

*ESOP Fiduciary Insights*

## ESOP FIDUCIARY REVIEW OF EMPLOYER CORPORATION STOCK VALUATION REPORTS

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*ESOP trustees rely on financial adviser's transaction opinions (e.g., fairness opinions, solvency opinions) and valuation opinions (e.g., fair market valuations and adequate consideration opinions) as important input in a number of trustee decisions. However, ESOP trustees should not naively accept the financial adviser's opinion. Rather, the ESOP fiduciary should submit the financial adviser's work to a rigorous due diligence process. This discussion summarizes some of the various factors that an ESOP fiduciary should consider when reviewing an employer corporation stock valuation report. This discussion includes a checklist for ESOP trustees to use in their review of the employer stock valuation report.*

### INTRODUCTION

For anyone serving as an employee stock ownership plan (ESOP) trustee ("trustee"), determining the fair market value of the employer stock owned by the ESOP trust is an important consideration. It is not uncommon for the valuation of the sponsor company's stock to be questioned by ESOP participants or governmental agencies—such as the U.S. Department of Labor (DOL) or the Internal Revenue Service ("Service").

ESOP trustees should remember that it is just as important that the subject employer stock interest not be overvalued as it is that the subject employer stock interest not be undervalued. Of course, it is also important that the value conclusion is at fair market value.

It is common for an ESOP trustee to hire an independent financial adviser to estimate the fair market value of non-publicly-traded employer corporation stock. However, it is the ESOP trustee who is ultimately responsible for:

1. the accuracy of the employer stock valuation report and
2. the validity of the employer stock value conclusions.

This discussion will provide fiduciaries with a list of issues that should be considered and questions that should

be answered when reviewing an employer stock valuation report. This discussion relates to any review of an employer stock valuation reports prepared for either (1) ESOP transaction purposes and (2) ESOP administration purposes.

The following sections include: (1) an overview of the typical employer stock valuation report content and (2) a checklist for ESOP trustees to incorporate in their review of the employer stock valuation report.

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### EMPLOYER STOCK VALUATION REPORT CONTENT

This section lists and briefly describes the specific sections of the employer stock valuation report that should be of particular interest to an ESOP trustee.

#### Description of the Subject Ownership Interest

The employer stock valuation report should adequately describe the ownership interest subject to valuation. That description should generally include (1) the legal name of the employer corporation, (2) the number of employer corporation shares owned by the ESOP, (3) the legal form of ownership, and (4) a discussion of all of the outstanding classes of employer corporation equity.

## Standard of Value and Premise of Value

The employer stock valuation report should specifically state that fair market value is the appropriate standard of value for the subject ownership interest. And, the employer stock valuation report should specifically define the term fair market value.

The employer stock valuation report should also describe the selected premise of value—that is (1) value as a going-concern business enterprise or (2) value in an orderly or forced disposition of assets.

## Purpose of the Analysis

The purpose of the valuation opinion report should be clearly stated. An ESOP financial advisory services engagement could include either (1) a transaction-related opinion such as a fairness opinion or (2) an annual employer stock valuation update.

## Valuation Date

The employer stock valuation report should state both (1) the effective valuation date and (2) the date that the valuation report was prepared.

## Level of Value

The employer stock valuation report (1) should identify the subject ownership interest and (2) should describe the ownership control rights (or the lack thereof) that accompanies the subject ownership interest.

## Sources of Information

A comprehensive employer stock valuation report will usually include a section that lists the data and documents relied on by the financial adviser to develop the employer stock value conclusions.

## Description of the Subject Employer Corporation

An employer stock valuation report should provide an adequate description of the employer corporation. The description should be complete enough that a third-party reader would be able to understand the fundamental operations of the subject employer business.

## Economic and Industry Forces

The valuation report should provide an overview of both (1) the macroeconomic and the microeconomic forces that

affect the employer corporation and (2) the industry-specific factors that affect the employer stock value conclusions.

## Employer Corporation Financial Performance

A summary of the employer corporation's historical financial statements and a description of all financial statement normalization adjustments should be described in the employer stock valuation report.

## Valuation Approaches and Methods

A discussion of the selected business/security valuation approaches and methods should be included in the employer stock valuation report. The employer stock valuation report should discuss the valuation approaches considered and the valuation methods selected to be used in the value calculations.

The employer stock valuation report should also discuss why any generally accepted business valuation methods were not considered in the analysis.

*“The ESOP trustee should feel confident with everything contained in the employer stock valuation report.”*

## Employer Stock Value Conclusion

The employer stock valuation report should contain a section that provides (1) a valuation summary of alternative value indications, (2) a final value conclusion, and (3) a discussion of why

certain valuation methods may be more or less applicable in calculating the final value conclusion.

## EMPLOYER STOCK VALUATION REPORT REVIEW CHECKLIST

The ESOP trustee should:

1. study the entire employer stock valuation report,
2. check for any facts that may have been misunderstood,
3. verify all of the figures are added properly, and
4. confirm that the report accurately reflects the “going-concern” value of the business.

After reviewing the employer stock valuation report, the ESOP trustee should schedule an interview with the valuation firm. The valuation analyst should walk the trustee through the report and should answer any questions or address any concerns the trustee has with regard to the report. The ESOP trustee should feel confident with everything contained in the employer stock valuation report.

The ESOP trustee should document the entire review process with notes indicating a thorough review of the valuation report. This documentation should include all of the questions that were asked and all of the answers that were provided. To facilitate this review process, a standard valuation report review checklist may prove helpful.

Based on guidance provided by the American Society of Appraisers, the following list presents issues that the ESOP trustee should consider during the employer stock valuation report review process:

- Are both the effective valuation date and report preparation date stated?
- Is the purpose of the valuation, i.e., ESOP employer stock valuation, clearly stated?
- Does the report cite Internal Revenue Service Revenue Ruling 59-60, which provides guidelines for the factors to be considered in certain business valuations?
- Does the report reference Section 3(18) of the Employee Retirement Income Security Act of 1974, as amended (ERISA), regarding fair market value and adequate consideration?
- Are stock ownership characteristics, such as degree of ownership control and marketability issues, outlined in the valuation report?
- Is the basic sponsor company information—such as history, description of products and services, market and competitive situations, management depth and succession issues, capital structure and distribution of ownership—included in the valuation report?
- Is there an analysis of the economy and of the industry outlook as it pertains to the subject sponsor company?
- Are the sources of information that the financial adviser used in developing the valuation report listed?
- Are sponsor company financials statements included in the valuation report? (e.g., income statement, balance sheet, cash flow statements, comparative financial ratio analysis.) The relevant periods for the financial statements should be indicated, as should the independent accountant's level of assurance (i.e., compiled versus reviewed versus audited).
- Are the generally accepted business valuation approaches used in the valuation report, including the income approach, market approach, and asset-based approach? Is there sufficient detail provided under these business valuation approaches to ensure that the report reader has a thorough understanding of the value conclusion?
- Is the sponsor company's financial statement information compared with itself, in order to identify timeline trends?
- If the guideline publicly traded company valuation method is used, are the criteria for the guideline company selection appropriate? Is the population from which the guideline companies has been drawn clearly specified?
- What discount for lack of marketability is used? Is sufficient data provided to support the selected discount for lack of marketability?
- Is a discount for lack of control used? If so, is it only applied to valuation methods that conclude a controlling ownership interest level of value? Are sufficient data provided to support the selected discount for lack of marketability?
- Is an ownership control premium used? If so, is it only applied to valuation methods that conclude a noncontrolling ownership interest level of values? Is sufficient data provided to support the selected ownership control premium?
- Is an employer stock valuation conclusion clearly stated? Does the conclusion include a sufficient discussion of the weightings applied to the various valuation method indications presented in the employer stock valuation report?

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## SUMMARY AND CONCLUSION

A professional valuation firm (a firm with an adequate depth of ESOP employer stock valuation experience) can help the ESOP trustee document the information recommended above. The valuation firm can also assist the ESOP trustee in his/her assessment of other items pertinent to the determination of the employer stock fair market value. Therefore, it is important for the ESOP trustee to judiciously select the independent financial adviser.

Once the draft valuation report has been reviewed by the ESOP trustee, the valuation firm should prepare a final valuation report that takes into account any changes resulting from the review. The ESOP trustee should retain this final valuation report, along with all notes documenting the valuation report review process.

The guidelines outlined above should provide a solid basis for the documentation of the ESOP trustee's review of the employer stock valuation report. This documentation should enable the ESOP trustee to answer ESOP participant questions and government/regulatory agency questions regarding the ESOP employer corporation stock valuation.

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