

An ESOP Appraisal Checklist

What should the trustee of an Employee Stock Ownership Plan (ESOP) generally look for in an appraisal of the fair market value of the sponsor company stock? Although the ESOP trustee is ultimately responsible for the accuracy of the report as well as its conclusions, the independent appraisal should meet the following checklist (based on ASA guidance) to ensure the report's compliance. The ESOP appraisal should:

- State the effective valuation date and report preparation date.
- Clearly state the purpose of the valuation.
- Cite Revenue Ruling 59-60 factors for guidance.
- Reference Section 3(18) of ERISA regarding fair market value and adequate consideration.
- Outline stock ownership characteristics, such as degree of ownership control and marketability.
- Reference basic sponsor company information, such as its history, a description of products and services, market and competitive situations, management depth and succession issues, capital structure, and ownership distribution.
- Analyze the economy and industry outlook, as it pertains to the sponsor company.
- List all the sources of information used by the appraiser.
- Include the sponsor company's financial statements (balance sheet, income and cash flow statements, comparative financial ratio analysis, etc.), as well as the relevant time periods and the accountant's level of assurance (i.e., compiled versus reviewed versus audited).
- Compare the sponsor company's financial information to itself, to identify timeline trends.
- Use the generally accepted business valuation approaches (income, market, asset-based), with sufficient supporting detail.

- Clearly state the valuation conclusion, including a sufficient weighting of each valuation method used.

In addition, the Trustee should make sure to check off the following questions regarding any ESOP appraisal:

- If the guideline company method is used, are the selection criteria for the comparables appropriate and the population from which they are drawn clearly specified?
- If a marketability discount is used, are sufficient data provided in support?
- If a lack of control discount is used, is it applied only to valuation methods that conclude a controlling ownership interest level of value, and is sufficient data provided in support?
- If an ownership premium is used, is it applied only to valuation methods that conclude a non-controlling ownership interest level of value, and is sufficient data provided in support?

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Valuing Intangibles for Financial Reporting: Understanding the Interplay of FASB Statements

Twenty years ago, most mergers and acquisitions involved the traditional ‘bricks and mortar’ companies, and most of the assets were tangible: real estate, plant, property, and equipment. The old accounting rules, which governed purchase price allocations, tended to throw everything into goodwill, amortized over forty years.

But the Internet changed the focus of the U.S. economy to assets of the “Information Age” and transactions involving technology companies. The Financial Accounting Standards Board (FASB) began looking at the billions of dollars in business combinations being allocated to goodwill and decided that, in an acquisition, the fair value of specific intangible assets should be recognized and placed on the balance sheet, amortized over a remaining useful life. That’s when FASB Statements of Financial Accounting Standards (SFAS) No. 141, 141R, and 142 appeared on the scene.

At about the same time, the FASB began working on its Convergence Project with the International Accounting Standards Board to bring U.S. GAAP--which takes a historic cost-based approach--more in line with International GAAP, which focuses on current values. So now there are more M&A transactions with assets tilted toward intangibles, and more of these are taking place in a global marketplace—hence the need for a sound understanding regarding intangible valuations.

Identifying intangibles

Paragraph 39 of SFAS 141 (Business Combinations) states:

An intangible asset shall be recognized as an asset apart from goodwill if it arises from contractual or other legal rights or, if not contractual, only if it is capable of being sold, transferred, licensed, rented or exchanged.

Examples of intangible assets that meet these criteria are:

- *Marketing-related*: trademarks, trade names, trade dress, Internet domain names;
- *Customer-related*: customer lists, order backlog, customer relationships;
- *Artistic-related*: plays, books, videos, musical works;
- *Contract-based*: licensing rights, supply contracts, leases, franchise rights; and,
- *Technology-based*: patents, software, databases, trade secrets, IPR&D (in-process research and development).

Generally, SFAS 141 provides for allocation of the identifiable intangibles on the date of acquisition, and then SFAS 142 (*Goodwill and Other Intangible*

Assets) provides a test for impairment of those assets in the years following the acquisition, as these assets are no longer amortized. SFAS 142 also tests for impairment of indefinite-lived intangible assets (such as a trade name) for which a useful life may not be readily estimated.

Additionally, in its currently proposed Statement 141R (*Business Combinations: Applying the Acquisition Method*), the FASB would require contingent assets and liabilities to be recorded at their fair values as of the acquisition date. Similarly, 141R would capitalize IPR&D—technology that’s in process as of the acquisition date but not fully developed; it would be considered an indefinite-lived intangible asset until it became developed, at which point a life would be assigned. This revised statement will eventually create an even greater emphasis on estimating the fair value of IPR&D.

Finally, SFAS 144 (*Accounting for the Impairment or Disposal of Long-Lived Assets*) governs the impairment testing for definite-lived intangible (and tangible) assets, which are subject to amortization in the years following the acquisition.

Factoring SFAS 157 into intangible valuations

There are now nearly three dozen FASB Statements that mention fair value, and SFAS 157 (*Fair Value Measurements*) attempts to clarify these by: (a) defining fair value; (b) establishing a framework for measuring fair value in GAAP; and (c) expanding disclosures about fair value measurements. (*Note*: SFAS 157 is effective for financial statements issued for fiscal years beginning after November 15, 2007.)

In this context, the FASB is trying to match the actual transactions taking place with their purpose and their pricing value from an exit perspective. Compared to the definition of fair value in SFAS 141, the definition in SFAS 157 is much cleaner:

<p>“Fair value is the amount at which that asset (or liability) could be bought (or incurred) or sold (or settled) in a current transaction between willing parties, that is, other than in a forced or liquidation sale.” SFAS 141</p>	<p>“Fair value is the price that would be received to sell an asset or paid to transfer a liability in an orderly transaction between market participants at the measurement date.” SFAS 157</p>
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Of course, this still raises questions regarding “market participants” and “orderly transaction,” but in general, SFAS 157’s definition of fair value is much closer to fair market value. Because it theoretically eliminates synergies from any particular buyer, SFAS 157’s definition is not as close to investment value, unless the market participants would generally recognize them.

Reconciling fair value for financial reporting with other purposes

It’s critical to understand the nuances between the various FASB Statements and their requirements. There is a difference between valuing intangible assets for financial reporting and for other purposes, and some of the methodologies recommended in the FASB pronouncements may not be appropriate in other venues. Essentially, a valuation for financial reporting purposes should follow the dictates of its particular context, which may not be applicable to another involving a different standard of value.

SOMETIMES YOU CAN HAVE YOUR CAKE AND EAT IT TOO!

(The time may be right to consider selling your business or partnering with a private equity group.)

Do you think it’s the right time to sell your business? Are you reluctant because you’d like to experience that next level of growth? How do you know that it is the right time to sell? Is it best to sell when: business is thriving; it’s right for you; or there are many buyers and the multiples paid are relatively high? Ideally, the answer is when all of the above is true! The expression “timing is everything” rings true when it comes to selling your business and getting a great deal. Presented below are a few thoughts and facts on recent M&A activity.

- Business value, or what someone is willing to pay for your business, will change over time
 - Company performance directly impacts value
 - The number, type, and willingness of buyers shape value
 - The availability of funding enables the realization of value
 - Timing impacts the relative amount of value
- M&A activity remains brisk, with private equity groups closing up to 35% of all deals in 2007
 - Private equity groups are typically considered to be financial buyers, but can also display characteristics of strategic buyers if their portfolio contains related businesses
- Thanks to the recent heavy deal flow driven by the well-funded private equity sector and also by the availability of lending institutions willing to finance deals, the window of opportunity is open for quality companies considering a sale
 - Timing is critical to maximize value (ideally, the selling company will be on an upswing at the same time as the market)
- In buying a company, investors look at the past trend to get an idea of the future - an upward trend in earnings which is expected to continue generally results in higher valuation multiples
- Purchase price multiples are currently at high levels
 - In the recent past, multiples of 3 times to 6 times EBITDA were common; multiples currently average 9.4 times for quality companies with an EBITDA of under \$25 million
- Most private equity investors are only interested in companies with an EBITDA of at least \$5 million (some will go as low as \$3 million)
- Private equity groups are growth oriented and will likely view the existing structure as a platform for future success
 - Often, these groups bring additional, specific expertise to the acquired company to support the in-place infrastructure and improve the likelihood for continued success
- Typically, private equity groups retain as much of management as possible, particularly the key people
 - They are very interested in establishing solid relationships with former owners/key people and value their worth highly in a successful transition
- Key people at acquired companies are routinely offered employment packages and different incentives, including:
 - Opportunity to re-invest on an equity level
 - Stock options
 - Performance bonuses

To speak confidentially about the sale of your business (or your client’s business), feel free to contact Andrew Wilusz at amw@ValueManagementInc.com.

VMI Highlights

Value Management Inc. welcomes **William Pembroke, Joseph Hollenbach** and **Susan Wilusz**. Bill and Joe are Financial Analysts. They are responsible for providing research and performing financial and economic analyses for the valuation of closely held enterprises, professional practices and publicly traded securities.

Bill received a Bachelor of Science degree in Business Administration with a concentration in International Business and a minor in German from Millersville University. Prior to **VMI**, he worked in Germany as a consultant for Volkswagen AG (VW). William's e-mail address is wjp@valuemanagementinc.com.

Joe received a Bachelor of Science degree in Finance and Real Estate from Temple University. Prior to **VMI**, he worked at Commerce Bank while attending school full-time. Joe's e-mail address is jjh@valuemanagementinc.com.

Susan is the new marketing coordinator of **Value Management Inc.** Susan is responsible for the marketing and business development within the firm. She is a graduate of Philadelphia University with a Marketing degree. Susan's e-mail address is smw@valuemanagementinc.com.

Welcome William, Joseph and Susan!

An article by **Andrew Wilusz** and the ethics committee of the Philadelphia Estate Planning Council (the "PEPC") appears in the May 2007 issue of *Trusts and Estates*. Andrew is the chair of the ethics committee and the article, "Practice Professionally", presents the latest version of the committee's ethics matrix, *Ethics Matrix 2007*. The ethics matrix presents excerpts from the codes of conduct of various professional organizations whose members are typically part of the estate planning team. The excerpts focus on the ethics committee's "five C's of ethics for estate planning professionals": confidentiality, conflicts of interest/disclosure, competence, compliance, and compensation.

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