

Selecting a Business Valuation Firm for Your ESOP

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

Therefore, choosing the right business valuation firm is a very important—and sometimes difficult—decision. There are several key qualifications to examine. In broad categories, the business valuation firm should have experience that is closely related to your industry and need, credentials that indicate the use of proper analytical methodologies, and independence that promises the delivery of an objective opinion that will withstand the scrutiny of other stakeholders. Even if you receive a referral to a business valuation firm from a trusted advisor, it is prudent to ask questions such as:

What are the qualifications of the firm's business valuation professionals?

Ask how many business valuation professionals the firm has on staff. Then review the credentials and, more importantly, the experience of the professionals in the firm you are considering. The four organizations that certify business appraisers in the United States are the American Society of Appraisers (ASA); Institute of Business Appraisers; Inc. (IBA); National Association of Certified Valuation Analysts (NACVA); and American Institute of Certified Public Accountants (AICPA). Seek a firm whose professionals regularly attend and speak at seminars and conferences and who write on professional topics related to valuation, your industry, and ESOPs.

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What is the firm’s ESOP experience?

A successful ESOP requires a strong team of advisors, and your appraiser should be active in the ESOP community, including participation in The ESOP Association and the National Center for Employee Ownership.

Ask the firm who its ESOP team is and how many ESOP valuations it performs each year. Also ask what type of ESOP assignments it has performed, which may include annual valuations; peer reviews; feasibility studies and fairness opinions related to the implementation of plans; and valuations, consulting and fairness opinions related to the termination of plans (which often coincides with the sale of the sponsor company).

While the standard of value for ESOP valuations is fair market value, there are issues that are specific to ESOP-owned companies. Some examples include the put right, repurchase obligation, ESOP loan, level of control exerted by the trustee, tax affecting, and issues related to fairness that protect the ESOP participants. The appraiser should be experienced with ESOP appraisals and able to comment on the impact of these issues on value.

Consequences of not addressing these issues appropriately can range from a simple error that can be corrected to a prohibited transaction.

What is the firm’s experience with the Department of Labor?

If a valuation firm regularly performs work on behalf of ESOPs, then it will likely have clients who have been audited by the Department of Labor (DOL). It is appropriate to ask the firm how its valuations have been viewed by the DOL. On the other hand, the firm may have experience working for the DOL or working to resolve issues with ESOP plans that the DOL has criticized.

How does the firm’s industry experience relate to your challenge?

Look for significant experience within the industry, as well as with the type of challenge and engagement you are facing. Beware of an appraiser who incorrectly applies “rules of thumb” from one industry to another.

What is the firm’s internal review process?

Because the business valuation field is a highly dynamic one that requires constant reevaluation of methodologies and protocols, it is difficult for any one practitioner to be up-to-date on every rule change and nuance. Therefore, a firm that uses a team and peer review approach is more likely to consistently produce a better product than an individual working alone. Ideally, there is a formalized, effective, and efficient internal review process.

How does the firm approach valuation?

There are three broad approaches to value—the income approach, the market approach, and the asset approach—and multiple methods within each approach. The appraiser should consider all of the approaches and methods and then apply the ones that are appropriate to your company and situation. Ideally, more than one approach will be applied, which gives greater validity to the ultimate value conclusion. Be wary of appraisers who apply only one method.

What elements are contained in the firm’s valuation report?

Look for a firm that provides a full narrative report, along with appropriate exhibits to substantiate the information used to arrive at the valuation opinion. The report should document the analysis of the company, its financial condition, valuation methods used, and rationale for any discounts or premiums applied. A complete report will better evidence that the ESOP trustee has done its job in ensuring that the analysis of the value was performed competently. The report should address the issues specified by USPAP, Revenue Ruling 59-60, Section 401(a)(28)(C) of the U.S. Internal Revenue Code and proposed regulation 29 CFR 2510.3-18(b) of the U.S. Department of Labor.

What data resources does the firm have access to?

A quality valuation is supported by quality data. Some data resources are fairly expensive and a part-time appraiser may not be able to justify the cost. Look for a valuation firm that—in addition to using government sources—also has access to current powerful information resources such as CapitalIQ, Compustat, Edgar Online, Ibbotson, Pratt’s Stats, and other proprietary databases.

What professional standards does the firm follow?

The firms you are considering should subscribe to the standards set by one of the established professional appraisal associations as well as the Uniform Standards of Professional Appraisal Practice (USPAP). Firms that follow professional standards help you avoid inappropriate methodologies, insufficient financial analyses, and incomplete reports. Valuations and analyses should be supported with reports or work product that details the basis for conclusions.

Can the firm provide an independent, defensible opinion?

To ensure that your valuation will be defensible, you should avoid any conflicts of interest—this is particularly true with ESOPs. The firm you hire should not already be providing you with services, such as accounting, auditing or tax preparation. Also, the firm providing an independent valuation should not be paid on a contingency basis.

What is the firm's time frame for delivering the work?

The firm should be able to deliver the report within the required time period. Let the appraiser know your deadlines and ensure that he/she can meet them. The gathering of documents, on-site due diligence, completion of the analysis, and issuance of the report typically takes several weeks or longer.

What fees does the firm charge for its services?

Seek a firm that is forthcoming about its fee structure, the scope of work, and expected product to be delivered. Additionally, ask about fees for updates, additional work, etc.

Bottom Line on Selection

The above list is not exhaustive. For example, you may also want to know the firm's history and how long it has been providing valuations, obtain references, and learn how your sensitive information will be safeguarded. You may also want to consider that working with a very large firm may mean a less personalized experience, while working with a very small firm may mean that the person you deal with has no/little backup

or peer support/review. Fit is important. Most importantly, look for a firm that you can trust and are confident in their ability to handle your specific valuation needs.

About the author

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Nick is the Managing Director of ComStock Advisors' Cincinnati office. He has appraised closely held businesses and intangible assets on behalf of ESOPs, as well as for estate taxes and estate planning, gifting, mergers, acquisitions, sales, lending, litigation support, and marital dissolution. Nick's valuation experience on behalf of ESOPs includes feasibility studies, implementation of ESOP plans, purchase of large blocks of stock, annual updates, sale of ESOP companies, and acquisitions of companies by ESOP companies. Each year, he reviews more than 70 ESOP valuations on behalf of ESOP trustees.

Prior to joining the firm, Nick was a Vice President at Firststar Bank (now U.S. Bank), where he specialized in providing financing for leveraged acquisitions. He earned a Bachelor of Business Administration in Finance and Real Estate from the University of Cincinnati and an MBA from Xavier University. Nick currently serves on the Advisory Committee of the Ohio/Kentucky Chapter of The ESOP Association.

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