

Understanding Your ESOP Appraisal - An In-House Trustee's Viewpoint

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Understanding your ESOP appraisal may be one of the most difficult challenges of an in-house Trustee. Often, many Trust Committees are made up of individuals with little or no financial background and thus they are not “savvy” in the financial nuances and jargon of business appraisal.

To the extent you, as an in-house Trustee, do not understand your ESOP appraisal, you must educate yourself. As such, the number one rule with regards to your ESOP appraisal is, “If you don’t understand it, ask about it”. There is no “magic” to the appraisal process. Open communication with the ESOP appraiser is essential. If you have a question, pick up the phone and ask. You are the client, and your appraiser is there help you. If you find your appraiser reluctant to answer your questions you should get a different ESOP appraiser.

This article addresses some of the more important factors that you as an in-house Trustee should be aware of and understand with regard to your ESOP appraisal.

In general, your ESOP appraisal conclusion should be:

- Based on a complete and thorough understanding of your Company and its risks and opportunities
- Take into consideration all relevant factors (internal Company factors and external market factors)
- Mathematically correct
- Reasonable
- In compliance with Internal Revenue Service and Department of Labor regulations

In reviewing your ESOP appraisal conclusion, you should be left with the knowledge that your ESOP appraisal was based on a complete and thorough understanding of your Company and its risks and opportunities. Gaining this understanding takes time and analysis on the part of the ESOP appraiser. As such, you should be aware of the appraiser’s due diligence process so you understand the basis of the ESOP appraiser’s knowledge for assessing risks and opportunities.

The appraisal conclusion should take into consideration all relevant internal Company factors such as the Company’s operations, management, facilities, financial condition and outlook, market position, and financial performance relative to others in the industry. Was an adequate assessment of management’s forecasts made by the appraiser? All relevant market factors should also be considered. For example, was the condition and outlook of the regional and/or national economic outlook in which the Company operates considered? Was the Company’s industry conditions and outlook considered? Was there adequate comparison and/or benchmarking of your Company against its industry peers and/or comparable companies? Additional appropriate market considerations include relevant industry-specific required rates of return on capital and comparable company market multiples.

Although it seems obvious that the appraisal should be mathematically correct, you would be surprised! When reviewing the appraisal report, get out your calculator and check the numbers.

Finally, do the conclusions seem reasonable? If not, ask questions.

Before finalizing your ESOP appraisal conclusion, you should have discussions with your ESOP appraiser regarding the appraisal process and the application of appraisal methodologies.

Generally, you are provided with a written report regarding your ESOP appraisal. Your appraisal report should be:

- Readable
- Replicable
- Comprehensive
- Concise

The appraisal report should minimize the use of investment and/or appraisal “jargon” and define acronyms, terms and methodologies making it easily understood by a non-financially oriented individual. Further, if you can’t replicate it, how can you understand it? All information used and/or calculated should be clearly defined in the appraisal report so that you can follow along, replicating the process, step by step.

The appraisal report should be comprehensive covering all of the steps of the analysis in written form. A fully documented appraisal report should include a written analysis of the appraisal assignment, sources of information used, economic and industry conditions and outlook, the Company’s financial condition and outlook with industry comparisons, the Company’s operations, and the appraisal of fair market value.

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Most importantly, the appraisal report should provide you with a comprehensive knowledge of the approaches to value that were used, how these approaches were applied and weighted, empirical support for the application of the valuation approaches, and whether or not any appropriate discounts or premiums were applied and the reasons for such. All of this information should be presented in a clear and concise manner.

In the end, ask yourself these questions:

- Do I understand all of the factors that were considered by the appraiser?
- Do I understand the approaches to value that were used and how they were applied to my Company?
- Does it all make sense?

If the answer to any of these questions is no, then the basic rule kicks in....“If you don’t understand it, ask about it.”

*The author of this article is member of The ESOP Association’s Advisory Committee on Valuation.
The author consulted with Committee Chair, Lee Bloom, of Aldine Advisors, Chicago, IL.*

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