Beyond Repurchase Liability — ESOP Sustainability Management

Forecasting and Managing Repurchase Liability Obligations

Many Employee Stock Ownership Plan (ESOP) sponsors are presented with the challenge of maintaining an ESOP over the long-term. ESOP sustainability can raise internal concerns about the finances of the business, as well as the general perception of employee ownership within an ESOP company.

As ESOP companies mature and become more successful, the repurchase liability increases, and proper planning becomes critical. Employee demographics and retirements are important factors in planning for the cash funding requirements of the repurchase liability. The success of the company and the high value of the ESOP account balances can be a retention tool or, conversely, an incentive for early retirement.

The repurchase obligation measures the future liability that may emerge out of the plan over time. It provides a sense of the future cash flow of the company that sponsors the ESOP. While it is an obligation of the sponsor, it is an off-balance sheet liability. Off-balance sheet liability should be measured regularly to understand the potential impact that it may have in the business. Events that trigger distributions — such as retirement, death, diversification, disability and terminations — may have an impact on this obligation. A repurchase liability study is performed to forecast the timing and amount of a company's ESOP repurchase obligations.

In this article, we will take a closer look at best practices in repurchase liability management as well as the process of embedding the repurchase liability study with a sustainability study.

Beyond Repurchase Liability Study – Sustainability Management

Most repurchase liability studies focus on projections of cash flows. Most of these studies do not incorporate the development of strategies to manage the ESOP cash flow over the long run. Every single case differs and no standard strategies work for all ESOPs.

Absent an ongoing risk and sustainability management embedded in the cash flow analysis, plan sponsors and trustees are not getting a complete view of the potential landmines.

Potential strategies that should be used in a repurchase liability study should include:

- **Scenario analysis:** The tax benefits can offer significant wealth creation for shareholders, management and employees.
- **Sensitivity analysis:** Providing employees with a direct stake in the company's success, ESOPs increase employee engagement and performance.
- **Impact of results in coordination with valuation firms:** Our analysis provides the opportunity to embed valuation adjustments as we go through the process of analyzing the repurchase liability. We consider this to be a holistic study, rather than an isolated component. Most other firms do not provide this feature.

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Sustainability Management

Our analysis will assist plan sponsors in understanding the risks, costs, and talent considerations associated with various alternatives to the current ESOP structure, as well as alternative strategy for managing these risks and the repurchase liability. Our approach is a collaborative and iterative process. We will listen to your concerns and objectives, and will also provide you with guidance on how to avoid the pitfalls and impediments that we are aware of based on our years of experience working with many ESOPs.

PKF O'Connor Davies innovates on a case-by-case basis for each client company. For example, we have designed a pension plan strategy that shifts the repurchase liability to another pension vehicle to manage the sustainability of the ESOP.

ESOP Repurchase Forecasting Methodology

Best practices for ESOP repurchase studies include:

- **Request and Review Data:** Request data from plan sponsor and reconcile data against previous study. Include inactive population in the study. (Regular repurchase liability studies do not include inactive population, thereby underestimating short-term liabilities.)
- **Develop Assumptions:** Assumptions should be developed based on an ongoing monitoring of death, disability, retirement, diversification and turnover. Be careful not to use standard actuarial tables without understanding how they were developed.
- **Apply Methods and Provisions Consistently:** Apply plan provisions appropriately. Review distribution policy and how shares are treated (redemption or recycling).
- **Gain/Loss Analysis:** Allows management, board members and trustees to understand why the repurchase liability differs from the previous analysis. It provides the principal component of the differences and helps explain differences.
- **Reconcile Data with Prior Analysis:** Developing data reconciliation helps management and trustees understand differences in the covered population since the prior study.
- **Population Projection:** The population projection provides stakeholders with the underlying projected population and provides an understanding of potential talent management issues.

Industry Recognition

- **Ranked 29 of "2018's Top 100 Firms"**
  – *Accounting Today,* 2018
- **Ranked 7 of the "Top Firms in the Mid-Atlantic"**
  – *Accounting Today,* 2018
- **"Tax Advice Award"**
  – *Family Wealth Report Awards,* 2018
- **Ranked 22 of the 50 "Best Accounting Employers to Work for in North America"**
  – *Vault,* 2018

The Employee Benefits Practice of PKF O'Connor Davies can assist companies and business owners with ESOP transactions, including financial, plan design, feasibility analysis, succession planning, tax, accounting, employee benefit transformation services and executive compensation analysis.

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