ESOPs & Valuation

Robert Reilly

Robert Reilly has been a managing director of Willamette Management Associates for over 20 years. Willamette Management Associates provides business valuation, forensic analysis, and financial opinion services for transaction, financing, taxation, bankruptcy, litigation, and planning purposes. Robert has provided ESOP sponsor company stock purchase/sale financial advisor opinions and ESOP sponsor company annual stock valuations for over 30 years. Robert has testified in federal court on numerous occasions with regard to ESOP transaction ERISA compliance matters. Robert recently testified before the DOL (on behalf of the AICPA) with regard to ESOP valuation analyst fiduciary issues.

Robert holds a BA in economics and an MBA in finance, both from Columbia University. He is a certified public accountant, accredited in business valuation, and certified in financial forensics. He is also a chartered financial analyst, chartered global financial accountant, certified management accountant, and certified business appraiser.

Robert is a member of the AICPA forensic and valuation services executive committee (FVSEC).

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Marilee Lau

Marilee provides consulting services and teaches various educational programs on accounting and auditing for employee benefit plans. Before retiring in 2009, Marilee was the National Partner in Charge of KPMG's Employee Benefit Plan Audit Practice.

Marilee Lau is a founding member and former Chair of the AICPA Employee Benefit Plan Audit Quality Center's Executive Committee which was established in 2004. Marilee is currently the AICPA's representative to the DOL's ERISA Advisory Council. She has served on the AICPA's Employee Benefits Plans Experts Panel and is the current chair of the EBP Audit Guide Overhaul Task Force.

Marilee is also on the Advisory Board for the Bureau of National Affairs Pension & Benefits Reporter which provides input on various pension issues and is currently serving on the Accountants Committee for the International Foundation of Employee Benefit Plans.

She is a member of the AICPA, California Society of CPA's, and the International Foundation of Employee Benefit Plans and a frequent speaker for numerous professional conferences and programs. She is a graduate of Santa Clara University with a BS in economics and an MBA in accounting.

Marcus Aron

Mr. Aron has over twenty years of experience in working with audits of ERISA-covered plans. He is responsible for the day-to-day implementation of EBSA's CPA Firm Inspection Program, providing technical assistance to plan filers and plan professionals, and providing ERISA-related accounting and auditing expertise within EBSA. Mr. Aron is a certified public accountant and holds a B.B.A. degree with a major in accounting from the College of William and Mary in Virginia.

ESOP Valuations

- What the DOL has found
- Auditor's responsibilities and related auditing standards
- ESOP Valuation Considerations from the Appraiser's point of view
- Q&A

ESOP Valuation Issues

- 59 – ESOP audits reviewed by the DOL
- 13 – full-scope audits, the CPA failed to review the appraisal of the employer stock
- 7 – limited-scope audits,
  - failure to obtain a certification from a "qualifying" entity, or
  - Failure to obtain a certification that was consistent with the plan's reporting period

ESOP Valuation Issues

- **Auditors have not adequately audited the fair value**
  - Reviewing qualifications of the appraisal firm
  - Reviewing the appropriateness of the assumptions used
  - Only work performed was to obtain the valuation report from management and agree to the financial statements
- **Inadequate documentation**
  - No review indicated or no documentation that the valuation report was reviewed with management
  - No review of the assumptions for reasonableness (business growth, discount rates, profitability)

Auditor Responsibilities

- **Using the work of an expert**
  - SAS 73 addresses the auditor's responsibility relating to the use of an expert
  - Does the expert have the necessary competence, capabilities, and objectivity
    - Personal experience
    - Discussions with the specialist
    - Knowledge of the specialist's qualifications, memberships in a professional body or industry association

Evaluation of the Work of the Specialist

- Making inquiries of the specialist
- Reviewing working papers and reports of the specialist
- Performing corroborative procedures, such as
  - Examining published data from reputable, authoritative sources
  - Confirming relevant matters with third parties, if applicable
  - Performing detailed analytical procedures
  - Performing calculations
- Engaging in discussions with another specialist with relevant experience
- Discussing the report with management

Reasonableness of the Work of the Specialist

- Presented in a manner consistent with any standards of the profession or industry of the specialist
- Clearly expressed the scope of the work performed and the standards applied
- Based on an appropriate period and taking into account subsequent events when relevant
- Based on appropriate consideration of errors or deviations encountered by the specialist

Other Responsibilities

- Auditor has sole responsibility for the opinion
  - Can't delegate to specialist
- Auditor concludes that the work of the specialist is adequate for the auditor's purposes
- Adequate audit evidence
- Verifying the source data that is significant to the work of the specialist
  - Reasonableness of the procedures performed and assumptions used

ESOP Employer Stock Valuation Considerations

1. Different types of ESOP-related financial advisory opinions
2. ESOP employer stock valuation and fair market value
3. Content of the employer stock valuation report
4. Qualifications of the employer stock business appraiser
5. Generally accepted valuation approaches and methods
6. ESOP-specific valuation considerations
7. Reviewing the employer stock valuation report
8. Business valuation professional credentials and professional standards

Different Types of ESOP-related Financial Advisory Opinions

1. **Transaction fairness opinion – issued by an independent financial advisor to the ESOP trustee related to a pending purchase or sale of the sponsor company stock.**
2. **Employer stock valuation – issued by an independent business appraiser to the ESOP trustee related to regulatory compliance and plan administration purposes.**

ESOP Transaction Fairness Opinions

1. **Fairness opinions are typically prepared when**
   - the ESOP makes an initial purchase of sponsor company stock
   - the ESOP makes a subsequent purchase of sponsor company stock
   - the ESOP receives an offer to purchase its sponsor company stock
   - there is a tender offer to purchase all of the sponsor company stock

ESOP Transaction Fairness Opinions (cont.)

2. **The fairness opinion opines that the proposed transaction is fair to the ESOP participants**
   - the ESOP will not pay more than adequate consideration
   - the ESOP will not receive less than adequate consideration
   - the deal structure is fair to the ESOP in absolute terms
   - the deal structure is fair to the ESOP in relative terms
   - the deal structure is not more beneficial to other transaction participants than it is to the ESOP
3. **The ESOP trustee will consider the fairness opinion in deciding whether to accept or not accept the proposed transaction.**

ESOP Employer Stock Valuations

1. **A closely held ESOP sponsor company must have an employer stock valuation performed at least annually.**
2. **The business appraiser will estimate the fair market value of the sponsor company stock. The business appraiser will recommend the fair market value to the ESOP trustee.**

ESOP Employer Stock Valuations (cont.)

3. The ESOP trustee will conclude the adequate consideration for the employer stock. Adequate consideration is defined by ERISA as "the fair market value of the asset as determined in good faith by the trustee or named fiduciary. . . pursuant to the terms of the plan and in accordance with regulations promulgated by the Secretary of Labor."

ESOP Employer Stock Valuations (cont.)

4. So, the business appraiser estimates fair market value.

   The trustee considers the terms of the plan and applies good faith and judgment to conclude adequate consideration.
5. The ESOP uses the employer stock valuation to allocate shares to plan participant accounts, to redeem stock that is put back to the sponsor company when the participant retires, and for other administrative purposes.

ESOP Employer Stock Fair Market Value

- **Consistent with IRS Revenue Ruling 59-60, the 1988 DOL proposed regulation relating to the definition of adequate consideration define the term fair market value as follows:**

  the price at which an asset would change hands between a willing buyer and a willing seller when the former is not under any compulsion to buy and the latter is not under any compulsion to sell, and both parties are able, as well as willing, to trade and are well informed about the asset and the market for such asset.

Contents of the Employer Stock Valuation Report

- **The business appraiser should consider the following factors in the employer stock valuation. The DOL expanded the Revenue Ruling 59-60 list of closely held business valuation factors to conclude the following list:**
  1. The nature of the business and the history of the enterprise from its inception,
  2. The economic outlook in general, and the condition and outlook of the specific industry in particular,
  3. The book value of the securities and the financial condition of the business,
  4. The earnings capacity of the company,
  5. The dividend-paying capacity of the company,

Contents of the Employer Stock Valuation Report (cont.)

6. Whether or not the enterprise has goodwill or other intangible value,
7. The market price of securities of corporations engaged in the same or a similar line of business, which are actively traded in a free and open market, either on an exchange or over-the-counter,
8. The marketability, or lack thereof, of the securities. Where the plan is the purchaser of the securities that are subject to "put" rights and such rights are taken into account in reducing the discount for lack of marketability, such assessment shall include consideration of the extent to which such rights are enforceable, as well s the company's ability to meet its obligations with respect to the 'put' rights (taking into account the company's financial strength and liquidity)

Contents of the Employer Stock Valuation Report (cont.)

a. Whether or not the seller would be able to obtain a control premium from an unrelated third party with regard to the block of securities being valued, provided that in cases where a control premium is taken into account:
   i. Actual control (both in form and in substance) is passed to the purchaser with the sale, or will pass to the purchaser within a reasonable time pursuant to a binding agreement in effect at the time of the sale, and
   ii. It is reasonable to assume that the purchaser's control will not be dissipated within a short period of time subsequent to acquisition.

Who Should Perform the Employer Stock Valuation Analysis?

- **The appraiser is not considered independent unless the plan fiduciary selects the appraiser, controls the relationship between the appraiser and the fiduciary, and has the right to terminate the services of the appraiser. However, the plan sponsor may pay the appraiser's fee.**
- **An ESOP fiduciary must retain an independent appraiser as that term is defined by Internal Revenue Code Section 170. Such an independent appraiser:**
  1. is not a party to the transaction, is not related to any party to the transaction, is not married to any person with a relationship to the transaction, is not regularly used by any of the parties to the transaction and who does not perform a majority of appraisals for these persons.

Who Should Perform the Employer Stock Valuation Analysis? (cont.)

2. holds himself or herself to the public as a valuation practitioner or performs appraisals on a regular basis,
3. is qualified to make appraisals of the type of property being valued including, by background, experience, education, and memberships, if any, in professional associations,
4. understands that an intentionally false or fraudulent over-statement of value may subject the valuation practitioner to a civil penalty, and
5. receives an appraisal fee that is not based upon a percentage of the appraised value of the property.

Employer Stock Valuation Report – Required Documentation

- **The 1988 DOL proposed regulation requires that the employer stock valuation report include the following information:**
  1. A summary of the qualifications to value assets of the type being valued of the person making the valuation,
  2. A statement of the asset value, a statement of methods used in determining that value, and the reasons for the valuation in light of those methods,
  3. A full description of the asset being valued,
  4. The factors taken into account in making the valuation, including any restrictions, understandings, agreements, or obligations limiting the use or disposition of the property,
  5. The purpose for which the valuation was made,

Employer Stock Valuation Report – Required Documentation (cont.)

6. The relevance or significance accorded to the valuation approaches taken into account,
7. The effective date of the valuation, and
8. In cases where a valuation report has been prepared, the signature of person(s) making the valuation and the date the report was signed.

Generally Accepted Business Valuation Approaches and Methods

- **The employer stock valuation report will include some combinations of the following approaches and methods:**
  1. income approach
     - discounted cash flow method
     - direct capitalization method
  2. market approach
     - guideline publicly traded company method
     - guideline merged and acquired company (transaction) method
     - backsolve method
  3. asset-based approach
     - asset accumulation method
     - adjusted net asset value method

Employer Stock Value – Valuation Synthesis and Conclusion

1. **All of the value indications should first be concluded on a consistent level of value—i.e., the level of value appropriate for the subject equity interest.**

   These level of value considerations include:
   - Is the ESOP-owned stock marketable or nonmarketable?
   - Is the ESOP-owned stock controlling or noncontrolling?
2. **After the various value indications are concluded on the same level of value, the analyst will weight the various indications in order to conclude a final value indication. This weighting can be either –**
   - quantitative or
   - qualitative

ESOP-Specific Considerations Common to Employer Stock Valuations

1. Many sponsor companies have preferred stock or convertible preferred stock in the capital structure. These securities have to be valued in the "waterfall" or residual valuation process of:
   - total invested capital value
   - – long-term debt value
   - = total equity value
   - – preferred stock value
   - = common stock value
2. Many sponsor companies have elected S corporation income tax status. S corporation status both increases sponsor company value (no federal income taxes) and decreases sponsor company value (increased lack of marketability).

ESOP-Specific Considerations Common to Employer Stock Valuations (cont.)

3. The plan participant put option reduces the typical discount for lack of marketability in the closely held sponsor company.
4. The ESOP may have contractual rights that disproportionately affect its control of the sponsor company. Such rights affect the ESOP-owned employer stock.
5. As the ESOP matures, the sponsor company repurchase obligation can have an increasingly negative impact on the employer stock value.

ESOP-Specific Considerations Common to Employer Stock Valuations (cont.)

6. A "floor price protection" or other plan term or condition can positively or negatively impact the employer stock value.
7. The treatment of the ESOP stock acquisition debt (as a liability of the sponsor company or of the plan) can affect the employer stock value.

Impact of ESOP-Specific Considerations on the Employer Stock Value

1. Often, there is no absolute correct or incorrect treatment of the ESOP-specific considerations on the sponsor company stock valuation.
2. The impact of each consideration can be quantified within each individual valuation approach or method.
3. Alternatively, the impact of each consideration can be quantified as a single discount or premium adjustment after the valuation synthesis but before the value conclusion.
4. The employer stock valuation should be explicit as to (a) its recognition of each ESOP-specific factor and (b) its quantification of each ESOP-specific factor.

Reviewing the Employer Stock Valuation Report

- **An effective employer stock valuation report should:**
  - explain the business valuation assignment
  - describe the subject block of employer securities and the subject bundle of legal rights related to those securities
  - explain the selection/rejection of all generally accepted business valuation approaches and methods
  - explain the selection and application of all specific analytical procedures
  - describe the business appraiser's data gathering and due diligence procedures
  - list all documents and data considered in the valuation analysis
  - include in the employer stock valuation report copies of all documents that were specifically relied on

Reviewing the Employer Stock Valuation Report (cont.)

- summarize all of the qualitative analyses performed
- include schedules and exhibits of all quantitative analyses performed
- avoid any unexplained or unsourced valuation variables or assumptions (i.e., avoid “leap of faith” variables)
- document the consideration of all ESOP-specific valuation factors and variables
- allow for the replicability of all employer stock valuation analyses
- fully explain the valuation synthesis and value conclusion process and procedures

Reviewing the Employer Stock Valuation Report (cont.)

- encourage the reader's confidence in the employer stock valuation report
  - the valuation report should be clear, convincing, and cogent
  - the valuation report should be well-organized, well-written, and well-represented
  - the valuation report should be free of grammar, punctuation, spelling, and mathematical errors

Business Appraiser Professional Qualifications and Professional Standards

1. **There are several organizations that grant professional standards to business valuation professionals, including:**
   - American Institute of Certified Public Accountants – ABV – accredited in business valuation
   - Institute of Business Appraisers – CBA – certified business appraiser
   - National Association of Certified Valuation Analysts – CVA – certified valuation analyst
   - American Society of Appraisers – ASA – accredited senior appraiser

Business Appraiser Professional Qualifications and Professional Standards (cont.)

2. **There are various sets of professional standards that business valuation professionals comply with:**
   - AICPA Statement on Standards for Valuation Services (SSVS)
   - IBA business valuation standards (conforms to SSVS)
   - NACVA business valuation standards (conforms to SSVS)
   - ASA business valuation standards
   - USPAP – Uniform Standards of Professional Appraisal Practice (The Appraisal Foundation)
3. **When reviewing an employer stock valuation report, consider:**
   - the professional qualifications of the business appraiser
   - the professional standards that the valuation report purports to comply with

ESOP Employer Stock Valuation Considerations – Summary and Conclusion

1. **Many parties rely on employer stock valuations, including the trustee, the plan participants, the sponsor company, the financing sources, and regulatory and taxing authorities.**
2. **These parties should recognize the differences between an employer stock valuation report and a financial advisory opinion prepared for other purposes.**
3. **These parties should recognize that there are generally accepted valuation approaches, methods, and procedures**

ESOP Employer Stock Valuation Considerations – Summary and Conclusion (cont.)

4. These parties should recognize that there are ESOP-specific factors that should be considered in the employer stock valuation.
5. These parties should recognize that there are general contents to an employer stock valuation report.
6. And, these parties should recognize that there are business valuation professional credentialing organizations and promulgated valuation professional standards.

ESOP Valuation and Financial Advisory Due Diligence Checklist

Robert F. Reilly
Steven D. Garber

This article presents a checklist listing the most common procedures that are performed during an ESOP valuation or a financial advisory due diligence analysis leading to a fairness opinion in an ESOP securities purchase transaction. The checklist is presented as a useful reminder to ESOP valuation practitioners, ESOP fiduciaries, and other ESOP advisors. It may be useful in conducting an ESOP valuation or a financial advisory analysis. It may also be helpful in the review and assessment of an ESOP valuation report or a financial advisor's analysis and opinion. However, the checklist should not be used as a substitute for the experience and judgment of the valuation practitioner or the financial advisor.

The Employee Retirement Income Securities Act (ERISA) requires employee stock ownership plans (ESOPs) to pay no more than adequate consideration when investing in employer securities. These employer securities include both common stock and convertible preferred stock.

The adequate consideration requirement has two general components: (1) a fair market value determination and (2) a good-faith process. This means that the ESOP trustees and fiduciaries must determine in good faith the fair market value of the employer securities. This determination must be made in compliance with certain regulations issued by the Internal Revenue Service and the United States Department of Labor (DOL).

This article presents a checklist that may be considered by ESOP valuation practitioners in conducting an ESOP securities valuation or in performing a financial advisory due diligence analysis, such as that performed before issuing a fairness opinion in an ESOP securities purchase

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transaction. This checklist may also be used by ESOP trustees and fiduciaries in their good-faith assessment of an ESOP securities valuation or of an ESOP transaction financial advisory opinion. Finally, this checklist may be considered by ESOP administrators and other ESOP advisors (attorneys, accountants, etc.) who rely on ESOP valuations.

There are many caveats associated with this checklist, as discussed below. These caveats should be carefully considered before this checklist is applied in an actual ESOP valuation or financial advisory due diligence analysis.

TRANSACTIONS INVOLVING AN OPINION OF ADEQUATE CONSIDERATION

The following types of transactions involving employer securities require the assessment of adequate consideration:

- A contribution of employer stock to the ESOP.
- A contribution of cash to the ESOP, where the cash is then used to buy employer stock (either directly from the corporation or from other shareholders).
- The purchase of employer stock from the ESOP trustee.
- The distribution of cash to former ESOP participants in place of the distribution of employer stock.
- The purchase of employer stock by the trustee from ESOP participants.

In each of these types of transactions, the ESOP trustee or fiduciary must address the issue of adequate consideration. The checklist presented in this article is intended to be useful in the assessment of adequate consideration.

VALUATION OPINIONS AND FAIRNESS OPINIONS

As part of the adequate consideration assessment, the fair market value of the employer securities must be estimated. This estimation is typically documented and reported in a valuation opinion. Some transactions involving ESOP-owned securities also involve an assessment of the fairness, from a financial perspective, of the proposed securities purchase transaction. This is particularly true in the case of multi-investor

ESOP transactions. In these cases, an independent financial advisor typically will perform a financial advisory due diligence analysis and issue a fairness opinion. The checklist presented in this article is also intended to be useful in the assessment of transactional fairness.

CAVEATS REGARDING THE CHECKLIST

It is important to consider several caveats regarding the use of any standardized valuation or financial advisory checklist.

First, the checklist should never substitute for the financial advisor's (or for the trustee's) independent judgment. Second, the following checklist is not intended to be comprehensive and all-inclusive. For example, it does not discuss every available ESOP valuation method, but only the more common ESOP valuation methods. Third, the terminology used in the checklist may have several interpretations. For example, the checklist refers only to "premiums and discounts"; the informed reader will understand that this term includes consideration of all related valuation factors, such as the discount for lack of marketability, the effects of the repurchase obligation, the discount for lack of control/premium for control, and the effects of leverage. Fourth, this checklist does not include a complete consideration of all of the aspects of a leveraged ESOP transaction or a leveraged ESOP valuation. Fifth, this checklist assumes that the appraisal subject is a security of an employer corporation for which there is no generally recognized secondary market.

Finally, this checklist should not be used to derive a quantitative score used to evaluate an ESOP valuation or financial advisory service. That is, the fact that an individual analysis did not receive a "score" of 100 does not indicate that the analysis is not in compliance with promulgated regulations and professional standards. Such an analysis may still be professional and competent, and be the appropriate basis upon which to assess adequate consideration.

Likewise, the fact that an individual analysis received a very high "score" does not necessarily indicate that the analysis was prepared in compliance with all promulgated regulations and professional standards. Such an analysis may still be lacking in professional competence and may be an inadequate basis on which to assess adequate consideration.

The checklist is just that—a handy checklist that valuation practitioners and ESOP fiduciaries can use as a procedural reminder in conducting

and assessing ESOP valuations and financial advisory opinions. The checklist may be used to document whether the requisite procedures were or were not performed. But the checklist will not evaluate the analytical quality and the professional judgment involved in the performance of the actual procedures. The checklist should not substitute for the good faith, due diligence, prudence, and professional care of the ESOP trustee or ESOP fiduciary.

88

PROCEDURAL CHECKLIST FOR THE ESOP VALUATION AND FINANCIAL ADVISORY DUE DILIGENCE PROCESS

I. Engagement Letter and/or Engagement Work Product

A. State the purpose and objective of the engagement
   1. Identify the purpose (fairness opinion, annual update, etc.)
   2. Identify the objective (estimate fair market value of ESOP ownership interest, etc.)

B. Define the appraisal assignment
   3. Identify the retaining party
   4. Identify the entity being appraised
   5. Identify the form of the subject organization (C corp., S corp., limited partnership, etc.)
      a. State of incorporation
      b. Date incorporated
   6. Identify the specific ownership interest being appraised
   7. Identify the valuation date ("as of" date of the appraisal)

C. Document the standard of value and premise of value
   8. Identify and define the appropriate standard of value (fair market value, fair value, etc.)
   9. Identify and define the appropriate premise of value—based on highest and best use considerations (value as a going concern, value in exchange, etc.)

II. Due Diligence/Collection of Data

A. Collect and review company documents and information
   10. Request financial information (typically, last five years and latest interim statements)
      a. Income statements
      b. Balance sheets
      c. Statements of cash flows
      d. Capital statements or statements of retained earnings
      e. Explanatory footnotes and supplemental disclosures to the financial statements
   11. Request a list of subsidiaries and/or financial ownership interests in other companies
      a. Relevant historical financial information

12. Request other financial information
    a. All current financial budgets and/or projections and/or forecasts
    b. Other financial schedules (depreciation, inventory, receivables, payables, open orders, production backlog, etc.)
    c. Existing contracts/leases (employment agreements, non-compete agreements, labor agreements, customer contracts, real estate leases, etc.)
    d. Amounts and description of insurance in force (key person, property/casualty, etc.)
    e. Compensation schedule for senior management and owners (salary, options, etc.)
    f. Prior valuation reports (prepared for any purpose)
    g. Schedule of dividends paid
13. Request company legal documents
    a. Articles of incorporation, bylaws, amendments, etc.
    b. Any existing buy/sell agreements, options, rights of first refusal, etc.
    c. Minutes from recent shareholders' meetings
    d. List of all stockholders
        (1) Number of shares owned by each, and/or
        (2) Number of shares owned by senior management
    e. Descriptions of all recent prior transactions of the subject stock and any recent bona fide offers to purchase the company and/or subject securities
    f. ESOP transaction documents
        (1) ESOP-related loan agreements
        (2) Stock purchase agreements
        (3) ESOP plan and trust documents
        (4) Other documents that may affect the rights of the securities
14. Request other relevant operational information
    a. History and description of the business
    b. Copies of sales/marketing materials
    c. Locations in which the company operates
    d. Major customers by annual dollar volume
    e. Major suppliers by annual dollar volume
    f. Major competitors (and size and/or market share, if available)

g. Breakdown of personnel (by department or function) and résumés of senior management
h. Descriptions of all patents, trademarks, copyrights, and other owned or licensed intellectual properties
i. Description of any contingent and/or off-balance sheet assets and liabilities
j. List of industry or trade associations, industry or trade publications, and corporate memberships of the subject business
k. Description and current appraisals (if available) of all non-operating assets of the subject business
l. Operational (for example, production) budgets and/or projections and/or forecasts

B. Conduct management interviews

15. Speak with senior management in all relevant functional areas, regarding:
    a. Historical operations and results
    b. Prospective operations and results
    c. Responsibility for functional areas
16. Discuss with senior management and/or outside legal counsel any pending or potential litigation or claims
    a. Commercial litigation
    b. Employment disputes
    c. Occupational and safety issues
    d. Environmental issues
    e. Tax disputes
    f. Other matters

C. Conduct plant/site inspections

17. Inspect representative plants and sites; consider:
    a. Capacity adequacy of existing plants, facilities, and equipment
    b. Functional and technological adequacy
18. Discuss plants and sites with management representatives; consider:
    a. Future expansion and capital investment plans
    b. Competitive effects of planned plant and facility changes

III. Economic Environment (as of Valuation Date)

A. Consider the national/international economic environment
   19. Research and analyze national/international economic environment and outlook (as appropriate)

B. Consider the regional/local economic environment
   20. Research and analyze regional/local economic environments and outlooks (as appropriate)

C. Consider the economic relationships to the performance of the company
   21. Identify significant relationships of economic performance with the performance of the company

IV. Industry Environment

A. Consider the industry in which the company operates
   22. Research and analyze the nature and history of the industry

B. Consider the current outlook for the industry
   23. Research and analyze the current outlook for the industry

V. Fundamental Position of the Company

A. Consider the subject company's capitalization and ownership
   24. Analyze all classes of stock, including:
      a. Rights, seniority, voting, etc. of each class
      b. Total outstanding shares and distribution of ownership of each class

B. Consider the subject company history and operations
   25. Review company history
   26. Review and analyze current business operations, including:
      a. Locations and markets served
      b. Products, service lines, and customer base
      c. Competition
         (1) Current and projected market size
         (2) Position of the subject company within the industry
         (3) Subject company competitive strengths and weaknesses
      d. Management and work force

e. Overall positive and negative aspects of the subject operations

C. Consider the outlook for the company

27. Review strategic plans, projections, and current business outlook

VI. Financial Statement Adjustments and Analysis

A. Make appropriate financial statement adjustments

28. Adjust inventory, as appropriate
    a. LIFO vs. FIFO
    b. Inventory write-offs and/or write-downs
29. Adjust for excessive/insufficient management compensation, as appropriate
30. Adjust for nonrecurring items, as appropriate
    a. Unusual gains/losses, insurance proceeds, nonrecurring revenues, and/or expenses, etc.

B. Perform historical financial statement analysis

31. Calculate and analyze common-size financial statements
32. Compute and analyze financial and operating ratios, including:
    a. Size
    b. Growth
    c. Liquidity
    d. Profitability
    e. Turnover/activity
    f. Leverage
33. Identify and explain any significant financial trends

C. Perform prospective financial statement analysis

34. Identify key financial variables (capacity constraints, cost/volume/profit relationships, etc.) for prospective results of operations
35. Obtain (if available) and analyze projections for prospective results of operations
36. Assess reasonableness of projections relative to historical results
37. Assess reasonableness of projections relative to industry data

VII. Valuation Analysis

A. Consider and select appropriate valuation approaches
   38. Identify and select appropriate valuation approaches (market approach, income approach, or asset approach)

B. Perform a market approach—guideline company method (also known as the publicly traded comparable company method) (if appropriate)
   39. Identify guideline publicly traded companies; consider:
      a. Same or a similar line of business
      b. Size
      c. Trading activity/pricing evidence
      d. Financial condition
   40. Adjust financial statements of the guideline companies (that is, adjust guidelines to make them more comparative to the subject company, that is, "apples to apples")
   41. Identify appropriate earnings and operating fundamentals
   42. Calculate market-derived pricing multiples for guideline companies
   43. Analyze range of market-derived pricing multiples
      a. Statistical analysis of range of multiples
      b. Correlation with performance factors (growth, returns, etc.)
   44. Compute and analyze financial and operating ratios for the guideline companies, including:
      a. Size
      b. Growth
      c. Liquidity
      d. Profitability
      e. Turnover/activity
      f. Leverage
   45. Compare the subject company to the guideline companies
   46. Select the appropriate market-derived pricing multiples for the subject company
   47. Apply the selected pricing multiples to the appropriate subject company earnings and operating fundamentals
   48. Synthesize an estimate of value
      a. Subtract the market value of subject company debt in debt-free valuation approaches

49. Identify appropriate valuation premiums/discounts (for the specific level of business interest subject to appraisal)
50. Quantify appropriate valuation premiums/discounts (for the specific level of business interest subject to appraisal)
51. Apply appropriate valuation premiums/discounts (for the specific level of business interest subject to appraisal)

C. Perform a market approach–guideline merged and acquired company method (if appropriate)
   52. Identify guideline merged or acquired companies/transactions, consider:
      a. Same or a similar line of business
      b. Size
      c. Financial condition
      d. Relevant time frame
      e. Availability of information
   53. Adjust financial statements of the guideline companies (that is, adjust guidelines to make them more comparative to the subject company, that is, "apples to apples")
   54. Identify appropriate earnings and operating fundamentals
   55. Calculate transaction pricing multiples for guideline companies
   56. Analyze range of guideline transaction pricing multiples
      a. Statistical analysis of range of multiples
      b. Correlation with performance factors (growth, returns, etc.)
   57. Compute and analyze financial and operating ratios for the guideline companies, including:
      a. Size
      b. Growth
      c. Liquidity
      d. Profitability
      e. Turnover/activity
      f. Leverage
   58. Compare the subject company to the guideline companies
   59. Select the appropriate transaction pricing multiples for the subject company
   60. Apply the selected multiples to the appropriate subject company earnings and operating fundamentals
   61. Synthesize an estimate of value

a. Subtract the market value of subject company debt in debt-free valuation approaches

62. Identify appropriate valuation premiums/discounts (for the specific level of business interest subject to appraisal)
63. Quantify appropriate valuation premiums/discounts (for the specific level of business interest subject to appraisal)
64. Apply appropriate valuation premiums/discounts (for the specific level of business interest subject to appraisal)

D. Perform an income approach—discounted economic income method (if appropriate)

65. Review and analyze projections related to prospective results of company operations
66. Develop the appropriate economic income fundamentals for analysis, for example, net cash flow, which considers:
    a. Earnings
    b. Noncash expenditures (depreciation, amortization, etc.)
    c. Capital expenditures
    d. Working capital requirements
67. Develop the appropriate discount rate for the present value calculation, with consideration to:
    a. Capital market environment
        (1) Risk-free rates of return
        (2) Equity rates of return (and/or equity risk premiums)
        (3) Company-specific risks/required rates of return, with consideration to:
            (a) Expected attainability of company projections
            (b) Degree of financial/operating leverage
            (c) Degree of diversification of the business base
    b. Capital structure
        (1) Capital structure of the subject company
        (2) Typical capital structure in the subject industry
68. Develop an estimate of the terminal/residual value, with consideration to:
    a. Terminal/residual year financial fundamentals (for example, net cash flow projection)
    b. Terminal/residual year direct capitalization rates (for example, as derived from the Gordon growth model)

69. Apply the derived discount rate to the estimated economic income projection (for example, net cash flow); include:
    a. The discrete projection period of periodic economic income
    b. The terminal/residual value estimate
70. Calculate an estimate of value
    a. Subtract the market value of subject company debt in debt-free valuation approaches
71. Identify appropriate valuation premiums/discounts (for the specific level of business interest subject to appraisal)
72. Quantify appropriate valuation premiums/discounts (for the specific level of business interest subject to appraisal)
73. Apply appropriate valuation premiums/discounts (for the specific level of business interest subject to appraisal)

E. Perform an asset approach—adjusted net asset method (if appropriate)
    74. Adjust all on-balance sheet assets to market value (current assets, fixed assets, etc.)
    75. Identify all off-balance sheet intangible assets
    76. Estimate the value of all off-balance sheet intangible assets
    77. Estimate the value of the total on-balance sheets and off-balance sheet tangible and intangible assets
    78. Adjust all liabilities to market value (including consideration of off-balance sheet and contingent liabilities)
    79. Calculate an estimate of the overall subject company equity value (as the total market value of all assets less the total market value of all liabilities)
    80. Identify appropriate valuation premiums/discounts (for the specific level of business interests subject to appraisal)
    81. Quantify appropriate valuation premiums/discounts (for the specific level of business interests subject to appraisal)
    82. Apply appropriate valuation premiums/discounts (for the specific level of business interests subject to appraisal)

F. Consider other relevant valuation approaches
   83. Consider the application of any alternative valuation approaches
   84. Perform the appropriate alternative valuation approach methods or document that such alternative approaches are not applicable

G. Prepare a synthesis of value
   85. Determine the relevance of the respective valuation approaches used in the analysis
   86. Weight the alternative estimates of value

H. Reach a conclusion of value
   87. Conclude the appropriate fair market value estimate for the appraisal subject

VIII. Reporting the Results of the Valuation Analysis and Financial Advisory Due Diligence Analysis

A. Prepare a fairness opinion, as requested
   88. Describe the proposed securities purchase transaction
   89. Analyze the proposed securities purchase transaction in order to conclude whether the ESOP is paying no more for the appraisal subject than any other typical willing buyer would pay
   90. Opine on the fairness of the proposed securities purchase transaction from a financial point of view, with consideration of the concluded fair market value for the appraisal subject

IX. Documentation of the Valuation Analysis and Financial Advisory Due Diligence Analysis

A. Prepare engagement work papers
   91. Prepare and maintain work papers and files that document the valuation analysis and the financial advisory due diligence analysis

B. Prepare a valuation opinion and valuation report
   92. Opine on the adequate consideration with regard to the appraisal subject consistent with the DOL proposed regulations

93. Opine on the fair market value of the appraisal subject consistent with the DOL proposed regulations
94. Prepare a valuation report in compliance with the fair market value requirement of the DOL proposed regulations, containing the following information:
    a. A summary of the qualifications of the person making the valuation to appraise assets of the type being valued
    b. A statement of the subject asset's value, a statement of the methods used in estimating that value, and the reasons for the valuation in light of those methods
    c. A full description of the subject asset being valued
    d. The factors taken into account in making the valuation, including any restrictions, understandings, agreements or obligations limiting the use or disposition of the subject asset
    e. The purpose for which the valuation was made
    f. The relevance or significance accorded to the valuation methods taken into account
    g. The effective date of the valuation
    h. In cases where a valuation report has been prepared, the signature of the person making the valuation and the date the report was signed
95. Include in any written valuation report an assessment of the following factors, consistent with the DOL proposed regulations:
    a. The nature of the business and the history of the enterprise from its inception
    b. The economic outlook in general, and the condition and outlook of the specific industry in particular
    c. The book value of the securities and the financial condition of the business
    d. The earnings capacity of the company
    e. The dividend-paying capacity of the company
    f. Whether the enterprise has goodwill or other intangible value
    g. The market price of securities of corporations engaged in the same or a similar line of business, which are actively traded in a free and open market
    h. The marketability, or lack thereof, of the securities

i. Whether the seller would be able to obtain a control premium with regard to the appraisal subject; in cases where a control premium is added, confirm that:
   (1) Actual control (both in form and in substance) is passed to the purchaser with the sale (or will pass to the purchaser within a reasonable time)
   (2) It is reasonable to assume that the buyer's control will not be dissipated within a short period of time after the securities purchase

ESOP Financial Advisory Insights

A Fiduciary's Guide to Selecting a Financial Adviser and Reviewing an ESOP Stock Valuation Report

Timothy J. Meinhart

This discussion summarizes the various factors that an ESOP fiduciary should consider when hiring an independent financial adviser. The article also presents a checklist of items that the ESOP fiduciary should consider when reviewing an employer corporation stock valuation report.

Introduction

ESOP trustees are expected to act in the best interests of the ESOP participants and the plan beneficiaries. To exercise prudence in this regard, ESOP trustees often rely on independent professional advisers to help them fulfill their fiduciary obligations.

One example of this exercise of prudence is when the trustee hires an independent financial adviser to estimate the fair market value of non-publicly-traded employer corporation stock for (1) an ESOP stock purchase/sale transaction and (2) plan administration purposes.

Given the importance of these employer stock valuations, it is important that the ESOP trustee hire a qualified, independent financial adviser. Moreover, the ESOP trustee should have a reasonable understanding of the valuation process, the valuation analysis, and the written valuation work product. This understanding can assist the ESOP trustee to properly fulfill his or her fiduciary duties.

This article provides a summary of the issues an ESOP trustee should consider when (1) selecting an independent financial adviser and (2) reviewing an ESOP employer stock valuation report.

Selecting a Qualified Financial Adviser

The ESOP trustee should exercise a great deal of discretion in selecting the financial advisory firm to conduct (1) employer corporation stock purchase/sale transaction-related valuation work or (2) the ERISA-required annual employer corporation stock valuations.

The criteria that are often considered during the ESOP trustees selection process include:

1. the qualifications of the financial advisory firm,
2. the qualifications of the principal analyst(s), and
3. independence issues regarding the professional firm.

> *"The individual qualifications of the principal analyst are just as important as the institutional qualifications of the financial advisory firm."*

The qualifications and competence of a financial advisory firm can be demonstrated in many different ways. An ESOP trustee should consider retaining only financial advisory firms that routinely render valuation opinions and fairness opinions related to ESOP engagements. Given the intricacies of ESOP-related valuation work, it is necessary for the financial adviser to be familiar with the various ERISA, IRS, and DOL guidelines and proposed regulations that impact ESOP-related analyses.

The financial advisory firm should be able to demonstrate its past experience to the ESOP trustee related to: (1) structuring ESOP transactions and (2) conducting valuation analyses for such ESOP assignments. This demonstration should include the financial advisory firm's relevant industry-specific valuation experience.

The individual qualifications of the principal analyst are just as important as the institutional qualifications of the financial advisory firm. Since the principal analyst will be conducting/managing the valuation engagement, it is important for the principal analyst to have a working knowledge of ESOP-related valuation issues. Often, the analyst acquires this knowledge through years of experience of working on a variety ESOP-related assignments.

While interviewing the individual valuation analyst, it is prudent for the ESOP trustee to inquire about the analyst's personal experience in conducting ESOP-related engagements. This inquiry would typically include questions related to the analyst's experience in providing advice on ESOP feasibility, structuring, and valuation issues. It may also be appropriate for the ESOP trustee to inquire about the analyst's industry experience, education, professional accreditations, and professional memberships.

While it is not required that the analyst be a specialist in a particular industry, the ESOP trustee should expect the analyst to have at least some relevant industry-specific experience that complements the subject assignment. This experience is particularly helpful when the subject employer corporation is affected by various industry-specific risk return factors and valuation metrics.

In terms of education, many ESOP financial advisers have formal education in finance, accounting, and/or economics. In the same respect, many analysts hold one or more professional accreditations that are specific to the business valuation discipline.

Some of the more noteworthy professional accreditations related to the business valuation profession include the following:

1. accredited senior appraiser (ASA) designation of the American Society of Appraisers,
2. certified business appraiser (CBA) designation of the Institute of Business Appraisers (IBA), and
3. accredited business valuation (ABV) designation of the American Institute of Certified Public Accountants (AICPA).

"The ESOP trustee should also be concerned with independence issues when hiring a financial adviser."

The ESOP trustee may also find it helpful to inquire about the analyst's involvement in professional organizations, specifically organizations dedicated to the business valuation profession. Involvement in these organizations demonstrates the analyst's interest and dedication in advancing his or her profession.

In selecting a financial advisory firm, the ESOP trustee should not hesitate (1) to conduct interviews with various firms and (2) to follow-up with references provided by the firms. Often, these interviews provide ESOP trustees with information that they could not gather by simply reviewing firm brochures.

For example, interviewing an analyst allows the ESOP trustee to learn about the analyst's expertise and experience. Such interviews also allow the trustee to evaluate the analyst's communication and presentation skills. These skills are important, especially in situations where the analyst will be making periodic presentations to the ESOP trustee, the employer corporation board, and/or the plan participants.

The ESOP trustee should also be concerned with independence issues when hiring a financial adviser. These independence issues tend to arise when the financial advisory firm either has or intends to provide other services to the sponsor corporation.

The ESOP trustee should understand what, if any, prior services have been provided by the financial advisory firm to the sponsor corporation. These prior services may include valuation services that were conducted for:

1. estate and gift tax planning,
2. succession planning,
3. financial reporting,
4. income tax purposes,
5. mergers and acquisitions, and
6. litigation-related purposes.

The ESOP trustee should also understand how those prior services impact the financial advisory firm's independence in providing advisory services to the ESOP trustee.

In the same respect, the financial advisory firm should evaluate the methods, assumptions, and limiting conditions that are part of its past valuation work for the sponsor corporation. The objective of such a review is to determine whether these methods, assumptions, and limiting conditions will be different in the context of an ESOP-related analysis.

This review will help the financial advisory firm foresee any possible conflicts that may arise due to changes in valuation procedures and assumptions.

Reviewing the Valuation Report

The first step in reviewing an ESOP employer stock valuation report is to become familiar with the business valuation process. The ESOP trustee should have a sense of the level of due diligence and analysis that was conducted by the analyst to reach the employer corporation stock valuation conclusion.

For example, the ESOP trustee may be interested in whether the analyst conducted interviews with company management during the course of the valuation. These interviews are normally conducted to:

1. understand the nature and history of the sponsor corporation and
2. discuss the historical and prospective performance of the sponsor corporation.

It is not uncommon for these interviews to take place in-person at the sponsor corporation facilities. This arrangement provides the analyst the opportunity to tour the sponsor corporation facilities and view the physical condition of the sponsor corporation tangible assets.

The interview process will also allow the analyst to gain a better understanding of the employer corporation: (1) products and/or services, (2) strategic plan, (3) competitors, and (4) competitive position in the market.

A thorough valuation analysis will be documented with a comprehensive valuation report. It is prudent for the ESOP trustee to review each periodic stock valuation report in order to understand its content.

The following sections of this article provide an overview of the typical employer stock valuation report content that should be of interest to an ESOP trustee.

Description of the Subject Ownership Interest

The valuation report should adequately describe the ownership interest subject to valuation. Often, this description includes:

1. the number of shares subject to valuation,
2. the name of the employer corporation, and
3. the form of ownership.

For example, a description of the valuation subject may read as follows:

> We estimated the fair market value of 20,000 voting common shares of ABC, Inc. ("ABC"). ABC is a corporation organized in the State of Delaware.

The above description provides the ESOP trustee with (1) the exact number of shares that are subject to valuation and (2) the name of the employer corporation that is subject to analysis.

Standard of Value and Premise of Value

Fair market value is the standard of value for ESOP-related valuations conducted for plan administration purposes. The valuation report should specifically state that fair market value is the appropriate standard of value for the subject engagement, and the valuation report should also define the term fair market value.

There are several definitions of fair market value, but many of these definitions contain similar language. Fair market value is commonly defined to be the price at which the property would change hands between a willing buyer and a willing seller, when neither is under any compulsion to buy or to sell, and with both parties having reasonable knowledge of the relevant facts.

Some analysts expand the definition to add that the buyers and sellers are hypothetical buyers and sellers—opposed to a specific buyer and/or seller. Nevertheless, the important elements of the definition remain the same. That is, an unrelated buyer and seller are coming together to conduct a transaction when neither is being forced to buy or sell and both parties are aware of all relevant information concerning the subject ownership interest.

The employer stock valuation report should describe the premise of value—that is whether the company was valued (1) as a going-concern business enterprise or (2) based on a liquidation premise of value. If the analyst did not value the employer corporation as a going concern, the valuation report should discuss the rationale for conducting the valuation in that manner.

Purpose of the Analysis

The ESOP valuation report should clearly outline the purpose of the analysis.

An ESOP transaction-related opinion—such as a fairness opinion—will state the analyst's opinion as to the fairness of a specific transaction from a financial point of view.

Alternatively, the analyst may conduct a valuation opinion on an annual basis for ESOP plan administration purposes. This analysis is typically conducted for the stock redemptions that occur under the normal operations of the ESOP.

In either case, the valuation opinion report should describe the purpose of the analysis so there is no confusion over the intended use of the report.

Valuation Date and Report Date

The valuation report should indicate (1) the valuation date and (2) the report date. The valuation date is the date "as of" which the analyst's opinion of value applies. The report date is the date the valuation report was prepared.

For example a valuation report may summarize the fair market value of an ownership interest as of December 31, 2004. However, the valuation report may not be prepared until April 15, 2005. In this case, the valuation date is December 31, 2004, and the report date is April 15, 2005.

In this example, the ESOP trustee should understand that the valuation opinion takes into account all known and knowable information available through December 31, 2004. Under the fair market value standard of value, the valuation report will typically not take into account any information that became available, or known, subsequent to the valuation date.

Level of Value and Prerogatives of Ownership Control

During the valuation analysis, the analyst will gain an understanding of the ownership control attributes (or lack thereof) associated with the ESOP ownership interest. For example, the subject ownership interest may consist of:

1. a 35 percent noncontrolling ownership interest in the employer corporation total equity,
2. a 51 percent ownership interest that has some control level attributes, or
3. a 70 percent ownership interest that has many of the features of absolute control.

The valuation report should clearly identify the subject ownership interest and describe the prerogatives of ownership control that accompany the subject interest.

For example, a 35 percent ownership interest may allow the ESOP trustee to elect one board member but may not provide any other opportunities to effectuate change at the employer corporation. In this case, the ownership interest would normally be valued as a noncontrolling ownership interest.

In contrast, a 51 percent ownership interest may allow the ESOP trustee to exercise ownership control over several aspects of the employer corporation. These prerogatives of control may include, but are not limited to:

1. the appointing of new board members and management personnel,
2. the changing or renegotiation of management compensation and perquisites,
3. the issuing or repurchasing of employer corporation shares,
4. the issuing or repaying of employer corporation debt, and
5. the changing of the strategic direction of the company.

In this case, the employer stock valuation report should (1) identify the specific control attributes of the subject ownership interest and (2) explain how these attributes were considered in the valuation process.

A holder of a 70 percent ownership interest may have not only the prerogatives of control listed in the previous paragraph, but also the ability to sell the sponsor corporation or substantially all of the sponsor corporation assets. Once again, this level of control should be identified in the valuation report and properly reflected in the valuation analysis.

In addressing the level of ownership control within the stock valuation report, an analyst may also discuss the distribution of stock ownership. This may be particularly relevant in situations where no one shareholder has a controlling ownership interest in the sponsor corporation common stock.

Sources of Information

A comprehensive valuation report will typically include a section that lists the data and documents that the analyst relied on to develop the employer stock valuation opinion.

By reviewing this section of the employer stock valuation report, the ESOP trustee will have an immediate understanding of (1) the publicly available and (2) the non-publicly-available documents that were considered in the valuation process.

> *"Under the fair market value standard of value, the valuation report will typically not take into account any information that became available, or known, subsequent to the valuation date."*

The sources of information list should include not only the financial-related documents used in the valuation analysis (e.g., financial statements, empirical market data), but the non-financial-related documents as well (e.g., ESOP documents, employer corporation documents).

When properly prepared, the sources of information list should enable an independent analyst to identify the documents necessary to replicate the subject stock valuation analysis.

Description of the Subject Employer Corporation

A detailed valuation report will provide an adequate description for the reader to understand the fundamental position of the subject employer corporation.

A comprehensive description of the subject employer corporation business will normally include the following:

- a discussion of the history of the employer corporation and its current position;
- a description of the products and/or services provided by the employer corporation;
- a description of the markets served by the employer corporation;
- a description of the environment in which the employer corporation competes and how the company is positioned within that environment;

- a discussion of the qualifications of employer corporation management and its depth;
- a discussion of significant relationships with related parties, customers, suppliers, etc.;
- a discussion of pending litigation that is significant to the employer corporation;
- a review of recent transactions in the employer corporation stock (if any); and
- a discussion of any recent offers received for the employer corporation or its assets.

Overview of Economic and Industry-Specific Conditions

The valuation report should provide an overview of economic and industry-specific factors that affect the valuation of the subject sponsor corporation.

The economic overview may include a discussion of trends in economic growth, inflation, consumer spending, consumer confidence, interest rates, construction starts, and business spending. In each case, the analysis should be tailored to the economic factors that most directly affect the subject sponsor corporation. This section of the report may also include a discussion of leading economic indicators that give insight into the future performance of the sponsor corporation.

The industry overview section of the valuation report will typically discuss how the industry operates and recent trends affecting companies within the industry. The section may also describe the sponsor corporation's position in the industry and its market share relative to other competing firms.

Employer Corporation Financial Performance

As part of the employer stock valuation process, the financial adviser will analyze the financial performance and financial condition of the employer corporation. A summary of this financial analysis should appear in the valuation report.

The historical financial performance of the employer corporation is reflected on the company income statements and cash flow statements. The valuation report may include a discussion of the following:

- the historical growth or decline in sales,
- the historical growth or decline in aggregate profitability (i.e., gross profit, operating profit, pretax profit, and net profit),
- the historical growth or decline in profit margins,
- the historical growth or decline in cash flow, and
- the historical payments of dividends.

The analyst will also review the employer corporation balance sheet to evaluate its financial condition. The valuation report may contain a discussion of the following balance-sheet-related items:

- the employer corporation liquidity and working capital position,
- the employer corporation asset utilization by means of various financial ratios (e.g., accounts receivable turnover, inventory turnover, etc.),
- the employer corporation tangible asset base, and
- the employer corporation capital structure and leverage.

"A thorough financial analysis will include not only a discussion of certain financial statement trends but also a discussion of what factors caused the respective trends."

A thorough financial analysis will include not only a discussion of certain financial statement trends but also a discussion of what factors caused the respective trends.

Also useful is a discussion of how the employer corporation performed relative to other companies in the industry. This comparative financial analysis typically identifies the financial strengths and weaknesses of the employer corporation compared to other guideline/competing companies.

The comparative analysis will help the ESOP trustee understand how the employer corporation performed relative to other companies in the industry. This comparative performance analysis may be based on such factors as growth, profitability, and volatility.

Financial Statement Normalization Adjustments

When appropriate, the analyst will make financial statement normalization adjustments (1) to the employer corporation and (2) to the selected guideline publicly traded companies. The financial statement normalization adjustments are necessary so that the employer corporation financial performance is on the same basis as the selected guideline companies' financial performance.

Some of the more common financial statements adjustments made to the employer corporation include the following:

- adjustments for extraordinary or nonrecurring income and expense items,

- adjustments for differences in inventory accounting methods,
- adjustments for nonoperating income and expense items,
- adjustments for non-arm's-length transactions/arrangements, and
- adjustments for ESOP benefit expense and normalized employee benefit expenses.

The valuation report should identify the financial statement adjustments and adequately explain the rationale for each adjustment.

Generally Accepted Business/Stock Valuation Approaches and Methods

There are three generally accepted approaches to the valuation of a business interest: the market approach, the income approach, and the asset-based approach.

The valuation report should clearly describe which approaches—and which valuation methods within each approach—were used in the analysis. In the same respect, the valuation report should explain which approaches were not used in the analysis and why they were not used.

The ESOP trustee should be concerned if the analyst changes the selected valuation methods from year to year without proper explanation and support. These unsupported changes often give the appearance that the analyst is attempting to support a predetermined value.

With regard to the market approach, and specifically the guideline publicly traded company method and the guideline merged and acquired company method, the employer stock valuation report should include the following:

- The criteria used to select the guideline companies. The selection criteria may include standard industrial code, business description, size, growth, profitability or a combination of several relevant factors.
- A detailed description of each selected guideline company. This description may include a discussion of the selected guideline company's business, its products and/or services, and its position in the market. Other information, such as whether the guideline company recently completed acquisitions, may also be relevant.
- The market-derived valuation pricing multiples that were selected for the analysis. These pricing multiples may include invested capital pricing multiples or equity pricing multiples. Industry-specific factors often influence the type of market pricing multiples that are used in the stock valuation analysis.

  For example, the valuation of a commercial bank will typically involve the use of market-derived valuation pricing multiples that are based on (1) the market value of equity and (2) earnings and/or book value of total equity capital.

  In contrast, the valuation of a manufacturing company may require the use of market-derived valuation pricing multiples that are based on (1) the market value of invested capital and (2) invested capital earnings and/or invested capital cash flow.
- The rationale for selecting the market-derived invested capital pricing multiples that are applied to the employer corporation financial fundamentals. The reader of the valuation report should be able to understand the analyst's thought process for arriving at the selected valuation pricing multiples.

  The application of an average or median market-derived pricing multiple, with no support for such a selection, is typically not appropriate.
- The rationale for the selected weighting used in the valuation synthesis. For example, if the value indication based on projected cash flow is given more (or less) weight than the value indication based on trailing 12-month cash flow, the valuation report should explain why.

With regard to the income approach, and specifically the discounted cash flow method, the employer stock valuation report should include the following:

- A discussion of who prepared the financial projections. The projections are often prepared by employer corporation management. In other cases, the projections are prepared by the analyst with input from employer corporation management.

  In the case of management prepared projections, the report should explain how the analyst tested the reasonableness of the projections. In all cases, the financial projections should be supportable.
- Consideration of debt repayments and other cash requirements. The valuation analyst should consider the timing of debt repayments (both ESOP and non-ESOP related debt)—and their impact on value. The valuation report should also consider the cash requirements for necessary capital expenditures and any anticipated stock repurchase requirements.
- The appropriate matching of financial projections and the present value discount rate. For example, if the discounted cash flow method incorporates a projection of invested capital cash flow, or cash flow available to invested capital, then the present value discount rate should be the weighted average cost of capital.

  In contrast, if the projection is of cash flow available to equity capital, then the present value discount rate should be the cost of equity capital.

- A discussion of the cost of capital components. This discussion would include an explanation of how the analyst estimated the cost of equity capital, the cost of debt capital, and the weighting of each cost component in a weighted average cost of capital calculation.
- Support for the selected residual value pricing multiple or residual value direct capitalization rate. In many valuations, the residual value of the employer corporation constitutes a significant portion of the employer corporation present value.

  As a result, the selected residual value pricing multiple, or residual value direct capitalization rate, often has a substantial effect on the concluded value of the employer corporation. The rationale for the selected residual pricing multiple, or the selected residual growth rate within the residual direct capitalization rate, should be adequately explained and supported.

The asset-based approach is typically not used in ESOP-related employer stock valuations. This is true unless the employer corporation:

1. is a holding company that owns other operating businesses or income-generating investments or
2, is expected to generate cash flow (or some other measure of economic income) that does not fully reflect the current market value of the corporation's operating and/or nonoperating assets.

However, when the asset-based approach, and specifically an asset accumulation method, is used, the valuation report should include a discussion of how each employer corporation asset and liability was valued. This discussion would include all assets (monetary, tangible, and intangible) and all liabilities (both recorded and contingent).

The analysis should specifically address all off-balance-sheet assets and off-balance-sheet contingent liabilities that may impact the employer stock valuation.

Valuation Synthesis and Conclusion

The employer stock valuation report should contain a section that provides (1) a valuation synthesis of alternative value indications and (2) a final conclusion of employer stock value. The following factors should be included in this section of the employer stock valuation report:

- A discussion of how each value indication from each approach and method was weighted in the value conclusion. An explanation should be provided for each of the selected weightings.
- A discussion of any valuation premium or discount that may be appropriate to reflect the ownership control, or lack of ownership control, attributes of the subject ESOP ownership interest. The discussion of the application of valuation adjustments should include:
  1. the rationale for each valuation premium or discount and
  2. the supporting data or factors used to estimate the valuation premium or discount.

  The estimated ownership control premium should reflect the adjustments that were made to the employer corporation financial statements. In other words, if the analyst adjusted the company's financial performance for ownership control level/discretionary items, then the analyst should not reflect these same control price benefits a second time through the application of an ownership control premium.

"The . . . report should contain a section that provides (1) a valuation synthesis of alternative value indications and (2) a final conclusion of employer stock value."

- A discussion of nonoperating assets (or liabilities) that need to be factored into the analysis. These may include excess cash or securities, related party loans, excess land, investments in other companies, or other assets that have not been properly reflected in the valuation analysis.
- A discussion of the illiquidity, or lack of marketability, of the subject ownership interest. Most noncontrolling ownership interests in non-publicly-traded companies are relatively illiquid. However, the liquidity of the ESOP-owned employer corporation stock may be affected by a put right that is part of the plan.

  The valuation analyst should consider any such put right in the estimate of the appropriate discount for lack of marketability, if any. In this regard, the analyst should consider various company-specific factors such as:
  1. the employer corporation's ability to honor the put right,
  2. the size of ESOP ownership interest,
  3. demographics of the ESOP participants,
  4. the company's expected repurchase liability,
  5. the employer corporation projected cash flow,
  6. the employer corporation's ability to raise capital, and
  7. other expected demands on the employer corporation capital.
- A discussion of any contingent and limiting conditions. The valuation report should contain language that lists

any contingent and limiting conditions regarding the analysis and opinion.

After reviewing the valuation report in its entirety, the ESOP trustee should be in a position to address the following questions:

- Was the report readable and easy to understand or was it filled with undefined valuation terms and jargon?
- Was the report comprehensive and organized in a logical manner?
- Has the concluded value changed over time, and if so, what were the primary drivers of this change in value (i.e., company performance, market performance, or a combination of the two)?
- Has the employer corporation financial performance improved or deteriorated over time, and has the concluded value changed accordingly?
- Have the business valuation approaches and/or methods that were used in the analysis changed over time, and if so, why have they changed?
- Does the employer stock valuation conclusion seem reasonable given (1) the historical and projected financial performance of the employer corporation, (2) the relevant market-based data, and (3) the relevant economic and industry-specific conditions?
- Does the valuation conclusion properly reflect the ESOP-specific factors such as the ESOP debt and its related income tax benefit?

Summary and Conclusion

When fulfilling its fiduciary duties, an ESOP trustee will typically hire an independent financial adviser to assist in estimating the fair market value of non-publicly-traded employer corporation stock. The ESOP trustee places a great deal of reliance on the valuation opinion of the independent financial adviser. As a result, the ESOP trustee needs to exercise care in selecting a qualified, independent financial adviser.

In reviewing the work of the financial adviser, the ESOP trustee needs to have a basic understanding of the valuation process employed by the financial advisory firm. This understanding will enable the trustee to appropriately conduct a thorough review of the ESOP employer stock valuation report.

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ESOP Fairness Opinions

continued from page 10

a fairness opinion of the transaction from a financial point of view to a particular party to the proposed transaction.

While one particular party may not perceive a conflict of interest, other parties to the transaction may perceive such a conflict. In an effort to mitigate some of the perceived conflicts of interest, the employer corporation may create special committees of independent board members (1) to evaluate a proposed transaction and (2) to obtain a second transaction fairness opinion.

There are several instances when an employer corporation should obtain a second fairness opinion. For example, additional assurance opinions may be appropriate if the financial adviser providing the transaction opinion:

1. has a financial interest (e.g., equity, debt, option);
2. has an existing relationship (e.g., board member, supplier, customer); or
3. has a stake in the outcome of the transaction (e.g., a contingency or performance-based fee).

The current focus on corporate governance points fiduciaries toward obtaining independent financial advice even when a fairness opinion has already been rendered to one particular party to the proposed transaction.

Summary and Conclusion

Fairness opinions serve a number of useful purposes for ESOP trustees. From a procedural standpoint, the analysis supporting the fairness opinion may be useful to the ESOP trustee in employer sock purchase/sale transaction negotiations.

From a legal standpoint, a fairness opinion provides evidence that the ESOP trustee exercised reasonable business judgment in the evaluation of the proposed transaction. From a practical standpoint, other parties to the proposed transaction may find comfort in the transaction if it is considered to be fair to the ESOP.

The form and context of the proposed employer corporation transaction will help to identify the appropriate standard of value to use when evaluating fairness. The fairness opinion for the ESOP trustee considers the financial benefits of the proposed transaction to all parties and whether the ESOP is being treated fairly relative to all of the other parties to the proposed transaction. The fairness opinion provides additional assurance that the ESOP trustee has satisfied the trustee's fiduciary obligation.

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ESOP Valuation Insights

The Basic Elements of the ESOP Employer Corporation Stock Valuation

Robert F. Reilly

Experienced ESOP valuation analysts recognize that there are ten basic elements to the ESOP employer stock valuation assignment. Experienced valuation analysts will discuss these valuation elements with the client (typically the ESOP trustee) prior to commencing the assignment. In addition, experienced valuation analysts will document these ten basic elements both (1) in the employer stock valuation workpaper file and (2) in the employer stock valuation report. Valuation analysts should be aware of these ten fundamental elements of the ESOP sponsor company valuation assignment. ESOP trustees, ESOP lenders, and other ESOP professional advisers should also be familiar with these ten basic elements of the ESOP employer stock valuation. That way, they will not rely on a sponsor company stock valuation analysis/report that is not appropriate for ESOP purposes.

Introduction

Employer corporation stock ESOP transactional valuations are typically required for purposes of: (1) the initial ESOP formation, (2) leveraged ESOP financing, (3) ESOP employer company recapitalization transactions, (4) purchase or sale of the ESOP-owned employer stock, (5) purchase or sale of the entire employer corporation, and (6) ESOP terminations.

Employer corporation stock ESOP notational valuations are typically performed annually for purposes of: (1) sponsor company stock contributions to the ESOP, (2) stock redemptions of retiring ESOP participants, and (3) annual income tax and regulatory compliance.

And, employer corporation stock ESOP litigation valuations may be required in response to: (1) challenges raised during Internal Revenue Service and/or U.S. Department of Labor audits and (2) litigation claims made by current or former dissenting ESOP plan participants.

All of these ESOP-related employer stock valuations (1) should be based on the fair market value standard of value and (2) should be in compliance with Internal Revenue Service and U.S. Department of Labor valuation guidance. Nonetheless, ESOP valuation analysts should be familiar (1) with alternative standards of value and (2) with all other fundamental elements of the valuation assignment. That way, the valuation analyst can ensure:

1. that he or she is actually applying the correct standard of value and
2. that all selected elements of the ESOP valuation are consistent with the fair market value standard.

In addition, ESOP trustees and ESOP legal counsel (and other ESOP professional advisers) should be familiar with the alternative elements of a business/stock valuation assignment. This way, the trustee will not unintentionally request (or accept) any elements of an employer stock valuation that are not appropriate for ESOP transaction or regulatory purposes. And, the ESOP legal counsel (and other ESOP professional advisers) will not rely on an employer stock valuation that is not appropriate for ESOP transaction, regulatory, or litigation purposes.

The ESOP Stock Valuation Assignment

In any employer corporation business/security valuation analysis, the same business, business ownership interest, or security may have a materially different value depending on the standard (or definition) of value concluded. That is, the valuation analyst may conclude a different value estimate for the same business/security depending on whether the concluded standard of value is:

1. acquisition value,
2. fair market value,
3. fair value,

4. investment value,
5. use value,
6. or some other common standard.

Inexperienced ESOP valuation analysts often struggle with the concept that different standards of value result in different business/security value conclusions. In addition, ESOP trustees, ESOP legal counsel, and judicial/administrative finders of fact often have difficulty embracing this fundamental valuation principle.

Because it can affect the quantitative value conclusion in the ESOP valuation assignment, the standard of value should be:

1. discussed between the valuation analyst and the client,
2. documented in the ESOP valuation engagement letter, and
3. identified in the ESOP employer corporation valuation report.

This caveat is true for all valuation assignments. It is particularly true for valuation analyses performed for ESOP transaction, accounting, tax, litigation, or regulatory purposes (i.e., assignments where a judicial or administrative finder of fact may rely on the value conclusion). This way, the valuation analyst, the ESOP trustee, regulatory auditors, or any other valuation report readers can see that the analysis is correctly prepared on a fair market value standard of value (or incorrectly prepared on some other standard of value).

Documenting the ESOP Employer Stock Valuation Assignment

The standard (or definition) of value is often referred to as one of the elements of a business/security valuation assignment. Experienced ESOP valuation analysts recognize that there are ten elements to the ESOP employer corporation valuation assignment. And, the selection or determination of each one of these ten elements may have an effect on the final value conclusion.

This discussion will review these ten common elements of an ESOP business valuation assignment. And, this discussion will indicate how the selection or determination of these elements may affect the value conclusion. Typically, ESOP valuation analysts will determine (and document) these ten elements of the assignment before performing any quantitative or qualitative valuation analyses.

As there are ten elements that should be determined at the inception of the ESOP valuation engagement, there are also ten reasons to document the assignment elements in the valuation engagement letter and/or workpaper file. The determination and documentation of the elements of the ESOP employer corporation stock valuation assignment:

1. assist the analyst to prepare a credible employer corporation business/security valuation analysis and report;
2. affect the scope of work that the analyst will perform during the valuation process;
3. minimize the opportunity for misunderstandings and/or disputes with the client;
4. minimize the opportunity for misunderstanding and/or confusion by any nonclient party who may rely on the valuation (e.g., a judge or regulatory authority);
5. demonstrate the analyst's compliance with recognized professional practices and standards;
6. document the analyst's compliance with any applicable regulatory requirements (e.g., Revenue Ruling 59-60 or Department of Labor valuation guidelines, etc.);
7. affect the analyst's selection of the appropriate analytical approaches, methods, and procedures;
8. affect the content and format of the valuation report;
9. affect the quantitative value conclusion; and
10. help the analyst withstand a contrarian review or challenge in an ESOP audit, litigation, or other controversy environment.

This discussion summarizes the ten common elements of the ESOP employer stock valuation assignment. This discussion provides fundamental information for less experienced ESOP valuation analysts as they plan and perform the valuation engagement. And, this discussion provides a useful reminder checklist to experienced ESOP valuation analysts as they prepare engagement letters and other documentation regarding the ESOP valuation assignment.

Ten Elements of the ESOP Employer Stock Valuation Engagement

The first eight elements relate to the objective of the business valuation analysis. The objective of the analysis describes what the analyst is going to do. The last two elements relate to the purpose of the business valuation analysis. The purpose of the analysis describes why the analyst is doing what was described in the objective statement.

The ten elements of the ESOP employer stock valuation engagement are listed below:

1. the subject of the analysis
2. the subject ownership interest
3. the level of value

4. any contractual rights or restrictions
5. the standard of value
6. the premise of value
7. the valuation date
8. the report date
9. the client/user of the analysis
10. the intended use of the analysis

Each of these ten elements will be described briefly.

1. The Subject of the Analysis

The valuation report (whether oral or written) should provide an adequate description of the valuation subject. The subject of the analysis means: What is it that the analyst is appraising? The subject of the typical business valuation may be, for example:

1. the total operating assets of the employer corporation business,
2. the total invested capital (long-term debt and equity) of the employer corporation business,
3. the total equity of the employer corporation business,
4. one class of stock (e.g., class B nonvoting stock) of the employer corporation business, or
5. a fractional block of stock (e.g., a 25 percent interest in the voting common stock) of the employer corporation business.

For ESOP purposes, the appropriate subject of the analysis is the class of employer corporation common stock that is owned by the ESOP. Accordingly, the valuation analyst should ensure that he or she is delivering—and the ESOP trustee should ensure that he or she is relying on—an employer stock valuation based on the appropriate analysis subject.

Vague or inadequate descriptions of the valuation subject (e.g., the business enterprise of the Employer Corporation) are inappropriate. This is because such imprecise descriptions do not adequately explain what assets or equities are included in (or excluded from) the subject valuation. Such imprecise or incomplete descriptions of the valuation subject (1) are not sufficiently informative for ESOP employer stock valuations and (2) tend to confuse the valuation report reader.

2. The Subject Ownership Interest

As emphasized in the 2006 edition of the *Uniform Standards of Professional Appraisal Practice* (USPAP), all business valuations appraise the ownership interests in a subject business. That is, the valuation concludes the value of the owner's rights in the business/security—and not the value of the business entity itself. For example, all of the standards rules in USPAP Standard 9 and 10 speak to "developing an appraisal of ***an interest*** in a business enterprise." [emphasis added]

The ownership interest describes the bundle of legal rights that is the subject of the analysis. Common alternative ownership interests include:

1. fee simple interest (i.e., the total bundle of legal rights),
2. a term interest,
3. a life interest, and
4. a reversionary interest.

With regard to common stock, the consideration of ownership interest will also include: (1) voting preferences, (2) dividend preferences, and (3) liquidation preferences.

This element of the valuation explains what legal interest in the appraisal subject the analyst should consider. In terms of the effect of the selected ownership interest on value, let's consider the difference between a fee simple interest and a life interest in the same subject common stock. Upon death, a fee simple interest is passed to the stockholder's estate, for distribution to his or her heirs. Upon death, a life interest reverts to (let's say) a trust; the ownership interest is not available to be distributed to the heirs.

Typically, the ESOP employer stock valuation should be based on a fee simple interest. The ESOP trustee should ensure that he or she is relying on an employer stock valuation that encompasses the appropriate ownership interest.

3. The Level of Value

The level of value focuses on two specific rights in the bundle of shareholder rights. The bundle of rights is often referred to by valuation analysts as a "stack of sticks." The level of value specifically focuses on two "sticks:"

1. liquidity and
2. ownership control.

Liquidity relates to how quickly and easily the appraisal subject can be converted into cash—that is, how quickly and easily the appraisal subject can be sold. Ownership control relates to whether the appraisal subject offers the owner/holder the right to control the operations of the subject business. In other words, by owning the appraisal subject, can the stockholder influence the employer corporation to implement any of the following actions:

1. enter/not enter contracts,
2. pay/not pay dividends,
3. buy/sell assets,
4. start/discontinue a product line,
5. hire/fire employees,
6. borrow/pay down a loan,
7. merge/liquidate the company, and
8. other various prerogatives.

Inexperienced ESOP valuation analysts sometimes believe that there are only three relevant levels of value:

1. a marketable, controlling ownership interest,
2. a marketable, noncontrolling (i.e., "as if publicly traded") ownership interest, and
3. a nonmarketable, noncontrolling ownership interest.

Experienced ESOP valuation analysts understand that the levels of value represent a continuous spectrum on two axes. One axis represents the complete investment spectrum of liquidity from (1) perfectly liquid to (2) perfectly illiquid. The other axis represents the complete investment spectrum of control from (1) absolute operational control to (2) a total lack of any operational control.

All valuation subjects can be placed somewhere along each of these two investment spectrums. The ESOP employer stock valuation assignment (and the ESOP business valuation report) should specify the level of value that is the subject of the analysis. This is because the same business interest (with the same ownership interest) can command different prices depending on (1) the liquidity attributes and (2) the ownership control attributes associated with that valuation subject.

4. Any Contractual Rights or Restrictions

This element of the valuation explains whether the actual asset/equity ownership interest is subject to any type of contractual right or obligation. Common contractual rights/obligations include: put options, call options, shareholder buy/sell agreement provisions, partnership/corporation and/or partner/shareholder agreements, S corporation tax election agreements, prenuptial family ownership restriction agreements, joint venture agreements, rights of first refusal, and so on.

In addition to contractual rights and restrictions, some analysts also consider state corporation law rights and restrictions as part of this element of the business/stock valuation. Such state corporation law rights may include rights related to voting, dividends, liquidation, and so forth.

The ESOP valuation assignment should specify, and the ESOP valuation report reader should be made aware of, any such contractual rights or restrictions. This is because the appropriate consideration of such contractual rights and restrictions may have a material impact on the final employer corporation stock value conclusion.

5. The Standard of Value

The one element of the ESOP business valuation that most analysts (and most clients) are familiar with is the standard of value. In the vernacular, the standard of value is called the definition of value. This element of the valuation relates to the question: What type of value is the analyst seeking to quantify?

An old appraisal slogan goes: The value of a thing is the price it will bring. That statement is true, but the standard of value defines who will pay that price. In other words, most of the alternative standards (or definitions) of value answer the question: Value to whom? In addition to answering the "value to whom?" question, most standards of value have several technical conditions in their generally accepted definitions.

At least with respect to the "value to whom?" question, the following list summarizes several of the common alternative standards of value:

1. **Fair market value**—the price between a hypothetical (but typical) willing buyer and a hypothetical (but typical) willing seller; this is the standard of value that is appropriate for ESOP employer stock valuation purposes.
2. **Fair value** (for statutory proceeding purposes)—the price that is equally fair to all buyers, sellers, and owners of the subject business enterprise.
3. **Fair value** (for GAAP accounting purposes)—the price that the actual buyer will pay to the actual seller, assumes that the subject is a going-concern business enterprise.
4. **Investment value**—the price a buyer will pay, given a predetermined set of investment return criteria.
5. **Use value**—the price a buyer will pay to own and operate the subject asset/equity for a specified use or purpose.
6. **Collateral value**—the amount that a lender will loan using the subject asset/equity as collateral.
7. **Synergistic value**—the price that a buyer will pay assuming certain expected post-acquisition vertical/horizontal synergies and economies of scale.
8. **Acquisition value**—the price that a specific buyer will pay, given that buyer's actual investment criteria (such as cost of capital, income tax rate, etc.)

First, it is noteworthy that the above definitions are summarized for purposes of this discussion. These are not the complete or official definitions that are endorsed by the valuation professional membership societies.

Second, the above list is not comprehensive. There are numerous alternative standards of value that are not discussed. Third, it is noteworthy (and confusing) that there are two different "fair value" standards of value.

The first fair value standard relates to (1) shareholder oppression statutes and (2) dissenting minority shareholder appraisal rights statutes. Accordingly, analysts should consult with legal counsel regarding the specific fair value statutory language in the relevant state. The second fair value standard relates to purchase accounting (SFAS No. 141), goodwill impairment testing (SFAS No. 142), long-lived asset impairment testing (SFAS No. 144), and other GAAP compliance matters.

Finally, it is noteworthy that the application of different standards of value to the same subject asset/equity interest may result in materially different value conclusions. Therefore, the ESOP employer stock valuation assignment, and the ESOP employer stock valuation report, should be clear as to the particular standard of value that should be concluded.

In particular, the ESOP valuation analyst should be careful that he or she is not labeling the subject analysis as a fair market value appraisal while effectively applying an alternative standard of value to the subject analysis.

6. The Premise of Value

The premise of value element describes the set of assumed circumstances under which the selected standard of value transaction will take place. In other words, let's assume that the selected standard of value is fair market value. The premise of value will describe under what set of transactional circumstances the subject operating business assets will exchange between the hypothetical willing buyer and the hypothetical willing seller.

There are numerous alternative premises of value that may apply to ESOP employer stock valuation assignments. The five most common premises of value are:

1. value in continued use, as a going-concern business enterprise
2. value in place, but not in current use in the production of income
3. value in exchange, as part of an orderly disposition of assets
4. value in exchange, as part of a voluntary liquidation of assets
5. value in exchange, as part of an involuntary liquidation of assets

Typically, the first five elements of the valuation are specified by the analyst's client as part of the ESOP employer stock valuation assignment. Sometimes, the premise of value is also selected by the engagement client. In such instances, the premise of value may be determined by the particular purpose and objective of the valuation assignment.

In some cases, the client will leave the selection of the premise of value up to the analyst's professional judgment. In such instances, the analyst will typically select the premise of value that represents the highest and best use (HABU) of the subject employer corporation business operations. In most employer stock valuations, the premise of "value in continued use" represents the HABU of the sponsor company. However, the analyst should not automatically make that assumption without performing a HABU analysis.

In other words, the analyst would typically select the premise of value:

1. that is consistent with the actual status of the employer corporation operations and
2. that will result in the highest fair market value indication.

7. The Valuation Date

The valuation date is often referred to as the "as of date" of the business valuation. The client typically determines the valuation date as part of the ESOP employer stock valuation assignment. This is an important element of the valuation, because an employer company's business value can change materially over time.

These changes in business value can result from factors that are either:

1. endogenous to the employer company (e.g., changes in the current operating results) or
2. exogenous to the employer company (e.g., changes in the industry competition).

Obviously, the engagement client can select any date as the assignment valuation date. For ESOP valuation purposes, the appropriate valuation date is typically:

1. a transaction date—for an ESOP transaction/financing valuation or
2. the employer corporation fiscal year end—for an accounting or regulatory valuation.

However, all possible valuation dates can be grouped into the following three categories:

1. **Contemporaneous date**—the valuation date is contemporaneous with the analyst's work; most transactional valuations are performed on a contemporaneous basis.
2. **Retrospective date**—the valuation date is historical compared to the analyst's work; most notational or litigation valuations are performed on a retrospective basis; this is because such valuations often relate to a specific historical event.
3. **Hypothetical date**—the valuation date is sometimes in the future compared to the analyst's work; an analysis performed as of a future date will reflect an employer company financial position that does not yet exist; therefore, such business valuations are typically called hypothetical valuations.

8. The Report Date

The valuation report date indicates the date on which the analyst completes and issues the written valuation opinion report. In the case of an oral report, the report date is the date on which the analyst presents the oral report—for example, the date that the analyst offers expert witness testimony.

The engagement client may request a certain report date as part of the valuation assignment. For example, the client may request that the valuation report be issued in time for the employer corporation to make a stock contribution, to file an income tax return, or to file a public report with the SEC. However, the actual report date is a matter of fact. It is the actual date on which the analyst completes and issues the ESOP valuation report document.

9. The Client/User of the Analysis

As mentioned above, the first eight elements relate to the objective of the ESOP employer stock valuation. The last two elements relate to the purpose of the ESOP employer stock valuation. The objective of the valuation indicates what the analyst intends to do in the analysis. The purpose of the valuation indicates why the analyst is performing the analysis.

The ESOP valuation report should specify (1) the party who retained the analyst (e.g., the ESOP trustee) and (2) any and all parties who may rely upon the value conclusion (e.g., the ESOP administrative committee and/or ESOP participants). This disclosure is required by most established business valuation standards, including USPAP.

Regardless of a particular disclosure requirement, it is appropriate to let the report reader know who retained the analyst. This fact may influence the degree of reliance that the report reader assigns to the valuation report (and to the value conclusion).

It is also appropriate for the report reader to know who may—and who may not—rely on the ESOP employer stock valuation report. This disclosure informs the report readers whether or not they may specifically rely on the valuation analysis. This disclosure also protects the analyst. The analyst should not have a duty to any party to whom the valuation report was not intended.

10. The Intended Use of the Analysis

The disclosure of this element of the valuation benefits both the report reader and the analyst. And, the disclosure of the intended use (or uses) of the valuation is required by most established business valuation standards, including USPAP.

The report reader should be aware of the intended use of the valuation. This disclosure may influence the report reader's degree of reliance on the valuation.

If a valuation is prepared for purpose A (e.g., an ESOP formation and employer corporation stock purchase), then the report reader should not rely on that valuation for purpose B (e.g., the substantiation of a charitable contribution tax deduction). This is because the two purposes may involve different standards of value, different premises of value, different regulatory requirements, and different value conclusions.

Likewise, this disclosure also protects the analyst. The analyst should not have a duty to a client who uses the valuation for purpose A when that valuation was specifically prepared for purpose B.

Hypothetical Conditions and Extraordinary Assumptions

Declarations with respect to any hypothetical conditions or extraordinary assumptions affecting the valuation are not considered elements of the business/security valuation. Nonetheless, the analyst should disclose any hypothetical conditions or extraordinary assumptions that affect the subject valuation.

Such a disclosure may affect the degree of reliance the report reader places on the valuation analysis. And, such a disclosure protects the analyst (including from allegations that the report reader was misled).

There are specific USPAP definitions for the terms (1) hypothetical condition and (2) extraordinary assumption. Simply described, however, a hypothetical condition is a condition that is contrary to actual reality.

For example, a hypothetical condition would exist if the analyst performed the business/stock valuation of Employer Corporation without considering the influence of the unprofitable ABC division. This condition is hypothetical if, on the valuation date, Employer Corporation does actually own and operate the ABC division.

Simply described, an extraordinary assumption is an assumption that, if proven wrong, would have a material effect on the value conclusion.

For example, an extraordinary assumption would exist in the business/stock valuation of Employer Corporation assuming it consummates its proposed acquisition of XYZ Company. If Employer Corporation does not complete its acquisition of XYZ Company, then the business/stock value of Employer Corporation would be materially different. Therefore, the assumption of the XYZ Company acquisition is an extraordinary assumption.

Compliance with Recognized Professional Standards

While not part of the ten elements of the business/security valuation assignment, the analyst should also consider if it is appropriate to apply a particular set of professional standards to the ESOP employer stock valuation assignment. Most business valuation assignments do not require compliance with any specific set of promulgated standards.

However, the analyst should be aware of when a particular assignment does require compliance with a specific set of standards. And, the analyst should prepare each valuation analysis and valuation report in compliance with the generally accepted practices of the valuation profession.

Various professional membership organizations have promulgated standards for their individual membership. For example, the American Society of Appraisers, the Institute of Business Appraisers, and the National Association of Certified Valuation Analysts have all published some form of business valuation standards applicable to their individual members. As of the date of this writing, the American Institute of Certified Public Accountants has exposed a draft set of business valuation standards for CPA valuation analysts.

USPAP is a set of standards that is often referenced in ESOP employer stock valuations. And, USPAP includes standards for business appraisals, as well as for other appraisal disciplines. USPAP is promulgated by the Appraisal Standards Board of The Appraisal Foundation. ESOP valuation analysts should generally be aware of the USPAP business valuation professional guidance.

However, it is noteworthy that compliance with the USPAP business valuation standards is only required in the three relatively rare circumstances when the application of USPAP:

1. is required by law,
2. is required by regulation, or
3. is required by an agreement with the client.

Summary and Conclusion

ESOP valuation analysts should consider all ten elements of the employer corporation stock valuation:

1. before accepting the ESOP valuation assignment,
2. before performing the valuation analysis, and
3. before preparing the ESOP valuation report.

If possible, the analyst should document the elements of the valuation assignment in a client engagement letter. This documentation should minimize the opportunity for a misunderstanding by, or dispute with, the client. And, this engagement letter documentation should help keep the analyst on track during the ESOP employer stock valuation assignment.

A written discussion of the elements of the valuation assignment (either in an engagement letter or in the workpaper files) helps the analyst to document:

1. the scope of work performed,
2. compliance with any applicable published professional standards, and
3. compliance with generally accepted professional practices.

And, the determination of the ten elements of the valuation assignment will influence the analyst's selection of the appropriate ESOP employer stock valuation approaches, methods, and procedures.

Finally, the determination of the ten elements of the ESOP valuation assignment will affect the final value conclusion. For example, employer corporation business values change over time, so the valuation date will affect the value conclusion.

The analyst will conclude different values for the same employer corporation stock depending on the selected ownership interest. The analyst will conclude different values for the same ownership interest depending on the selected standard of value. The analyst will conclude different values for the same standard of value depending on the selected premise of value.

And, the valuation client/user and intended purpose will affect both (1) the scope of analytical work performed in the ESOP employer stock valuation and (2) the format and content of the ESOP employer stock valuation report.

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