

ESOP Valuation Insights

ETHICS CONSIDERATIONS IN ESOP EMPLOYER STOCK VALUATIONS

Robert F. Reilly

Valuation analysts and financial advisers who practice in the ESOP area should be familiar with all generally accepted business/security valuation approaches, methods, and procedures. These valuation analysts and financial advisers should have experience and expertise with regard to ESOP employer stock purchase transactions, employer stock sale transactions, leveraged ESOP financings, transaction fairness opinions, and financing solvency opinions. However, in addition to ESOP valuation and financial adviser technical expertise, these analysts should have a current and constant appreciation for the ethics considerations involved in ESOP employer stock transactions, financings, and regulatory compliance valuations. This discussion will focus on the six "C"s of ESOP valuation and financial adviser ethics considerations.

INTRODUCTION

Valuation analysts perform employer corporation business and security valuations for a wide range of client purposes. Most of these purposes may be grouped in the following categories of client motivations: (1) fairness opinions with regard to ESOP formations and initial purchases of plan sponsor company stock, (2) financing (or refinancing) of leveraged ESOP stock purchase transactions, (3) periodic valuations for employer stock contributions and employee stock redemptions, (4) fairness opinions with regard to the ESOP trustee's consideration of major capital transactions related to the employer corporation, (5) taxation and regulatory agency compliance and audits, and (6) ESOP plan terminations.

These categories of client motivations encompass various types of analyses and reports prepared by the valuation analyst, including: (1) fair market value valuations, (2) fairness opinions, (3) solvency opinions, (4) adequate consideration opinions, (5) fair value opinions, and so forth.

From the client's perspective, all of the above-listed valuation services and client motivations have one thing in common: they all involve controversy. The controversy may be explicit—that is, between two parties with adverse economic interests. Or, the controversy may be implicit—that is, as a component of the client's decision-making process.

Explicit valuation controversies are usually easy to recognize—for example, between the ESOP trust stock buyer

and the employer corporation stock seller, between the ESOP trustee and other classes of sponsor company stockholders, between the leveraged ESOP and the financing source, between the DOL and an employer corporation in an ERISA matter, between the IRS and the employer corporation in a taxation matter, and between a current/former ESOP participant and a trustee/employer corporation defendant in an ERISA or commercial litigation claim.

Implicit valuation controversies are less easy to recognize. This is because the controversy is usually between the client and him/herself.

"Explicit valuation controversies are usually easy to recognize. . . ."

Examples of valuation-related implicit controversies include personal or corporate decisions such as: Should the employer corporation form an ESOP? Should the controlling stockholder take the plan sponsor company public and, if so, when? Should the employer corporation restructure, reorganize, or refinance? Should the employer corporation convert from a C corporation to an S corporation? Should the ESOP trust purchase the employer corporation stock at the offered price? Should the trustee vote for or against the employer corporation proposed capital transaction, restructuring, or tender offer? What should the controlling stockholder do to maximize the value of the plan sponsor company?

These strategic decisions represent implicit valuation controversies because the client has to choose between competing alternatives, each of which have their own costs and benefits.

ESOP VALUATION ANALYST ETHICS CONSIDERATIONS

From the analyst's perspective, all of the above-listed ESOP valuation services and client motivations have another thing in common: they all involve analyst ethics. The analyst ethics may be professional, or the analyst ethics may be personal.

That is, the analyst ethics consideration may be imposed by statutory authority, administrative rules, professional organization membership requirements, licensure regulations, or client/contractual expectations. Or, the analyst ethics consideration may be imposed by the analyst's moral compass and individual commitment to "do the right thing."

This discussion will focus on the analyst's ethics considerations in performing ESOP employer stock valuation services. Some limited discussion will focus on specific organizational and regulatory professional standards. However, this discussion will primarily focus on the practical aspects of ethics considerations in ESOP valuation engagements.

In other words, this discussion will focus on the factors that an analyst should consider in order to "do the right thing" and, particularly, in order to "do the right thing the right way." For purposes of this discussion, we will categorize these factors into the "six Cs" of analyst ethics considerations.

THE SIX CS OF ETHICS CONSIDERATIONS

In performing employer corporation stock valuation services for any purpose, an analyst should consider the following six Cs of ethics considerations:

1. compliance with promulgated professional standards
2. competency to perform the subject valuation analysis
3. completeness of the subject valuation analysis
4. correctness of the valuation analysis and value conclusion
5. confusion in the valuation analysis caused by the analyst
6. consistency with previous valuation positions

Each of these six C categories of valuation analyst ethics consideration will be discussed below.

First C: Compliance with Promulgated Professional Standards

As mentioned above, this discussion will not detail all of the published professional standards related to the busi-

ness/security valuation profession. Rather, for purposes of this discussion, we will segregate the analyst's compliance with all professional standards into three categories of considerations:

1. compliance with generally recognized professional standards
2. compliance with membership organization professional standards
3. compliance with generally accepted professional practices

First, in all ESOP sponsor company business/security valuation assignments, an analyst should consider when it is appropriate to comply with the *Uniform Standards of Professional Appraisal Practice* (USPAP). The 2006 edition of USPAP became effective as of July 1, 2006. The 2006 edition of USPAP describes an ethics rule that has four sections. These four sections are:

1. conduct of the valuation engagement
2. management of the valuation engagement
3. confidentiality of both analyst and client information
4. record keeping related to engagement workpaper files

All ESOP valuation analysts should be familiar with the requirements regarding the four sections of the USPAP ethics rule. Even if USPAP does not apply to the particular ESOP stock valuation assignment, the analyst should consider the applicability of these four sections of the USPAP ethics rule.

The management section of the USPAP ethics rule includes consideration of an analyst bias and conflicts of interest in the following provision (from page 8 of the USPAP *2006 Edition* published by The Appraisal Foundation):

It is unethical for an appraiser to accept an assignment, or to have a compensation arrangement for an assignment, that is contingent on any of the following:

1. the reporting of a predetermined result (e.g., opinion of value);
2. a direction in assignment results that favors the cause of the client;
3. the amount of a value opinion;
4. the attainment of a stipulated result; or
5. the occurrence of a subsequent event directly related to the appraiser's opinions and specific to the assignment's purpose.

While an analyst should consider the relevance of the USPAP ethics rule in all ESOP valuation engagements, it is noteworthy when (and only when) the USPAP analysis and reporting standards apply to valuation assignments.

The application of USPAP is required in (and only in) three specific circumstances:

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

In fact, these three circumstances are specifically listed in the USPAP ethics rule in the following provision (from page 7 of the *USPAP 2006 Edition* published by The Appraisal Foundation):

Compliance with USPAP is required when either the service or the appraiser is obligated by law or regulation, or by agreement with the client or intended users, to comply. In addition to these requirements, an individual should comply any time that individual represents that he or she is performing the service as an appraiser.

“The application of USPAP is required in (and only in) three specific circumstances.”

Accordingly, an analyst should generally consider the application of USPAP in all ESOP employer stock valuation assignments. And, an analyst will comply with USPAP by applying the USPAP standards rules in the three above-listed circumstances.

Second, in all ESOP business/security valuation assignments, analysts should comply with the professional standards and codes of ethics/professional practices of the organizations of which they are members. Currently, the American Institute of Certified Public Accountants has issued business valuation standards in draft format. As of the date of this writing, these AICPA business valuation standards are in the process of being finalized.

Currently, the American Society of Appraisers, the Canadian Institute of Certified Valuation Analysts, the Institute of Business Appraisers, and the National Association of Certified Valuation Analysts have each issued some form of business valuation standards for their respective members. Analyst members of any of these professional societies should comply with both the ethics standards and the technical standards of their membership organizations.

Third, in all ESOP employer stock valuation assignments, an analyst should comply with the generally accepted practices of the business/security valuation profession. Unlike promulgated professional standards, professional practices are not always written down. This is because pro-

fessional practices are not promulgated or updated by any one regulatory or membership organizations.

Rather, professional practices represent the practice and procedures that most valuation analysts and/or professional financial advisory service firms would employ in a similar situation. Accordingly, the consideration of generally accepted professional practices should apply to every analyst in every ESOP sponsor company business/security valuation assignment.

Second C: Competency to Perform the Valuation Analysis

An ESOP valuation analyst’s competency is usually demonstrated by professional experience, academic education, specialized training, rigorous research of authoritative literature, professional credentials, and so on.

In controversy (e.g., ERISA litigation, IRS/DOL audit, ERISA regulatory challenge) matters, focused competency is generally more relevant than general competency. That is, the finder of fact (i.e., a judge or jury) may be less interested in the analyst’s general valuation experience.

Instead, the finder of fact may be more interested in the analyst’s specific valuation experience (1) in the subject industry, (2) related to the subject type of equity instrument or other business interest, and (3) for the specific ESOP sponsor company valuation engagement purpose.

Some examples of where focused competency is particularly relevant to ESOP valuation assignments include: (1) the effect of GAAP accounting issues on a valuation analysis, (2) the effect of a valuation analysis on GAAP financial reporting, (3) the analysis of complex capital structures, (4) the analysis of complex capitalization rate issues, (5) consideration of the sponsor company’s ESOP stock repurchase obligation, and (6) consideration of the sponsor company’s ability to meet the plan’s put option.

Whether related to an ESOP controversy assignment or not, an analyst should not perform an ESOP valuation analysis for which he or she is not qualified.

The demonstration of focused competency is a particular ethics consideration when the analyst provides litigation support and expert testimony services. Many consumers (particularly mothers) may remember a popular television commercial for a brand of children’s cough medicine. The commercial featured a distinguished looking actor who was a regular cast member on a long-running daytime soap opera.

Dressed in a white laboratory coat, the actor told the audience “I’m not a doctor, but I play one on TV.” The Federal Trade Commission ordered the cough medicine

company to stop showing that TV commercial. This was because the FTC was concerned that viewers would mistake the actor for an actual physician endorsement.

When an analyst without the appropriate focused competency offers ESOP employer stock valuation expert testimony, the analyst is effectively saying: “I’m not an expert, but I play one in the court room.”

ESOP trustees, ESOP legal counsel, and finders of fact expect that a testifying expert will have bona fide competency. The ESOP valuation expert witness who cannot demonstrate such focused competency faces serious ethics considerations.

Third C: Completeness of the Valuation Analysis

Clients (and others who rely on the ESOP sponsor company business/security valuation analysis and report) expect that the analyst’s work will be complete. Clients (and others) expect that the analyst appropriately considered all of the fundamental elements of the ESOP business/security valuation assignment.

With regard to completeness, the analyst should consider (and document consideration of) all generally accepted business/security valuation approaches, methods, and procedures. Such consideration includes any valuation approach that is less commonly used, such as the asset-based approach.

For example, if the analyst automatically assumes away the use of the asset-based approach, then the analyst will not apply that approach in the occasional circumstance when it is directly applicable.

The analyst should consider (and document consideration of) all applicable employer corporation financial statement normalization adjustments. Such adjustments may include balance sheet adjustments as well as income statement adjustments. And, the normalization adjustment process applies to any selected guideline companies, as well as to the subject ESOP sponsor company.

The analyst should consider (and document consideration of) all potential guideline companies—both guideline publicly traded companies and guideline merged and acquired companies. The analyst should not automatically assume that there are no guideline companies that are sufficiently similar to the subject ESOP sponsor company.

The analyst should consider (and document consideration of) relative rates of return on investment, profit margin, and historical/expected growth rates with regard to the selection of valuation pricing multiples. The range of pricing multiples typically will be determined by the selected guideline companies. And, the analyst can calculate mean and median pricing multiples from the market-derived range of pricing multiples. However, mean or median pricing multiples are rarely appropriate for a subject ESOP sponsor company.

Rather, the analyst should select a subject-appropriate pricing multiple from the market-derived range of pricing multiples. And, the selection should be based on the returns, margins, and growth rates of the subject ESOP sponsor company relative to the returns, margins, and growth rates of the guideline companies.

The analyst should consider (and document consideration of) all relevant valuation adjustments—that is, discounts and premiums—related to the subject stock ownership interest. This consideration should include appropriate level of value adjustments—that is, discounts and premiums—related to the elements of marketability and ownership control.

And, this consideration should include all plan sponsor company-specific valuation adjustments—such as discount for key employee dependence, key customer dependence, key supplier dependence, and so forth. This consideration should include all security-specific valuation adjustments—such as a premium for supervoting stock, consideration of convertible preferred stock conversion features, and so on.

The analyst should consider (and document consideration of) all relevant strategic and competitive analyses with regard to the subject ESOP sponsor company. That is, in addition to the perfunctory financial ratio, common size, and trend line analysis, the analyst should compare the subject ESOP sponsor company to its industry competitors, with regard to: (1) strength, (2) weaknesses, (3) opportunities, and (4) threats.

The analyst should consider (and document consideration of) all procedures within a selected business/security valuation approach and method. For example, let’s say the analyst decides to perform an asset-based approach and an asset accumulation method.

The analyst should consider the appraisal of the subject ESOP sponsor company net working capital, real estate, and tangible personal property—and not simply assume book value for each of these asset categories. In addition, the analyst should identify and value all of the sponsor company’s discrete intangible assets, including an analysis of any intangible value in the nature of goodwill. Lastly, the analyst should consider the value of the sponsor company’s contingent liabilities as well as the value of the sponsor company’s intangible assets.

The analyst should consider (and document consideration of) the appropriate due diligence procedures with regard to reliance on management projections in an income approach valuation analysis. Depending on the purpose and objective of the ESOP employer stock valuation, the analyst should consider the appropriate procedures to test the reasonableness of management projections, including:

1. analytical review procedures and
2. due diligence investigations of projection variables.

The above discussion presents only a partial list of the considerations an analyst should make to ensure the completeness of the ESOP employer stock valuation analysis. Clients (and other report readers) not only expect the analyst to perform a competent valuation, they expect the analyst to perform a complete valuation.

Fourth C: Correctness of the Valuation Analysis

Clients (and others who rely on the ESOP business/security valuation) expect that the analyst's work will be correct. This ethics consideration encompasses—but goes way beyond—mathematical accuracy.

Of course, clients (and others) expect that the ESOP stock valuation will not contain arithmetic mistakes. This ethics consideration also encompasses the selection and application of all the elements of the ESOP sponsor company business/security valuation.

For example, the correctness of the ESOP employer stock valuation analysis is affected by these (and other) issues:

1. Did the analyst value the correct security/ownership interest?
2. Did the analyst value the correct bundle of legal rights?
3. Did the analyst select the correct valuation date?
4. Did the analyst select the correct standard of value?
5. Did the analyst value the correct premise of value?
6. Did the analyst select the correct level of value?
7. Did the analyst consider all appropriate regulatory, taxation, and accounting influences on the valuation?
8. Did the analyst consider all appropriate contractual influences on the valuation?

Ultimately, this ethics consideration is influenced by the question: Did the analyst achieve the stated objective of the ESOP employer stock valuation? In other words, did the analyst apply the correct standard of value to the correct appraisal subject as of the correct valuation date?

Clients (and other report readers) expect that the analyst will deliver an ESOP employer stock valuation report that achieves the intended purpose and objective of the analysis.

Fifth C: Confusion in the Valuation Analysis

Clients (and others) expect that the analyst will mitigate or eliminate the confusion inherent in the subject appraisal problem. Certainly, clients (and others) do not expect that the analyst will create or exacerbate the confusion inherent in the subject appraisal problem.

An analyst should strive to make the valuation analysis clear, comprehensive, and self-contained. And, an analyst should strive to make the ESOP valuation report complete, cogent, and self-explanatory. More importantly, as an ethics consideration, an analyst should strive to avoid extraneous financial accounting influences and extraneous public disclosure influences on the subject ESOP stock valuation.

Examples of extraneous financial accounting influences include the subject sponsor company's adoption of the FASB SFAS Nos. 141, 142, 143, and 144. This is because the value conclusion should influence the subject sponsor company's business combination purchase accounting, goodwill and long-lived asset impairment recognition, and capitalization of asset retirement costs.

In contrast, the subject sponsor company's accounting under FASB SFAS Nos. 141, 142, 143, and 144 should not influence the analyst's value conclusion. In other words, the valuation analyses/conclusions are not extraneous to the sponsor company's financial accounting. However, the sponsor company's financial accounting may be largely extraneous to the ESOP stock valuation analyses/conclusions.

Extraneous public disclosure influences include disclosures made by the subject sponsor company that should have little or no effect on the subject valuation. For example, the CEO of a ESOP sponsor company may announce an optimistic statement regarding the future potential of the corporation. However, if this optimism is not supported by the facts and circumstances, then the CEO's optimism should not necessarily influence the valuation of the subject ESOP sponsor company.

Similarly, an executive of a pending merger company may announce optimistic expectations of post-merger synergies and other economic benefits. However, those expectations are often unproven and based on "best case" projection scenarios. Therefore, those expectations should not necessarily influence the valuation of the merger target ESOP sponsor company.

Also, some ESOP sponsor companies prepare financial budgets and plans that are goal-oriented. This means that the projections represent goals or targets for operating management. That is, the projections do not represent the most likely expected results of operations. If the analyst concludes that management projections are goal-oriented (and not realistic financial targets), then those projections should not necessarily influence the valuation of the subject ESOP sponsor company.

Clients (and others) expect that, as an ethics consideration, the analyst will clarify the confusion of the subject valuation problem. In addition, clients (and others) expect that the analyst will not create confusion by focusing on extraneous influences that:

1. should not have a material influence on the ESOP employer stock value conclusion but
2. could confuse the ESOP valuation report reader.

Sixth C: Consistency in the Valuation Analysis

Clients (and others) expect that, as an ethics consideration, the analyst's valuation analysis will be fundamentally consistent with (1) previous ESOP sponsor company sponsor company business/security valuation reports, (2) previous professional publications, and (3) previous expert testimony.

This ethics consideration does not imply that it is better to be consistent than to be right. And, this ethics consideration does not imply that the analyst's valuation methodology and analytical variables should not adopt to differing subject sponsor company facts and circumstances.

Rather, this ethics consideration does imply that any fundamental changes in the analyst's prior methodological positions should be explainable—particularly in reference to the specific facts and circumstances of the subject ESOP employer stock valuation assignment.

Clients, report readers, and finders of fact are justifiably concerned when the analyst is presented with contradictory prior reports, publications, and testimony. This is particularly the case when the prior position includes the words “always” or “never.” Such impeachment, if not explainable, may raise a question regarding the analyst's ethical practices.

Of course, there may be very good reasons why an analyst may take apparently contradictory positions in two different valuations. And certainly, any informed reader would expect valuation variables (such as pricing multiples, capitalization rates, profit margins, growth rates) to differ between time periods, industries, and individual ESOP sponsor companies.

But, even fundamental changes in methodology may be explained by “exception to the rule” unique circumstances related to the subject assignment. Of course, clients (and others) would expect that the analyst mention such unique circumstances in the ESOP valuation analysis and ESOP valuation report.

As an ethics consideration, clients (and others) expect the analyst to adopt the position of “that's my story, and I'm sticking to it” with regard to fundamental methodological issues. This does not mean that clients expect an analyst to be dogmatic.

Rather, clients do expect an analyst to have firm and well-founded convictions. However, when the analyst effectively takes the position of “that's my story, and I'm not

sticking to it,” clients (and others) may question both the analyst's convictions and the analyst's ethics.

SUMMARY AND CONCLUSION

ESOP business/security valuations are often relied on and/or reviewed by various parties, including clients, plan participants, other valuation analysts, other professionals (e.g., ESOP bankers, ESOP accountants, ESOP lawyers, etc.), government regulators and auditors, and judicial finders of fact. All of these parties expect that the analyst contemplate all applicable ethics consideration when conducting the ESOP stock valuation.

Analysts who include the above-described six Cs of ethics considerations in their valuation process should satisfy the expectations of all interested parties.

As explained above, this discussion did not focus on analyst advocacy and independence issues. These issues include many of the representations that an analyst makes in the typical ESOP employer stock valuation certification: (1) I am independent of the subject client and of the subject business interest, (2) I am impartial and unbiased, (3) my professional fee is not contingent on my value conclusion, and so forth.

Most analysts (and most clients) are fully aware of these ethics considerations. And, in any event, these advocacy and independence issues are encompassed in the “compliance with professional standards” ethics consideration discussed above.

Instead, this discussion focused primarily on the practical application of ethics considerations, particularly with regard to the expectations of clients and of other interested parties.

In the ESOP sponsor company business/security valuation, these parties expect the analyst to appraise the right business interest—and to appraise the right business interest the right way. In the ESOP business/security valuation, these parties expect the analyst to do what he/she said—and to say what he/she did. And, in the ESOP business/security valuation, these parties expect the analyst to tell the truth, the whole truth, and nothing but the truth.

Clients and other interested parties expect the analyst to weave ethics considerations into the basic fabric of each ESOP business/security valuation. If the above-described six Cs of ethics considerations are part of the analyst's loom, then the whole cloth of the ESOP business/security valuation should meet these client expectations.

“... clients do expect an analysis to have firm and well-founded convictions.”

Robert Reilly is a managing director of the firm and is resident in the Chicago office. Robert can be reached at (773) 399-4318 or rfreilly@willamette.com.