in–capital, retained earnings or stock depending upon the specific facts and circumstances of the plan sponsor.

Statements of cash flows
The fourth financial statement is the statements of cash flow. The existence of an ESOP does not change the content or the presentation of this financial statement. However, if the amount is material, there may be one or more line items included on this statement relative to the ESOP. If shares are contributed to the plan, they will be reflected as a noncash expenditure. If the compensation cost reported varies materially from the cash contribution made to the plan, there will be a line item that reconciles from net income to cash flow from operations associated with that difference. Where a direct obligation of the ESOP is reflected on the financial statements of the plan sponsor, the payment of the debt is not reflected in the Cash Flow from Financing Activities because it is already reflected as a reduction in cash flow from operations. Where the ESOP is financed with an indirect loan from the plan sponsor, cash flow is not affected by the ESOP debt service, except for any tax benefit. This is because the plan sponsor contributes the cash to the ESOP to fund the debt and the ESOP returns the same cash to the Plan Sponsor in repayment of its debt. Thus, the statement of cash flows from operations may reflect an add-back of the entire ESOP compensation cost.

The critical issue relating to the impact of a leveraged ESOP on the statements of cash flows goes more to the calculation of any loan covenants, rather than the financial statement effect. Frequently, loan agreements include a concept of coverage. This relates to the ability of company cash flow to cover required payments on the debt. Where the debt is provided directly through the ESOP, cash flow from operations is reduced by the contribution to the ESOP. Thus, in defining the coverage ratio in the loan agreements, it is important to specifically account for this effect.

Footnote disclosures
A general consensus of accounting authority recommends disclosure of the following information:

- A plan description, including the purpose, qualified status, contribution formula, method of releasing shares from collateral and a description of the employer’s securities held by the plan
- A comparative table illustrating the number of allocated, released, committed to be released and unallocated shares should be disclosed
- The fair value of the unearned ESOP shares and the allocated shares as of the balance–sheet date
- An ESOP loan description, including the terms, interest rate and payment commitments
- The amount of compensation recognized for the period
- The method of measuring compensation expense, including dividends, if applicable
- A disclosure of the repurchase commitment, e.g. put option terms, for shares that are not publicly traded. To the extent that shares have been put to the employer before the end of the fiscal year but not yet paid, the liability would have to be booked, not just footnoted
There is no current requirement to record or disclose the projected repurchase obligation, even if the amount is significant. Nor is any actuarial projection to be required for footnote disclosure. The only information required that relates to this concept is the requirement to disclose the fair value of all allocated shares.

**Special Issues**

**Book/tax differences**
Where the plan sponsor is faced with material amounts of income tax liabilities, GAAP requires recognition of the deferred tax effects that arise when income or expense is recognized at a different time for financial statements than for income tax reporting. This is a very complex standard governed by ASC 740. When accumulating the information to present the current and deferred tax effects on the plan sponsor’s financial statements, the following effects of the leveraged ESOP are to be considered.

1. Compensation cost is measured by the average fair market value of the shares released for GAAP. The deduction for tax purposes is the cash contributed to the plan to service the debt. This results in one or two book tax differences.
   a. The difference between the original cost of the shares and the market value is a permanent difference.
   b. The difference between the original cost of the shares and the principal payment is a timing difference.

2. For GAAP reporting the interest is excluded on indirect loans, but for tax purposes, the interest expense of the ESOP loan is part of the contribution deduction. The interest paid to the employer in repayment of the loan is interest income to the employer. This is just a classification difference. There may, however, be a timing difference as the interest reported for GAAP is that attributable to the financial statement period. For tax purposes, the contribution may include interest through the due date of the tax return, including extensions.

**Contributions paid in advance of required debt service**
This is an issue that is not included in GAAP, but consensus has been reached among most accountants. It is not uncommon for a company to set up an ESOP in year one and make a contribution for that year, but not close the leveraged transaction until the following year. Alternatively, a cash contribution in excess of what is required for current debt service might be made to provide extra liquidity in the ESOP in the event that the sponsor experiences a cash shortage in a later year. These amounts are part of compensation cost for the year paid or accrued. They are required to be allocated to participant accounts for that period. However, where the appropriate documentation has been provided to the plan fiduciary, it is possible for such cash amounts to be applied to debt service in a later year. In such an event, the normal rule that compensation expense is measured by the average fair value of the shares released for that period would result in the double counting of compensation. It would have been recorded in the year of the contribution and again in the year that the funds were applied to debt service. To avoid this issue, there is a simple result. The compensation expense for the year that this cash is applied to debt service is reduced by the amount that has previously been included in expense.

**ESOPs in leveraged buyouts**
Accounting for ESOP transactions becomes particularly complicated when the ESOP is a party to a leveraged buyout of an entity. In these situations, the ESOP accounting complexities are added to the purchase accounting issues presented by any business combination. This discussion is outside the scope of this chapter. It is critical to recognize that the business combination rules basically are applied first to the reporting, and the impact of the ESOP as a provider of some of the financing is only then integrated into the reporting. Where preferred shares are used or where shares are transferred over a period of time, special rules may apply.

**S corporations**
Since the law was changed in 1998 to permit S corporations to have an ESOP as a shareholder, many ESOP sponsors have elected S corporation status. An S corporation does not pay federal or most state income taxes directly. Rather, taxable income is passed through to shareholders who then pay tax or not based upon their own tax situation. Under current law, an ESOP is exempt from tax on income passed through from an S corporation as long as a variety of technical requirements are satisfied.

The S election does not change the format of the financial statements, nor does it change the general rules described above for the accounting of ESOP transactions. However, there are some unique financial reporting consequences to an S election that need to be considered:

1. When a company changes to S corporation status, deferred taxes do not have to be recognized for any temporary book/tax differences occurring after the date of the change in tax status, except in the case of post-1986 S corporation elections discussed below. When a company converts from C corporation status to S corporation status, it must retain any material existing deferred tax liability to the extent it would be subject to built-in gains tax. The deferred tax liability will continue to be remeasured at each balance sheet date until the end of the 10-year period. Any other deferred tax amounts are eliminated as of the date of change from C to S status.

2. Under the Revenue Act of 1987, a company with last in, first out (LIFO) inventories electing S corporation status after December 17, 1987, will include its LIFO reserve in its last return filed as a C corporation. The tax is payable in equal amounts over four years, with the first payment due by the due date (not including extensions) of the last return filed as a C corporation. The total liability should be accrued and charged to income tax expense applicable to income from continuing operations at the date of change. When a company is subject to the LIFO recapture requirement, the LIFO recapture represents a new LIFO base for income tax purposes. However, for financial statement purposes the LIFO recapture requirement does not affect the LIFO base. Accordingly, it will be necessary for those affected companies to
maintain LIFO cost records separately for income tax and financial statement purposes.

3. Similar rules to the LIFO recapture apply to financial institutions with respect to bad debt reserves. The built-in gains rules are also more complicated for financial institutions.

4. There is no tax benefit associated with such dividends. Thus, the financial reporting consequences for debt payments from S corporation distributions are easier to understand and to apply.

5. Because other plan terms may also change with the election of S status, the footnote disclosures for the ESOP may change.

ESOPs and ASC 810/FIN 46R—variable interest entities
One of the most frustrating things that face ESOP sponsors is when their advisors do not agree on some technical issue. Generally, such disagreements arise in situations where the guidance is subject to different interpretations. This topic is apparently one of those areas. Under GAAP, where a company has a holding in a “variable interest entity,” the financial results of that entity must be reflected on the financial statements of the holder. Similar to the comments made earlier about the ESOP’s participation in acquisitions, this is a very technical subject beyond the scope of this chapter. This topic is apparently one of those areas. Under GAAP, where a company has a holding in a “variable interest entity,” the financial results of that entity must be reflected on the financial statements of the holder. Similar to the comments made earlier about the ESOP’s participation in acquisitions, this is a very technical subject beyond the scope of this chapter. However, because of the varying interpretations on the application of this standard, it is important to highlight the basis for these interpretations.

ASC 810 does not apply to a benefit plan which is accounted for under ASC 715 / FAS 87. Those parties who hold that leveraged ESOPs are subject to assessment under the variable interest entity standard believe that SOP 93–6 is a separate standard, independent of FAS 87. Those parties who conclude that the variable interest entity rules do not apply to a leveraged ESOP believe that SOP 93–6 is merely an interpretation of FAS 87, as was required to consider the implications of unallocated assets within a benefit plan trust. This author was party to the drafting of SOP 93–6. During the FASB hearings on what eventually became SOP 93–6, specific comments were made as to whether the expense recognition would be controlled by principals similar to option reporting under what was then APB 25 or the principals of FAS 87. It was concluded in those hearings that because the ESOP is a qualified defined contribution plan, the principals articulated in FAS 87 controlled. However, this conclusion did not come through very clearly in the final draft of the SOP as the references to existing standards simply say that the SOP is consistent with FAS 87 with respect to the accounting for nonleveraged ESOPs. It is likely that when the components of the financial presentation are compared, there may not be a lot of difference between the financial results with or without variable interest entity treatment. But, to avoid controversy, the plan sponsor should resolve this matter with their advisors at implementation.

Practical applications
As Tables 7–1 and 7–2 illustrate, the impact of a leveraged ESOP on a company’s balance sheet is dramatic. Financial ratios, like debt to equity, are substantially affected. This case was fairly minor, as it anticipated that the capital would stay in the company. When the capital is leaving the company to repurchase the stock of a retiring shareholder, circumstances become even more exotic. In this case, it is not at all unusual to see a negative equity section.

In many cases, the “adverse” consequences of the accounting treatment can be minimized through a well-planned transaction. In some cases, the accounting rules cannot be managed. For example, until the users of statements become more sophisticated, the ESOP accounting rules simply will not allow for a highly leveraged ESOP that is used to retire a former owner in an enterprise whose ability to do business is a current function of its equity section; for example, an enterprise subject to bonding or a financial institution. In all cases, the accounting needs to be discussed at the beginning of the transaction, not after closing.

Alternative options are available for companies that could not tolerate the accounting consequences of recording the ESOP debt on the balance sheet and the offsetting, negative impact on the equity section. Unfortunately, these alternatives require the loss of some ESOP advantages in exchange for the less objectionable accounting treatment.

Table 7–1. Traditional leveraged ESOP

<table>
<thead>
<tr>
<th>Balance sheet pre-ESOP</th>
<th></th>
</tr>
</thead>
<tbody>
<tr>
<td>Accounts payable</td>
<td>$30,000</td>
</tr>
<tr>
<td>Bank debt</td>
<td>$10,000</td>
</tr>
<tr>
<td>Total liabilities</td>
<td>$40,000</td>
</tr>
<tr>
<td>Stockholders’ equity</td>
<td>$70,000</td>
</tr>
<tr>
<td>Total liability and</td>
<td></td>
</tr>
<tr>
<td>stockholders’ equity</td>
<td>$110,000</td>
</tr>
<tr>
<td>Total assets</td>
<td>$110,000</td>
</tr>
</tbody>
</table>

<table>
<thead>
<tr>
<th>Balance sheet post-ESOP</th>
<th></th>
</tr>
</thead>
<tbody>
<tr>
<td>Accounts payable</td>
<td>$30,000</td>
</tr>
<tr>
<td>Bank debt</td>
<td>$10,000</td>
</tr>
<tr>
<td>ESOP debt</td>
<td>$1,000</td>
</tr>
<tr>
<td>Total liabilities</td>
<td>$41,000</td>
</tr>
<tr>
<td>Stockholders’ equity</td>
<td>$71,000</td>
</tr>
<tr>
<td>ESOP contra account</td>
<td>(1,000)</td>
</tr>
<tr>
<td>Total stockholders’</td>
<td></td>
</tr>
<tr>
<td>equity</td>
<td></td>
</tr>
<tr>
<td>Total liability and</td>
<td></td>
</tr>
<tr>
<td>stockholders’ equity</td>
<td></td>
</tr>
<tr>
<td>Total assets</td>
<td>$111,000</td>
</tr>
</tbody>
</table>
Nonleveraged ESOP

Under this approach, the ESOP does not use debt financing to purchase the shares. Instead, an annual cash contribution is made to the plan, which it uses to purchase shares or the plan sponsor simply contributes shares to the plan. Since there is no ESOP debt in this case, there is no need to record the debt or the offsetting contra-equity entry. However, this transaction means that there is not a single purchase of stock that qualifies for all the leveraged ESOP incentives. Instead, there will be a series of purchases that may eventually qualify for certain ESOP incentives.

The primary cash flow advantage of an ESOP can be simulated with this approach. This is the deductible principal. Assume a company needed $1 million in additional capital. It could borrow the funds from a lender under a typical commercial loan. As annual principal payments are required, the company could contribute to the ESOP shares with a value equal to that year’s principal payment. Assuming that the contribution was within the limitations of section 404(a)(3) of the Code, the company would get a tax deduction for a noncash expense, the contribution of stock. Thus, its cash flow picture would be exactly the same as if the ESOP had borrowed the $1 million and it had made a plan contribution sufficient to amortize the debt. (However, a leveraged ESOP may offer more tax incentives, as discussed in the first chapter of this book.)

Table 7–2. Two–step ESOP loan

<table>
<thead>
<tr>
<th></th>
<th>Accounts payable</th>
<th>Bank debt</th>
<th>ESOP debt</th>
<th>Total liabilities</th>
</tr>
</thead>
<tbody>
<tr>
<td></td>
<td>$30,000</td>
<td>$10,000</td>
<td>$900</td>
<td>$40,900</td>
</tr>
<tr>
<td>Stockholders’ equity</td>
<td>$71,000</td>
<td></td>
<td></td>
<td></td>
</tr>
<tr>
<td>Current year’s loss</td>
<td>(900)</td>
<td></td>
<td></td>
<td></td>
</tr>
<tr>
<td>Total stockholders’ equity</td>
<td></td>
<td></td>
<td></td>
<td>$69,900</td>
</tr>
<tr>
<td>Total liability and stockholders’ equity</td>
<td></td>
<td></td>
<td></td>
<td>$110,800</td>
</tr>
</tbody>
</table>

Total assets $110,000

Balance sheet pre–ESOP

Accounts payable $30,000
Bank debt $10,000
Total liabilities $40,000
Stockholders’ equity $70,000
Total liability and stockholders’ equity $110,000
Total assets $110,000

Balance sheet post–ESOP

Accounts payable $30,000
Bank debt $11,000
Total liabilities $41,000
Stockholders’ equity $71,000
ESOP receivable (1,000)
Total stockholders’ equity $70,000
Total liability and stockholders’ equity $111,000
Total assets $110,000

Conclusion

The advantages of ESOPs can be maximized and the disadvantages minimized with proper planning. A clear picture of what the accounting effects of an ESOP should be considered at the earliest possible stage of planning for an ESOP.

The financial reporting for ESOP transactions has been and continues to be in a state of change. As such, ESOP sponsors and corporations contemplating the implementation of an ESOP need to be sensitive to this.