Statutory Issue Paper No. 78

Employee Stock Ownership Plans

STATUS
Finalized March 16, 1998

Original SSAP and Current Authoritative Guidance: SSAP No. 12

Type of Issue:
Common Area

SUMMARY OF ISSUE

1. Current statutory accounting guidance for the plan sponsors’ accounting for Employee Stock Ownership Plans (ESOPs) is provided in the Accounting Practices and Procedures Manuals for Life and Accident and Health (Life/A&H Accounting Practices and Procedures Manual) and for Property and Casualty Insurance Companies (P & C Accounting Practices and Procedures Manual). This guidance provides that debt obligations of 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.

2. GAAP addresses the plan sponsors’ accounting for ESOPs in AICPA Statement of Position 93-6, Employers’ Accounting for Employee Stock Ownership Plans (SOP 93-6) and FASB Emerging Issues Task Force Issue No. 89-11, Sponsor’s Balance Sheet Classification of Capital Stock with a Put Option Held by an Employee Stock Ownership Plan (EITF 89-11).

3. The purpose of this issue paper is to establish statutory accounting principles for the plan sponsors’ accounting for ESOPs that are consistent with the Statutory Accounting Principles Statement of Concepts and Statutory Hierarchy (Statement of Concepts). It does not address financial reporting by ESOPs.

SUMMARY CONCLUSION

4. An ESOP is an employee benefit plan that is described by the Employee Retirement Income Security Act of 1974 (ERISA) and the Internal Revenue Code of 1986 as a stock bonus plan, or a combination stock bonus and money purchase pension plan, designed to invest primarily in employer stock. For such plans, reporting entities shall adopt SOP 93-6 except that debt obligations of ESOPs shall be reported consistent with Issue Paper No. 80—Debt (Issue Paper No. 80) and the related income tax effects shall be accounted for consistent with Issue Paper No. 83—Accounting for Income Taxes (Issue Paper No. 83), as further clarified in this issue paper. There are two basic forms of ESOPs: nonleveraged and leveraged. A summary of the financial reporting for each is provided below.

Leveraged ESOPs

5. A leveraged ESOP borrows money to acquire shares of the employer company (sponsor). The money may be borrowed from the plan sponsor or from an outside lender, with or without a guarantee from the plan sponsor. The debt usually is collateralized by the employer’s shares. As required by Issue Paper No. 80, debt obligations of ESOPs shall be reported as borrowed money by 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.
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 unallocated shares. As the debt is repaid (generally from employer contributions and dividends on the employer’s stock) suspense shares are released and must be allocated to individual accounts as of the end of the ESOP’s fiscal year. As ESOP shares are committed to be released, unearned ESOP shares should be credited and, depending on the purpose for which the shares are released, either (a) compensation cost, (b) dividends payable, or (c) compensation liabilities should be charged as outlined in paragraph 26 of this issue paper.

8. Because employers control the use of dividends on unallocated shares, dividends on unallocated shares are not considered dividends for financial reporting purposes (although such dividends are generally subject to normal dividend requirements under state statutes or regulations). 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. Dividends on allocated shares should be charged to unallocated surplus.

9. If the ESOP sells the suspense shares and uses the proceeds to repay the debt, the employer shall 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, such difference shall be reported as a capital gain or loss on extinguishment of debt as defined in Issue Paper No. 80 and, accordingly, shall be charged to operations and disclosed in the notes to the financial statements in accordance with Issue Paper No. 24—Discontinued Operations and Extraordinary Items (Issue Paper No. 24).

10. If an employer reacquires the suspense shares from the ESOP, the purchase of the shares should be accounted for as a treasury stock transaction as outlined in paragraph 26 of this issue paper.

Nonleveraged ESOPs

11. Employers with nonleveraged ESOPs should report compensation cost equal to the contribution called for in the period under the plan as outlined in paragraph 26 of this issue paper.

12. Employers with nonleveraged ESOPs should charge dividends on shares held by the ESOPs to unallocated surplus, except that dividends on suspense account shares of a pension reversion ESOP should be accounted for the same way as dividends on suspense account shares of leveraged ESOPs.

Pension Reversion ESOPs

13. Pension reversion ESOPs are created by transferring the assets of a defined benefit pension plan to an existing or newly created ESOP and may be leveraged or nonleveraged. Pension reversion ESOPs should be accounted for as outlined in paragraph 26 of this issue paper.

Issues Related to Accounting for Income Taxes

Leveraged ESOPs

14. The amount of ESOP-related expense for a leveraged ESOP 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. Such differences should be reported in accordance with Issue Paper No. 83.

15. If the cost of shares committed to be released is greater than their fair value, the employer should credit the tax effect of the amount by which the deductible expense exceeds the book expense to unassigned funds. Conversely, if the cost of shares committed to be released is less than their fair value,
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

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 for GAAP reporting purposes. The SEC states that there is a significant difference between a security with mandatory redemption requirements or whose redemption is outside the control of the issuer and conventional equity capital. The SEC believes that it is necessary to highlight the future cash obligations attached to this type of security so as to distinguish it from permanent capital. There is no such requirement for non-SEC reporting companies. Paragraph 18 of this issue paper requires reporting of such securities consistent with the GAAP requirements for non-SEC reporting companies and is consistent with the accounting for capital stock as discussed in Issue Paper No. 72—Statutory Surplus. Additionally, paragraph 19 of this issue paper requires disclosure of the existence and nature of any repurchase obligation. EITF 89-11 addresses the accounting for SEC reporting companies and is therefore rejected.

23. This issue paper is consistent with the reporting of ESOP debt as discussed in Issue Paper No. 80.

24. The conclusions above are consistent with the Statement of Concepts which states:

Objectives of Statutory Financial Reporting

The primary responsibility of each state insurance department is to regulate insurance companies in accordance with state laws with an emphasis on solvency for the protection of policyholders. The ultimate objective of solvency regulation is to ensure that policyholder, contractholder and other legal obligations are met when they come due and that companies maintain capital and surplus at all times and in such forms as required by statute to provide an adequate margin of safety. The cornerstone of solvency measurement is financial reporting. Therefore, the regulator’s ability to effectively determine relative financial condition using financial statements is of paramount importance to the protection of policyholders. An accounting model based on the concepts of conservatism, consistency, and recognition is essential to useful statutory financial reporting.

RELEVANT STATUTORY ACCOUNTING AND GAAP GUIDANCE

Statutory Accounting
25. The P & C Accounting Practices and Procedures Manual, Chapter 13 and the Life/A&H Accounting Practices and Procedures Manual, Chapter 17 include the following guidance in (only the pertinent excerpts are included below):
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 Income Security Act of 1974 (ERISA) and the Internal Revenue Code (IRC) of 1986 as a stock bonus plan, or combination stock bonus and money purchase pension plan, designed to invest primarily in employer stock.

3. This SOP supersedes American Institute of Certified Public Accountants (AICPA) SOP 76-3, Accounting Practices for Certain Employee Stock Ownership Plans, and affects certain Emerging Issues Task Force (EITF) consensuses. A list of the documents affected is provided in appendix D of this SOP.

Background

4. SOP 76-3 was issued in December 1976, primarily to deal with accounting and reporting issues relevant to employers with leveraged ESOPs, and it has been the primary source of guidance on the subject.

5. Since the issuance of SOP 76-3, Congress has revised laws concerning ESOPs several times and the Internal Revenue Service (IRS) and the U.S. Department of Labor have issued many regulations covering the operation of plans, which actions have resulted in changes in the way ESOPs may operate and the reasons they are established by companies. Those changes, the most significant of which are described in Appendix C, were factors in the growth in the number of plans from fewer than 2,500 plans in 1976 to nearly 10,000 at the end of 1990.²

² Statistics from an unpublished study completed in 1991 by the National Center for Employer Ownership, Oakland, Calif.

6. The increase in the number of ESOPs since the issuance of SOP 76-3 was matched by an increase in their complexity. It is no longer possible to describe a typical ESOP. ESOPs are used for many purposes in addition to furthering employee ownership, some of which were not contemplated when SOP 76-3 was issued. These include the following:
• 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. 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.

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. 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

---

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. 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
a related outside loan, or directly from an outside lender. Outside loans to the ESOP are generally guaranteed by the sponsor.

______________

Terms defined in the glossary are in italicized type the first time they appear in this SOP.

______________

Reporting the Purchase of Shares by ESOPs

13. An employer should report the issuance of shares or the sale of treasury shares to an ESOP when they occur and should report a corresponding charge to unearned ESOP shares, a contra-equity account. That account should be presented as a separate item in the balance sheet. Furthermore, even if a leveraged ESOP buys outstanding shares of employer stock on the market rather than from the employer, the employer should charge unearned ESOP shares and credit either cash or debt, depending on whether the ESOP is internally or externally leveraged (see paragraph 24).

Reporting the Release of ESOP Shares

14. ESOP shares are released for different purposes: to compensate employees directly, to settle employer liabilities for other employee benefits, and to replace dividends on allocated shares that are used for debt service. As ESOP shares are committed to be released, unearned ESOP shares should be credited and, depending on the purpose for which the shares are released, either (a) compensation cost, (b) dividends payable, or (c) compensation liabilities should be charged. Regardless of the account charged, the amount of the charge should be based on fair values of committed-to-be-released shares.

______________

Paragraph 20 of this SOP contains guidance on fair value.

______________

15. Under this SOP, when shares are committed to be released, rather than when shares are legally released, is significant for accounting purposes. That refinement was made in recognition of the fact that ESOP shares are legally released from an ESOP's suspense account (and from serving as collateral for ESOP debt) when debt payments are made, but the employee service to which the shares released relates is continuous. Accordingly, for purposes of reporting compensation cost and satisfaction of liabilities under this SOP, accounting recognition should occur when shares are committed to be released, which may occur before the shares are legally released. Shares that have not been legally released, but that relate to employee services rendered during an accounting period (interim or annual) ending before the related debt service payment is made, should be considered committed to be released. The periods of employee service to which shares relate is generally specified in the ESOP documents.

16. Some employers establish ESOPs that are not linked to any other employee benefit or compensation promise; therefore, the ESOP shares directly compensate the employees. For ESOP shares committed to be released to compensate employees directly, the employer should recognize compensation cost equal to the fair value of the shares committed to be released. The shares generally should be deemed to be committed to be released ratably during an accounting period as the employees perform services, and, accordingly, average fair values should be used to determine the amount of compensation cost to recognize each reporting period (interim or annual). The amount of compensation cost recognized in previous interim periods should not be adjusted for subsequent changes in the fair value of shares.

17. Some employers agree to provide a specified or determinable benefit, such as a contribution to a 401(k) plan or to a formula profit-sharing plan, to employees and use the ESOP to partially or fully fund the benefit. Employers should recognize compensation cost and liabilities
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 equivalent to a common stock, should be regarded as a common stock equivalent. For convertible preferred stock not held by an ESOP, an effective yield test is applied to the securities at the time of issuance to determine whether the securities should be considered common stock equivalents. However, the terms of convertible preferred shares held by ESOPs generally differ from other convertible preferred stock in two ways:

a. Convertible preferred shares held by ESOPs generally cannot remain outstanding indefinitely.

b. ESOP participants cannot withdraw their convertible preferred shares from the plan; the terms generally require participants to redeem the shares with the employer or convert the shares to common stock when participants withdraw their account balances from the ESOP plan. (Whether a participant chooses redemption of conversion depends on the value of the employer’s common stock in relation to the stated minimum value of the convertible preferred stock.)

ESOP shares with such characteristics should always be considered common stock equivalents. However, if the convertible preferred shares held by an ESOP may be withdrawn from the plan and sold to someone other than the employer or other ESOP participants, the employer should apply the effective yield test to determine whether the shares should be considered common stock equivalents.

31. **Number of Shares Outstanding.** Under this SOP, ESOP shares are not considered outstanding until they are committed to be released. For ESOP shares considered common stock equivalents, the number of common shares that would be issued on conversion of the convertible shares held by an ESOP that have been committed to be released should be deemed outstanding in the if-converted EPS computations for both primary and fully diluted EPS if the effect is dilutive. Convertible preferred shares held by the ESOP that have not been committed to be released should not be considered outstanding and, accordingly, would be excluded from the if-converted computations for both primary and fully diluted EPS.

32. When participants withdraw account balances containing convertible preferred shares from an ESOP, they may be entitled to receive common shares or cash with a value equal to either the fair value of the convertible preferred shares of a stated minimum value per share. Accordingly, if the value of the common stock issuable is less than the stated minimum value or the fair value of the preferred, participants may receive common shares or cash with a value greater than the value of the common shares issuable at the stated conversion rate. In determining EPS, the employer should presume that such a shortfall will be made up with shares of common stock. However, that presumption may be overcome if past experience or a stated policy provides a reasonable basis to believe that the shortfall will be paid in cash. In applying the if-converted method, the number of common shares issuable on assumed conversion, which should be included in the denominator of the EPS calculation, should be the greater of (a) the shares issuable at the stated conversion rate and (b) the shares issuable if the participants were to withdraw the shares from their accounts. Shares issuable on assumed withdrawal should be computed for primary earnings based on the ratio of (a) the average fair value of the convertible stock or, if greater, its stated minimum value, to (b) the average fair value of the common stock. For fully diluted EPS, the ratio should be (a) the end-of-period fair value of the convertible stock or, if greater, the stated minimum value, to (b) the end-of-period value of the common stock, if that ratio is more dilutive than the primary EPS ratio. The appropriate ratios should then be applied to the shares issuable at the state conversion rate to determine the number of shares issuable on assumed withdrawal.

---

6 Financial Accounting Standards Board (FASB) Interpretation No. 31, *Treatment of Stock Compensation Plan in EPS Computations*, used such a presumption for stock appreciation rights and other variable plan awards.
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.

Reporting Dividends on ESOP Shares

42. Employers with nonleveraged ESOPs should charge dividends on shares held by the ESOPs to retained earnings, except that dividends on suspense account shares of a pension reversion ESOP should be accounted for the same way as dividends on suspense account shares of leveraged ESOPs.

Reporting Redemptions of ESOP Shares

43. 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 the employer 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, which on exercise requires the employer to repurchase the shares at fair value. Employers should report the satisfaction of such option exercises as purchases of treasury stock.

Earnings per Share

44. All shares held by a nonleveraged ESOP should be treated as outstanding in computing the employer’s EPS, except the suspense account shares of a pension reversion ESOP, which should not be treated as outstanding until they are committed to be released for allocation to participant accounts. If a nonleveraged ESOP holds convertible preferred stock, the guidance in paragraphs 29-34 of this SOP for leveraged ESOPs should be considered.

Pension Reversion ESOPs

45. An employer that terminates a defined benefit pension plan may avoid part of the excise tax on an asset reversion by transferring the assets to an existing or newly created ESOP, which could be either leveraged or nonleveraged. The reverted assets may be used either to purchase shares of the employer stock or to retire existing ESOP debt.

46. If the assets from the pension plan are used by the ESOP to purchase employer shares, the employer should report the share issuance the same way as other share issuances to an ESOP. The issuance of shares or the sale of treasury shares to the ESOP should be recognized when it occurs, and a corresponding charge to unearned ESOP shares, a contra-equity account, should be reported. If the shares are purchased on the market, the employer should similarly charge unearned ESOP shares. (The credit would be to cash.)

47. Because the number of shares the ESOP acquires in a pension plan reversion is usually more than the IRS permits to be allocated to participant accounts in a single year, some of the shares are held in a suspense account until they are committed to be released in future years for allocation to participant accounts. The guidance in this SOP, for shares held by leveraged ESOPs, should be applied to suspense account shares.

48. If the assets from the pension plan reversion are used to repay the debt of an existing ESOP, ESOP shares are committed to be released from suspense. In such situations, the guidance for leveraged ESOPs in this SOP should be followed. The employer should reduce the debt as it is repaid and reduce unearned ESOP shares as shares are committed to be released. How the committed-to-be-released shares are used determines what accounts are charged upon release of shares (see paragraphs 14-18).
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 36.e. of Statement No. 109 requires that the tax effects of expenses for employee stock options recognized differently for financial reporting and tax purposes be recognized in the related component of shareholders’ equity.

50. In accordance with paragraph 36.e. of Statement No. 109, if the cost of shares committed to be released is greater than their fair value, the employer should credit the tax effect of the amount by which the deductible expense exceeds the book expense to shareholders’ equity. Conversely, if the cost of shares committed to be released is less than their fair value, the employer should charge the tax effect of the amount by which the book expense exceeds the deductible expense to shareholders’ equity to the extent of previous credits to shareholders’ equity related to cost exceeding fair value of ESOP shares committed to be released in previous periods.

51. 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. Under paragraph 36.f. of FASB Statement No. 109, the tax benefit of tax-deductible dividends on unallocated ESOP shares that are charged to retained earnings should be credited to shareholders’ equity. However, because dividends on unallocated shares would not be charged to retained earnings under this SOP, paragraph 36.f. of Statement No. 109 would not apply to ESOP shares accounted for under this SOP.

Nonleveraged ESOPs

52. 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 under Statement No. 109.

Disclosures

53. An employer sponsoring an ESOP should 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, the classification of dividends on ESOP shares, and the treatment of ESOP shares for EPS computations. If the employer has both old ESOP shares for which it does not adopt the guidance in this SOP and new ESOP shares for which the guidance in the SOP is required (see paragraphs 54 and 55), the accounting policies for both blocks of shares shall be described.
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 value 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 Health Insurance Companies, Chapter 17, Other Liabilities
- Accounting Practices and Procedures Manuals for Property and Casualty Insurance Companies, Chapter 13, Other Liabilities
- Issue Paper No. 5—Definition of Liabilities, Loss Contingencies and Impairments of Assets
- Issue Paper No. 24—Discontinued Operations and Extraordinary Items
- Issue Paper No. 72—Statutory Surplus
- Issue Paper No. 80—Debt
- Issue Paper No. 83—Accounting for Income Taxes

Generally Accepted Accounting Principles
- AICPA Statement of Position 93-6, Employers’ Accounting for Employee Stock Ownership Plans.
- FASB Emerging Issues Task Force Issue No. 89-11, Sponsor’s Balance Sheet Classification of Capital Stock with a Put Option Held by an Employee Stock Ownership Plan

State Regulations
- No additional guidance obtained from state statutes or regulations.

Other Sources of Information
- Securities and Exchange Commission Codification of Financial Reporting Policies, Section 211 - Redeemable Preferred Stocks