



Employee Stock Ownership Plan (ESOP) **Audit Considerations**

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ESOP Audit Webinar

Presenters



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Objectives

1. Understanding ESOPs: What They Are & How They Work
2. Determining When an ESOP Audit Is Necessary
3. Key Procedures Involved in Conducting an ESOP Audit
4. Identifying & Addressing Common Errors in ESOP Audits



01

ESOPs Defined



Definition

What Is an ESOP?



- An ESOP is a qualified retirement plan, similar to a 401(k) plan.
- It allows employees to own a portion of the company they work for, often as a way to reward employees, foster sense of shared purpose, & increase retention.
- It is designed to hold the stock of the sponsoring company.
- ESOPs offer significant tax benefits for both the company & selling shareholders.
- Companies contribute their own stock (or cash to buy stock) to the ESOP trust, which holds shares on behalf of employees.
- ESOPs are often used as mechanism for business owners to sell their company, providing smooth transition of ownership while maintaining company culture.

ESOPs vs. 401(k) Plans

What Are the Major Differences

	ESOP	401(k) Plan
Purpose	Employee ownership & retirement savings	Retirement savings, no ownership
What is investment in?	Primarily in employer stock	Various investments [stocks, mutual funds, etc.]
Contributions	Company contributes to employees in the form of stock	Both Company (employer) & employee contributes
Taxes	Tax-qualified plan with potential tax advantages	Tax-qualified plan with potential tax advantages

Types of ESOPs

Leveraged vs. Nonleveraged

- Leveraged ESOPs
 - Include ESOP debt categorized by a loan (direct loan, employer loan, etc.)
 - For ESOPs with direct loans, employers accrue interest cost on the debt & report cash payments to the ESOP that are used by the plan to service debt.
 - For ESOPs with employer loans, employers do not report the ESOP's note payable & the employer's note receivable in the employer's balance sheet. Accordingly, employers shall not recognize interest cost or interest income on an employer loan.
- Nonleveraged ESOPs
 - The employer contributes cash to the ESOP, which is used by the ESOP to purchase the employer's stock, or the employer contributes its stock directly to the ESOP.
 - This type of ESOP is essentially a defined contribution plan.

02

Audit Requirements



Audit Requirements

Do You Need an Employee Benefit Plan Audit?

- Generally, a plan audit is required when an existing plan has 100 or more participants with a balance on the first day of the plan year (typically, January 1).
- Rule changed 1/1/23 – previously eligible participants, now participants with account balances.
- 80-120 rule
 - One exception to this requirement is the “80-120 Participant Rule.”
 - Under this rule, if the number of participants is between 80 & 120 & a Form 5500 was filed for the prior plan year, you may elect to complete the Form 5500 in the same category, *i.e.*, large plan or small plan, as was filed for the prior year.
 - Could file as a large plan again if desired (within 80-120)
- Initial Year Exception – 1st year of Plan’s existence, the 100-participant rule applies & an audit is required if there are 100 or more participants.

Example	New Plan?	Eligible participants @ beginning of the year	Participants with account balances @ beginning of year	Participants with account balances @ end of year	Prior year plan type (large or small)	Large plan with audit requirement
Plan A	No	300	150	175	Large	Yes
Plan B	No	300	150	70	Large	Yes
Plan C	No	150	75	85	Large	No
Plan D	No	150	85	95	Large	No
Plan E	No	110 ¹	90	90	Small	No
Plan F	Yes	200	0	130	NA	Yes
Plan G	Yes	200	0	101 ²	NA	Yes

1 - Plan E never had more than 120 participants in the plan &, therefore, always utilized the 80-120 rule to be exempt from the audit requirement.

2 - Plan G has an audit requirement since it has 100 or more participants with account balances as of the end of their first year. They would not be able to apply the 80-120 rule & use the threshold of 120 since they would not have had a prior-year filing.

03

Audit Procedures



Audit Procedures Check List

- ESOP Plan Documentation Review & Compliance Assessment
- Internal Control Design Review
- Investments
- Contributions/Participant Allocation Testing
- Participant Eligibility Testing
- Distributions
- Benefit Obligations
- Form 5500 & Other Compliance Matters



Audit Procedures

ESOP Plan Documentation Review & Compliance Assessment

Obtain related documents & records

- Ensure you obtain & retain all the most up-to-date ESOP-related documents.
 - Plan adoption agreements, plan descriptions, amendments, IRS letters, etc.
- Obtain records of board meetings & key transactions with ESOP to ensure you capture all significant decisions & discussions.
- Compliance Assessment – Auditor should assess the ESOP plan's compliance with applicable laws & regulations, including ERISA (Employee Retirement Income Security Act).

Audit Procedures

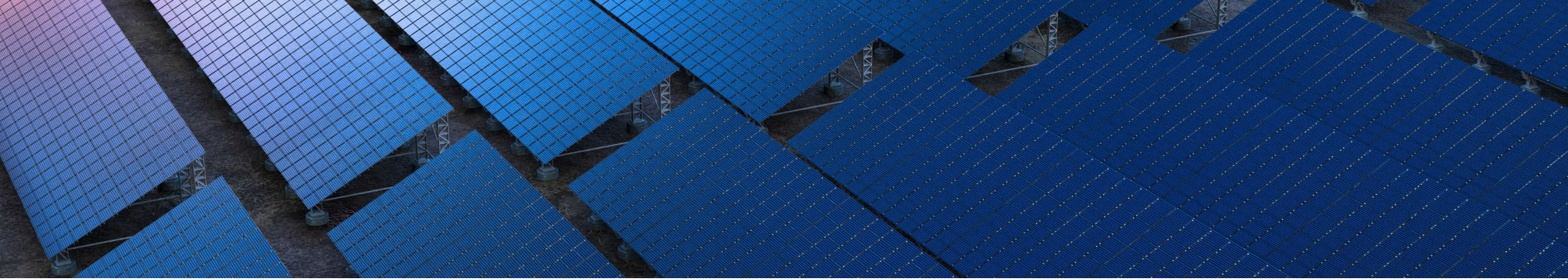
Internal Control Design Review

Why do we look at internal control & what are the steps?

- **Goal: To ensure the financial integrity of the plan, safeguard assets, & verify compliance with regulations like ERISA.**
- Steps/Procedures
 - Obtain understanding of plan control environment, oversight process, & how plan management establishes & communicates policies
 - Obtain an understanding of design of IT environment
 - Obtain an understanding of the Contribution/Allocation process in the ESOP
 - Obtain an understanding of Participant Data Process
 - Obtain an understanding of Distributions process
 - Obtain an understanding of Payroll
 - Obtain an understanding of Investment process

Audit Procedures

Investments

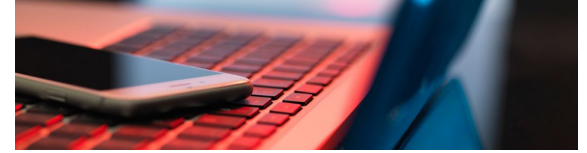


Does the plan only consist of company stock or are there other investments?

- Company stock
 - Obtain valuation from third-party firm
 - Test inputs & assumptions in report
- Company stock & other investments
 - Companies could have other investments & money market accounts
 - Typically tested through confirmation

Audit Procedures

Contributions/Participant Allocation Testing



- Test total contributions to the plan
- Test the allocation of stock contributions to participant accounts
 - Determine that sample of employees was eligible per plan document
 - Vouch participant data
 - Test hours & wages
 - Test allocation by recalculating using tested inputs
- Test allocation of any cash contributions & dividends
- Consider forfeitures

Audit Procedures

Participant Eligibility Testing

You have tested participant allocations or contributions.

What about employees not listed as participants?

- Auditor is required to perform eligibility testing for a sample of employees
 - Select a sample of non-participating employees
 - Evaluate & test reason for non-participation

Audit Procedures

Distributions



What is required for distribution testing?

- Sample
- Vouch selections to signed distribution paperwork (authorization)
- Ensure distributions follow plan document
- Consider forfeitures
- Agree distributions to copies of checks

Audit Procedures

Benefit Obligations

ESOPs create benefit obligations for companies, primarily the obligation to repurchase shares from retiring participants, known as the “repurchase obligation.”

- The auditor should ensure accurate participant balances.
- The auditor should ensure payouts are in accordance with plan document.
- The auditor should be a trusted advisor for plans & offer suggestions when needed.
- Consider sustainability studies for future repurchase obligations.

Audit Procedures

Form 5500 & Other Compliance Matters



Form 5500

- The auditor is required to obtain a draft of Form 5500 that is substantially complete prior to dating the auditor's report
- Auditor must review the draft Form 5500 to ensure no significant discrepancies exist that are not either corrected or disclosed
- The existence of significant variances could cause either an amended Form 5500 filing or a restatement

Audit Procedures

Form 5500 & Other Compliance Matters



Other Compliance Matters

- Auditor is required to obtain insurance/bond coverage documentation
- Annual Nondiscrimination Testing
 - Top Heavy Testing
 - Minimum Coverage Requirements
 - Other Nondiscrimination Tests (as applicable)

Audit Procedures

Other ESOP Procedures & Matters



Be Aware

- Auditors are now required to perform additional enhanced procedures on related parties & significant unusual transactions.
- While rare for *most* plans, these procedures require additional audit effort & will result in additional questions to plan management that may have not come up in prior audits.

04

Common Errors



Common Errors

Issue 1

Valuation not performed or inaccurate

- Most ESOPs don't have publicly traded stock; therefore, it's important to engage with valuation specialists who are familiar with ESOPs.
- Management-engaged specialists vs. auditor-engaged specialists.



Common Errors

Issue 2

Stock allocations not following plan document

- Most allocations are based on compensation & calculated by a third-party administrator.
- Ensure you have reputable TPA.



Common Errors

Issue 3

Is the correct amount being transmitted?

- Are the employee contributions being credited to the correct participant account?



Common Errors

Issue 3

Failure to follow the plan document compensation issues

- Not using the plan definition of compensation

Types of compensation



Base Pay



Commissions



Overtime Wages



Tip Income



Bonus Pay



Recognition Pay



Benefits



Stock Options



Other Noncash Benefits

Common Errors

Issue 4

Failure to follow the plan document eligibility

- Improperly excluding eligible employees from the opportunity to defer into the plan
- Potential corrective contributions

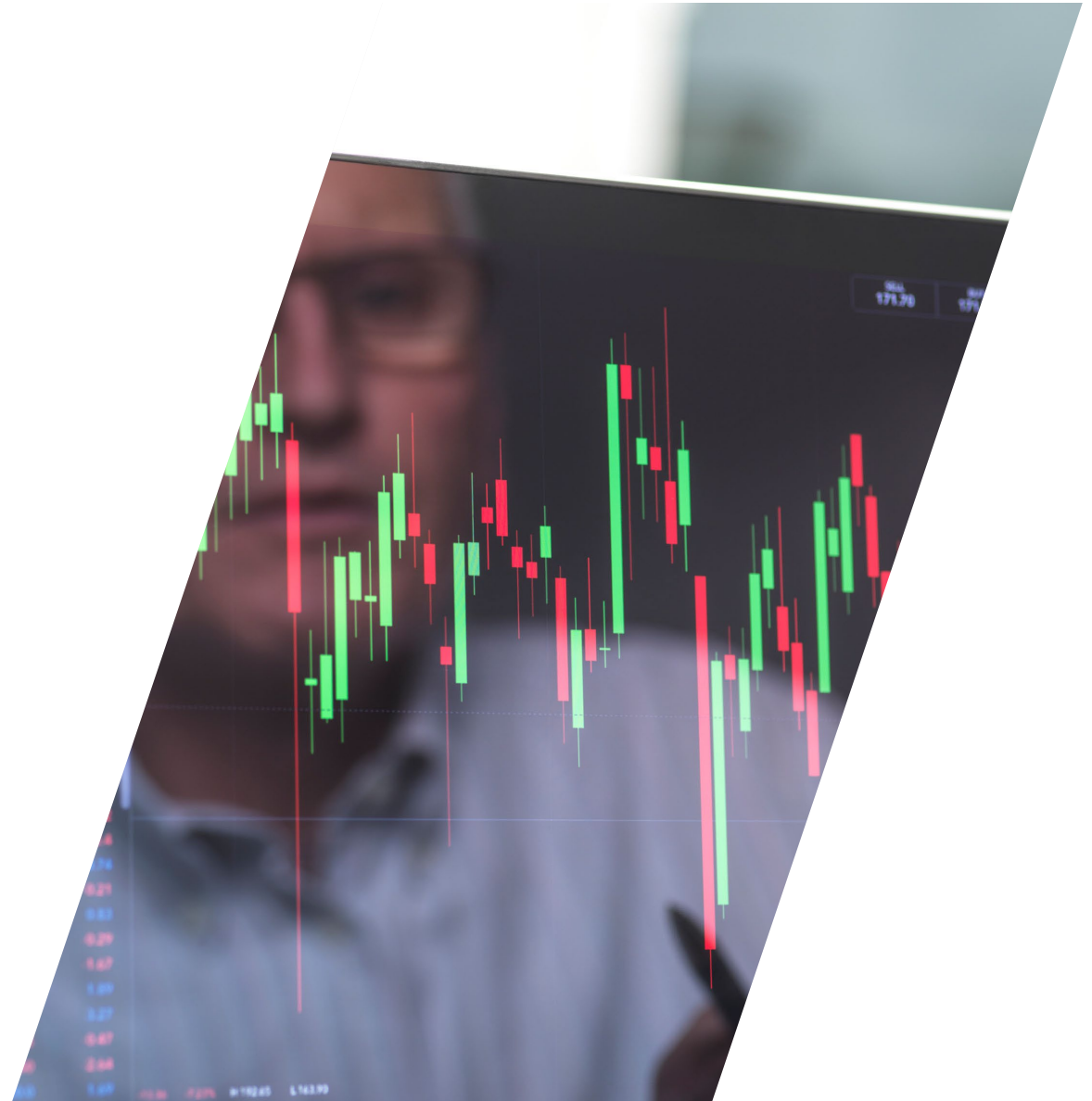


Common Errors

Issue 5

Is the vested portion properly calculated?

- Participants can receive more than what they are entitled, costing the plan sponsor the ability to use forfeited funds.
- Participants can receive less than they are entitled, possibly jeopardizing retirement benefits, & opening the plan sponsor to liability.
- Outsourcing & not checking information provided to the TPA.



Common Errors

Issue 6

Fiduciary responsibilities

- Internal vs. external trustee



ESOP Audit Considerations

Summary

What good governance looks like

- Right providers
 - Successful ESOP will have a trustee, attorney, valuation company, third-party administrator, advisor, & potentially an auditor
 - Do your research to be sure they have the credentials & experience to steer your plan in the right direction
 - Ask the tough questions
- Management oversight is key
 - Includes documentation of decisions made throughout the year as well as consulting with advisors
 - Keep track of compliance issues & obstacles
- Form 5500 filing is due 7 months after your year-end with 2.5-month extension
 - Generally, 100+ participants at the beginning of the plan year, you will need an audit
 - Be sure to review early & plan ahead
 - Track proper eligibility requirements to allow employees into the plan as well as allocating shares to those in the plan
 - Plan document should be your guide

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