FIDUCIARY PROCESS FOR THE ANNUAL UPDATE TO THE SHARE VALUE

Introduction

ESOP trustees are required by law to set the employer stock price at least annually which in turn allows the ESOP's third-party administrator to perform the mandatory annual accounting and testing procedures that culminate in the issuance of annual ESOP participant statements. An ESOP participant statement includes the participant's account balance as of the end of the plan year, based on the new stock price.

The trustee sets the share price based on the fair market value of the employer stock determined by an independent third-party valuation firm.[1]

This article is intended as a high-level discussion of the process related to the annual update of the share price for plan administration purposes.[2] These steps are intended as general guidelines. The actual steps necessary for a prudent process will depend on the specific facts and circumstances of the annual update engagement.

---

1. The trustee can set the share price at something different than the value provided by the third-party independent valuation firm. However, the trustee would have to explain why they differed from the valuator. And, this is not very common, but it is important to note that ultimately the trustee is the one that sets the share price.

2. Depending on the plan document, there may be quarterly or semi-annual updates to value. The process for these updates would be generally be similar to that of the annual update described herein.

Selecting A Qualified Valuation Advisor

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 advisors to help them fulfill their fiduciary obligations.

One example of this exercise of prudence is when the trustee hires an independent valuation advisor to estimate the fair market value of non-publicly-traded employer corporation stock for plan administration purposes. Given the importance of these employer stock valuations, it is important that the ESOP trustee hire a qualified, independent valuation advisor. 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 its fiduciary duties.

Prudently Investigate Valuation Advisor Qualifications

In selecting a valuation advisor, the trustee may prepare a written analysis addressing the following topics:

- The reason for selecting the particular valuation advisor;
- A list of all the valuation advisors that the trustee considered;
- A discussion of the qualifications of the valuation advisors that the trustee considered;
- A list of references checked and discussion of the references' views on the valuation advisors;
- Whether the valuation advisor was the subject of prior criminal or civil proceedings; and
- A full explanation of the bases for concluding that the Trustee's selection of the valuation advisor was prudent.

For an annual update, it is common to keep the same valuation advisor from year-to-year. However, it should not be a foregone conclusion that the same valuation advisor is used. While you may not have to go through the same process as you would when first selecting a valuation advisor, the following minimum steps should be performed and documented:

- the trustee documents in writing that it previously performed the analysis of the valuation advisor;
- the date(s) on which the trustee performed the analysis, and the results of the analysis; and
- the valuation advisor certifies that the information it previously provided is still accurate.

Conflicts of Interest

The trustee typically should not use a valuation advisor for an annual update that has previously performed work for or on behalf of the ESOP sponsor (as distinguished from the ESOP), any counterparty to the ESOP involved in a prior transaction, or any other entity that structured prior transactions (such as an investment bank) for any party other than the ESOP or its trustee. The trustee generally should not use a valuation advisor for an annual update that has a familial or corporate relationship (such as a parent-subsidiary relationship) to any of the aforementioned persons or entities. The Trustee will obtain written confirmation from the valuation advisor selected that none of the above-referenced relations exist.

Financial Statements

As part of the valuation annual update, it is critical that the valuation advisor have complete and accurate financial information, including the sponsor company financial statements. If performing the valuation for the first time, the valuation advisor will need the last five years of financials. If the valuation is an update, the valuation advisor will need the most recent set of annual financials. It is important to determine if there were any changes to previous year's financial financials. For example, there can be changes in accounting methods or financial restatements. In such instances, any updated or revised financial statements for those years should be provided the valuation advisor. In certain instances where these changes are material, a trustee may need to determine whether previous valuations should be updated as well. That topic is beyond the scope of this article.

Review And Documentation Related To The Valuation

In connection with the annual valuation update for plan administration purposes, there are various items that need to be included in the valuation report prepared by the valuation advisor. If those items are not included in the valuation report, it is the trustee's responsibility to document those items. Generally, if the trustee hires a qualified valuation advisor with ESOP experience that follows professional standards, most of the valuation-related documentation requirements would be included and discussed in 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. It is recommended that the trustee be included in these company management interviews (either in-person or remotely). 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.

There should be an analysis of the company's strengths and weaknesses, which may include, as appropriate, personnel, plant and equipment, capacity, research and development, marketing strategy, business planning, financial condition, and any other factors that reasonably could be expected to affect future performance.

The trustee should document in writing its bases for concluding that the information supplied to the valuation advisor, whether directly from the ESOP sponsor or otherwise, was current, complete, and accurate.

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.

Company Description

A valuation report should 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:

- discussion of the history of the employer corporation and its current position;
- description of the products and/or services provided by the employer corporation;
- description of the markets served by the employer corporation;
- description of the environment in which the employer corporation competes and how the company is positioned within that environment;
- discussion of the qualifications of employer corporation management and its depth;
- discussion of significant relationships with related parties, customers, suppliers, etc.;
- discussion of pending litigation that is significant to the employer corporation;
- review of recent transactions in the employer corporation stock (if any); and
- discussion of any recent offers received for the employer corporation or its assets.

Economic and Industry Analysis

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.

The valuation report should be able to explain why the economic and industry analyses are important and relate the critical information and data back to the subject company and analysis. For example, if the subject company is forecasting 10 percent growth over the next five years compared to 3 percent industry growth, the valuation report should explain and reconcile such differences.

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

The valuation report should identify the specific control attributes of the subject ownership interest and explain how these attributes were considered in the valuation process. Any discount for lack of control or control premium should be discussed and supported in the valuation report. Additionally, any discount for lack of marketability should be explained.

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.

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).

Financial Statement Analysis

As part of the employer stock valuation process, the valuation advisor 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 valuation advisor should 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.

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.

Normalization Adjustments

When appropriate, the valuation advisor 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 non operating 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 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 trustee should be concerned if the valuation advisor 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.

Income Approach - Projections

With regard to the income approach, and specifically the discounted cash flow method, the 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.
- A discussion of any conflicts of interests for parties that created the projections. If conflicts of interest exist related to the projections, there should be documentation of how such conflicts were considered in determining the value.

- A discussion as to the reasonableness of any projections considered in connection with the proposed transaction and explain in writing why and to what extent the projections are or are not reasonable. At a minimum, the analysis may consider how the projections compare to, and whether they are reasonable in light of, the company's five-year historical averages and/or medians and the five-year historical averages and/or medians of a group of comparable public companies (if any exist) for the following metrics, unless five-year data are unavailable (in which case, the analyses shall use averages extending as far back as possible):
  - Return on assets
  - Return on equity
  - EBIT margins
  - EBITDA margins
  - Ratio of capital expenditures to sales
  - Revenue growth rate
  - Ratio of free cash flows (of the enterprise) to sales

- If it is determined that any of these metrics should be disregarded in assessing the reasonableness of the projections, document in writing both the calculations of the metric (unless calculation is impossible) and the basis for the conclusion that the metric should be disregarded. The use of additional metrics to evaluate the reasonableness of projections other than those listed above is not precluded as long as the appropriateness of those metrics is documented in writing.
- If the company is projected to meet or exceed its historical performance or the historical performance of the group of comparable public companies on any of the metrics, document in writing all material assumptions supporting such projections and why those assumptions are reasonable.
- To the extent that the trustee or its valuation advisor considers any of the projections provided by the ESOP sponsor to be unreasonable, document in writing any adjustments made to the projections.
- If adjustments are applied to the company's projected financial metrics in a valuation analysis, determine and explain in writing why such adjustments are reasonable.
- 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.

It is the trustee's responsibility to ensure these items are included and properly discussed. The trustee should prepare supplemental documentation of the items to the extent they were not documented by the valuation advisor.

Market Approach - Guideline Companies

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:

- A discussion of the comparability of the guideline companies - the bases for concluding that the guideline companies are actually comparable to the company being valued, including on the basis of size, customer concentration (if such information is publicly available), and volatility of earnings.
- 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.
- Explanation of any discounts applied to the multiples selected. And, if no discount is applied to any given multiple, explain in significant detail the reasons.

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 conclusions. 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.

- A discussion of non operating 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?

Summary And Conclusion

When fulfilling its fiduciary duties, an ESOP trustee will typically hire an independent valuation advisor 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 valuation advisor. As a result, the ESOP trustee needs to exercise care in selecting a qualified, independent valuation advisor.

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

The trustee should document in writing its bases for concluding that the information supplied to the valuation advisor, whether directly from the ESOP sponsor or otherwise, was current, complete, and accurate.

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.

It is the trustee's responsibility to ensure all relevant items are included and properly discussed. The trustee should prepare supplemental documentation of the items to the extent they were not documented by the valuation advisor.

Frank "Chip" Brown CFA, CPA/ABV/CFF, CVA
Senior Vice President, TI-TRUST