

White Paper on Recommended Procedure for ESOP Companies in Response to Auditors Request for ESOP Valuation Report *

BACKGROUND

Section (a)(1)(A) of the Employee Retirement Income Security Act of 1974, as amended (“ERISA”) requires the sponsor of an employee pension benefit plan, which includes an “employee stock ownership plan,”¹ to file an annual report with the Internal Revenue Service on the form prescribed for such purpose. Section 103(a)(3)(A) of ERISA generally requires that the ESOP’s financial statements be audited.² Section 103(a)(3)(A) includes a requirement that the financial statements be audited in accordance with generally accepted auditing standards.

Statement of Auditing Standards 101 (the “SAS”), which is effective for periods beginning on and after June 15, 2003, establishes standards for auditing “fair value assessments” and related disclosure in financial statements. As a result, the SAS applies to financial statements issued by sponsors of ESOPs and ESOPs which hold non-publicly traded employer securities. The SAS requires auditors to acquire sufficient information to enable them to have a “...reasonable assurance that fair value assessments and disclosures are in conformity with GAAP.”

Conflicts have arisen in connection with the review by auditors of stock valuation reports prepared by fiduciaries of ESOPs which hold non-publicly traded employer stock. These conflicts are between (i) ESOP sponsors and their auditors, and (ii) ESOP fiduciaries and valuation firms responsible for determining the fair market value of employer securities and the auditors of the ESOPs. Recent anecdotal evidence indicates the conflicts have resulted in a number of consequences, including refusal of fiduciaries to release the reports, requests for indemnification by valuation firms, termination of auditors, and insistence by auditors that a valuation be performed by another firm. Lenders to ESOP sponsors and providers of ERISA fiduciary liability insurance often insist on being provided with copies of valuation reports.

A Task Force comprised of members of the Interdisciplinary Advisory Committee on Fiduciary Issues of The ESOP Association has examined this issue. The objective was to develop a recommended procedure for ESOP sponsors and fiduciaries to protect the confidentiality of the reports while allowing the auditors to perform the tasks required by the SAS. The consensus of the Task Force is that reports can be released under circumstances where the (i) person making the request confirms in writing the confidentiality standards applicable to the review of reports, and (ii) fiduciaries and their valuation firms obtain “no sue” and/or indemnification undertakings from the person requesting the report. The latter instance recognizes the fact that the work performed by the

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¹ For purposes of this Memorandum, an “ESOP” means an “employee stock ownership plan” as described in Section 4975(e)(7) of the Internal Revenue Code of 1986, as amended.

² In the case of a plan, including an ESOP, with fewer than 100 participants, Section 104 of ERISA generally allows the Plan administrator to waive the audit requirement.

valuation firms is solely on behalf of the fiduciary responsible for determining the fair market value of employer stock—most frequently the trustee. Many valuation reports are prepared pursuant to engagement agreements which provide they cannot be provided to anyone other than the fiduciary without the valuation firm’s prior written consent. A normal exception, which is often included in either the valuation firm’s engagement letter or the report itself, is made for the use of the report by the “administrator” of the ESOP for plan administration purposes.

RECOMMENDED PROCEDURES

The Task Force recommends ESOP sponsors and fiduciaries consider the following procedures for addressing requests for valuation reports:

- **Requests for Reports Should be in Writing.** In view of the status and use of valuation reports, requests for reports should be in writing and specify the purpose for which the report will be reviewed. In the case of requests by auditors, the requests should confirm that the review will be conducted in accordance with the requirements and limitations of the SAS. The request should also confirm the confidentiality requirements applicable to auditors in general and to the report in particular.
- **Person(s) Responsible for Providing Reports.** From a contractual, if not legal, standpoint, valuation reports belong solely to the fiduciary responsible for determining the fair market value of the employer stock. Thus, even if the audit relates to the ESOP sponsor’s financial statements, the report should be released by the fiduciary or the valuation firm, as discussed below. The Task Force does not recommend the ESOP sponsor release the report.
- **Agreements Regarding Reports.** Depending on the terms of the engagement agreement (in the case of the valuation firm) or the trust instrument (in the case of the trustee), the fiduciary and valuation firm may determine that it is appropriate to release the report under a written agreement with the person requesting same. The Task Force believes the agreement may require the requester to acknowledge the report (i) was prepared solely for and delivered to the fiduciary responsible for determining value, (ii) has not been updated, (iii) is not an opinion as to the current value of the employer stock, and (iv) was based on the assumptions, limitations and qualifications set forth therein. The agreement may also make it clear that (A) the valuation firm and fiduciary make no representation or warranty with respect to the report or any information contained therein, (B) information regarding the stock valuation may have been communicated to the fiduciary by the valuation firm which is not part of the written report, (C) the report does not constitute advice to the requester, and (D) in the case of auditors, they do not acquire any rights by receiving the report which are greater than the rights they otherwise have as auditors under the SAS.

The agreement may include release and/or indemnification provisions to the effect that the requester releases and/or indemnifies the fiduciary and valuation firm from any liability it may incur with respect to the report. The agreement may also include a covenant by the requester to the effect that it will not file a claim against or sue the

fiduciary or valuation firm with respect to the report. The ESOP sponsor would be provided with a copy of the agreement.

Attached as **Exhibit A** is a specimen form of agreement for use with auditors. This document is not intended to constitute legal advice and should not be used without consulting counsel. It is provided for informational purposes only.

- **Dealing With Requester's Questions.** If questions arise, the Task Force recommends the fiduciary maintain a written record of discussions with the auditors and/or the ESOP sponsor.
- **Role of Counsel to the Fiduciary.** The Task Force recommends fiduciaries utilize their counsel to review the agreement among the parties referred to above and the fiduciary's written responses to questions which indicate the requesters have concerns about the adequacy of a valuation report. Counsel for the ESOP sponsor should also be given an opportunity to review and comment on these documents.

The Material contained herein is for information only and is not to be considered legal advice. Each person's circumstances are unique and must be evaluated individually. Competent legal counsel should be sought before taking any action in reliance on information contained in this Memorandum.

The ESOP Association wishes to acknowledge, and express its thanks, to the volunteer members of the Association's Interdisciplinary Advisory Committee on Fiduciary Issues Audit Issues Task Force who have worked on this project. **Judith L. Kornfield**, ESOP Economics, Inc. is Chair of the Interdisciplinary Advisory Committee on Fiduciary Issues.

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EXHIBIT A, referenced above, a copy of the *Suggested Form of Letter from ESOP Trustee to Auditor – Conditions of Release of Stock Valuation Report*, is available to ESOP Association members in the members only section of the website. Go to www.esopassociation.org and click on the members section link at the top right of the homepage. In the members only section, on the left side menu, click on the Advisory Committees link. A link to the Fiduciary Issues Committee can be found on the Advisory Committees page.

If you need additional information or help logging into the members only section, please send an email to Lisa@esopassociation.org or call 202/293-2971.