What to know when your client is considering employee ownership

Accountants who advise clients interested in employee ownership plans need to be aware of the pros and cons of different models.

By Andrew Kenney

Employee ownership of businesses has been around for many years, but the different models are still widely misunderstood, forgotten, and even shunned — including by accountants.

The most popular model is the employee stock ownership plan, or ESOP (see the related article, "Employee Ownership and Taxes: Why Firms Are Choosing ESOPs"), which was conceived of by political economist Louis Kelso in 1956. An ESOP is a Sec. 401(a) qualified defined contribution plan that allows employees to own stock in the company for which they work. An ESOP is created as a tax-advantaged buyout that transfers stock ownership from a business's shareholders to a trust representing the interests of a broad group of employees. ESOPs can be leveraged or nonleveraged.

ESOPs are governed by the Internal Revenue Code and the Employee Retirement Income Security Act (ERISA). ERISA is administered in part by the IRS and in part by the U.S. Department of Labor (DOL). In late 2024, the DOL approached the AICPA for assistance because many CPAs have discouraged clients from embracing the ESOP model and are unfamiliar with other forms of employee ownership. The DOL aims to encourage best practices regarding ESOP valuation and fiduciary responsibility and to educate the public about the full range of employee ownership options.

About the author

Andrew Kenney is a freelance writer based in Colorado. To comment on this article or to suggest an idea for another article, contact Jeff Drew at Jeff.Drew@aicpa-cima.com.

Understanding a company's valuation and its likely growth trajectory is crucial to designing a durable employee ownership structure.

Accountants who work with employee-owned business clients understand their colleagues' fears but say that they are largely overblown and may lead accountants to dismiss a potentially beneficial business model.

"They think it's just complex and it's going to get litigated," said Kyle Wolf, CPA/ABV, a business valuation consultant at Stern Brothers Valuation Advisors in Kansas City, Mo. "That's a huge misconception."

To help practitioners gain a better understanding, this article addresses key questions accountants should be able to answer if a client expresses interest in pursuing an ESOP or another employee-owned business structure.

HOW PREVALENT ARE ESOPs?

Nearly 15 million people across about 6,600 companies are enrolled in ESOPs in the United States.

Among companies with ESOPs, approximately 29% are in service sectors, 21% in manufacturing, 16% in construction, and 14% in finance, insurance, and real estate combined, according to DOL information.

Mark Flinchum, CPA, a senior partner at Katz, Sapper & Miller (KSM) and co-chair of the firm's ESOP Services Group in Indianapolis, has deep experience in ESOPs. He has numerous ESOP clients, and the firm itself was restructured as an ESOP more than 20 years ago.

"Our clients are primarily family-owned, closely held businesses. A large number of times those businesses are significant employers in small communities," Flinchum said.

Often, he added, interest in ESOPs comes from owners who "are more concerned by what the business means for the community" and not as concerned about getting the highest possible purchase price. The same goes for worker cooperatives and other employee ownership models (see the sidebar, "What Differentiates Employee-Ownership Models?").

He recalled one client, the owner of a trucking company. The client had sold a previous transportation company to private equity (PE) and was disappointed by the results, which can often include relocation, centralized management, and employee cuts.

"The [client] said, 'I saw what PE did with my trucking company when I sold it to them, and I'm not doing that again,'" Flinchum said.

CONCERNS ABOUT ESOPs AND OTHER EMPLOYEE-OWNERSHIP STRUCTURES

When it comes to helping a client with an ESOP, some accountants fear they'll have to hold the hands of the sellers and business leaders for years to come, said Miyaka Cochrane.

What differentiates employee-ownership models?

An employee stock ownership plan (ESOP) is one model under which employees can own the company. Here are three others:

- Employee stock purchase plans (ESPPs), more common in public companies, allow employees to purchase stock at discounted rates.
- Worker cooperatives, common in smaller and midsize private companies, share profits among employees and involve staff in democratic decision-making. In some cases, sellers can get tax benefits that are comparable to ESOPs.
- Employee ownership trusts (EOTs) place ownership of the company in a trust managed for the benefit of workers. This model doesn't carry inherent tax benefits for sellers.

ESOPs are seen as providing the most clear-cut tax benefit for sellers, but the appeal of employee-ownership models goes beyond taxes.

For example, in 2019 Saul Rockman sold Rockman et al, his independent research firm in San Francisco, to his roughly 15 employees in the form of a worker cooperative.

"I didn't come out rich, but I came out happy," he said. The cooperative model is an option for companies that don't have the size and debt capacity for an ESOP, he said.

Overall, employee ownership is more common, and far less exotic, than many people believe. In some cases, employee ownership functions primarily as a financial mechanism to reward workers for business performance. In others, employee-owners have new avenues to influence decision-making (for example, in worker cooperatives, employee-owners elect and serve on the board of directors). But many employee-owned businesses are managed much like any other organization. As Saul Rockman found, it is the culture — the intangibles — that tends to shift when employee ownership is done well.

He works with companies interested in employee ownership in his role at Project Equity, a not-for-profit that promotes and advises on employee ownership.

In fact, most of the complexity of an ESOP or worker cooperative comes in its formation, Cochrane said. "Employee ownership feels a lot more complicated than it is. The complication is frontloaded."

But there are unavoidable concerns.

For example, ESOPs often require the company to take on substantial debt, a risk that requires a realistic expectation of future growth.

Also, conversion to an ESOP or another employee ownership model doesn't guarantee that a company will stay employee-owned forever. Despite hundreds of new ESOPs being formed each year, the number in existence has remained steady — a result, in part, of ESOP companies tending to be successful and having strong performances that lead to secondary sales to PE or other buyers, Flinchum said.

When it works, employee ownership aligns the incentives of workers and the company — rewarding business performance with returns for employees.

WHAT ARE SOME OF THE NUTS AND BOLTS?

There's plenty for CPAs to learn about ESOPs and other forms of employee ownership.

"The accounting for an ESOP is unique in and of itself. The concept of unreleased ESOP shares being recorded as a contra-equity balance often causing the employee-owned company to have negative equity can be confusing if the user of the financial statement is not familiar with ESOPs," Flinchum said. "Having all the company's financial advisers and legal advisers on board in an ESOP is important to understand what to expect."

The education required for a practitioner entering this space "greatly depends on what base level of knowledge that CPA has," Cochrane said. "If they're doing large corporate finance, it's going to be an easier lift to adopt ESOP accounting practices."

ESOPs come with oversight and filing deadlines. "It's very regimented, and the cost of mistakes can be quite high," Cochrane said.

Knowledge of the client's industry is also important, Wolf said. Understanding a company's valuation and its likely growth trajectory is crucial to designing a durable employee ownership structure.

"You have to have a good idea of where that industry's going, how this company compares to similar companies in the industry," he explained.

Bruce Mayer, CPA, specializes in employee ownership as a partner with Wegner CPAs and frequently works with [employee-owned] cooperatives. His clients range from composting companies to landscaping crews and even a chocolate shop.

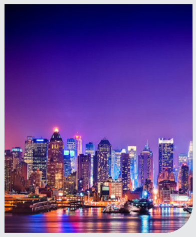
"One of the challenges in working with co-ops is that the business can be almost anything," Mayer said. "We have to be able to adapt."

The key for serving these organizations, he said, is to have a small business generalist who's willing to learn.

"It's a really good niche," Mayer said. "We just pick up client after client."

Major support groups for employee ownership include The ESOP Association, Employee-Owned S Corporations of America (ESCA), and the National Center for Employee Ownership. The DOL provides resources via its Employee Ownership Initiative webpage. Project Equity also offers

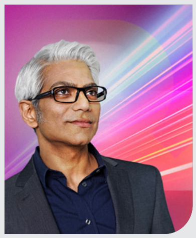
LEARNING RESOURCES



CPExpress

Access ESOP-specific training and CPE through the CPExpress courses "Employee Benefit Plans: Employee Stock Ownership Plans (ESOPs)" (auditing) and "Purchase/Sale of Closely-Held Business: Specialty Transaction: Employee Stock Ownership Plan & Trust" (tax).

CPE SELF-STUDY

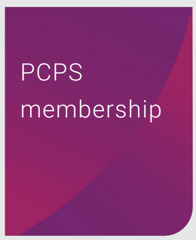


ENGAGE 25

Firm practice management is on the agenda at the biggest event in the accounting profession, AICPA & CIMA ENGAGE 25, to be held at the ARIA in Las Vegas. Don't miss it!

June 9–12

CONFERENCE



PCPS membership

The Private Companies Practice Section (PCPS) is an add-on firm membership section within the AICPA that supports CPA firms of all sizes in the everyday intricacies of running a practice by providing practical and customizable practice management resources. For more information, click on the PCPS membership headline above.

SECTION

For more information or to make a purchase, go to aicpa-cima.com/cpe-learning or call 888-777-7077.

ESOPs come with oversight and filing deadlines.

educational resources for CPAs and other professionals, in addition to consulting services. Flinchum's firm, KSM, offers white papers and other resources.

For CPAs interested in helping clients implement or even just assess their potential fit with employee ownership — whether with ESOPs, worker cooperatives, or another model — special expertise is critical.

For a cooperative, that experience will help with filing returns, computing corporate taxes in relation to patronage, and advising members on filing their own tax returns, according to David Wilmore, managing director of the organization now known as Rockman et al Cooperative Inc. Wilmore advises businesses considering a cooperative structure to make sure they have an accountant who "is familiar and has working experience with cooperatives."

But individual CPAs need not know every facet of employee ownership before getting involved. If necessary, a CPA can tap specialized practitioners to assist in an engagement, including experts who may focus on governance structures, management, or valuation.

"Generally, what we recommend is to explore it and to get to know the fundamentals," Cochrane said.

THE BOTTOM LINE IS PEOPLE

Saul Rockman — who sold his independent research firm to his employees — said it's important for practitioners to go beyond the nuts and bolts.

"The first thing I would look for is a positive attitude. 'Yes, you can do this,'" Rockman said.

Ultimately, it's about understanding the mission and intangibles of employee ownership.

"For me, the greatest benefit was the fact that people who had worked as employees became owners and took on the responsibility," he added. "I didn't expect it to be so different — the sense of ownership really affected everybody." ■

AICPA & CIMA MEMBER RESOURCES

Articles

- "Employee Ownership and Taxes: Why Firms Are Choosing ESOPs," *JofA*, April 1, 2025
- "ESOP Exploration: Can the 'New' Ownership Model Age Well?" *JofA*, Sept. 5, 2023

Podcast episode

- "The Power of ESOPs in Reshaping Your Firm's Future," Dec. 12, 2024

Website

- Employee Stock Ownership Plans (ESOPs) Resource Center

Forensic and Valuation Services (FVS) Section resource

- Valuations Performed for Employee Stock Ownership Plans (ESOPs) — FAQs (exclusive for FVS Section members)