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Understanding And Applying The New ESOP Reporting Requirements

By: Susan E. Anderson and **Kennard S. Brackney**

Abstract

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Understanding and Applying the New ESOP Reporting Requirements

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In December 1992, a task force of the Accounting Standards Executive Committee (AcSEC) of the American Institute of CPAs issued an exposure draft of a proposed statement of position (SOP) on employers' accounting for employee stock ownership plans (ESOPs). The proposal calls for fundamental changes in the way employers account for their ESOP-related transactions. If adopted, these changes would very likely affect reported net income and earnings per share (EPS) for many companies. This article identifies the important areas of change and illustrates how the accounting and reporting would be affected.

BACKGROUND AND BASIC STRUCTURE OF ESOPs

An ESOP is a company-funded benefit plan for employees that invests primarily in the stock of the employer. Lawyer and author Louis Kelso conceived the ESOP idea in the 1950s as a way to provide employees with an opportunity for ownership and companies with a cheaper source of funding. In its most elementary form, the nonleveraged ESOP, an employer-sponsor makes periodic contributions to an ESOP trust in accordance with a specified formula in either cash or its own shares. The ESOP trustees then allocate the contributions to individual employees' accounts based on such factors as the employees' compensation and their length of service. When the participating employees leave the company, to the extent their benefits are vested, they receive them in the form of stock or cash.

In a leveraged ESOP, the ESOP trust, with the backing of a loan guarantee or repayment commitment from the employer, borrows to purchase additional shares of employer stock. Once the ESOP obtains the loan, the company issues shares of stock to the ESOP and then is

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free to use the loan proceeds to invest in new capital. Through periodic contributions and dividend payments on the ESOP's shares, the company provides the ESOP with the funds needed to pay off the debt. As the debt is repaid, the ESOP's trustees release shares of the employer's stock from a suspense account to the employees. The released shares are then allocated to individual accounts in the same way as for nonleveraged ESOPs.

With Kelso's help, the first ESOP was established in 1957. By 1973, approximately 300 plans were in existence. In 1974, primarily through the efforts of Senator Russell Long, Congress authorized the core aspects of Kelso's conception of ESOPs as part of the Employee Retirement Income Security Act (ERISA). ESOP trusts were permitted to concentrate their holdings in stock of the employer and borrow from or with the assistance of the employer to acquire shares. Relatedly, Congress also allowed companies to deduct interest and principal payments on ESOP debt.

Presently, approximately 11.5 million employees participate in an ESOP plan (12 percent of the civilian work force).

Many other inducements were added over the next fifteen years. As a result, the number of ESOP plans increased dramatically, from about 1,500 in 1975 to over 10,000 in 1989. Presently, approximately 11.5 million employees participate in an ESOP plan (12 percent of the civilian work force). ESOP assets have an estimated value of $60 billion (2 percent of all U.S. corporate stock). ESOP arrangements are particularly common in private companies and in the manufacturing and finance sectors of the economy.

EXISTING GUIDANCE ON EMPLOYER ACCOUNTING FOR ESOPS

The first authoritative guidance on accounting by employers for ESOP-related transactions was provided in SOP 76-3, "Accounting Practices for Certain Employee Stock Ownership Plans," issued in December 1976. Under SOP 76-3, employer-sponsors are required to record an ESOP's debt if they guarantee the obligation or otherwise commit to repaying it. The offsetting entry is made to unearned compensation (a contra-equity account). As the principal is repaid, the debt and unearned compensation are reduced simultaneously. Interest expense is recognized based on the contributions for interest, and compensation expense is recognized based on the contributions for principal reduction. All shares held by the ESOP (allocated and unallocated) are considered to be outstanding for dividend and EPS purposes.

In essence, SOP 76-3 viewed the compensation cost inherent in an ESOP arrangement as being related more to the debt than to the equity. Consequently, compensation expense was recognized based on the amount of loan principal paid down each period.

Over the next ten years or so, the purposes and structures of ESOPs grew increasingly more diverse and complex. In addition to providing employee benefits, raising investment capital, and strengthening workers' incentives, the range of purposes expanded to include such things as:

- Securing needed tax breaks
- Eliminating a major owner's interest
- Transferring majority ownership to employees
- Reducing the likelihood of unionization or hostile takeover

Some of the changes in the structure of ESOPs that began appearing included using debt with nonlevel payments and/or deferred principal reduction, borrowing without a formal guarantee or repayment commitment from the company, and issuing convertible preferred stock to the ESOP instead of common stock. In an effort to update the guidance on accounting and reporting for ESOPs for these developments, the Financial Accounting Standards Board's (FASB's) Emerging Issues Task Force (EITF) provided a series of consensus opinions on key technical questions beginning in the mid-1980s.

To address the increasing variation in repayment terms of ESOP debt, the FASB provided EITF Issue No. 89-8, "Expense Recognition for Employee Stock Ownership Plans." The EITF concluded that compensation expense should be tied not to the repayment of debt principal, but to the release of shares to employees. Under the shares-allocated method, compensation expense is recognized based on the original cost to the ESOP of the shares released each period.

To address employers' reporting of ESOP debt when no guarantee or repayment commitment exists, the FASB provided EITF Issue No. 89-10, "Sponsor's Recognition of Employee Stock Ownership Plan Debt." The EITF believed that employers should continue to report the ESOP's debt unless the ESOP has the intent and ability to satisfy the debt from nonemployer sources.

To give guidance on matters related to the calculation of EPS when convertible preferred stock is issued to an ESOP, the FASB provided EITF Issue No. 89-12, "Earnings Per Share Issues Related to Convertible Preferred Stock Held by an Employee Stock Ownership Plan." The EITF indicated that the common stock equivalence status of these shares should be based on the general guidance provided in FASB Statement No. 85, "Yield Test for Determining whether a Convertible Security Is a Common Stock Equivalent." In applying the if-converted method to the convertible shares, companies should reduce net income for any additional dividends that would be required to satisfy debt servicing. Also, in general, companies should increase the number of common shares assumed to be outstanding if the common stock's market price is below the guaranteed minimum redemption value for the preferred stock.

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A NEED FOR A FRESH LOOK AT ACCOUNTING FOR ESOPS?

Many believe that the EITF's contributions, while helpful, were pretty much limited to plugging holes that existed in the authoritative guidance on accounting and reporting for ESOP-related transactions. The AcSEC, in particular, believed that what was really needed was a comprehensive reexamination of the standards in this area. In late

1989, the AcSEC formed a task force to take a fresh look at the accounting for ESOPs. The task force was charged with trying to develop an accounting approach that better reflected the economic reality of ESOP arrangements. Especially at issue were the measurement of compensation expense and the treatment of unallocated shares for dividend reporting and EPS purposes. Last December, the task force completed an exposure draft of a proposed SOP on ESOPs and released it for public comment.

CHANGES PROPOSED BY THE NEW EXPOSURE DRAFT

The changes described in the exposure draft (ED) are based on the AcSEC's conclusion that accounting for an ESOP's debt should be separate from accounting for an ESOP's shares. The ED only contains proposals affecting the accounting for leveraged ESOPs; accounting for nonleveraged ESOPs is covered under FASB Statement No. 87, "Employers' Accounting for Pensions."

The accounting procedures to be used in recording the establishment of an ESOP depend on whether the ESOP is internally or externally leveraged.

Establishing an ESOP

The accounting procedures to be used in recording the establishment of an ESOP depend on whether the ESOP is internally or externally leveraged. If the ESOP borrows from an unrelated third party, it is considered externally leveraged. The employer provides all of the financing for internally leveraged ESOPs.

Externally Leveraged ESOPs

Employers must report an externally leveraged ESOP's debt on their balance sheets. The employer shares acquired with the debt are placed in the ESOP trust to be allocated to employees based on future services. AcSEC believes the substance of the transaction is that the cash received by the ESOP represents the proceeds from a borrowing, not consideration for the purchase of employee stock, as under current accounting procedures. To illustrate the accounting treatment proposed in the ED, assume that an ESOP borrows $10,000,000 to acquire employer stock. The employer would record the transaction as follows:

Cash	$10,000,000	
ESOP Debt		$10,000,000
Unearned Compensation	$10,000,000	
Common Stock/Paid-in Capital		$10,000,000

Because the employer will receive future employee services in exchange for the stock, the employer will charge unearned compensation, a contra-equity account, for the cost of the shares purchased by the ESOP. AcSEC concluded that total stockholders' equity should not change since the shares are not exchanged for assets, services, or a reduction of liabilities. Total stockholders' equity

is changed only when ESOP shares are committed to be released for allocation to participant accounts.

The current accounting procedures do not separate the accounting for the ESOP's debt from the accounting for the ESOP's shares. The existing rules associate unearned compensation with the debt and the stock with the cash received from the borrowing, as shown in this example:

Cash	$10,000,000	
Common Stock/Paid-in Capital		$10,000,000
Unearned Compensation	$10,000,000	
ESOP Debt		$10,000,000

Internally Leveraged ESOPs

If an ESOP is internally leveraged, the ESOP's note payable does not represent an obligation of the employer to transfer assets to an unrelated party. Likewise, the employer's note receivable does not represent a claim on the resources of an unrelated party. AcSEC determined that these claims should not be recorded as assets or liabilities. If an employer loans an ESOP $10,000,000 to purchase its stock, the entry to record the transaction is:

Unearned Compensation	$10,000,000	
Common Stock/Paid-in Capital		$10,000,000

Employer Contributions

Under existing accounting procedures, employers charge contributions to interest and compensation expense. AcSEC believes that since contributions are used to repay what is effectively the employer's debt, they should be allocated between debt reduction and interest expense based on the terms of the ESOP debt. This approach attempts to link the accounting treatment with the use of the contributions.

Under existing accounting procedures, employers charge contributions to interest and compensation expense.

Dividends

Currently dividends on all ESOP shares are charged to retained earnings. The proposed SOP distinguishes between dividends on allocated and unallocated shares. Since dividends on ESOP shares belong to ESOP participants and are not controlled by employers, AcSEC recommends that these dividends should be charged to retained earnings.

While dividends on unallocated shares legally belong to the ESOP, employers are able to control the use of these dividends. For example, employers may use dividends on unallocated shares to compensate participants or to pay debt service. AcSEC believes that the use of dividends on unallocated shares should determine the accounting treatment. If these dividends are used to compensate employees, they

should be charged to compensation expense. If the dividends are used to service debt, they should be reported as reductions of debt and interest payable.

The Release of ESOP Shares

The ED introduces major changes in accounting for the release of ESOP shares. Under current rules, the cost of all ESOP shares released increases compensation expense and reduces unearned compensation. The proposed SOP would require employers to measure compensation expense using the fair value of the shares on the date they are committed to be released. AcSEC cites four reasons supporting the change to the fair value measure:

1. According to APB 25, "Accounting for Stock Issued to Employees," compensation expense should be measured at the date on which the number of shares that an individual is entitled to receive is known. In an ESOP, the number of shares individual employees receive cannot be determined until the shares are committed to be released.
2. The fair value of the shares at the date they are committed to be released is a better measure of the value of services provided by the employee.
3. The employer retains the risks and rewards of ownership until the shares are committed to be released since the employer has significant control over the employee's total compensation package and over how the ESOP debt will be repaid. For example, the employer may have to increase other forms of compensation if the stock is declining in value.
4. In a nonleveraged ESOP, compensation expense is measured using the fair value of the stock when the employer commits to contribute the shares to the ESOP. AcSEC believes that compensation should be measured in the same way for both types of ESOPs.

AcSEC believes that now employers use ESOP shares for a variety of purposes, including . . . settling liabilities for employee benefits and replacing dividends on allocated ESOP shares that are used for debt service.

When ESOPs were first established, the primary purpose of releasing ESOP shares was to compensate employees, so employers recorded the cost of the released shares as compensation expense. AcSEC believes that now employers use ESOP shares for a variety of purposes, including compensating employees directly, settling liabilities for employee benefits, and replacing dividends on allocated ESOP shares that are used for debt service. Under this ED, the accounting for the release of ESOP shares is determined by the purpose of the release. Regardless of the purpose for the shares' release, employers must measure the shares committed to be released at their fair value.

Shares Used To Compensate Employees Directly

AcSEC states that the employer should record compensation expense when the employee renders services in exchange for stock. AcSEC proposes that this exchange occurs when shares are committed

to be released, rather than when the ESOP shares are allocated or when employees become vested.

To demonstrate the effect of the ED's changes, consider the following example. Assume an ESOP acquires employer stock at a cost of $200,000. At the date the shares are committed to be released, the shares have a fair value of $500,000. The difference between the cost and fair value of the stock would be recorded as an adjustment to additional paid-in capital, as shown in the following entry:

Compensation Expense	$500,000	
Unearned Compensation		$200,000
Additional Paid-in Capital		$300,000

Under the current accounting procedures, the transaction would be recorded as follows:

Compensation Expense	$200,000	
Unearned Compensation		$200,000

Shares Used To Fund Liabilities for Other Employee Benefits

AcSEC concludes that the method of funding employee benefits should not affect the measurement and recognition of the employer's cost and liability. If employee benefits are financed by debt or cash, the employer's compensation expense is measured using the fair value of the assets given in the exchange. Likewise, AcSEC argues, the appropriate measure of benefits provided by an ESOP is the fair value of the shares committed to be released. Under the current procedures, compensation is measured using the cost of shares contributed to the ESOP.

AcSEC concludes that the method of funding employee benefits should not affect the measurement and recognition of the employer's cost and liability.

The following example illustrates the differences between the two approaches. Assume ESOP shares are used to fund an employer's 50 percent matching contribution under its 401(k) plan. The market value of the ESOP shares on their release date determines the number of shares allocated to individual participants. If the market value is less than the employer's required contribution, the employer must provide cash or additional shares to fund the difference (called "top-up" shares). The employees contribute $100,000 to their 401(k) plan, so the employer is required to contribute $50,000. The market value of the shares committed to be released is $35,000, while these same shares cost the ESOP $25,000. Because the employer's liability is greater than the market value of the ESOP shares, the employer must contribute top-up shares to the ESOP.

Under the current accounting procedures, the employer would record compensation expense of $40,000 ($25,000 cost of ESOP shares plus $15,000 current cost of top-up shares). The ED requires that compensation expense be measured using the market value of all shares funding the employer's contribution, which is $50,000 in this example ($35,000 market value of shares in ESOP plus $15,000 market value of top-up shares).

Shares Used To Replace Dividends

Employers may use dividends on allocated shares to service debt but must replace these dividends. AcSEC decided that these replacement dividends must be measured as if they were paid in cash.

Earnings Per Share

AcSEC distinguishes between ESOP shares that are committed to be released and those shares not yet committed to be released in calculating EPS. Because ESOP shares committed to be released have been exchanged for employee services, AcSEC believes these shares should be considered as outstanding for EPS purposes. However, AcSEC contends that ESOP shares that have not been committed to be released should not be considered outstanding for EPS because these shares have yet to be exchanged for employee services.

AcSEC states that convertible preferred stock in ESOPs should be treated as a common stock equivalent because these shares can be converted to common stock after the passage of a prescribed time period. In addition, if participants withdrawing their shares are entitled to receive additional common shares because the fair value of the convertible preferred stock is greater than the fair value of the common shares issued at conversion, the ED states that these additional shares should be assumed to be issued in the if-converted EPS calculations.

Terminations

It is difficult to terminate an ESOP because the Internal Revenue Service and ERISA require a valid business reason for doing so. A valid business reason would include significant shrinkage in the work force or bankruptcy. If an ESOP is terminated, AcSEC recommends that the termination be accounted for as a treasury stock transaction. Thus, the employer would debit paid-in capital when the fair value of the shares at termination is less than the ESOP's cost of the shares. Paid-in capital would be credited if the fair value of the shares at termination is greater than the cost of the shares to the ESOP.

If an ESOP is terminated, AcSEC recommends that the termination be accounted for as a treasury stock transaction.

A summary comparison of the current and proposed rules for employer's accounting for leveraged ESOPs is provided in **Exhibit 1. Exhibit 2** gives a comprehensive example showing the potential effect of the proposed SOP on companies' income. In the example, with the release of shares being recorded at fair value and the dividends on unallocated shares being charged to the purpose they actually serve, Company X's compensation expense would increase from $100,000 under the current rules to $210,000 under the proposed rules. If the company's stock price had instead fallen, to $8.50 per share, its compensation expense under the proposed SOP would have been $150,000.

IMPLEMENTATION OF THE PROPOSED SOP

The proposed SOP would be effective for fiscal years ending after December 15, 1993. Employers would be required to apply the new

Exhibit 1
Summary Comparison of Current and Proposed Rules for Leveraged ESOPs

Recording of ESOP's Debt
Current: Record if from outside lender; debit unearned compensation.
Proposed: Record if from outside lender; debit cash.
Issuance of Shares to ESOP
Current: Debit cash.
Proposed: Debit unearned compensation expense.
Contributions to ESOP
Current and Proposed: Charge interest expense and ESOP debt.
Release of Shares to Employees
Current: When released, charge compensation expense for cost of shares.
Proposed: When committed to be released, charge compensation expense for fair value of shares.
Dividends on Allocated Shares
Current and Proposed: Charge retained earnings.
Dividends on Unallocated Shares
Current: Charge retained earnings.
Proposed: If used for debt service, charge accrued interest and ESOP debt; if paid to employees, charge compensation expense.
Total Interest Expense
Current and Proposed: Interest cost accrued on debt during period.
Total Compensation Expense
Current: Cost of shares released during period minus dividends used for debt service.
Proposed: Fair value of shares committed to be released during period minus dividends on allocated shares used for debt service plus dividends on unallocated shares paid to employees.
Shares Outstanding for EPS Calculations
Current: All ESOP shares.
Proposed: Only ESOP shares released or committed to be released.

rules to shares purchased by ESOPs after September 23, 1992, that have not been committed to be released as of the beginning of the year of the proposed SOP's adoption. September 23, 1992, was the selected date because that was when AcSEC received approval from the FASB to issue the ED.

Employers would be able to elect to apply the proposed SOP's provisions to shares purchased by ESOPs on or before September 23, 1992, that have not been committed to be released as of the beginning of the year in which the SOP is adopted. This election would be available only for financial statements for years ending on or before December 31, 1994. If an employer does not initially make this election, but establishes a significantly new ESOP or adds a significant

Exhibit 2

Example of the Proposed SOP's Effect on Income

Facts

- Company X establishes a leveraged ESOP on 1/1/1.
- The ESOP borrows $1,000,000 from an outside lender at 10 percent for 5 years.
- X issues 100,000 shares of convertible preferred stock to the ESOP at an average price of $10 per share.
- The stock's annual dividend is $1.00 per share, payable quarterly.
- 20,000 shares are released each year and allocated on 12/31.
- The Year 2 amounts for principal reduction and interest are $180,177 and $83,620, respectively.
- The average price of the stock during Year 2 is $11.50 per share.
- All dividends are used for debt service.

Year 2 Amounts for Company X

	Current	*Proposed*
Dividends (allocated shares)	$ 20,000*	$ 20,000
Dividends (unallocated shares)	80,000+	80,000
Contributions	183,797±	183,797
Interest expense	83,620	83,620
Compensation expense	100,000§	210,000//
Total expense	183,620	293,620

* 20,000 shares allocated on 12/31/1 times $1 dividend per share.

\+ 80,000 unallocated shares times $1 dividend per share.

± $263,797 required debt service ($180,177 principal plus $83,620 interest) minus dividends on unallocated shares used for debt service ($80,000).

§ $200,000 cost of shares released in Year 2 (20,000 shares released times cost of $10 per share) minus dividends used for debt service ($20,000 plus $80,000).

// $230,000 value of shares released in Year 2 (20,000 shares released times fair value of $11.50 per share) minus dividends on allocated shares used for debt service ($20,000).

number of shares to an existing ESOP after December 31, 1994, it would be able to apply the proposed SOP to all shares that have not yet been committed to be released in the year in which the new ESOP shares are purchased.

All public companies with ESOPs will be affected by the proposed SOP. The ED requires public companies not adopting the proposed SOP to disclose pro forma income before extraordinary items, net income, and EPS computed as if the employer had adopted the proposed SOP's provisions.

CRITICISMS OF THE PROPOSED SOP

Perhaps the most controversial aspect of the proposed SOP is the requirement that compensation expense be measured using the fair value of the shares committed to be released. Critics of the approach believe that the fair value measure introduces too much volatility into earnings, particularly for rapidly growing companies. They contend the cash flow impact to the company is determined when shares are issued to the ESOP; therefore, they argue, the cost of the ESOP shares is the appropriate measure.

Perhaps the most controversial aspect of the proposed SOP is the requirement that compensation expense be measured using the fair value of the shares committed to be released.

Three AcSEC members dissented on the issuance of the proposed SOP because of the fair value measure. These dissenters believe there are two types of ESOPs. In the first type, shares are released to compensate employees directly. Since these ESOPs do not fund other employee benefits, the fair value of the shares at the time of release does not directly impact the company. The dissenting AcSEC members argue that current accounting procedures are appropriate for these ESOPs.

In the second type of ESOP, the shares released fund other employee benefits, such as an employer's match to a 401(k) plan. The fair value of the shares released determines the employer's remaining obligation for the benefit. The dissenters agree that the provisions of the proposed SOP should apply to these ESOPs.

A compromise to the cost versus fair value dispute would be to disclose changes in the fair value of ESOP shares. Disclosure would not create potential earnings fluctuations that may be confusing to financial statement users. Corporations may be more willing to accept this less radical approach.

TAKING ANOTHER LOOK

The increase in the complexity of ESOPs in recent years means we should take another look at the procedures used in accounting for them. ESOPs are currently used for a number of different purposes other than directly compensating employees. The proposed SOP seeks to align the accounting for ESOPs with their function.

The changes contained in the ED are expected to have a significant impact on financial statements. Compensation expense may significantly increase for those firms whose ESOPs contain shares not yet committed to be released with a cost less than fair market value. This increase in compensation expense, however, may not result in reduced EPS because ESOP shares not yet committed to be released would no longer be considered as outstanding.

Since the proposed changes are so significant, AcSEC will have to consider many diverse views before releasing a final document. AcSEC hopes to issue a final SOP in the fourth quarter of 1993. ◆