Accounting practices for certain employee stock ownership plans : recommendation to the Financial Accounting Standards Board; Statement of position 76-3;

American Institute of Certified Public Accountants. Accounting Standards Division

Statement of Position

on

76-3

Accounting Practices for Certain Employee Stock Ownership Plans

December 20, 1976

Recommendation to the Financial Accounting Standards Board

Issued by
Accounting Standards Division

American Institute of
Certified Public Accountants

AICPA

Notes

Statements of Position of the Accounting Standards Division are issued for the general information of those interested in the subject. They present the conclusions of at least a majority of the Accounting Standards Executive Committee, which is the senior technical body of the Institute authorized to speak for the Institute in the areas of financial accounting and reporting and cost accounting.

The objective of Statements of Position is to influence the development of accounting and reporting standards in directions the Division believes are in the public interest. It is intended that they should be considered, as deemed appropriate, by bodies having authority to issue pronouncements on the subject. However, Statements of Position do not establish standards enforceable under the Institute's Code of Professional Ethics.

AICPA

American Institute of Certified Public Accountants

1211 Avenue of the Americas, New York, New York 10036 (212) 575-6200

December 20, 1976

Marshall S. Armstrong, CPA
Chairman
Financial Accounting Standards Board
High Ridge Park
Stamford, Connecticut 06905

Dear Mr. Armstrong:

The accompanying Statement of Position presents recommendations of the Accounting Standards Division on Accounting Practices for Certain Employee Stock Ownership Plans (ESOPs). It was prepared on behalf of the Division by the Accounting Standards Executive Committee for consideration by the Financial Accounting Standards Board and for such action as the Board deems appropriate.

The Statement deals primarily with accounting and reporting issues that have arisen with respect to those ESOPs that borrow funds from a bank or other lender to acquire shares of stock in the employer company or that issue notes to existing shareholders in exchange for shares of stock. However, certain conclusions in the Statement are also applicable to ESOPs that have not entered into such transactions.

The Statement's major recommendations are briefly summarized below:

- An obligation of an ESOP should be recorded as a liability in the financial statements of the employer when the obligation is covered by either a guarantee of the employer or a commitment by the employer to make future contributions to the ESOP sufficient to meet the debt service requirements.

- The offsetting debit to the liability recorded by the employer should be accounted for as a reduction of shareholders' equity.

- The liability recorded by the employer and the offsetting debit should both be reduced as the ESOP makes payments on the debt.

- The amount contributed or committed to be contributed to an ESOP with respect to a given year should be charged to expense by the employer; the compensation and interest elements of the contribution should be separately reported.

- All shares held by an ESOP should be treated as outstanding shares in the determination of earnings per share. Dividends paid on those shares should be charged to retained earnings.

- Any additional investment tax credit should be accounted for as a reduction of income tax expense in the year in which the contribution to the ESOP is charged to expense.

The Division would appreciate being advised as to the Board's proposed action on the recommendations set forth in this Statement of Position.

Sincerely yours,

Raymond C. Lauver

Raymond C. Lauver
Chairman
Accounting Standards Division

cc: Securities and Exchange Commission

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INTRODUCTION

1. The Employee Retirement Income Security Act of 1974 describes an Employee Stock Ownership Plan (ESOP) as a qualified stock bonus plan, or a combination stock bonus and money purchase pension plan, designed to invest primarily in "qualifying employer securities."[1/] Qualifying employer securities include the employer's stock and its other marketable obligations. The essential differences between an ESOP and other qualified stock bonus plans are that (a) an ESOP is permitted, in certain circumstances, to incur liabilities in the acquisition of employer securities and (b) the employer may be permitted to increase his maximum allowable investment tax credit by as much as an additional $1\frac{1}{2}\%$ if that amount is contributed to an ESOP.

2. In some cases, funds are borrowed from a bank or other lender by the ESOP and are used to acquire shares of stock in the employer company. The stock may be outstanding shares, treasury shares, or newly issued shares, and is held by the ESOP until it is distributed to the employees. (In some cases, an ESOP may issue notes to existing shareholders in exchange for qualifying employer securities.) The stock may be allocated to individual employees even though it may not be distributed to them until a future date. The debt of the ESOP is usually collateralized by a pledge of the stock and by either a guarantee of the employer or a commitment by the employer to make future contributions to the ESOP sufficient to meet the debt service

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1/ Employee Retirement Income Security Act of 1974, Title II, Subtitle B, Section 2003.

requirements. The employer company makes annual contributions to the ESOP that are deductible for tax purposes, subject to the limitations of the Internal Revenue Code. Cash contributions and dividends received are used by the ESOP to:

(a) Satisfy the annual amortization of the outstanding debt principal.

(b) Satisfy the annual interest costs on such debt.

(c) Obtain short-term investments to provide for liquidity.

(d) Pay other expenses.

(e) Acquire additional shares of the employer company's stock, to the extent of the excess, if any, over that required by (a) through (d) above.

3. Several accounting and reporting issues have arisen with respect to those ESOPs that borrow funds from a bank or other lender to acquire shares of stock in the employer company, or that issue notes to existing shareholders in exchange for shares of stock.[2/] These issues are being dealt with in practice in different ways. This Statement of Position has been issued because the Division believes it is desirable to narrow the range of alternative accounting practices in this area.

4. Final regulations clarifying the rights and duties of the parties affected by an ESOP have not been issued by the Internal Revenue Service. Readers of this Statement of Position should also be cognizant of the content of such regulations, when they are issued.

2/ This Statement of Position does not deal directly with ESOPs that might invest in qualifying employer securities other than equity securities.

ACCOUNTING FOR AN OBLIGATION OF AN ESOP GUARANTEED BY THE EMPLOYER

Recording an ESOP's Obligation In the Employer's Financial Statements

5. The Division believes that an obligation of an ESOP should be recorded as a liability in the financial statements of the employer when the obligation is covered by either a guarantee of the employer or a commitment by the employer to make future contributions to the ESOP sufficient to meet the debt service requirements. The employer's guarantee or commitment is, in substance, the assumption of the ESOP's debt and the related obligation to reduce that debt. The employer has assumed these obligations either (a) to buy back its own shares (in the case where the ESOP uses the loan proceeds to acquire previously outstanding shares) or (b) to finance additional working capital or other fund needs (in the case where the ESOP uses the loan proceeds to acquire previously unissued or treasury shares from the employer).

6. It does not follow from the above that assets held by an ESOP should be included in the financial statements of the employer. Ownership of these assets rests in the employees, not in the employer.

Recording the Offsetting Debit To the Recorded Liability

7. The Division believes that the offsetting debit to the liability recorded by the employer should be accounted for as a reduction of shareholders' equity. Therefore, when new shares are issued to the ESOP by the employer, an increase in shareholders' equity should be

reported only as the debt that financed that increase is reduced. (The offsetting debit in shareholders' equity in this case is akin to the unearned compensation discussed in APB Opinion No. 25, paragraph 14.) When outstanding shares, as opposed to unissued shares, are acquired by the ESOP, shareholders' equity should similarly be reduced by the offsetting debit until the debt is repaid.

Reducing the Recorded Liability

8. The Division believes that the liability recorded by the employer should be reduced as the ESOP makes payments on the debt. The liability is initially recorded because the guarantee or commitment is in substance the employer's debt. Therefore, it should not be reduced until payments are actually made. Similarly, the amount reported as a reduction of shareholders' equity should be reduced only when the ESOP makes payments on the debt. These two accounts should move symmetrically.

MEASURING COMPENSATION EXPENSE

9. The Division believes that the amount contributed or committed to be contributed to an ESOP with respect to a given year should be the measure of the amount to be charged to expense by the employer.[3/] Such contributions measure the amount of expense

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3/ This conclusion is also applicable to ESOPs that have not borrowed funds from a bank or other lender (or issued notes to existing shareholders) to acquire shares of stock in the employer company.

irrevocably incurred whether or not they are used concurrently to reduce the debt guaranteed by the employer.

10. Since the debt of the ESOP is, in substance, the employer's debt, the Division believes that the employer should report separately the compensation element and the interest element of the annual contribution, and should disclose the related interest rate and debt terms in the footnotes to the financial statements. However, a significant minority within the Division believes that the entire annual contribution should be reported as compensation expense.

REPORTING DIVIDENDS PAID AND EARNINGS PER SHARE

11. The Division believes that all shares held by an ESOP should be treated as outstanding shares in the determination of earnings per share. An ESOP is a legal entity holding shares issued by the employer, whether or not those shares have been allocated to employee accounts.

12. Dividends paid on shares held by an ESOP should be charged to retained earnings. Such dividends should not be included at any time in compensation expense.

13. A minority within the Division believes that when trust debt proceeds are transferred to the employer corporation, a transaction of a predominantly financing nature has occurred. The minority believes that shares should be considered outstanding for earnings

per share calculations only to the extent that they become constructively unencumbered by repayments of debt principal. To do otherwise, according to this minority view, would result in an inconsistent and initially excessive effect on earnings per share in that the total number of shares purchased by the ESOP would be immediately included in the calculation of earnings per share, even though the related compensation expense would be spread over a period of time on the basis of the employer's contribution to the trust. Consistent with this position, the minority would also charge dividends to retained earnings only to the extent that trust shares are unencumbered. Any remaining balance would be reported as additional compensation expense in the period the dividends were declared.

OTHER MATTERS

Investment Tax Credit

14. The Division believes that the additional investment tax credit should be accounted for (to the extent that it is available and utilized) as a reduction of income tax expense in the same year in which the contribution to the ESOP is charged to expense, irrespective of the accounting for the normal investment tax credit on property acquisitions.[4/] This additional credit arises from the contribution to the ESOP, not solely from the property acquisitions of the employer.[5/]

4/ See footnote 3.

5/ See also Section 101(c) of the Revenue Act of 1971.

Applicability of APB Opinion No. 11

15. Excess contributions, as defined, made in any one year may be carried over to future periods for income tax purposes. The Division believes that the financial statements of the employer should reflect the tax effect of timing differences in accordance with APB Opinion No. 11.[6]

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[6] See footnote 3.

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