

## THE BASIC ELEMENTS OF THE ESOP EMPLOYER CORPORATION STOCK VALUATION

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*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.*

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### 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 work-paper 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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