

6. The sponsor shall report the issuance of shares or the sale of treasury shares to an ESOP when they occur. The consideration recorded for the stock issued is unearned compensation and the unearned ESOP shares shall be reported as a separate reduction of surplus as a component of unassigned funds.
7. The unearned shares initially held by the ESOP in a suspense account are called suspense or

the employer should charge the tax effect of the amount by which the book expense exceeds the deductible expense to unassigned funds to the extent of previous credits to unassigned funds related to cost exceeding fair value of ESOP shares committed to be released in previous periods.

16. Furthermore, the tax benefit of tax-deductible dividends on allocated ESOP shares should be recorded as a reduction of income tax expense allocated to continuing operations.

Nonleveraged ESOPs

17. Employers with nonleveraged ESOPs may accrue compensation cost for financial reporting purposes earlier than the cost is deductible for income tax purposes. Accruing the compensation cost earlier for financial reporting purposes creates a temporary difference that shall be accounted for in accordance with Issue Paper No. 83.

Other

18. Under federal income tax regulations, employer securities (such as convertible preferred stock) that are held by participants in an ESOP and that are not readily tradable on an established market must include a put option. Securities subject to such repurchase obligations shall be reported as outstanding and as a component of surplus. The repurchase obligation shall be disclosed in accordance with paragraph 19 below.

Disclosures

19. An employer sponsoring an ESOP shall disclose the following information about the plan, if applicable.

- a. A description of the plan, the basis for determining contributions, including the employee groups covered, and the nature and effect of significant matters affecting comparability of information for all periods presented. For leveraged ESOPs and pension reversion ESOPs, the description should include the basis for releasing shares and how dividends on allocated and unallocated shares are used;
- b. A description of the accounting policies followed for ESOP transactions, including the method of measuring compensation and the classification of dividends on ESOP shares;
- c. The amount of compensation cost recognized during the period;
- d. The number of allocated shares, committed-to-be-released shares, and suspense shares held by the ESOP at the balance sheet date;
- e. The fair value of unearned ESOP shares at the balance sheet date;
- f. The existence and nature of any repurchase obligation, including disclosure of the fair value of the shares allocated as of the balance sheet date, which are subject to a repurchase obligation.

DISCUSSION

20. The Life/A&H Accounting Practices and Procedures Manual and the P & C Accounting Practices and Procedures Manual provide that debt obligations of Employee Stock Ownership Plans (ESOPs) must be recorded as debt obligations of company sponsors, except when the ESOP has both the ability and intent to satisfy the debt from sources other than dividends on the company stock, contributions from the company or the sale or exchange of the company's securities. This issue paper is consistent with current statutory guidance. It expands on current statutory guidance to address the accounting for ESOPs in greater detail and to expand the disclosure requirements for ESOPs.

21. This issue paper adopts the GAAP guidance set forth in SOP 93-6 except for:
- a. Paragraphs 13 and 25 to the extent that those paragraphs require reporting all debt obligations of an ESOP as liabilities. Statutory accounting provides an exception in situations where the ESOP has both the ability and intent to satisfy the debt from sources other than dividends on the company stock, contributions from the company or the sale or exchange of the company's securities. Pursuant to current statutory guidance and Issue Paper No. 80, such obligations do not meet the definition of liabilities (of the sponsor) as defined in *Issue Paper No. 5—Definition of Liabilities, Loss Contingencies and Impairments of Assets*.
 - b. Paragraphs 28-34 and paragraphs 44 and 53.b. as they relate to the calculation and reporting of earnings per share.
 - c. Paragraph 37 as it relates to reporting gains and losses on extinguishment of debt. Such gains and losses shall be accounted for and disclosed consistent with Issue Paper No. 24.

22. Under federal income tax regulations, employer securities (such as convertible preferred stock) that are held by participants in an ESOP and that are not readily tradable on an established market must include a put option. Pursuant to Securities and Exchange Commission (SEC) *Codification of Financial Reporting Policies*, Section 211 - Redeemable Preferred Stocks, SEC reporting companies are required to report such securities outside of permanent equity.

Debt Obligations of Employee Stock Ownership Plans (ESOP)

Insurance company sponsors of ESOP's must record the debt obligations of such ESOP's on the books of the company in all situations, except when the ESOP has both the ability and intent to satisfy the debt from sources other than dividends on the company's stock, contributions from the company, or the sale or exchange of the company's securities.

Generally Accepted Accounting Principles

26. SOP 93-6 provides the following guidance related to debt obligations of ESOPs (only the pertinent excerpts are included below):

Scope

1. This statement of position (SOP) provides guidance on employers' accounting for employee stock ownership plans (ESOPs). It applies to all employers with ESOPs, both leveraged and nonleveraged. It does not address financial reporting by ESOPs.¹

¹ Financial reporting by ESOPs is discussed in the AICPA Audit and Accounting Guide *Audits of Employee Benefit Plans*.

2. An ESOP is an employee benefit plan that is described by the Employee Retirement

- To fund a matching program for a sponsor's 401(k) saving plan, formula-based profit-sharing plan, and other employee benefits
- To raise new capital or to create a marketplace for the existing stock
- To replace lost benefits from the termination of other retirement plans or provide benefits under postretirement benefit plans, particularly medical benefits
- To be part of the financing package in leveraged buy-outs
- To provide a tax-advantaged means for owners to terminate their ownership
- To be part of a long-term program to restructure the equity section of a plan sponsor's balance sheet
- To defend the company against hostile takeovers

7. The borrowing arrangements used by leveraged ESOPs have also become more diverse. When SOP 76-3 was issued, most leveraged ESOPs borrowed from outside lenders, and the loan terms were relatively simple. Since then, internally leveraged ESOPs (ESOPs that borrow from the sponsor) have become more common. Furthermore, some ESOP loans are now structured so that a large portion of the debt service will be paid with dividends on shares held by the ESOP rather than with employer contributions.

8. Employers' accounting for ESOP transactions, particularly the measurement of compensation cost and the treatment of dividends on shares held by an ESOP, has been a source of accounting controversy for many years. Even when SOP 76-3 was issued, there was disagreement about some ESOP issues.³ Changes in laws and regulations that apply to ESOPs and the increased diversity in the structure and purpose of ESOPs have called new attention to the limitations of SOP 76-3. Furthermore, SOP 76-3 does not address some of the accounting issues presented by the new ESOPs. Although the EITF has addressed a number of ESOP issues, it has done so on an ad hoc basis.

³ Paragraph 13 of SOP 76-3 presents a minority view that disagrees with that SOP's recommendations on reporting dividends paid and earnings per share.

9. Therefore, the Accounting Standards Executive Committee (AcSEC) undertook this project to reconsider SOP 76-3 and to consider current ESOP issues that are not specifically addressed in the accounting literature. AcSEC's objective in issuing this SOP is to enhance the relevance and representational faithfulness of financial statements of employers that sponsor ESOPs.

10. There are two basic forms of ESOP: nonleveraged and leveraged. This SOP addresses the financial reporting for each separately.

Conclusions

11. The following conclusions should be read in conjunction with the "Discussion of Conclusions" beginning with paragraph 59 of this SOP. That section explains considerations that were deemed significant by members of AcSEC in reaching the conclusions.

Leveraged ESOPs

12. Unlike other kinds of employee benefit plans, an ESOP is permitted by ERISA to borrow from a related party or with the assistance of a related party. A leveraged ESOP borrows money to acquire shares of the employer company. The debt usually is collateralized by the employer's shares. The shares initially held by the ESOP in a suspense account are called *suspense shares*.⁴ The debt is generally repaid by the ESOP from employer contributions and dividends on the employer's stock. As the debt is repaid, suspense shares are released from the suspense account, and the released shares must be allocated to individual accounts as of the end of the ESOP's fiscal year. The money can be borrowed by the ESOP from the sponsor, with or without

associated with providing such benefits to employees in the same manner they would had an ESOP not been used to fund the benefit. For ESOP shares committed to be released to settle liabilities for such benefits, employers should report satisfaction of the liabilities when the shares are committed to be released to settle the liability. The number of shares released to settle the liability is based on the fair value of shares as of dates specified by the employers, which are usually specified in the ESOP documents.

18. The IRC allows employers to use dividends on ESOP shares that have been allocated to participants for debt service if participants are allocated shares of employer stock with a fair value no less than the amount of the dividends used for debt service. If shares released will include shares designated to replace *dividends on previously allocated shares used for debt service*, employers should report the settlement of the dividend payable when the shares are committed to be released to replace the dividends on shares used for debt service. (See paragraphs 21 and 22; only dividends on allocated shares should be charged to retained earnings.) The number of shares committed to be released to replace the dividends on allocated shares used for debt service is based on the fair value of shares as of dates specified by the employer, which are usually specified in the ESOP documents based on the employer's interpretation of current IRS regulations.

19. Unearned ESOP shares should be credited as shares are committed to be released based on the cost of the shares to the ESOP. Employers should charge or credit the difference between the fair value of shares committed to be released and the cost of those shares to the ESOP to shareholders' equity in the same manner as gains and losses on sales of treasury stock (generally to additional paid-in capital).

Fair Value

20. The fair value of ESOP shares is needed to apply certain provisions of this SOP. The fair value of an ESOP share is the amount the seller could reasonably expect to receive for it in a current sale between a willing buyer and a willing seller, that is, other than a forced or liquidation sale. For shares that are traded, the price in the most active market should be used to measure fair value. If there is no market price, the employer's best estimate of fair value should be used. The use of independent experts may be necessary to estimate fair value. For example, the amount determined in a recent (within twelve months of the employer's year-end) independent stock valuation report may aid in determining the best estimate of fair value.

Reporting Dividends on ESOP Shares

21. Because employers control the use of dividends on unallocated shares, dividends on unallocated shares are not considered dividends for financial reporting purposes. Dividends on unallocated shares used to pay debt service should be reported as a reduction of debt or of accrued interest payable. Dividends on unallocated shares paid to participants or added to participant accounts should be reported as compensation cost.

22. Dividends on allocated shares should be charged to retained earnings. The dividends payable may be satisfied either by contributing cash to the participant accounts, by contributing additional shares to participant accounts, or by releasing shares from the ESOP's suspense account to participant accounts (see paragraph 18).

Reporting Redemptions of ESOP Shares

23. Regardless of whether an ESOP is leveraged or nonleveraged, employers are required to give a put option to participants holding ESOP shares that are not readily tradable, which on exercise requires employers to repurchase the shares at fair value. Furthermore, public company sponsors sometimes offer cash redemption options to participants who are eligible to withdraw traded shares from their accounts. Employers should report the satisfaction of such option exercises as purchases of treasury stock.

Reporting of Debt and of Interest

24. For purposes of applying this SOP, ESOP debt is characterized as follows:

- *Direct loan* — A loan made by a lender other than the employer to the ESOP. Such loans often include some formal guarantee or commitment by the employer.
- *Indirect loan* — A loan made by the employer to the ESOP, with a related outside loan to the employer.
- *Employer loan* — A loan made by the employer to the ESOP, with no related outside loan.

ESOPs with indirect loans and employer loans are often referred to as internally leveraged.

25. Employers that sponsor an ESOP with a direct loan should report the obligations of the ESOP to the outside lender as liabilities. Furthermore, employers should accrue interest cost on the debt and should report cash payments to the ESOP that are used by the ESOP to service debt, regardless of whether the source of cash is employer contributions or dividends, as reductions of the debt and accrued interest payable when the ESOP makes the payments to the outside lender.

26. Employers that sponsor an ESOP with an indirect loan should report outside loans as liabilities. Employers should not report a loan receivable from the ESOP as an asset and should, therefore, not recognize interest income on such receivable. Employers should accrue interest cost on the outside loan and should report loan payments as reductions of the principal and accrued interest payable. Contributions to the ESOP and the concurrent payments from the ESOP to the employer for debt service would not be recognized in the employer's financial statements.

27. Employers that sponsor an ESOP with an employer loan should not report the ESOP's note payable and the employer's note receivable in the employer's balance sheet. Accordingly, employers should not recognize interest cost or interest income on an employer loan.

Earnings per Share

28. For purposes of computing primary and fully diluted earnings per share (EPS), ESOP shares that have been committed to be released should be considered outstanding. ESOP shares that have not been committed to be released should not be considered outstanding.

29. Employers with ESOPs that hold convertible preferred stock may encounter unique EPS issues. The remainder of this section provides guidance on how to deal with some of those issues, particularly the following:

- Whether convertible preferred shares held by an ESOP should be considered common stock equivalents
- How to determine the number of shares assumed to be outstanding in the if-converted EPS computations
- How earnings applicable to common stock in if-converted EPS computations should be adjusted for dividends on allocated shares used for debt service
- Whether prior periods' EPS should be restated for changes in conversion rates

This SOP does not provide a step-by-step discussion of how to apply the if-converted method to compute EPS and does not address all possible EPS questions that may arise. Accounting Principles Board (APB) Opinion No.15, *Earnings per Share*; the AICPA's accounting Interpretations of that Opinion; and illustrations 4 and 5 in appendix A of this SOP provide additional guidance.

30. *Common Stock Equivalents*. APB Opinion No. 15 requires that a convertible security, which at the time of issuance has terms that make it for all practical purposes substantially the

33. *Adjustments to Earnings.* Employers that use dividends on allocated ESOP shares to pay debt service should adjust earnings applicable to common shares in the if-converted computation for the difference (net of income taxes) between the amount of compensation cost reported and the amount of compensation cost that would have been reported if the allocated shares had been converted to common stock at the beginning of the period.

34. *Changes in Conversion Rates.* In consonance with paragraphs 56-58 of APB Opinion 15, prior period EPS should not be restated for changes in the conversion rates.

Accounting for Terminations

35. Upon termination of a leveraged ESOP, either in whole or in part, all outstanding debt related to the shares being terminated must be repaid or refinanced. An ESOP may repay the debt using an employer contribution to the plan, dividends on ESOP shares, the proceeds from selling suspense shares to the employer or to another party, or some combination of these. The law limits the shares employers may reacquire to the number of shares with a fair value equal to the applicable unpaid debt and requires that the remaining shares, if any, be allocated to participants.

36. If the employer makes a contribution to the ESOP or pays dividends on unallocated shares that are used by the ESOP to repay the debt, the employer should charge the debt and accrued interest payable when the ESOP makes the payment to the outside lender. Similarly, an employer sponsoring an ESOP with an indirect loan should report loan repayments as reductions of the debt and accrued interest payable.

37. If the ESOP sells the suspense shares and used the proceeds to repay the debt, the employer should report the release of the suspense shares as a credit to unearned ESOP shares based on the cost of the shares to the ESOP, charge debt, and accrued interest payable, and recognize the difference in paid-in capital. However, if there is a difference between the amount paid to an outside lender and the net carrying amount of the debt, paragraph 20 of APB Opinion No. 26, *Early Extinguishment of Debt*, as amended by FASB Statement of Financial Accounting Standards No. 4, *Reporting Gains and Losses from Extinguishment of Debt*, requires that difference to be included in the employer's income when the debt is extinguished.

38. If an employer reacquires the suspense shares from the ESOP, the purchase of the shares should be accounted for as a treasury stock transaction. The treasury stock should be reported at the fair value of the shares at the reacquisition date. Unearned ESOP shares should be credited for the cost of the shares, and the difference should be recognized in additional paid-in capital.

39. If the fair value of the suspense shares on the termination date is more than the unpaid debt balance, the release of the remaining suspense shares to participants should be charged to compensation in accordance with paragraphs 14-18 of this SOP. That is, compensation cost should equal the fair value of the shares at the date the ESOP debt is extinguished, because that is when the shares are committed to be released.

Nonleveraged ESOPs

40. An employer with a nonleveraged ESOP periodically contributes its shares or cash to its ESOP on behalf of employees. The shares contributed or acquired with the cash contributed, which may be outstanding shares, treasury shares, or newly issued shares, are allocated to participant accounts and held by the ESOP until distributed to the employees at a future date, such as on the date of termination or retirement. The shares of employer stock obtained by the nonleveraged ESOP must be allocated to individual participant accounts as of the end of the ESOP's fiscal year.

Reporting Purchase of Shares by ESOPs

41. Employers with nonleveraged ESOPs should report compensation cost equal to the contribution called for in the period under the plan. Compensation cost should be measured as the fair value of the shares contributed to or committed to be contributed to the ESOP or as the cash contributed to or committed to be contributed to the ESOP, as appropriate under the terms of the plan.

Issues Related to Accounting for Income Taxes

Leveraged ESOPs

49. For employers with leveraged ESOPs, the amount of ESOP-related expense reported under this SOP for a period may differ from the amount of the ESOP-related income tax deduction (prescribed by income tax rules and regulations) for that period. Differences result if (a) the fair value of shares committed to be released differs from the cost of those shares to the ESOP and (b) the timing of expense recognition is different for income tax and financial reporting purposes. Such differences should be reported in accordance with *FASB Statement No. 109, Accounting for Income Taxes*. Similar differences arise from employee stock options. Paragraph

- c. The amount of compensation cost recognized during the period.
- d. The number of allocated shares, committed-to-be-released shares, and suspense shares held by the ESOP at the balance-sheet date. This disclosure should be made separately for shares accounted for under this SOP and for grandfathered ESOP shares (see paragraphs 54 and 55).
- e. The fair value of unearned ESOP shares at the balance-sheet date for shares accounted for under this SOP. (Future tax deductions will be allowed only for the ESOP's cost of unearned ESOP shares.) This disclosure need not be made for old ESOP shares for which the employer does not apply the guidance in this SOP (see paragraphs 55 and 56).
- f. The existence and nature of any repurchase obligation, including disclosure of the fair value⁷ of the shares allocated as of the balance-sheet date, which are subject to a repurchase obligation.

⁷ See paragraph 20 for guidance on fair value.

RELEVANT LITERATURE

Statutory Accounting

- Statutory Accounting Principles Statement of Concepts and Statutory Hierarchy
- Accounting Practices and Procedures Manuals for Life and Accident and He