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Accounting practices for certain employee stock ownership plans; Exposure draft (American Institute of Certified Public Accountants), 1976, Sept. 30

American Institute of Certified Public Accountants. Accounting Standards Executive Committee

ACCOUNTING PRACTICES FOR CERTAIN EMPLOYEE STOCK OWNERSHIP PLANS

A Proposed Recommendation to the
Financial Accounting Standards Board

EXPOSURE DRAFT

This exposure draft has been prepared for public comment by the Accounting Standards Executive Committee of the American Institute of Certified Public Accountants. It has been distributed to Members of Council of the AICPA; Members of Technical Executive Committees of the AICPA; State Society Presidents and Executive Directors; Chairmen of State Society Committees on Accounting Practices; and certain organizations outside the accounting profession. Copies are available to interested persons and organizations upon request.

Comments should be sent, in time to arrive not later than November 1, 1976, to —

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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 employ the principles of leverage in the acquisition of employer securities and (b) the employer may be permitted, under the Tax Reduction Act of 1975, to increase his maximum allowable investment tax credit by an additional 1% if that amount is contributed to an ESOP.

2. In certain ESOPs, 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. 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 requirements. The employer company makes annual contributions to the ESOP that are deductible for tax purposes, subject to the limitations of the

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1/ Pension Reform Act of 1974, Title II, Subtitle B, Section 2003.

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. These 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.

ACCOUNTING FOR AN OBLIGATION OF AN ESOP GUARANTEED BY THE EMPLOYER

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

4. 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.[2/] The employer's guarantee or commitment is, in

2/ At the time an ESOP is formed, it generally has no economic substance apart from that provided by the sponsoring employer.

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).

5. 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. Further, those assets have no effect on or relationship to the employer's compensation expense or his guarantee of the ESOP's debt.

Recording the Offsetting Debit
To the Recorded Liability

6. The Division believes that the offsetting debit to the liability recorded by the employer should be accounted for as a reduction of shareholders' equity. The ESOP is merely a vehicle to transfer benefits from employer to employee; it generally has no economic substance of its own and its debt is, in substance, the employer's debt. 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 still be reduced until the debt is repaid, because these shares are akin to treasury stock.

7. A minority within the Division believe that the offsetting debit should be recorded as deferred compensation on the asset side of the balance sheet when outstanding shares, as opposed to unissued shares, are acquired by the ESOP.

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 guaranty 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, for the reason indicated earlier.

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 employer's annual compensation expense.[3/] Such contributions measure the amount of compensation irrevocably

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

incurred whether or not they are used concurrently to reduce the debt guaranteed by the employer. Since contributions to an ESOP are generally discretionary, similar to those to a profit sharing plan, they should be recorded as compensation expense in a similar manner.

10. A minority within the Division believe that the measure of compensation should be the fair market value of shares allocated by the ESOP to individual employee accounts during the year. They believe this position is consistent with the measurement principles set forth in APB Opinion No. 25.

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. Dividends on employer securities held by any other type of benefit plan, it should be noted, would also be charged to retained earnings.

13. A minority within the Division believe that when trust debt proceeds are transferred to the employer corporation, a transaction of a predominantly financing nature has occurred. In their view, 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, the minority believe, 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 primary 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.

14. Consistent with this position, the minority would also require that the employer company separately report in its income statement the interest element of the annual contribution and disclose the related interest rate and debt terms in the footnotes to the financial statements. Dividends would be charged to retained earnings to the extent that trust shares are unencumbered with any remaining balance being reported as additional compensation expense in the period declared.

OTHER MATTERS

Investment Tax Credit

15. The Division believes that the additional investment tax credit (presently 1%) 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 is made to the ESOP and is charged to compensation expense, irrespective of the accounting for the normal investment tax credit on property acquisitions.[4/]

4/ See footnote 3.

This additional credit arises from the contribution to the ESOP, not solely from the property acquisitions of the employer.

Applicability of APB Opinion No. 11

16. 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.[5/]

5/ See footnote 3.

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