

# I Have My ESOP Valuation Report: *Now What Do I Do With It?*

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# Valuation Report Review

- ▶ **Donovan v. Cunningham (716 F.2d 1455 (1983)):**
  - ▶ "An independent appraisal is not a magic wand that fiduciaries may simply wave over a transaction to ensure that their responsibilities are fulfilled. It is a tool and, like all tools, is useful if used properly. To use an independent appraisal properly, ERISA fiduciaries need not become experts in the valuation of closely held stock – they are entitled to rely on the expertise of others."

# Valuation Report Review

## ▶ Howard v. Shay:

- ▶ “The fiduciary is required to make an honest, objective effort to read the valuation, understand it, and question the methods and assumptions that do not make sense. If after a careful review of the valuation and a discussion with the expert, there are still uncertainties, the fiduciary should have a second firm review the valuation.”

# Valuation Report Review

- ▶ Settlement in Couturier case:

- ▶ “The fiduciaries must . . . :

- ▶ Investigate the qualifications of the independent appraiser before being retained to do the independent valuation;
    - ▶ Determine that the appraiser’s opinion letter is justified by reading and understanding the opinion and any supporting documents in the independent appraiser opinion letter, including identifying, questioning, and testing assumptions that underlie the assumption in the opinion;

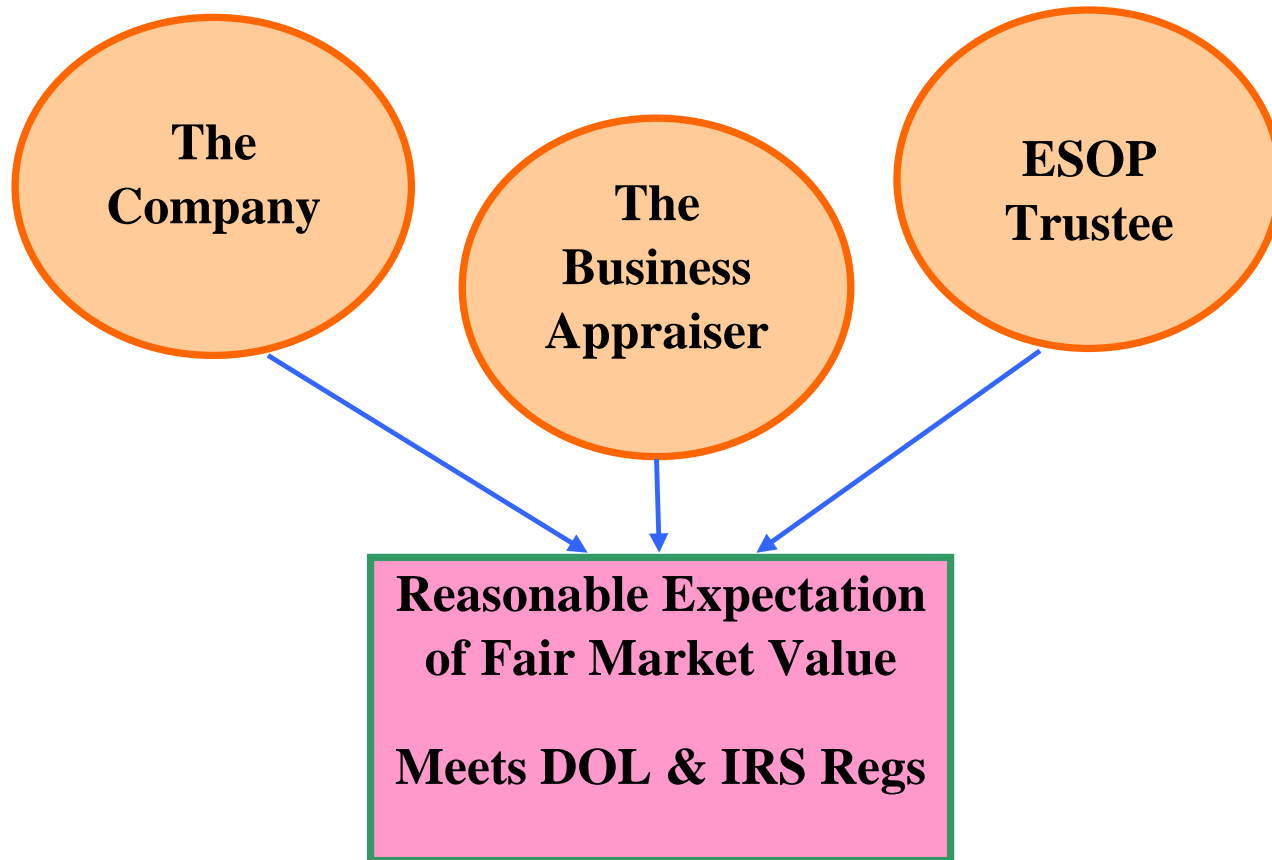
# Valuation Report Review

- ▶ Settlement in Couturier case:

- ▶ “The fiduciaries must . . .

- ▶ Verify that conclusions in the opinion are consistent with the data and analysis of the valuation report, and all other reports, are internally consistent; and,
    - ▶ If necessary, retain additional expert support to aid understanding and addressing any problems with the valuation report and other deemed necessary reports and/or advice and supporting documents.”

# The Valuation Engagement



# Selecting the Valuation Firm

- ▶ Trustee engages the valuation firm
- ▶ Valuation firm should be independent, qualified, experienced in ESOPs, and active in ESOP industry
- ▶ Criteria:
  - ▶ ESOP experience – how long and how many
  - ▶ Independence
  - ▶ Industry experience
  - ▶ Approaches and methods
  - ▶ Involvement in the ESOP community
  - ▶ Credentials

# Selecting the Valuation Firm

## ▶ Credentials:

- ▶ Accredited Senior Appraiser (ASA), American Society of Appraisers
- ▶ Chartered Financial Analyst (CFA), CFA Institute
- ▶ Certified Business Appraisers (CBA), Institute of Business Appraisers
- ▶ Certified Public Accountant Accredited in Business Valuation (CPA/ABV), American Institute of Certified Public Accountants
- ▶ Certified Valuation Analyst (CVA), National Association of Certified Valuation Analysts

# Working with the Valuation Firm

- ▶ Work with ESOP company and valuation firm to schedule due diligence review meeting, delivery of due diligence items, and timeline
- ▶ Trustee should be involved in the due diligence review meeting
- ▶ Trustee should monitor the company's performance during the year

# Trustee Report Review Process

- ▶ Allow proper amount of time for review
- ▶ Committees – Know roles & make sure there is a quorum
- ▶ Formally document the process & steps taken in the review (checklist)
- ▶ Formally review valuation report with valuation firm
- ▶ Prepare formal minutes and/or memo regarding review process

# Key Areas Requiring Discussion

- ▶ Major change in the performance of the company
- ▶ Major change in the business structure of the company
- ▶ Future forecast not in line with past performance
- ▶ Change in how company is being valued
- ▶ Big value shift either way
- ▶ No or little analysis (following screens)

# Potential Issues in the Report

- ▶ Report not addressed to trustee
- ▶ *Revenue Ruling 59-60* or *DOL's Proposed Regulation* not addressed
- ▶ Limited analysis of company and/or industry, or if analysis is done, but explanation or details are thin or not there
- ▶ Methods and approaches not discussed for inclusion or exclusion
- ▶ Adjustments to financials not done and/or not explained

# Potential Issues in the Report

- ▶ Premiums and discounts not used and/or explained
- ▶ Repurchase obligation not addressed
- ▶ Company debt not analyzed properly
- ▶ SAR or other equity arrangements not addressed
- ▶ Unique factors not considered (key management issues, client or supplier concentrations)

# Common Mistakes in Trustee Review

- ▶ “Rubber stamp” – no review
- ▶ Casual review – read, but don’t question
- ▶ Individuals not qualified to review report
- ▶ Trustee is conflicted (usually internal trustee)
- ▶ No discussion between trustee & valuation firm
- ▶ Lack of understanding of valuation methods & approaches
- ▶ Math not checked

# Who Gets Share Price & Valuation Report?

- ▶ Trustee “owns” the valuation report
- ▶ Valuation firm delivers report to trustee
- ▶ Confidentiality issues come into play
- ▶ Share price usually shared with ESOP company, employees, TPA, and audit firm
- ▶ Report may be shared by trustee, if appropriate

# Working Through Issues

- ▶ Communication is key!
- ▶ Most communication is between trustee & valuation firm
- ▶ When to bring ESOP company into discussion?
- ▶ What if issues cannot be resolved?

# Valuation Report Review

- ▶ Specialized area of appraisal practice
- ▶ Professional Standards:
  - ▶ Standard 3: Appraisal Review, Development and Reporting of the Uniform Standards of Professional Appraisal Practice (USPAP)
  - ▶ Proposed Standard 8, Business Appraisal Review of the Business Appraisal Standards of the Institute of Business Appraisers

# Valuation Report Review

- ▶ Opinion regarding the “credibility” of the report
- ▶ Opinion regarding:
  - ▶ Completeness
  - ▶ Accuracy
  - ▶ Relevance
  - ▶ Appropriateness
  - ▶ Reasonableness
- ▶ May include a separate opinion of value

# Selecting the Reviewer

- ▶ Designations:
  - ▶ Accredited in Business Appraisal Review (ABAR)
  - ▶ Accredited Senior Appraiser in Appraisal Review & Management (ASA-ARM)
- ▶ Familiarity with the *Uniform Standards of Professional Appraisal Practice* and the professional standards of all of the accrediting organizations
- ▶ Instructor for business valuation courses, ESOP appraisal courses, or report review courses
- ▶ Experience in preparing valuations for ESOP purposes

# The Report Review Process

- ▶ Read report and identify areas for concern for additional investigation
- ▶ Replicate the process used by the appraiser
  - ▶ Trace information to source documents
  - ▶ Check calculations of key variables
- ▶ Check all math
- ▶ Check internal consistency of the report
- ▶ Check compliance with applicable standards and generally accepted appraisal practices

# The Report Review Process

- ▶ Table of valuation trends and explanations for changes from year to year
- ▶ Tests of Reasonableness (Justification for Purchase Analysis)

# Common Errors

- ▶ Lack of analysis, assessment, and reasoning to support conclusions
- ▶ Insufficient support for discount for lack of marketability
- ▶ Lack of disclosure of key information regarding the ESOP that affects the valuation, i.e., repurchase obligation
- ▶ Inadequate disclosure/analysis of industry conditions and outlook
- ▶ Mismatching cost of capital with earnings being capitalized or discounted
- ▶ Improper identification of the interest being valued

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## QUESTIONS

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