Financial Statement Normalization Adjustments for ESOP Sponsor Company Valuations

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Normalizing financial statements is the procedure for removing the impact that nonoperating assets and liabilities and nonrecurring or unusual income and expense items exert on the "normal"—or continuing—financial results of a company. Such a procedure is performed in order to establish a level of normal operations, and related operating results, that reasonably can be relied on to develop the valuation of an ESOP sponsor company.

Introduction

Recent estimates indicate that there are approximately 6,600 employee stock ownership plans ("ESOPs") covering approximately 14 million employee participants in the United States, and controlling approximately $1.4 trillion in corporate value (approximately 8 percent).[1]

ESOP regulations require that, at least annually, an ESOP sponsor company, representing the entity in which the ESOP participants own shares, must be appraised by an independent, qualified financial adviser to facilitate the administration of the ESOP.

While this discussion provides some general background regarding ESOPs, it is not intended to provide a detailed analysis regarding ESOP regulations, or the intricacies associated with forming and operating an ESOP. The valuation of an ESOP sponsor company should comply with generally accepted valuation practices and with business valuation standards. These practices and standards include the analyst's consideration and application of one or more valuation methods within the three generally accepted business valuation approaches:

1. The income approach
2. The market approach
3. The asset-based approach

This discussion assumes that the reader possesses a basic level of familiarity with the generally accepted business valuation approaches and underlying methods. Based on this premise, this discussion will not present a detailed analysis regarding the implementation of generally accepted business valuation approaches and methods.

Rather, this discussion focuses on financial statement normalization considerations that have the potential to exert a significant impact on the expected earning potential and, therefore, on the estimated value, of an ESOP sponsor company.

ESOP Background

An ESOP is a qualified, defined contribution employee benefit plan in which the sponsor company makes annual contributions. ESOPs were designed as a tax-advantaged mechanism for transferring ownership into the hands of American workers.

When establishing an ESOP, the sponsor company sets up a trust fund. There are two basic forms of an ESOP: (1) nonleveraged and (2) leveraged.

A nonleveraged ESOP trust, or ESOT, is funded without the use of debt, and the annual contributions are made in the form of sponsor company stock, or in cash to purchase existing sponsor company stock. The sponsor company shares held by a nonleveraged ESOP are allocated to individual participant accounts, generally on the basis of relative compensation.

A leveraged ESOP trust is funded through borrowing money to purchase shares in the sponsor company. The purchased shares are held in a suspense account and a proportionate number of shares are released as the ESOP loan is amortized. As the shares are released from the suspense account, they are allocated to individual participant accounts.

The sponsor company makes annual, tax-deductible contributions to the ESOP typically represented by the principal and interest payments made to pay down the underlying loan.

The Employment Retirement Income Security Act of 1974 ("ERISA") sets the minimum standards for many retirement and health plans, including ESOPs. ESOP fiduciaries must comply with the rules and standards of conduct set by ERISA. An ESOP fiduciary is considered to be anyone with authority or control over the assets of the ESOP, or anyone who participates in the management or administration of the plan.

ERISA established both the U.S. Department of Labor ("DOL") and the Internal Revenue Service ("Service") as federal oversight agencies for ERISA.

It is important for fiduciaries to ensure they comply with ERISA. Failure to comply can result in costly fines and penalties. The most important requirement provided by ERISA is that the fiduciary must act in the best interest of the beneficiaries and plan participants of the ESOP.

This requirement includes overseeing the acquisition of employer shares by the ESOP. According to the DOL and the Service, an ESOP may not pay more than "adequate consideration" for the shares acquired.

Federal statutes mandate that private companies provide participants with "put" options. With a "put" option, the sponsor company and/or the ESOP must repurchase the departing employee sponsor company shares at a price no less than fair market value ("FMV").

A generally accepted definition of FMV is stated in Revenue Ruling 59-60 of the Internal Revenue Code. The Service defines FMV as "the price at which the property would change hands between a willing buyer and willing seller when the former is not under any compulsion to buy and the latter is not under any compulsion to sell, both parties having reasonable knowledge of relevant facts."

Publicly traded companies with ESOPs generally can rely on prices established by arm's-length transactions in the market, as published in public exchanges, to establish the FMV of sponsor company stock. A sponsor company with stock that is thinly traded (i.e., subject to low trading volume) may be required to engage an independent financial adviser to estimate the FMV of the ESOP stock.

However, the majority of ESOP sponsor companies are closely held with no public market for their shares. When this is the case, a primary fiduciary responsibility of an ESOP trustee is to set the FMV of the sponsor company securities owned by the ESOP.

ESOP trustees are required by the DOL to obtain a third-party independent valuation of the sponsor company stock held by the ESOP at least annually, though many sponsor companies are valued more frequently for ESOP purposes (e.g., semi-annually or quarterly).

These recurring ESOP valuations generally are referred to as "valuation updates." Valuation updates are integral to annual ESOP administration procedures. In addition, an ESOP trustee may retain the services of a financial adviser for a proposed transaction involving the ESOP, either as a buyer or a seller.

Although the financial adviser is tasked with providing the trustee with an independent estimate of the FMV of the sponsor company shares, it is ultimately the trustee's fiduciary responsibility for procuring, reviewing, and accepting the FMV of the sponsor company securities owned by the ESOP.

If the trustee were to set the share price as something different than that recommended by the financial adviser, the trustee would need to provide an explanation for the difference.[2]

Financial Statement Normalization Considerations for ESOP Sponsor Company Valuations

A financial adviser typically faces many decisions when performing a sponsor company stock valuation. One typical decision is whether to apply valuation adjustment and normalization adjustments.

The term "valuation adjustment" generally is recognized within the valuation profession as an umbrella term. Often, the term is used to describe adjustments applied to the initial result of a valuation process in order to arrive at the desired level of value based on the ESOP ownership interest.

The generally accepted levels of value regarding the stock of a sponsor company typically are categorized as one of the following:

1. Controlling ownership basis—that is, exercisable, voting control, generally on a marketable basis
2. Noncontrolling ownership basis—that is, the absence of voting control, generally on marketable basis[3]

Unlike the illiquidity inherent in the stock of most private (i.e., nonpublic) companies, the "put" right attached to the ESOP stock of a sponsor company creates a market for the security, rendering the security "generally marketable." The ultimate liquidity created by an enforceable and financially supportable put right is a topic beyond the scope of this discussion.

However, it is important to note that the put right associated with ESOP stock of a financially viable sponsor company typically results in a significant reduction, or even elimination, of the discount for lack of marketability that otherwise would be applied to estimate the FMV of the stock of a private company.

Another frequently recurring valuation adjustment consideration relates to whether nonoperating assets (e.g., excess working capital, nonoperating real estate, litigation awards) or liabilities (e.g., debt on nonoperating assets, litigation claims) exist at a particular valuation date. If so, such items typically are added to (i.e., nonoperating assets) or subtracted from (i.e., nonoperating liabilities) the estimated operating value of the sponsor company to conclude the final total value of the sponsor company equity.

Another analyst decision in all business valuations is whether to normalize a company's historical financial statements.

While the *valuation adjustments* previously discussed are made to preliminary indications of the value of a sponsor company to arrive at the final conclusion of value, *normalization adjustments* typically are made to the reported financial statements of the sponsor company to develop a normal, or reasonable, expectation regarding the sponsor company's financial position and operating results.

Financial statement normalization involves adjusting the sponsor company's historical and prospective financial statements for the impact of recognized accounting items that are determined not to reflect the normal, ongoing operating performance of the sponsor company.

Adjustments often should be made to a company's reported financial results to develop a more accurate estimate of the long-term earning capacity of the sponsor company. Typical adjustments include those for extraordinary and/or nonrecurring items, which may understate or overstate the reported results of normal operations, and any income or expense relating to nonoperating assets.

The resulting cash flow should represent the normalized cash flow that stakeholders (i.e., debt and equity investors) reasonably could expect the sponsor company to generate in future operating periods.

Depending on the sponsor company, there can be a significant difference between operating results reported in historical financial statements and the adjusted/normalized operating results, thereby significantly affecting the estimated value of the sponsor company and its underlying stock.

Financial statement normalization can provide a financial adviser with a clearer picture of recurring expenses, revenue, and cash flow, and a sound basis for comparing the operating results of the sponsor company with the operating results of guideline companies and industry metrics.

Additionally, a rational and well-executed normalization process can provide a solid foundation for developing future performance expectations for the sponsor company and understanding the sponsor company's risk exposures.

In addition to considering extraordinary and/or nonrecurring items, a financial adviser may need to consider normalization adjustments relating to discretionary expenditures. The necessity for and appropriateness of discretionary expenditure adjustments generally is dependent on the level of ownership control the ESOP has over the sponsor company.

However, this statement is only true if an ESOP trustee is (1) acting as controlling shareholder and (2) acting independently from the employer corporation owners/decision makers.[4]

Careful scrutiny should be given to potential normalization adjustments, as such adjustments can exert a material impact on the estimated value of the sponsor company and underlying ESOP shares.

As previously discussed, ESOP transactions are measured by the "adequate consideration" standard. As a result, an overstated or understated ESOP valuation can plague an ESOP sponsor company as ESOPs determined to have paid more than adequate consideration when buying, or receiving less than adequate consideration when selling, can result in serious financial ramifications for the parties to the transactions.

Additionally, ESOP sponsor company valuations ultimately determine the value of ESOP participant retirement accounts. Therefore, a financial adviser

should carefully consider and adequately support any normalization adjustments.

The remaining sections of this discussion focus on the considerations a financial adviser makes when identifying and quantifying normalization adjustments for sponsor company stock valuations. Many of the considerations identified are also relevant in non-ESOP valuation contexts.

Valuation adjustment (i.e., ownership control and investment marketability) considerations are discussed only to the extent they relate to, or are affected by, the financial statement normalization adjustments.

Financial Statement Normalization Adjustments

It is important to note that when completing a business valuation, there are certain normalization adjustments that a financial adviser should consider regardless of:

1. who owns the stock subject to valuation or
2. what level of ownership (i.e., controlling or noncontrolling status) is represented by the subject ownership interest.

These adjustments include unusual or nonrecurring income and expense items. They should be addressed to accurately reflect the expected financial performance and, ultimately, the value, of the sponsor company.

A financial adviser should consider when and how to make financial statement adjustments when completing ESOP sponsor company valuations. Normalization adjustments typically include those for extraordinary and/or nonrecurring items.

The Financial Accounting Standards Board ("FASB") provides guidance in determining such items. According to the FASB Accounting Standards Codification ("ASC") topic 225, an extraordinary item is one that is both:[5]

> Unusual in nature—the underlying event or transaction should possess a high degree of abnormality and be of a type clearly unrelated to, or only incidentally related to, the ordinary and typical activities of the entity, taking into account the environment in which the entity operates.
>
> Infrequent in occurrence—the underlying event or transaction should be of a type that would not reasonably be expected to recur in the foreseeable future, taking into account the environment in which the entity operates.

One method frequently applied to identify extraordinary and/or nonrecurring items is to perform year-over-year trend analysis. As implied, trend analysis allows a financial adviser to review historical operating relationships (e.g., balance sheet accounts relative to total assets and income or expense accounts relative to total revenue) over time.

Trend analysis provides the financial adviser with an understanding of recurring, or "normal," financial and operating relationships.

Such relationships can be analyzed by comparing individual asset and liability categories with total assets, and by comparing individual revenue and expense categories with total revenue—a process typically referred to as common-size trend analysis.

However, not all normalization adjustments can be identified based on reviewing the sponsor company's historical financial statement trends as asset, liability, revenue, and expense classifications can change over time, thereby limiting the usefulness of trend analysis.

The process of identifying and estimating normalization adjustments requires informed diligence on the part of a financial adviser.

The review and analysis of the financial and operating records of the sponsor company typically is supplemented by in-depth management interviews, sponsor company site visits, independent industry and economic research, and potential consultation with experts in relevant fields of specialization.

Such due diligence often provides the following:

1. A clearer picture of what can be considered "normal" operations for the sponsor company
2. A solid foundation for any normalization adjustments ultimately incorporated in the valuation analysis

A noncomprehensive list of categories of typical normalization adjustments includes the following:

- Nonrecurring revenue/expense items
- Separation of operating and nonoperating items
- Change of accounting or generally accepted accounting principles ("GAAP") effects on financial statements

The following discussion provides a more in-depth explanation of the above-listed categories.

Nonrecurring Revenue/Expense Adjustments

The income statement includes the economic impact of all the reportable revenue and expense events that took place during an accounting period. However, there may be some events that occurred that may not be part of the normal course of business.

A financial adviser should carefully consider the likelihood of the recurrence of the events and determine whether it is necessary to adjust the reported financial statement results to produce a best estimate of the sponsor company's earning power.

Although nonrecurring items have cash flow consequences, the focus of income normalization adjustments is to provide insight into the core operations of the sponsor company.

A financial adviser may add or subtract nonrecurring items to eliminate their impact on reported income. The normalization process should not be interpreted as "correcting" the reported financial results of the sponsor company.

The objective of the normalization process is to eliminate the impact of reported items determined to be unusual or nonrecurring in nature in order to develop a reasonable expectation regarding normal operating results for the sponsor company.

The following noncomprehensive list includes examples of nonrecurring revenue/expense items that may be present in ESOP sponsor company financial statements:

- Nonrecurring expenses associated with the ESOP installation
- Litigation costs, payments, or proceeds
- Unusual gains or losses on the sale of business assets
- Property loss or extraordinary expenses due to disasters such as fire, flood, hurricane, or other casualty (both physical damage and business interruptions) losses, and so forth, not covered by insurance
- Acquisition-related expenses
- Restructuring-related expenses
- Severance payments
- Nonrecurring bad debt expense, such as the expense associated with the write-down of a note receivable

Certain nonrecurring items may have income tax and/or regulatory consequences. It is important for the financial adviser to understand these relationships and make appropriate adjustments for the related consequences.

Separation of Operating and Nonoperating Items

It is typical for private companies to own nonoperating assets—assets that are not required for ongoing business operations. Although nonoperating assets may provide an income stream, this income stream typically would not represent a normal part of business operations. The liquidation of such assets would not, in theory, impair ongoing business operations.

For example, it is not uncommon for a private company to hold real estate for investment purposes. If such real estate generates rental or lease income which is not central to the operations of the business, this income should be excluded from normalized earnings.

If a financial adviser is applying the market approach to estimate value, it would be reasonable to consider eliminating any material nonoperating assets from the total asset base of the sponsor company (assuming the asset base is incorporated directly in the market approach analysis).

Associated with the removal of nonoperating assets from the asset base of the sponsor company, the financial adviser should normalize the reported income of the sponsor company by eliminating any reported income and expense attributable to the nonoperating asset.

Ideally, such financial statement adjustments are made early enough in the valuation process to allow for the impact of such adjustments to be considered in trend and financial statement ratio analysis. This is particularly important if such analyses are used to select guideline publicly traded companies and develop pricing multiples.

It is important to note that some level of normalization process may also be appropriate with regard to the reported financial results of selected guideline companies (included in the guideline publicly traded company method or the guideline merged and acquired company method).

Normalizing financial statements typically facilitates a better comparison of operating results among the subject sponsor company and the guideline companies.

If the financial adviser removes income associated with nonoperating assets from the historical and/or prospective operating results of the sponsor company, the value of the related nonoperating assets (less any associated debt) should be added to the total indicated operating equity value of the sponsor company (after consideration of any related relevant valuation adjustments such as a discount for lack of control, when appropriate).

Accounting/GAAP Adjustments

A financial adviser should consider making accounting/GAAP normalization adjustments. Comparability is an important consideration in business and stock valuations. Financial statements issued over time that were prepared using the same accounting practices and reported in a similar fashion are considered to be comparable.

Financial statement comparability can become challenging when companies employ a different set of accounting practices for internal bookkeeping and financial statement reporting purposes. This statement is true even for companies that prepare their financial statement in accordance with GAAP.

Unlike the financial statement reporting practices of large public companies, many closely held companies' financial statements are not audited or prepared in accordance with GAAP.

Therefore, the financial adviser often evaluates certain reported items and makes appropriate adjustments to address the impact of differences resulting from alternative accounting practices. Normalization adjustments implemented to address the impact of different accounting practices allow for easier comparison of two or more companies and/or comparison to industry metrics.

One accounting adjustment is to account for differences in inventory accounting methods. These differences include adjusting for the impact of:

1. utilizing the first-in, first out ("FIFO") inventory accounting method versus the last-in, first-out ("LIFO") method and
2. inventory write-down and write-off policies.

The different inventory accounting methods can significantly affect the value of reported inventories, which directly influence cost of goods sold and earnings, and thus the value of the company.

Therefore, for consistency purposes, when implementing the market approach, the financial adviser should consider adjusting the earnings and asset values to the same inventory accounting method that the guideline companies employ. This procedure can be accomplished by using information provided in the financial statements.

Additional items that may be subject to accounting method normalization adjustments include the following:[6]

- Depreciation methods and schedules
- Depletion methods and schedules
- Allowance for doubtful accounts
- Adequacy or deficiency of liabilities (e.g., pension termination liabilities, deferred income taxes, and unrecorded payables)
- Treatment of intangible assets (e.g., leasehold interest)
- Policies regarding the capitalization or expensing of various payments
- Timing and recognition of revenue and expenses (e.g., contract work, installment sales, sales involving actual or contingent liabilities, and prior period adjustments)
- Net operating losses carried forward
- Adequacy or deficiency of assets (e.g., excess or deficient net working capital)
- Discontinued operations

ESOP-Specific Normalization Adjustments

There are some typical ESOP-specific normalization adjustments a financial adviser should consider when developing a valuation of a sponsor company. These considerations include adjustments relating to the impact of (1) stock appreciation rights ("SARs") and phantom stock and (2) ESOP contribution expense.

SARs and Phantom Stock

For some ESOP companies, a component of the overall executive compensation scheme is a benefit represented by stock-based incentives. Stock-based compensation is the practice of compensating key employees based on the sponsor company stock price. This is a typical practice in public companies and a prevalent issue for private companies that are competing with public companies for talent.

The primary purpose of stock-based compensation plans is to align the economic interests of the shareholders with the managers of the sponsor company. Stock-based compensation can take the form of incentive stock options, nonqualified stock options, restricted stock, SARs, and phantom stock.

SARs and phantom stock represent two common types of synthetic equity. These compensation components are deemed synthetic equity because no actual ownership interest is transferred to executives in these plans.

The employee is awarded based on the appreciation of sponsor company stock on which the compensation plans are based. Plans are settled in cash without diluting the ESOP's equity interest in the sponsor company.

For the purpose of financial reporting, SARs and phantom stock plans are forms of deferred compensation. The related benefits are accrued as bonus expenses in the operating statement of the

sponsor company through the eligibility period that the eligible employee can exercise the awards.

To ensure the bonus expense is reflected in the historical and prospective financial statements, the financial adviser may obtain and review the deferred bonus agreement.

The financial adviser may make normalization adjustments to both the historical and the prospective financial statements if it is discovered that the deferred bonus costs are not appropriately included in the financial statements.[7]

ESOP Contribution Expense

A financial adviser should understand the annual ESOP contribution and the accounting associated with it before determining whether to make an adjustment.

A leveraged ESOP trust is funded by borrowing money to purchase shares in the sponsor company. Typically, a loan is established with the participation of both the sponsor company and the ESOP. Sponsor companies are required by GAAP to record the debt on the balance sheet of the plan sponsor as negative equity in an account titled "unearned ESOP shares."[8]

This account represents the shares that are held as collateral for the ESOP debt. Within the ESOP, these shares are held in a suspense account.

The company makes annual tax-deductible contributions to the ESOP for both the principal and interest of the ESOP loan. As the loan is amortized, the sponsor company credits (reduces) the unearned ESOP shares account at the historical cost of the sponsor company stock.

An account called contribution expense is then debited (charged) as an expense equal to the FMV of the shares being released from the suspense account.

As the sponsor company stock increases in value, the ESOP contribution expense increases as well.

Contribution expense can vary significantly for many reasons, which can be challenging for a financial adviser when assessing the reasonableness of reported contribution expense. It may be appropriate to eliminate the reported ESOP contribution expense and replace it with a market-derived, or industry-average, retirement benefit level in order to normalize operating results.

Any adjustment to reported contribution expense should make economic sense for valuation purposes. There are certain factors a financial adviser should consider, including the following:

- Leveraged ESOPs generally report higher-than-normal contribution expenses for several reasons. It is common for a leveraged ESOP to contribute more than required to cover principal and interest payments in order to pay down debt at an accelerated rate.

  Without adjustment, this practice can exert a direct impact on the equity price due to the related reduction in earnings. Furthermore, required contribution levels can limit the sponsor company's ability to reduce cash contributions in the event the sponsor company stock price increases.

- The maturity of the ESOP should be considered. Newer ESOPs may experience greater fluctuations in stock price, while more mature ESOPs may face significant repurchase obligations, each having their own unique impact on contribution expense.
- The early departure of participants can impact contribution expense as significant redemptions can result in increased contribution expense.
- A repurchase study may provide insight to the level of contribution expense that is expected in the future.

In addition to evaluating the characteristics of a sponsor company's ESOP contribution expense, a financial adviser should interview management regarding expected contribution levels. This procedure may help provide insight into the specifics of ESOP contributions that are not obvious from analyzing financial statements alone.

Control-Related Normalization Adjustments

If an ESOP owns a controlling position in the sponsor company, and certain normalization adjustments are deemed appropriate, it is important to consider how the normalization adjustments may affect the level of valuation adjustments incorporated later in the valuation process.

For example, any adjustments to normalize discretionary expenses that result in an increase in earnings and an ultimate increase in value should be taken into consideration when estimating a control premium that might be applied as a valuation adjustment. This circumstance is true in valuations of both ESOP-owned sponsor company stock and any other type of controlling equity ownership interest.

In the context of an ESOP, control-related normalization adjustments should only be made if the ESOP trustee is willing to (1) act as a controlling shareholder and (2) act independently from the employer corporation owners/decision makers.

There is a spectrum of ownership control ranging from (1) absolute operational control to (2) a total lack of any operational control.

In some cases, the determination of ownership control is straightforward; however, the assessment of ownership control, from an operational basis, is not always a clear-cut issue. The degree of control inherent in an ESOP-owned block of sponsor company stock may fall anywhere along the ownership control continuum and may be affected by a number of factors.

To determine the degree of control, a financial adviser should consider the following:

1. The percentage of outstanding shares owned by the ESOP
2. The rights inherent in the ESOP-owned block of sponsor company stock
3. The inherent control in the remaining sponsor company stock that is not owned by the ESOP trust

Ownership control can depend on several factors, including the following:[9]

- Which party controls the sponsor company board of directors
- Which party controls the sponsor company CEO and other executive management positions
- What are the key contractual provisions in the ESOP trust documents and sponsor company stock purchase agreement
- State corporation laws in the state where the sponsor company is incorporated

When assessing the level of ownership control inherent in an ESOP ownership interest, it is important for the financial adviser to obtain and review relevant sponsor company documents. Such a review is important because the application of control-related valuation adjustments does not always relate to whether the ESOP trust owns a noncontrolling interest (less than 50 percent ownership of the sponsor company's outstanding shares).

There are ESOPs that enjoy contractually granted elements of ownership control even if the ESOP owns a noncontrolling interest in the sponsor company equity.

In addition to the usual records required for a valuation engagement, the financial adviser may obtain and review the ESOP document, the ESOP trust document, any ESOP loan documents, the relevant stock purchase agreement, and relevant Forms 5500.

When valuing a controlling ownership interest for ESOP purposes, similar to such a valuation completed for non-ESOP purposes, the financial adviser should understand the facts and circumstances specific to the sponsor company to determine the relevance and level of valuation adjustments.

A noncomprehensive list of normalization adjustments that typically relate to a controlling owner's discretionary expenditures are as follows:[10]

- Excess shareholder/employee compensation
- Employee compensation expense related to less than fully productive shareholder friends and relatives who may be included on the sponsor company payroll
- Shareholder-related personal expenses that are paid by the sponsor company
- Above-market rents/rates paid by the sponsor company for the lease of controlling shareholder-owned real estate or other assets, or the purchase of controlling shareholder-provided services or products

Financial advisers may consider an adjustment for excess compensation of key employees. In private companies, compensation to owners and managers may be based on the desires of the owner rather than the value of the services performed by those individuals.

In an ESOP sponsor company valuation, it is only appropriate to make a compensation adjustment if the compensation policies are likely to be changed. If the higher level of compensation is expected to continue into the future, the ESOP sponsor company valuation should reflect the ongoing compensation practices.[11]

In addition to owner/employee compensation, owners may take out what normally would be considered profits in the form of compensation and personal expenses. Typical examples may include personal car expenses, travel and meal expenses, and certain professional fees. These expenses generally benefit the owners and deviate from the costs required to operate the business.

The financial adviser should consider if employee compensation expense includes any employees who are on the sponsor company's payroll but do not actively participate in the operations of the business. Often there are family members of the

owners who receive some level of compensation from a company without employment capacity. In these situations, compensation expenses should be adjusted.

In the valuation of a controlling ownership interest, discretionary expenditures typically are adjusted to a market-derived, or industry-average, expense level. The normalization of discretionary expenditures does not imply that the hypothetical willing buyer will not make any discretionary expenditures. Rather, the procedure recognizes that the buyer and seller may not make the same discretionary expenditures.

However, it would be rare for an ESOP sponsor company to report discretionary expenses or related-party expenses to the detriment of the ESOP, particularly if the ESOP maintained ownership control or was under the oversight of an independent trustee.

In the valuation of a noncontrolling interest, the financial adviser may not make normalization adjustments for discretionary expenditures. This is because the noncontrolling block of sponsor company stock cannot affect the type/amount of a controlling shareholder's discretionary expenditures.

Therefore, the buyer of the noncontrolling block of sponsor company stock will not have control over the type/amount of the controlling shareholder's discretionary expenditures.

It is important to note that although a financial adviser should consider the need to normalize discretionary expenditures, in theory this should not be an issue in an ESOP sponsor company valuation based on the existence of a trustee(s) who maintains the responsibility of protecting the ESOP's economic interests.

In some instances, the ESOP administrators and the named fiduciary (i.e., the party primarily responsible for the plan) are representatives of the sponsor company. A trustee who is simply taking directions from sponsor company representatives is vastly different than an independent trustee who makes independent decisions.

If the ESOP trustee is not independent, then the company (through its board of directors) has the primary fiduciary duty to act in the best interest of the ESOP participants.

Summary and Conclusion

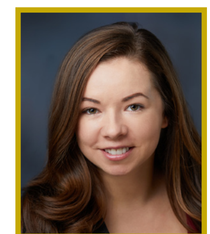
A well developed valuation of a sponsor company completed for ESOP purposes typically includes an assessment of historical operating results. This assessment frequently results in a "normalization" process, during which the impact of nonoperating assets and liabilities and unusual or nonrecurring income and expense items are adjusted from the historical financial results of the sponsor company.

This normalization process is appropriate because it enables a potential investor to assess the true and continuing economic earning capacity of the sponsor company. The experienced financial adviser should be well versed in the normalization process.

A credible sponsor company value conclusion can be developed if the valuation is based on a supportable level of expected economic earnings for the sponsor company, typically achieved through a diligent normalization process.

Notes:

1. "Employee Ownership by the Numbers," National Center for Employee Ownership, www.nceo.org (September 19, 2019).
2. "What Every Valuation Analyst Should Know About Employee Stock Ownership Plans (ESOPs)" (white paper), American Institute of Certified Public Accountants, www.aicpa.org/content/dam/aicpa/interestareas/forensicandvaluation/resources/downloadabledocuments/esop-white-paper-1907-02158.pdf (2019).
3. Robert F. Reilly and Robert P. Schweihs, *Guide to ESOP Valuation and Financial Advisory Services*, 2nd ed. (Chicago, IL: Willamette Management Associates, 2006), 154.
4. Ibid., 152.
5. FASB Accounting Standards Codification Topic 225-20, Income Statement—Extraordinary and Unusual Items (Norwalk, CT: Financial Accounting Standards Board, 2015).
6. Shannon P. Pratt and Alina V. Niculita, *Valuing a Business: The Analysis and Appraisal of Closely Held Companies*, 5th ed. (New York: McGraw-Hill, 2008), 131–32.
7. "What Every Valuation Analyst Should Know About Employee Stock Ownership Plans (ESOPs)."
8. Ibid.
9. Reilly and Schweihs, *Guide to ESOP Valuation and Financial Advisory Services*, 150.
10. Ibid., 152.
11. Pratt and Niculita, *Valuing a Business*, 817.



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