Plan Sponsor ESOP Accounting – Advanced Sponsor Topics

Employee Stock Ownership Plan

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U.S. Presence

Top 10

U.S. Public Accounting Firm*

$2bn

Revenue (2023)

79

Markets

28

States

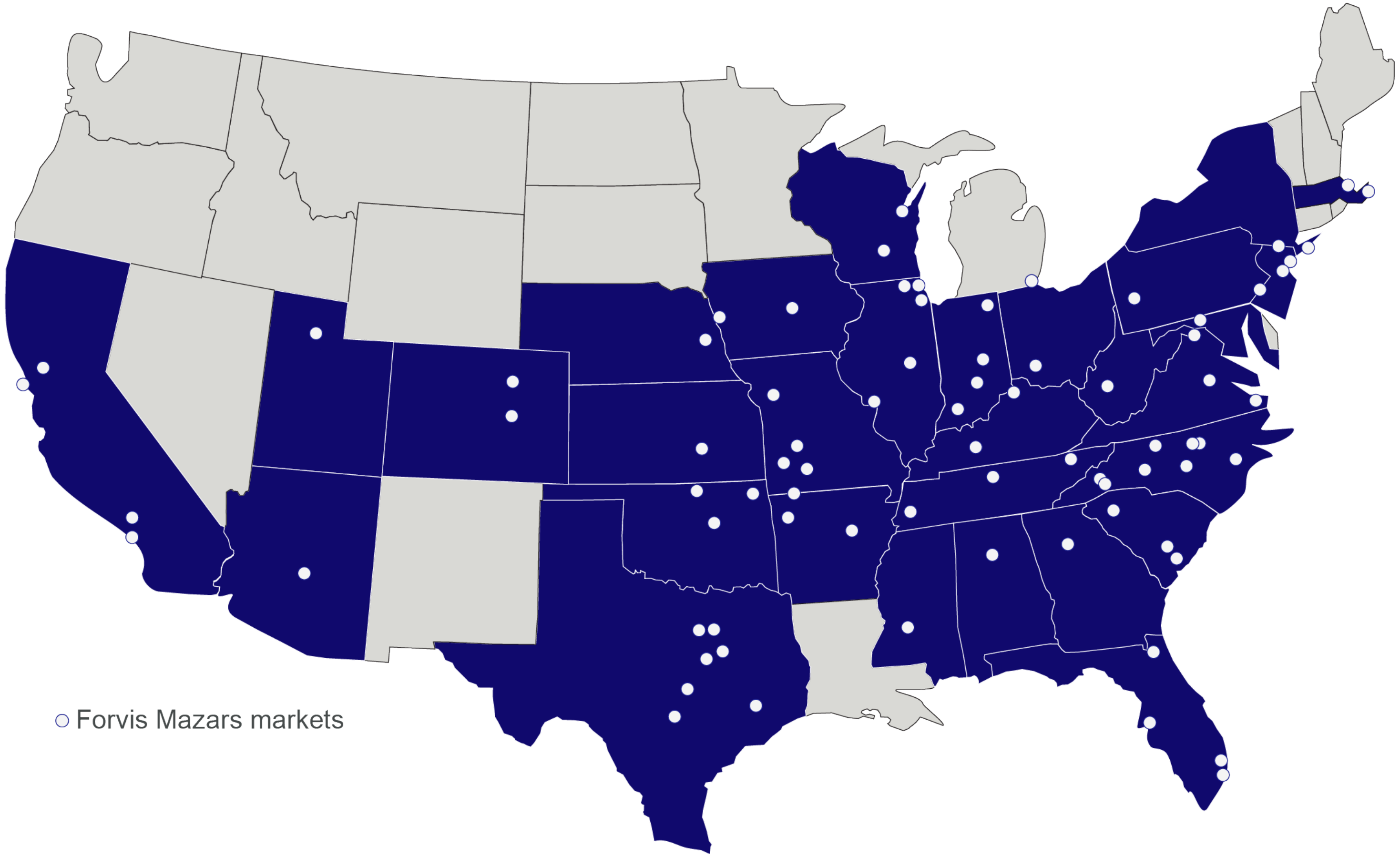
600+

Partners & Principals

7,000+

Employees

*Source: Inside Public Accounting, based on most recent rankings
2023 combined revenues: FORVIS $1.7bn, Mazars USA (expected) $305M



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Plan Sponsor ESOP Accounting – Advanced Sponsor Topics

Presenters

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Objectives

1. Warrants
2. Stock Appreciation Rights
3. Closing

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Understanding Warrants
Employee Stock Ownership Plan

What Is a Warrant?

- A warrant is a financial instrument that allows the holder to purchase stock of the issuer at a specified price for a period of time (warrant term)
- A warrant is issued in conjunction with note payable

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Understanding Warrants
Employee Stock Ownership Plan

What Is a Warrant?

- Typically used to compensate seller-financed ESOP purchase
- Stated rate on Seller Note typically below market
- Allows sellers to continue to participate in the success of the business
- Generally issued with a strike price equal to the initial ESOP share value
- Not considered outstanding stock for S corporation purposes, if designed correctly

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Accounting for Detachable Warrants
Employee Stock Ownership Plan

Warrants Will Add Complexity to the Sponsor’s Financial Statements

- Two issues to consider:
  - How to value the warrants
  - Proper classification of warrants on the balance sheet

FASB Accounting Standards Codifications (ASC) 470-20 *Debt with Conversion and Other Options* & 480-10 *Distinguishing Liabilities from Equity* provide guidance

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Determining the Value of the Warrant
Employee Stock Ownership Plan

Must Be Recorded at Fair Value at Date of Grant

- Proceeds of the debt instrument with warrants must be allocated to the debt & the warrants based on the relative fair values at the date of issuance
- Requires the use of an option pricing model
- Usually results in the debt being recorded at a discount

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Determining the Value of the Warrant
Example Calculation

Inputs Needed for Calculation

1. Value of the stock
2. Exercise or strike price
3. Expected life
4. Risk-free rate
5. Volatility

- Black-Scholes Model frequently used
- Volatility can be obtained by industry sector

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I Have Determined the Value
Employee Stock Ownership Plan

Now What?

- Must consider proper classification on the balance sheet
- ASC 480-10 requires liability treatment if both of the following characteristics are met
  - It embodies an obligation to repurchase equity shares

    And
  - It requires or may require the issuer to settle the obligation by transferring assets (cash)

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I Have Determined the Value
Employee Stock Ownership Plan

Now What?

- Careful consideration of the terms of the warrant agreement must be made to determine proper classification
- Put options generally require liability treatment
- Most warrants issued in conjunction with ESOPs will have put option
  - No intent for warrant holder to own shares upon exercise

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Liability Treatment
Understanding Warrant Accounting

Liability

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

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Initial Transaction – Accounting
Understanding Warrant Accounting

Equity

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

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Initial Transaction – Accounting
Sample Transaction

Financial 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

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Initial Transaction – Accounting

Entry #4 – 01/01/2025		
Note Payable – Discount	$400,000	
Warrant Obligation		$400,000
To record the fair value of warrants		

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Ongoing Accounting
Annual, Recurring Entries

1. Annual ESOP contribution & loan payment

2. Annual payment on seller notes

3. Amortization of note payable – discount

4. Change in fair value of warrants
   - Must determine FV at each reporting date

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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 & the liability is updated

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Ongoing Accounting

- At 12/31/25, the company makes a $1,202,414 payment on the seller notes

Entry #5 – 12/31/2025		
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		

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Ongoing Accounting

- At 12/31/25, the warrants have a fair market value of $550,000

Entry #6 – 12/31/2025		
Warrant Expense	$150,000	
Warrant Obligation		$150,000
To record change in fair value of warrants		

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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

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Understanding Synthetic Equity
SARs & ISOs

Stock Appreciation Rights (SARs) & Incentive Stock Options (ISOs)

- Used to attract, retain, & motivate management
- ISOs allow holder to purchase stock at a set price for a period of time
- SARs generally allow for holder to receive the excess of the fair value of the stock at exercise date over the grant price of the SAR
- Must be approved by Trustee

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Ongoing Accounting
SARs & ISOs

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
- Record compensation expense with a corresponding credit to paid in capital or liability account
- <u>Non-public companies have option to measure award using the intrinsic-value method</u>
  - Intrinsic value is the difference between the strike price & the stock price
  - The company must remeasure the intrinsic value at the end of each period

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SARs & ISOs
Summary of SARs/ISOs

	Equity Settled (Equity Treatment*)		Cash Settled (Liability Treatment*)			
	Incentive Stock Options	Nonqualified Stock Options	Incentive Stock Options	Nonqualified Stock Options	Phantom Stock	Stock Appreciation Rights
GAAP Expense						
Measured at	Grant Date	Grant Date	Each Period	Each Period	Each Period	Each Period
Based on	Fair Value	Fair Value	Fair or Intrinsic Value**	Fair or Intrinsic Value**	Fair or Intrinsic Value**	Fair or Intrinsic Value**
Determined by	Pricing Model	Pricing Model	Pricing Model or Intrinsic**	Pricing Model or Intrinsic**	Pricing Model or Intrinsic**	Pricing Model or Intrinsic**
Recognized Through	Service Period	Service Period	Service Period	Service Period	Service Period	Service Period
Tax Expense						
Determined by	Sale Price of Stock	Stock Value at Exercise	Sale Price of Stock	Stock Value at Exercise	Formula or Valuation	Formula or Valuation
Recognized on	Sale of Stock or Never	Exercise of Option	Sale of Stock or Never	Exercise of Option	Payment of Cash	Payment of Cash
Cash Required						
By Employer	None	None	Upon Redemption	Upon Redemption	Upon Maturity	Upon Maturity
By Employee	Upon Exercise	Upon Exercise	None (If Net Cash Settled)	None (If Net Cash Settled)	None (If Net Cash Settled)	None (If Net Cash Settled)
Employee's Taxable Income						
Type of Income	Capital Gain or Loss	Ordinary & Capital	Ordinary Income	Ordinary Income	Ordinary Income	Ordinary Income
Recognized upon	Sale of Stock	Exercise & Sale of Stock	Receipt of Cash	Receipt of Cash	Receipt of Cash	Receipt of Cash

** Liability treatment occurs if the option permits cashless exercise or the employer must repurchase the stock.*

*** Nonpublic companies may make a one-time election to use intrinsic value rather than fair value as described in ASU 2016-09, Compensation—Stock Compensation.*

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Ongoing Accounting
SAR Liability

- During 2025, the Board awards 5,000 SARs to key employees. The strike price of each SAR unit is $4.50. The SARs vest equally over four years
- At 12/31/25, 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 – 12/31/2025	Fair Value Method		Intrinsic Value Method	
SAR compensation expense	$7,500		$625	
SAR liability		$7,500		$625
To record the SAR liability				

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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, & outstanding during the year

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Pushdown Accounting in ESOP Transactions

- If allowed & elected, employer is required to prepare financial statements using new basis of accounting under Topic 805 (purchase accounting)
- Could help reduce the equity deficit created in most ESOP transactions
- Deficit created by the recognition of the company's loan to the ESOP trust (inside loan) recorded as Unearned ESOP shares as a contra equity account

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Pushdown Accounting

Who Qualifies?

- Must follow guidance in Topic 810 – Consolidation & determine if a change in control occurred
- Assessment of change in control is based on specific facts & circumstances of the transaction

Relevant Considerations

- Is the operating company a variable interest entity (VIE) or voting interest entity under Topic 810?
- How are the governing documents (board composition) designed?
- Consideration of lender rights

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Pushdown Accounting
Recording

If a Change of Control Occurred & Push Down Is Elected

- Record all assets & liabilities as fair value as of the date of change in control
    - May require third-party valuations of equipment, real estate, inventory
    - Generally, will result in fair values higher than recorded book value
    - Goodwill would be recorded for any remaining purchase price not allocated to existing assets or liabilities
- Offsetting credit to additional paid in capital
- Credit to APIC will help offset Unearned ESOP shares contra-equity account

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Pushdown Accounting

Election Must Be Made at Change in Control Date

Pros

- Improved equity position
- Write-up of assets & liabilities

Cons

- Additional depreciation & amortization reduce net income
- Additional complexity in recording ESOP transaction
- May require additional valuations of assets & liabilities

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Questions?

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