

# Introduction to Post-Transaction GAAP ESOP Accounting – Common Entries and Effect on Financial Statements

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# CE Requirements Onsite

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# Disclaimer

The following information is for discussion and illustration purposes only. The information contained in today's presentation is just an example transaction. This is not meant to be all encompassing for every transaction. Please consult your accountant.



# Agenda

- Showcase an example transaction
- Demonstrate the entries required to record the transaction
- Demonstrate the entries required to record annual activity
- Demonstrate possible footnotes to the annual financials

# Initial Transaction – Accounting

## **Understand transaction economics**

- Obtain final closing binder
- Determine sequence of events
- Evaluate financing package (warrants, if any)
- Evaluate management incentive plan (ISOs/SARs)

# Initial Transaction – Accounting

## Understand the Sequence of Events

- Transaction can include:
  - Pre-closing distribution
  - Redemption
  - ESOP Purchase
- Debt to third parties is a liability of the employer (Plan Sponsor)

# Initial Transaction – Accounting

## Sample Transaction

- ABC Shareholders sold 100% of their shares in ABC Company for \$10 million on January 1, 2021.
  - The transaction was funded with all seller financing.
  - The transaction included a \$2M pre-closing distribution, \$7M redemption followed by a \$1M ESOP purchase. (\$10M)
  - The ESOP borrowed the \$1M from the Company to establish the leveraged ESOP (internal loan).

# Initial Transaction – Accounting

## Understanding Leveraged ESOP Accounting

- ESOP is an employee benefit (ASC Topic 718-40)
- Leveraged ESOP – ESOP borrows \$\$ to purchase shares
- Unearned ESOP shares
  - No “receivable” from ESOP reported by the employer
  - Contra equity account
  - Always measured and adjusted at cost (not fair value)

# Initial Transaction – Accounting

## Entry #1 - 01/01/2021

Shareholder Distributions	\$ 2,000,000	
Distribution Term Loan		\$ 2,000,000

To record the pre-closing distribution.

## Entry #2 - 01/01/2021

Treasury Shares	\$ 7,000,000	
Redemption Term Loan		\$ 7,000,000

To record the stock redemption.

## Entry #3 - 01/01/2021

Unearned ESOP shares	\$ 1,000,000	
ESOP Acquisition Loan		\$ 1,000,000

To record the ESOP purchase.

# Initial Transaction – Accounting

## Understanding Warrants

- Typically used to compensate seller financed ESOP purchase
- Stated rate on Seller Note typically below market
- Allows sellers to participate in the success of the business
- Not considered outstanding stock for S corporation purposes, if designed correctly

# Initial Transaction – Accounting

## Understanding Warrant Accounting - Liability

- Company can't settle warrant for equity
- Typically, holder has a put option to sell warrant back to company
- S Corporation considerations

# Initial Transaction – Accounting

## Understanding Warrant Accounting - Liability

- Warrant recorded at fair value
- Warrant's fair value booked as a liability with a corresponding debit to Note Payable-Discout
- New amortization schedule required due to discount on note payable
- Net effect, increase in interest expense

# Initial Transaction – Accounting

## Understanding Warrant Accounting - Equity

- Warrant is converted/settled in only shares
- Holder cannot settle the warrants for cash

# Initial Transaction – Accounting

## Sample Transaction – Financing Package

- The seller notes will be amortized over 10 years at 3.5% interest. Annual payments of \$1,202,414.
- Simultaneous to the transaction, 20,000 warrants are issued on the Redemption Notes. At date of issuance, the warrants have a fair value of \$400,000.
- The warrants contain a put option to sell the warrants back to the company therefore they are classified as a liability.

# Initial Transaction – Accounting

## Entry #4 - 01/01/2021

Note Payable - Discount	\$	400,000		
Warrant Obligation			\$	400,000

To record the fair value of warrants.

# Ongoing Accounting

## Annual, Recurring Entries

- Annual payment on seller notes
- Amortization of note payable – discount
- Change in fair value of warrants
- Annual ESOP contribution and loan payment
- Fair value of management incentive plan (SARs/ISOs)

# Ongoing Accounting

## Understanding Warrant Accounting - Liability

- New amortization schedule required due to discount on note payable
- Net effect, increase in interest expense
- Each year, the warrant liability is revalued to FMV and the liability is updated

# Ongoing Accounting

At 12/31/21, the company makes a \$1,202,414 payment on the seller notes.

## Entry #5 - 12/31/2021

Note Payable	\$	852,414	
Interest Expense		414,186	
Note Payable - Discount			\$ 64,186
Cash			1,202,414

To record annual seller loan payment with amortization of note payable - discount.

# Ongoing Accounting

**Total Amortization Schedule - face value of note**

	Payment	Interest	Principal	Balance
				10,000,000
1	1,202,414	350,000	852,414	9,147,586
2	1,202,414	320,166	882,248	8,265,338
3	1,202,414	289,287	913,127	7,352,211
4	1,202,414	257,327	945,086	6,407,125
5	1,202,414	224,249	978,164	5,428,961
6	1,202,414	190,014	1,012,400	4,416,561
7	1,202,414	154,580	1,047,834	3,368,727
8	1,202,414	117,905	1,084,508	2,284,218
9	1,202,414	79,948	1,122,466	1,161,752
10	1,202,414	40,661	1,161,752	-

**Total Redemption Amortization Schedule - face value of note**

	Payment	Interest	Principal	Balance
				7,000,000
1	841,690	245,000	596,690	6,403,310
2	841,690	224,116	617,574	5,785,737
3	841,690	202,501	639,189	5,146,548
4	841,690	180,129	661,560	4,484,988
5	841,690	156,975	684,715	3,800,273
6	841,690	133,010	708,680	3,091,593
7	841,690	108,206	733,484	2,358,109
8	841,690	82,534	759,156	1,598,953
9	841,690	55,963	785,726	813,227
10	841,690	28,463	813,227	-

**Total Redemption Amortization Schedule - net of discount**

	Date	Payment	Interest	Principal	Balance
	12/31/2020				6,600,000
1	12/31/2021	841,690	309,186	532,503	6,067,497
2	12/31/2022	841,690	284,240	557,449	5,510,048
3	12/31/2023	841,690	258,126	583,564	4,926,484
4	12/31/2024	841,690	230,788	610,901	4,315,583
5	12/31/2025	841,690	202,170	639,520	3,676,063
6	12/31/2026	841,690	172,210	669,479	3,006,584
7	12/31/2027	841,690	140,848	700,842	2,305,742
8	12/31/2028	841,690	108,016	733,674	1,572,068
9	12/31/2029	841,690	73,646	768,044	804,024
10	12/31/2030	841,690	37,666	804,024	-

# Ongoing Accounting

At 12/31/21, the warrants have a fair market value of \$550,000.

## Entry #6 - 12/31/2021

Warrant Expense	\$	150,000		
Warrant Obligation			\$	150,000

To record change in the fair value of warrants.

# Ongoing Accounting

## Understanding Leveraged ESOP Accounting

- Annual contribution to the ESOP is made and contribution is used make a payment on the internal loan
  - No cash flow impact!
- Shares are released and allocated to participant accounts
- Company records compensation expense equal to the number of shares released times the price of the shares during the period
- Company records the cost basis of shares released to unearned ESOP shares

# Ongoing Accounting

At 12/31/21, the Company makes a contribution of \$50,000 to the ESOP. The ESOP uses the contribution and makes a \$50,000 loan payment on the internal loan. Before the loan payment, there were 100,000 shares in suspense. The loan payment released 5,000. The share price at 12/31/21 was \$15.

## Entry #7 - 12/31/2021

ESOP Compensation Expense	\$	75,000		
Additional Paid in Capital			\$	25,000
Unearned ESOP shares			\$	50,000

To record fair market value of shares released from annual contribution and loan payment.

# Ongoing Accounting

## Understanding Leveraged ESOP Accounting

- Often, on Day 1, the unearned ESOP shares balance is the same as the dollar amount the ESOP borrowed to purchase the shares.
- After Day 1, the balance of unearned ESOP shares will NOT represent the internal loan balance
- On a go-forward basis, unearned ESOP shares should always represent the number of unallocated shares times the historical purchase price of those shares

# Ongoing Accounting

## Understanding SARs/ISOs

- Used to attract, retain and motivate management
- Deferred compensation – stock-based compensation
- Accounted for as equity or a liability – dependent on language

# Ongoing Accounting

## Understanding SARs/ISOs

- Generally, stock-based compensation is accounted for as equity unless:
  - Settled for cash instead of equity
  - Company right to purchase, and likely will
  - Employee has the right to sell it back to the company
- Governed by ASC718 – stock-based compensation

# Ongoing Accounting

## Understanding SARs/ISOs

- Accounting for Compensatory SARs/ISOs
  - Compensation cost measured at fair value
    - Option Pricing Model to determine value (Black-Scholes Model)
  - Cost recognized over vesting period
  - Cost is a compensation expense with a corresponding credit to paid in capital.
  - Non-public companies have option to measure award using the intrinsic-value method
    - Intrinsic value is the difference between the strike price and the stock price
    - The company must remeasure the intrinsic value at the end of each period

# Ongoing Accounting

During 2021, the Board awards 5,000 SARs to key employees. The strike price of each SAR unit is \$4.50. The SARs vest equally over 4 years.

At 12/31/21, the fair value of a SAR unit is valued at \$6.00. On the same date, the fair value of common stock is valued at \$5.00

Entry #7 - 12/31/2021	Fair Value Method		Intrinsic Value Method		
SAR compensation expense	\$	7,500	\$	625	
SAR liability		\$	7,500	\$	625
To record the SAR liability					

# Financial Statement Presentation

## Balance Sheet Presentation

	<u>Pre-Closing</u>	<u>Post-Closing</u>	<u>12/31/21</u>
<b>ASSETS</b>			
Cash	522	522	522
Accounts receivable, net of allowance for doubtful accounts	3,076	3,076	3,076
Inventories	51	51	51
Prepaid expenses and other assets	132	132	132
Fixed assets	<u>1,229</u>	<u>1,229</u>	<u>1,229</u>
<b>Total Assets</b>	<u><b>5,010</b></u>	<u><b>5,010</b></u>	<u><b>5,010</b></u>
<b>LIABILITIES AND STOCKHOLDERS' EQUITY</b>			
Accounts payable	2,449	2,449	2,449
Accrued expenses	293	293	293
Warranty liability	-	400	550
Distribution/Redemption/Acquisition notes (sellers)	-	10,000	9,148
Note payable - discount	-	(400)	(336)
<b>Total Liabilities</b>	<u><b>2,742</b></u>	<u><b>12,742</b></u>	<u><b>12,104</b></u>
Retained earnings	2,268	(6,732)	(6,144)
Unearned ESOP shares	-	(1,000)	(950)
<b>Total Equity</b>	<u><b>2,268</b></u>	<u><b>(7,732)</b></u>	<u><b>(7,094)</b></u>
<b>Total Liabilities and Stockholders' Equity</b>	<u><b>5,010</b></u>	<u><b>5,010</b></u>	<u><b>5,010</b></u>

# Financial Statement Presentation

## Income Statement Presentation

	<u>12/31/21</u>
Revenues	28,000
Cost of revenues	<u>24,000</u>
Gross profit	4,000
General and administrative expense	2,000
ESOP compensation expense	<u>75</u>
Operating income	1,925
Other income (expense)	
Interest expense	(100)
Other income (expense)	<u>200</u>
Total other income (expense)	100
Net income	<u><u>2,025</u></u>

# Financial Statement Presentation

## Footnote Disclosures

- Repurchase obligation is not required to be reflected as a liability on the plan sponsor's balance sheet for private companies
- Plan sponsor should disclose the existence and nature of any repurchase obligation, including disclosure of fair value of shares allocated as of the balance sheet date

# Financial Statement Presentation

## Footnote Disclosures

- ASC Subtopic 718-40 requires the following disclosures:
  - Description of the plan, basis for determining contributions and employee groups covered
  - Description of accounting policies followed for ESOP transaction, including method of measuring compensation, classification of dividends on ESOP shares and treatment of ESOP shares for earnings-per-share computations
  - Amount of compensation cost recognized during the period
  - Number of allocated, committed-to-be-released and suspense shares held by ESOP as of balance sheet date

# Financial Statement Presentation

## Footnote Disclosures

- ASC Subtopic 718-40 requires the following disclosures:
  - Fair value of unearned ESOP shares at balance sheet date
  - Existence and nature of any repurchase obligation, including the fair value of the shares allocated as of the balance sheet date, which are subject to the repurchase obligation

# Financial Statement Presentation

## Footnote Disclosures

- Example warrant footnote would include:
  - Description of warrants
  - Method of determining fair value
  - Inputs for determining fair value (if using Black-Scholes method)
  - Estimated fair value at end of year

# Financial Statement Presentation

## Footnote Disclosures

- Example SARs footnote would include:
  - Description of SARs along with vesting period
  - Method of determining fair value
  - Inputs for determining fair value (if using Black-Scholes method)
  - Estimated fair value at end of year
  - Number of SARs granted, exercised, forfeited and outstanding during the year

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