Adjustments to Financial Statements for ESOP Contribution Expense

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This article is reprinted, with permission from The Journal of Employee Ownership Law and Finance*, Volume 19/3.* *Determining any financial statement adjustments is a necessary procedure in an ESOP sponsor company appraisal. This discussion explains the common procedures for determining whether any financial statement adjustments are necessary for ESOP contribution expense. A practitioner may develop a basis for including ESOP contribution expense adjustments that best correspond with a particular set of facts and circumstances.*

An analyst is often faced with many decisions when performing a valuation. In an ESOP valuation analysis, a practitioner may need to consider potential financial statement adjustments related to ESOP contribution expense to develop appropriate indications of value. This article discusses normalizing- and control related adjustments to financial statements, the financial statement analysis of ESOP contribution expense, and the treatment of ESOP contribution expense.

ESOP Contribution Background

An ESOP is a defined contribution plan to which the sponsor company generally makes annual contributions. The annual contributions, in both the actual cash contributed and the expense recorded for financial reporting purposes, can vary from year to year. Participant accounts may receive such contributions in company stock or in cash.

The allocation of the shares and/or cash is generally based on the participant's compensation as a percentage of total covered payroll of all ESOP participants. Each participant has an account and additions are made to such an account from the sponsor company contributions, forfeitures from other participants, and income from the non-company stock investments held by the ESOP.

Contributions can be made for two basic kinds of ESOPs: leveraged and non-leveraged. For a non-leveraged ESOP, the annual contribution can be in the form of stock or cash. In a leveraged ESOP, the ESOP borrows money to purchase stock either from the sponsor company, from an outside lender (ESOP debt usually guaranteed by the sponsor company), or from existing shareholders. The purchased shares acquired by the ESOP with an ESOP loan are generally pledged as security for the loan and are held in a suspense account.

For a leveraged ESOP, the company makes annual deductible contributions to the ESOP for both principal and interest. The ESOP may use such cash to repay the ESOP loan. As the principal on the ESOP loan is amortized, a proportionate number of shares are released from the suspense account.[1] After releasing shares, the shares are allocated to participants' accounts. Shares allocated to participants' accounts no longer serve as collateral for the debt.

Normalizing- and Control-Related Adjustments to Financial Statements

One must understand normalizing and control adjustments to financial statements before attempting to apply such adjustments to an ESOP sponsor company, and specifically ESOP contribution expense. There are five primary types of financial statement adjustments:

1. Accounting or Generally Accepted Accounting Principles ("GAAP") adjustments
2. Nonrecurring adjustments
3. Non-arm's-length transactions adjustments
4. Financial control adjustments
5. Separation of operating and nonoperating items

While these adjustments appear somewhat similar at first, there are specific valuation impacts of each. The differences between the five types of adjustments can be significant from a fair market value perspective. The characteristics and distinctions of the five adjustment types are summarized below.

Accounting/GAAP Adjustments

Accounting-related adjustments are generally made because (1) the financial statements of the subject company and/or the guideline companies are inconsistent in accounting policies/reporting (e.g., aggressive or "low" quality vs. conservative or "high" quality) and (2) certain financial statement items prepared according to GAAP may need to be adjusted to something that better reflects economic reality. Some examples include:

- depreciation methods,
- inventory accounting,
- revenue recognition issues, and
- net operating losses.

Nonrecurring Item Adjustments

These adjustments relate to certain specific or isolated events that affected the subject company's past earnings performance. Some examples include:

- unusual gains or losses on sale of assets;
- lawsuit settlements;
- property loss due to fire, hurricane, flood, etc., not covered by insurance;
- expenses (not expected going forward) associated with the ESOP installation; and
- elimination of past items that might tend to distort the company's current and future earning power.

Non-Arm's-Length Transaction Adjustments

These adjustments relate to related-party transactions and often discretionary expenses. These items are more common in privately held companies. Some examples include:

- excess compensation paid to the owner(s) or to the family members of the owner(s),
- nonmarket rent paid to the owner(s), and
- personal travel and entertainment expenses of the owner(s).

For purposes of this article, non-arm's-length transactions are discussed separately from financial control adjustments. There is a difference of opinion among appraisers on whether adjusting non-arm's-length transactions, such as nonmarket owner compensation, represents "control" adjustments, and whether these adjustments should be made when valuing a noncontrolling interest. Further discussion on this disagreement is beyond the scope of this article.

Financial Control Adjustments

These adjustments relate to economies or efficiencies available to the typical financial buyer (which may or may not be present in the subject company at the time of appraisal), and not present on the as-if-freely-traded basis.[2] Prospective financial control buyers may consider adjustments that can improve the normalized earnings stream. These adjustments may also be a result of better management, which may also affect the expected growth rate of adjusted earnings.[3]

Separation of Operating and Nonoperating Items

Appraisers may adjust historical and/or projected financial statements of the ESOP sponsor company to exclude income or expense associated with a nonoperating asset or liability. For example, a practitioner may remove income associated with a rent property owned by a manufacturing company (i.e., renting properties not part of the core operations). If this income is removed from the historical and/or projected financial statements of

the subject company, the value of the real estate (less any debt associated with it) should be included in the total indicated value of the company (e.g., added to the indicated value of equity of the operating company).

ESOP Contribution Expense Financial Statement Analysis

Before an analyst can decide whether to make adjustments associated with ESOP contributions, he or she should first understand what is being adjusted. Specifically, the analyst should have a general understanding of the accounting associated with ESOP contribution expense, and ultimately the impact on the financial statements. For example, the analyst may make adjustments for financial statement items that may be in accordance with GAAP but do not make economic sense for valuation purposes.

As ESOP shares are committed to be released, unearned ESOP shares should be credited, and generally ESOP contribution expense should be debited or charged.[4] The amount of the entry should be based on the fair values of committed-to-be-released shares. Thus, as the sponsor company shares increase in value, the ESOP contribution expense increases as well.

Under AICPA Statement of Position 93-6, compensation/benefit expense is based on the fair value of the shares allocated, released, or committed to be released for any payments made on the ESOP debt that year. Hence, even if the company makes the same cash contribution amount each year, the expense on the income statement could fluctuate significantly if the share price has increased or decreased by a substantial amount.

The contribution expense could also vary significantly even if the share price has not. For example, if the sponsor company has made contributions to the ESOP greater than the required contribution for the principal and interest payments, the excess contribution amount is expensed in the current period. In future years, when that excess contribution is used to make debt payments, the difference between (1) the fair value of the shares released in the future period and (2) the expense amount already recognized in the previous period is recorded as an expense (if the share price has increased) or a credit to expense (if the share price has decreased).

Other Reasons for Variance in Contribution Expense

Significant variance in the contribution expense is not limited to leveraged ESOPs. Even after the debt has been repaid, contribution expense may be above or below a normal level of benefits due to repurchases of participants' shares.

The contribution expense associated with repurchased shares depends on whether the shares are "redeemed" (considered a capital transaction that does not affect the income statement) or "recycled" (expense recorded at the fair value of the shares times the number of shares recycled). If the shares are recycled, the associated contribution expense may be above a market/normal level of benefits if there is a significant number of recycled shares and/or there has been a significant increase in the share price.

Whatever the reason that contribution expense is higher than normal/market, a practitioner still faces the same decisions regarding the treatment of ESOP contribution expense in a valuation analysis.

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Treatment of ESOP Contribution Expense in a Valuation Analysis

As described previously, ESOP contribution expense (on a GAAP basis) can vary significantly even if the ESOP sponsor company makes consistent cash contributions. In addition, some people question whether GAAP accounting for contribution expense reflects the true economic reality of the cost a hypothetical willing buyer or seller of the ESOP company shares would consider.

However, adjusting to a “market level” of benefit expense may not be appropriate. Unless there is a significant reduction in share price, the ESOP will eventually have to repurchase those participant shares at fair market value. Another issue arises regarding the use of a market level of benefits if ESOP contribution expense is expected to remain high going forward for the subject company and an acquisition of the company is unlikely.

Factors to Consider

There is not a definitive answer for how to always treat ESOP contribution expense in an analysis. It is an analyst’s judgment based on the specific characteristics of the subject ESOP sponsor company. However, there are certain factors that should be considered in appropriate treatment of ESOP contribution expense in a valuation analysis. Some of the factors to consider are as follows:

- Leveraged ESOPs generally have more fluctuation and often higher levels of ESOP contribution expense. This is because the mandatory contribution amount (to cover the principal and interest) releases a portion of shares held in suspense. The fair market value of the shares released may be higher than a market level of benefits. Also, the sponsor company cannot reduce the cash contribution to offset the increase in share price, so as the stock price increases, so does the contribution expense.
- It is often common for a newly formed leveraged ESOP to make higher than the mandatory contribution in order to pay the debt down quicker. This compounds the issue of higher-than-normal contribution expense, because (1) it is a higher cash amount being contributed, which releases a greater number of sharers, and (2) it generally increases the equity price more quickly because the debt is paid down faster.
- A sponsor company with a new ESOP can have more fluctuation in stock price than a later-stage ESOP sponsor company, which directly affects the recognition amount of ESOP contribution expense on the income statement.
- A mature ESOP sponsor company may face a significant repurchase obligation. If the ESOP sponsor company decides to recycle a significant number of shares to minimize the cash flow impact, the ESOP contribution expense may be higher than normal.
- It is unlikely that ESOP contribution expense will be a consistent percentage of revenue over time for many ESOP sponsor companies, which might lead a hypothetical willing buyer and seller to negotiate a sale price on a normalized contribution/benefit level or the expectation of the ESOP contribution expense going forward.
- Participants could leave before they are fully vested and may not realize the full benefit that was recorded as an expense by the company in a previous period.
- A purchase study may help better understand the level of contribution expense going forward (e.g., if a significant number of shares are expected to be put back in the next few years, and the company plans on recycling such shares).

Discussions with ESOP Sponsor Company Management

Once an analyst has an understanding of the items above, he or she should interview management to learn the specifics of ESOP contributions for the sponsor company. Some interview questions may focus on the following:

1. *The company’s method for accounting for ESOP contribution*. Is it consistent with GAAP? Where specifically on the income statement is the ESOP contribution expense being reported? If the company has audited financials, there should be a footnote that discusses this. If the ESOP was formed before 1992, the company does not have to use current accounting standards in recording ESOP contribution expense.

2. *Historical fluctuations in ESOP contribution expense*. Is it due to increases or decreases in the share price, increases or decreases in the actual cash contributed, or an increase in recycling of shares put back or forfeited by participants?

3. *Projected ESOP contribution*. What is the expected ESOP contribution going forward? What are the reasons for the projected contribution being inconsistent with historical amounts or for the fluctuations in the projected contributions?

4. *Debt payments*. If this is a leveraged ESOP, does the sponsor company anticipate only making the required contribution, or will the company pay down debt quicker than the amortization schedule?

5. *The company's total benefits*. What types of benefits are provided to employees? Is the ESOP replacing a prior benefit plan? What was the contribution made to the prior benefit plan?

6. *Potential for sale*. Are there any plans to sell the company? Any bona fide offers?

Analyst Decisions regarding ESOP Contribution Expense

After determining answers and information related to the items above and analyzing the company's financial statements, an analyst generally has three options for eating ESOP contribution expense in the valuation analysis:

1. Add back the entice ESOP contribution expense (and other benefit expenses) and then subtract a market level of benefits. The analyst would do this as an adjustment to the historical and projected income statements.

2. Use management's target or optimal ESOP contribution amount, based on discussions with management. The analyst would make this adjustment to the historical and projected income statements. Generally, one would expect this target/optimal ESOP contribution amount to be higher than a market level.

3. Make no or few adjustments and keep historical and projected income statements as-is or close to as-is.

An appraiser must use his or her judgment to determine which of the three options above to use. Which one to use depends on the specifics of the engagement There is no blanket right answer. There are reasons for using each of the three options, which in general are as follows:

Potential Reasons to Use a Market Level of Benefits

- If valuing on a financial control ownership basis
- If valuing for fair value for financial reporting purposes
- There is a planned sale or high potential for sale of company
- Management does not have a set contribution policy and is inconsistent year to year
- Elimination of past items that might tend to distort the company's current and future earning power
- Less subject to management's influence
- Above-market ESOP contribution expense is being separately incorporated into the repurchase obligation analysis
- Sponsor company would achieve the same/similar financial results/growth even if employees received a market level of benefits that is lower than the current level of benefits received from the sponsor company

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Potential Reasons to Use Management's Target or Optimal Level of ESOP Contributions

- Unusual or non-recurring events that caused ESOP contribution expense to be higher or lower than management's target or optimal amount
- If valuing assuming the company will continue having an ESOP (e.g., also calculating the ESOP tax benefit of the principal payments)
- The company contributed a higher-than-mandatory amount either to pay down debt quicker or to fund the ESOP for future year contributions
- Not as sensitive to changes in stock price
- Specific to the company and not a theoretical level based on limited market participant or industry data
- Elimination of past items that might tend to distort the company's current and future earning power
- Above-market ESOP contribution expense is being separately incorporated into the repurchase obligation analysis
- The sponsor company would not achieve the same historical and/or projected financial results and growth if employees received a market level of benefits that is lower than the current level of benefits received from the sponsor company

Potential Reasons to Use the Actual Level, with No or Few Adjustments

- Less subject to management's influence and to the analyst's subjective judgment
- If there are very few unusual or non-recurring items related to ESOP participants
- ESOP contribution expense has been relatively consistent
- Sale of company unlikely
- If valuing company assuming it will continue as an ESOP company (e.g., also calculating the ESOP tax benefit of the principal payments)

Summary and Conclusion

An appraiser's decisions on adjusting ESOP contribution expense have a directed and quantifiable impact on the valuation analysis of the ESOP sponsor company stock. An appraiser needs to understand not only the types of and reason for adjustments that may be made but also the basic accounting methods for ESOP contribution expense on the sponsor company financial statements.

There are many different factors that may influence a practitioner's decisions on whether to and how to adjust for ESOP contribution expense. Such decisions can be an extremely complex process. Adding to the complexity is the often volatile nature of ESOP contribution expense and the necessity to rely on certain assumptions. Despite this complexity, if necessary, there are ways to adjust ESOP contribution expense based on a particular set of facts and circumstances.

Notes:

1. Some ESOPs release shares based on a principal-and-interest formula.
2. Z. Christopher Mercer. *The Integrated Theory of Business Valuation* (Memphis, TN: Peabody Publishing, LP, 2004), 155.
3. Ibid.
4. There are other accounts that could be used, e.g., dividends payable or a compensation-related liability. For purpose of this discussion, we assume the entire amount is charged to ESOP contribution expense.

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