



Ins and Outs of ESOP Valuations

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- A professional services firm with three distinct business lines
 - Wealth Advisory
 - Outsourcing
 - Audit, Tax, and Consulting
- More than 4,500 employees
- Offices coast to coast
- CLA has been providing employee benefit plan services, including ESOP consulting, compliance, and reporting assistance for more than 40 years.
- We currently provide consulting, compliance, and reporting services for more than 100 ESOP clients nationwide.



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Speaker Introductions



- **Ben Miller, ASA, Principal**

Ben Miller has more than 20 years of experience in the valuation of business interests, including both publicly- and closely-held businesses and intangibles. He also has experience as an expert witness and has provided testimony regarding business valuation and economic damages.



- **Darren Paumen, CPA, RPA, Director**

Darren has over 16 years of experience in public accounting and benefits. He specializes in auditing employee benefit plans including defined contribution (401(k), profit sharing, money purchase pension, employee stock ownership plans), defined benefit and health and welfare plans.



Learning Objectives

- Identify the risks associated with the valuation and DOL scrutiny
- Explain the valuation process and reporting
- Name key aspects in selecting an appraiser



Risks Associated with Valuation

- DOL scrutiny
 - Several cases pending with the DOL that include accusations of privately held ESOP's of using inflated valuations
 - DOL looking to strengthen the standards of accountability for ESOP valuation firms
 - ESOP fiduciaries subject to same duty of prudence that applies to ERISA fiduciaries in general



Risks Associated with Valuation

- Initial valuation (ESOP buying from selling shareholder(s))
 - Valuation is “too high”
 - Value drops precipitously (excluding the effect of new debt) after the transaction
 - Focus of DOL scrutiny
 - ◇ AIT Laboratories’ settlement with the DOL



Risks Associated with Valuation

- Initial transaction
 - DOL scrutiny (cont'd)
 - ◇ GreatBanc agreement with the DOL
 - Selection of appraiser
 - Heavy focus on supporting projections
 - Weighting of valuation methods
 - Stock repurchase obligations
 - Can company service the debt?
 - Debt cannot be more than fmv of enterprise
 - Irrespective of the interest rate on the debt



Risks Associated with Valuation

- Annual ESOP Valuations
 - Wide swings in value
 - ◇ Plan participants must be educated on “market risk” of ESOP investment
 - Flat valuations
 - ◇ Could impact employee morale
 - Company cannot “afford” the repurchase obligations
 - ◇ Important to engage a firm who specializes in calculating the repurchase liability at least every other year.
 - Can affect the annual audit of the Plan



The Valuation Process

- Engagement letter
 - Make sure the scope of the engagement is clearly defined
 - ◇ Date of valuation
 - ◇ What is being valued
 - ◇ Level of value
 - Control, minority, marketable vs. non-marketable
 - ◇ Definition (and source) of value used
 - Should be “fair market value.”
 - ◇ Fees



The Valuation Process

- Document request list
 - Receipt of financial statements
 - ◇ Draft year ends or final (note GreatBanc)
 - Projections
 - ◇ Usually critical to the valuation
 - Other documents
 - ◇ Shareholder agreement
 - ◇ ESOP Plan documents
 - ◇ Prior appraisal reports (if new appraiser)
 - ◇ Etc.



The Valuation Process

- Interview management
 - With or without a physical site visit
- Selection of valuation approaches and methods
 - Asset
 - Income
 - Market



The Valuation Process

- Receipt and review of draft appraisal report
 - Understand the use of the approaches and methods
 - Understand the assumptions within the analysis
 - Understand the “valuation levers” used in the analysis
 - ◇ Adjustments to income statements
 - ◇ Valuation multiples
 - ◇ Discount and capitalization rates
 - ◇ Minority and/or marketability discounts
 - ◇ Other



The Valuation Process

- Final steps
 - Send the report to the auditor
 - ◇ Auditor will rely upon valuation specialist for review
 - ◇ The audit firm may have questions for the appraiser. Usually they pertain to:
 - Projections (significant change from the prior year's analysis)
 - Selection of valuation multiples
 - Clarification/basis for assumptions/selections contained in the report
 - Make sure to turn the ERISA compliance appraisal report into a consulting report!



What Should be in the Report?

- Short list would include:
 - History of the business
 - Section on the ESOP
 - Description of the company's products and services
 - Management and other key employees
 - Capitalization table
 - Competition
 - Discussion of industry (and impact on company)



What Should be in the Report?

- Short list (cont'd)
 - Description of valuation approaches/methods considered
 - ◊ Rationale for those selected
 - Detailed description and rationale for adjustments made to income statements
 - Detail on assumptions used in the creation of the projected income statements and cash flows.
 - Basis for selected discount/capitalization rate



What Should be in the Report?

- Short List (cont'd)
 - Selection of Guideline Companies
 - Analysis of Guideline companies (comparison to subject company)
 - Selection of multiples and adjustments
 - Concluded result of market approach
 - Reconciliation of Indicated Values
 - Application of discounts
 - Consideration of repurchase obligation



Selection of Appraiser

- The appraiser should be engaged by the ESOP's trustee
 - The appraiser must be independent of company management, other shareholders, and the trustee!
 - Therefore, the company's/ESOP plan's auditor is precluded from appraising the ESOP securities



Selection of Appraiser

- Attributes to look for in selecting an appraiser
 - Experience in the valuation of closely held businesses
 - Experience in the valuation of businesses in the Company's industry
 - Experience in the valuation of ESOP owned businesses
 - Professional Appraiser Credentials
 - Produces adequate appraisal reports



Selection of Appraiser

- Process of selection of appraiser
 - Be proactive with the trustee
 - Get referrals!
 - ◇ From your auditor
 - ◇ From your attorney (who should be experienced with ESOPs)
 - ◇ From your banker
 - ◇ From ESOP organizations



Selection of Appraiser

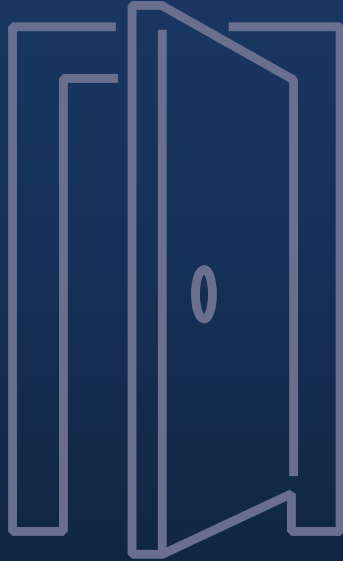
- Process of selection of appraiser (cont'd)
 - Make a request to review sample appraisal reports
 - ◇ If referral did not come from audit firm, pass the reports to the auditors to ensure that they will be comfortable with the form and content of the report
 - Interview at least three potential appraisal firm candidates.
 - Consider the cost of the appraisal



Questions?



Thank you



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