The Fiduciary Process for the Annual Update of the ESOP Share Value

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This discussion provides an overview from the trustee's perspective of the process for periodic sponsor company valuation for ESOP administration purposes. This overview lists criteria that a trustee typically considers in (1) selecting a valuation adviser, (2) reviewing the sponsor company valuation report, and (3) establishing the fair market value of the ESOP-owned shares for administration purposes.

Introduction

ESOP trustees are required by law to set the sponsor company stock price at least annually. This process allows the ESOP's third-party administrator to perform the mandatory annual accounting and testing procedures that culminate in the issuance of the 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 sponsor company stock price.

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

This discussion provides an overview of the process related to the annual update of the sponsor company share price for plan administration purposes.[2]

The procedures described in this discussion are intended only as general guidelines. The actual procedures necessary for a prudent process will depend on the specific facts and circumstances of the annual sponsor company stock valuation update engagement.

Selecting a Qualified Valuation Adviser

ESOP trustees are expected to act in the best interests of (1) the ESOP participants and (2) the plan beneficiaries.

To exercise prudence in this regard, ESOP trustees often rely on independent professional advisers to help them fulfill their fiduciary obligations.

One example of this exercise of prudence is when the trustee hires an independent valuation adviser to estimate the fair market value of non-publicly-traded sponsor company stock for plan administration purposes.

Given the importance of these periodic sponsor company valuations, it is important that the ESOP trustee hire a qualified, independent valuation adviser.

Moreover, the ESOP trustee should have a reasonable understanding of the overall valuation process, the adviser's actual valuation analysis, and the adviser's written valuation work product. Such an understanding can assist the ESOP trustee to properly fulfill his or her fiduciary duties.

Prudently Investigate the Valuation Adviser Qualifications

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

- The reason for selecting the particular valuation adviser
- A list of all the valuation advisers that the trustee considered
- A discussion of the qualifications of the various valuation advisers that the trustee considered
- A list of references checked and a discussion of the references' views on the valuation advisers
- Whether the selected valuation adviser was the subject of prior criminal or civil proceedings
- A full explanation of the bases for concluding that the trustee's selection of the valuation adviser was prudent

For an annual sponsor company valuation update, it is typical to keep the same valuation adviser from year to year. However, it should not be a foregone conclusion that the same valuation adviser will be retained.

While the trustee may not have to go through the same process as it would when first selecting a valuation adviser, the following minimum procedures should be performed and documented:

- The trustee documents in writing that he or she previously performed the analysis of the valuation adviser.
- The trustee states the date(s) on which the trustee performed the analysis, and the results of the analysis.
- The valuation adviser certifies that the information the adviser previously provided is still accurate.

Conflicts of Interest

The trustee typically should not use a valuation adviser for an annual update that has previously performed work for or on behalf of the ESOP sponsor company (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 adviser 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 may obtain written confirmation from the valuation adviser selected that none of the above-referenced relations exist.

Financial Statements

As part of the valuation annual update, it is important that the valuation adviser have complete and accurate financial information, including the sponsor company financial statements. If developing the valuation for the first time, the valuation adviser will typically ask for financial statements from the previous five fiscal years.

If the sponsor company valuation is an update, the valuation adviser will need the most recent set of financial statements.

It is important to determine if there were any changes to previous years' financial statements. 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 to the valuation adviser.

In certain instances where these changes are material, a trustee may need to determine whether previous sponsor company valuations should be updated as well.

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 adviser. 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 adviser with ESOP experience that follows professional standards, most of the valuation-related documentation requirements should be included and discussed in the valuation report.

The first procedure 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 valuation adviser in order to reach the sponsor company stock valuation conclusion.

For example, the ESOP trustee may be interested in whether the valuation adviser 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 sponsor company management interviews are normally conducted in order to:

- understand the nature and history of the sponsor company and
- discuss the historical and prospective performance of the sponsor company.

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

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

There should be an analysis of the sponsor 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 adviser, 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 discussion provide an overview of the typical sponsor company stock valuation report content that should be of interest to an ESOP trustee.

Sponsor Company Description

A valuation report should provide an adequate description for the reader to understand the fundamental position of the sponsor company. A comprehensive description of the 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, and the like
- Discussion of pending litigation that is significant to the employer corporation
- Review of recent transactions in the employer corporation stock (if any)
- Discussion of any recent offers received for the employer corporation or for 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 sponsor company.

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 company.

This section of the report may also include a discussion of leading economic indicators that give insight into the future performance of the sponsor company .

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 company'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 sponsor company and analysis. For example, if the sponsor 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 valuation adviser 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 ownership 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 typically includes a section that lists the data and documents that the valuation adviser relied on to develop the employer corporation stock valuation opinion.

By reviewing this section of the employer stock valuation report, the ESOP trustee will have an immediate understanding of both (1) the publicly available documents 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 organizational and strategic documents).

Financial Statement Analysis

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

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

- 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
- The historical payments of dividends

The valuation adviser should also review the sponsor company 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
- 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 sponsor company compared to its industry competitors.

The comparative analysis will help the ESOP trustee understand how the sponsor company 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 adviser may make financial statement normalization adjustments related to both:

1. the sponsor company and
2. the selected guideline publicly traded companies.

Some of the typical financial statements adjustments made to the sponsor company include the following:

- Adjustments for extraordinary or nonrecurring income and expense items
- Adjustments for differences in inventory accounting methods
- Adjustments for nonoperating income and expense items
- Adjustments for non-arm's-length transactions/arrangements

- 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 ownership interest: the income approach, the market 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 adviser changes the selected valuation methods from year to year without proper explanation and support. These unsupported changes often give the appearance that the valuation adviser is attempting to support a predetermined value.

The following discussion on due diligence related to (1) the financial statement projections and (2) the selected guideline companies is based on the procedures set forth in the fiduciary process agreements.[3]

The fiduciary process agreements are specifically required for the subject independent trustees in their role as ESOP trustee in transactions. However, the valuation items in the fiduciary process agreements can be applied to annual update valuation analyses.

Income Approach—Financial Projections

With regard to the income approach, and specifically with regard to the discounted cash flow method, the trustee should understand the following:

- Preparation of the financial projections. The financial projections are often prepared by sponsor company management. In other cases, the projections are prepared by the valuation adviser with input from sponsor company management.

  In the case of management-prepared projections, the report should explain how the valuation adviser tested the reasonableness of the projections. In all cases, the financial projections should be supportable.

- 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.

- Reasonableness of the projections. 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
  - Earnings before interest and taxes margins
  - Earnings before interest, taxes, depreciation, and amortization margins
  - Ratio of capital expenditures to sales
  - Revenue growth rate
  - Ratio of free cash flow (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.

- Comparison to historical performance. If the company is projected to meet or exceed its historical performance or the historical performance of the group of guideline public companies on any of the metrics, document in writing all material assumptions supporting such projections and why those assumptions are reasonable.

- Valuation adviser adjustments to the projections. To the extent that the trustee or its valuation adviser considers any of the projections provided by the ESOP sponsor company 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.
- Cost of capital components. There should be an explanation of how the valuation adviser 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.

The trustee should prepare supplemental documentation of the items to the extent they are not documented by the valuation adviser in the valuation report.

Market Approach—Guideline Companies

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

- 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.
- 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.
- 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.
- Selected multiples. This discussion may include 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.
- Discounts. This discussion may include an explanation of any discounts applied to the pricing multiples selected. And, if no discount is applied to any given pricing multiple, explain in significant detail the reasons.

Valuation Synthesis and Conclusion

The sponsor company stock valuation report should contain a section that provides:

1. a valuation synthesis of alternative value indications and
2. a final conclusion of sponsor company stock value.

The following factors should be included in this section of the sponsor company 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 the following:

  - The rationale for each valuation premium or discount
  - The supporting data or factors used to estimate the valuation premium or discount.
- A discussion of nonoperating assets (or liabilities) that need to be factored into the analysis. These may include excess cash or securities, related party loans, excess land, investments in other companies, or other assets that have not been properly reflected in the valuation analysis.
- A discussion of the illiquidity, or lack of marketability, of the subject ownership interest. Most noncontrolling ownership interests in non-publicly-traded companies are relatively illiquid.

  However, the liquidity of the ESOP-owned employer corporation stock may be affected by a put right that is part of the plan. The valuation adviser should consider any such put right in the estimate of the appropriate discount for lack of marketability, if any.

> **"The ESOP trustee places a great deal of reliance on the valuation opinion of the independent valuation adviser."**

In this regard, the valuation adviser should consider various company-specific factors such as:

- the employer corporation's ability to honor the put right,
- the size of ESOP ownership interest,
- demographics of the ESOP participants,
- the employer corporation's expected repurchase liability,
- the employer corporation projected cash flow,
- the employer corporation's ability to raise capital, and
- 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 applied in the analysis changed over time, and if so, why have they changed?
- Does the employer corporation 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 adviser to assist in estimating the fair market value of non-publicly-traded sponsor company stock.

The ESOP trustee places a great deal of reliance on the valuation opinion of the independent valuation adviser. As a result, the ESOP trustee needs to exercise care in selecting a qualified, independent valuation adviser.

In reviewing the work of the valuation adviser, 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 sponsor company stock valuation report.

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

A thorough valuation analysis should 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 adviser.

Notes:

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 he or she differed from the valuation analyst. The trustee ultimately 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.
3. As of this publication, the DOL has established process agreements with five independent trustees.

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