

## Reviewing the ESOP Valuation Report

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Director

One of the key elements of implementing or administering an ESOP is the valuation. A thorough valuation is critical to ensure the ESOP does not overpay for the stock when acquiring shares. On an annual basis, an accurate value is important so that benefits are not over/under distributed to plan participants due to an inaccurate price.

Now here's the zinger – the appraiser does not determine the fair market value of the stock in the ESOP trust. That responsibility (and the liability that goes with it) falls on the ESOP trustee.

The trustee may hire a business valuation firm to value the stock, but the valuation is a tool that the trustee uses to determine the value.

The trustee must read the valuation report and ensure that it is reasonable and that valuation approaches and methods have been applied appropriately. Where there are questions or uncertainties, the trustee must ask the appraiser to explain and support his position. This analysis of the valuation report should be documented as evidence that the proper due diligence was performed by the trustee in determining the fair market value of the stock.

However, most trustees are not experts in valuing closely held stock, and it can be difficult to assess the quality and completeness of an ESOP stock valuation report. One solution to this dilemma is to have an independent review of the valuation performed by a third party appraiser.

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A qualified review appraiser should have the expertise to review the valuation and make sure that it is thorough, accurate and defensible.

### ***The Role of the Review Appraiser***

The purpose of the review is not for one appraiser to prove that he or she is smarter than the other. The valuation of a closely held business involves the application of generally accepted appraisal practices by a professional who must exercise judgment in applying those practices. Since valuation is not strictly mechanical and involves judgment, there are areas in which appraisers will differ. The review appraiser must look at how the valuation was performed and ask the following questions:

#### ***Are the valuation approaches and methods generally recognized by the valuation community?***

The valuation profession continues to evolve. A third party review appraiser should know what the current state of the art is. It is rare to find an ESOP valuation where generally accepted practices are not used. Moreover, when such an incident is identified, it may be impossible to determine whether the conclusion of value is too low, too high, or reasonable unless a re-valuation of the company is performed.

#### ***Did the appraiser apply valuation methods correctly and in a consistent manner?***

Examples of inconsistencies include making control-level adjustments to minority values, applying enterprise-level multiples to equity-level earnings streams, and not holding tax assumptions consistent in all elements of an income-based analysis. Though these items can be fairly technical, they may have a large impact on value. A review appraiser may be more adept at spotting inconsistencies in the application of valuation methods.

#### ***Do the underlying assumptions appear to be reasonable and are they well documented?***

The review appraiser may raise questions about the assumptions and methods used in the valuation. The trustee should then ask the valuator about these issues. If the appraiser provides additional back-up and justification for his assumptions, then this process makes the valuation more defensible.

#### ***Even if each individual assumption appears reasonable, is there a pattern where every assumption appears to be selected to generate a high (or low) value?***

The review may reveal overly aggressive or conservative assumptions that may need to be readdressed. Sometimes, having a second person look at the assumptions and question them can cause management to rethink their outlook for the future, or the strengths and risks of the company.

#### ***Based on the financial statements, are there any potential issues that the valuation does not address?***

In addition to providing the review appraiser with the valuation report, the trustee may also want to provide him with the financial statements used by the original appraiser. The review appraiser will not be performing his own due diligence and appraisal of the company. However, the review appraiser may notice items, such as potential non-operating assets or contingent liabilities, which merit having the trustee ask the original appraiser whether and how these items were considered.

#### ***Does the valuation address issues specific to ESOPs appropriately?***

While the standard of value for ESOP valuations is fair market value, there are issues that are specific to ESOP-owned companies. Some examples are the put right, the repurchase obligation, the ESOP loan, the level of control exerted by the trustee, tax



affecting, and DOL requirements. Both the original appraiser and the review appraiser should be experienced with ESOP appraisals and should be able to comment on the impact of these issues on value.

### ***How does the appraisal compare to prior years' appraisals?***

Consistency in the valuation approach is generally considered to be important in preserving the perceived fairness of the ESOP to the participants. This is different than maintaining a consistent value regardless of company performance or market conditions. An experienced review appraiser is able to identify the key value drivers and efficiently compare valuations over time. If approaches or assumptions have changed, the original appraiser should be able to explain why. Often there is, in fact, a valid reason. Documenting that the trustee has inquired about such changes lends credibility to the value determination.

### ***Are there calculation errors that are either so significant or so numerous as to reduce the credibility of the valuation?***

Minor errors may not be material or may be easily corrected. Unfortunately, appraisers are often hesitant to admit when there is an error and may brush off errors as immaterial. Although the review appraiser's role is not to reappraise the company, he may be in a position to analyze the specific impact of errors on the value. Such an analysis would allow the trustee to be comfortable that the errors are immaterial or, if they're not, to insist that the original appraiser correct his analysis.

### ***Is the valuation report adequately thorough to allow the reader to ask and answer these questions?***

There are times when the valuation report is so brief that the review appraiser is unable to determine whether the conclusion of value is too low, too high or reasonable. Sometimes there are simply questions about the valuation analysis that require the trustee to follow up with the original appraiser. However, an

inadequately documented valuation report raises the question as to how it was possible for the trustee to determine fair market value based on the information received from the appraiser.

### ***Conclusion***

A thoughtful and thorough review of a valuation by a third party who is familiar with valuation practices and ESOP-related issues can provide an additional valuable tool to the trustee when determining the fair market value of the stock. Using a review appraiser and addressing and resolving issues raised by the review appraiser has several benefits:

- Having a second appraiser concur with the original appraiser adds to the credibility of the valuation.
- Legitimate issues with the valuation may be corrected, resulting in a more accurate value.
- Questioning the original appraiser and receiving additional explanation and documentation of the analysis makes the valuation more defensible.
- The process of using a review appraiser, following up with the original appraiser on issues raised, and resolving those issues demonstrates that the trustee took steps to fulfill his or her fiduciary duty to determine the fair market value of the company's stock.

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## About the Author

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Nick is the Director of ComStock Advisors in Cincinnati. He has appraised closely held businesses and intangible assets on behalf of employee stock ownership plans, for estate taxes and estate planning, gifting, mergers, acquisitions, sales, lending, litigation support, and marital dissolution. Nick's valuation experience on behalf of Employee Stock Ownership Plans (ESOPs) includes feasibility studies, the implementation of ESOP plans, the purchase of large blocks of stock, annual updates, the sale of ESOP companies, and acquisitions of companies by ESOP companies. Each year, he reviews over 70 ESOP valuations on behalf of ESOP trustees. Prior to joining ComStock Advisors, Nick was a Vice President at Firststar Bank (now U.S. Bank) in Cincinnati, where he specialized in providing financing for leveraged acquisitions. Nick earned his Bachelor of Business Administration in Finance and Real Estate from the University of Cincinnati and his MBA from Xavier University. Nick currently serves as President of the Cincinnati/Dayton chapter of the American Society of Appraisers.