

# ESOP: The Financial Realities for A/E Firms

PRESENTED BY:

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# Meet Your Presenters



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# Learning Objectives

- Understand the differences in A/E firm valuation in three transition scenarios: internal sale, M&A and ESOP
- Understand the impact of corporate tax structure on the benefits of an ESOP and whether a change of structure could be beneficial.
- Understand the ongoing financial impacts after an ESOP is implemented and the operational requirements that come with an ESOP
- Understand the conceptual tax benefits in the ESOP statutes and the real-world practices in A/E firms to realize those benefits.

# Anticipatory Thinking

“the ability to prepare in time for challenges and opportunities, many of which may not be clearly understood until they are encountered”

Hard Trends = *Will* Happen

Soft Trends = *Might* Happen

# Why Consider an ESOP

“incentivize people to stay around long enough to develop owner-like mindsets and behaviors that will facilitate ownership transition”

CEO quote from our recent interviews

but of course...the devil is in the details



# Trends Impacting the ESOP Decision

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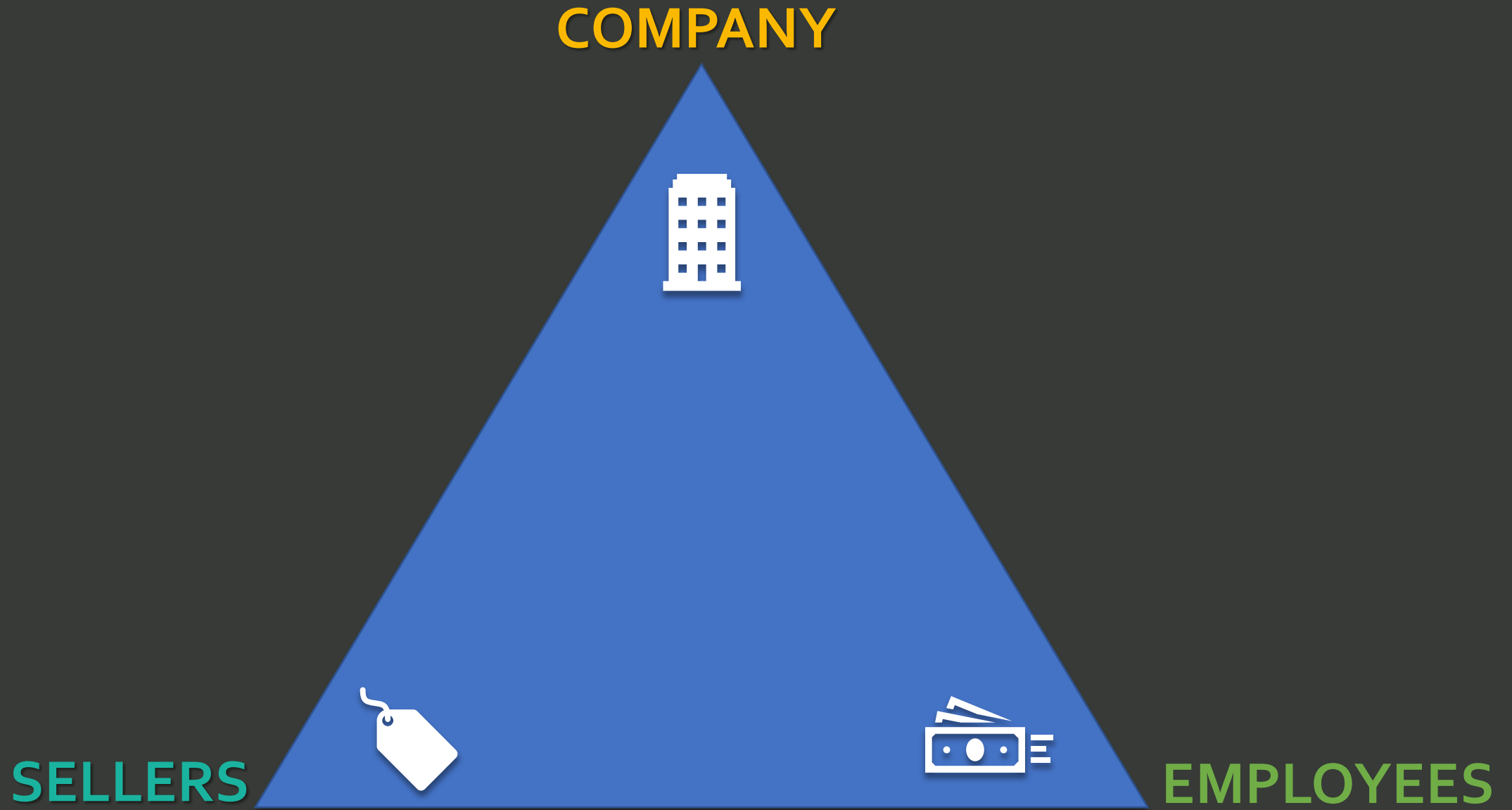
## Hard Trends:

- Current shareholders will retire
- The war for talent isn't going away
- Employees want more from their jobs than a paycheck
- Taxes on higher income individuals are generally going up

## Soft Trends:

- The A/E industry is consolidating
- Larger firms generally have better pay and benefits
- Smaller firms have more engaging cultures
- The appeal of direct ownership might be waning

# The “Model” ESOP



# What Are Your Goals?

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- Liquidity event for existing shareholders
- Retention of people through better engagement
- Increase firm performance
- Encourage behaviors that add value



# Two Basic Shapes of ESOPs

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## Leveraged

Bank debt and seller debt used to facilitate the purchase of shares by the ESOP

## Unleveraged

Stock issued by the company to the ESOP for future use

Many other hybrid variations on ESOP structure

# A/E Firm ESOP Valuation

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- Required to be “Fair Market Value” by the ESOP statutes
- Higher than a “facilitated” internal sale
- Less than an external “strategic” sale
- How can that be?

## Polling Question

Our firm valuation is:

- Set at book value
- Set by a buy-sell formula
- Determined by a valuator
- Set subjectively by leadership
- Generally unknown

# Tax Benefits of an ESOP

“we were advised to be very careful to not let the  
“tax tail” wag the dog – greater financial complexity  
has diminishing returns”

CEO quote from our recent interviews

# The Impacts of Corporate Tax Structure on ESOP Benefits

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- Most A/E firms report revenue and expenses for tax purposes on the cash basis of accounting
- Smaller, younger firms tend to be “pass-through” entities
- Larger, older firms are “C-corporations” more often
- What about LLP’s or Partnerships?

# What Benefits are Most Useful to You?

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- Tax free exchange of company stock sold to ESOP
- Tax deductible expenses for stock issued to ESOP
- Tax deductible loan payments for ESOP debt
- Tax free profits allocated to the ESOP



## Polling Question

### Our corporate tax structure:

- Partnership
- LLC or LLP
- S-corp – Cash basis
- C-corp – Cash basis
- S or C – Accrual basis



# Realizing the Benefits

“our ESOP committee does an excellent job communicating and reinforcing the benefits of our ESOP – in our opinion, it has to be treated like an employee benefit”

CEO quote from our recent interviews

# Setting Up and Living with an ESOP

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- Annual valuation
- Reviewed or audited financial statements
- Impact on FAR overhead rates
- Information sharing requirements
- Relationship with the ESOP trustee
- Initial and ongoing costs

# Operational Considerations for ESOP Ownership

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- Role of the trustee – internal or external?
- Role of the Board of Directors – independence?
- Minority or majority ESOP ownership?
- Managing the function of the ESOP

## Polling Question

### Our attitude about financial information:

- Owners have full access
- Owners and leaders have full access
- Leaders have partial (summary) access
- All employees have full access
- All employees have access to summary reports

# The Case-Study From our Recent Blog

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- Single owner C-corporation – very successful, desirable location
- Significant “gap” between ESOP and strategic value
- Long-standing relationship with several banks – competing proposals
- Leveraged ESOP with future stock warrants for seller
- Firm underperforming due to economic conditions

## Polling Question

Our current interest in ESOPs is:

- Evaluating if it is right for us
- Implemented an ESOP recently
- Generally happy with our ESOP
- Looking to get more from our ESOP
- Other...



# Questions?

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November 3, 2022 | 2:00PM EST

Account-Based Strategies for High  
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November 17, 2022 | 2:00PM EST

The Critical Role of IT in M&A



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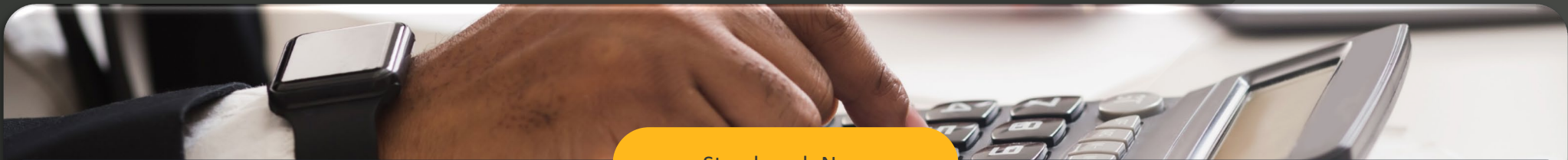
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# Thank You!



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