ESOP Due Diligence Checklist

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Authored by Robert Reilly & Robert Schweihrs - Click Here to Order Online

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### Exhibit 25-1
Employer Stock Valuation and Financial Adviser Due Diligence Procedures

<table>
<thead>
<tr>
<th>Analytical Procedures Typically Considered by an Independent Financial Adviser in an Employer Corporation Stock Valuation or Related Due Diligence Analysis</th>
<th>Procedure Performed by the Financial Adviser?</th>
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</table>
| **I. Engagement Letter and/or Engagement Work Product**  
**A. State the purpose and objective of the engagement**  
1. Identify the purpose of the analysis, or the reason to conduct the analysis (to issue a transactional fairness opinion, an employer corporation stock valuation, etc.)  
2. Identify the objective of the analysis, that is, what the analysis is intended to do (e.g., to estimate the fair market value of a specified ESOP employer stock ownership interest, etc.)  
**B. Define the analysis assignment**  
1. Identify the party who retained the financial adviser (i.e., the client)  
2. Identify the business entity and the specific security interest subject to analysis  
3. Identify the form of the subject employer corporation (e.g., C corporation, S corporation, limited liability company, etc.)  
a. Indicate the state of incorporation  
b. Indicate the date of incorporation  
4. Identify the specific employer corporation ownership or security subject to analysis  
5. Identify the valuation date (i.e., the "as of" date of the analysis)  
**C. Document the appropriate standard of value and the appropriate premise of value**  
1. Identify and define the appropriate standard, or definition, of value (e.g., fair market value or fair value)  
2. Identify and define the appropriate premise of value—based on an analysis of the highest and best use of the subject employer corporation or security interest (e.g., value as a going concern, value in exchange, etc.) |

| II. Due Diligence/Collection of Data  
**A. Collect and review employer corporation documents and information**  
1. Request historical financial information (typically, last five fiscal years financial statements and latest interim financial statements) including: |
Valuation and Fairness Opinion Due Diligence Checklist

1. Request the following financial information:
   a. Income statements
   b. Balance sheets
   c. Statements of cash flow
   d. Capital statements or statements of retained earnings
   e. Explanatory footnotes and supplemental disclosures to the financial statements

2. Request a list of employer corporation subsidiaries and/or financial ownership interests in other related companies:
   a. Obtain relevant historical financial information the same as listed in item II.A.1 above
   b. Obtain a description of the business entities and interests, including the type of organization, the percentage of ownership, the original cost investment, and so on

3. Request other employer corporation financial information, including:
   a. All current financial budgets, projections, forecasts, or plans (prepared for any reason)
   b. Other financial schedules, prepared as of the valuation date (e.g., capital asset account balances, accumulated depreciation, inventory, accounts receivable, accounts payable, open orders, production backlog, etc.)
   c. Copies of all material employer corporation contracts/leases (e.g., employment agreements, noncompete agreements, labor agreements, customer contracts, real estate leases, etc.)
   d. Amounts and description of employer corporation insurance in force (e.g., key person, property/casualty, business interruption, etc.)
   e. Compensation schedule for employer corporation senior management and employee/owners (e.g., salary, options, commissions, etc.)
   f. Copies of any prior employer corporation stock valuation and/or asset appraisal reports (prepared for any purpose during the past five years)
   g. Schedule of dividends declared and paid during the past five years

4. Request employer corporation legal documents, including:
   a. Articles of incorporation, by-laws, amendments to articles and by-laws, etc.
b. Any existing employer corporation stock buy/sell agreements, options, rights of first refusal, etc.

c. Minutes from recent employer corporation shareholders/meetings, typically covering the past two years

d. List of all employer corporation shareholders
   1) ESOP-related loan agreements
   2) Number of shares owned by senior management
   3) Number of shares owned by employee/owners

e. Descriptions of all recent prior transactions of the employer corporation stock and any recent bona fide offers to purchase the employer corporation and/or subject employer securities

f. ESOP employer stock purchase/sale transaction documents, including:
   1) ESOP-related loan agreements
   2) Employer stock purchase agreements
   3) ESOP plan and trust documents
   4) ESOP plan summary
   5) Any other documents that may affect the legal rights related to the ESOP-owned employer corporation securities

5. Request other relevant operational employer corporation information, including:
   a. History (since inception) and current description of the employer corporation
   b. Copies of all current employer corporation sales/marketing materials, brochures, advertisements, etc.
   c. List of locations (owned or leased) in which the employer corporation operates
   d. List of major customers by annual dollar volume
   e. List of major suppliers by annual dollar volume
   f. List of major competitors (including their size and/or market share, if available)
   g. Breakdown of personnel (by department or by function) and resumes of senior management
   h. Descriptions of all patents, trademarks, copyrights, and other owned or licensed intellectual properties
   i. Description of any off-balance-sheet assets and contingent liabilities
   j. List of related employer corporation industry or trade associations, related industry or trade publications, and memberships of the employer corporation
   k. Description and current appraisals (if available) of all employer corporation nonoperating assets
I. Operational budgets, projections, plans, or forecasts (e.g., for production, sales, purchases, inventory, etc.)

B. Conduct employer corporation management interviews
   1. Speak with employer corporation senior management in all relevant functional areas, regarding:
      a. Historical operations and results
      b. Prospective operations and results
      c. Responsibility for functional areas
   2. Discuss with employer corporation senior management and/or outside legal counsel any pending or potential litigation or claims, including:
      a. Commercial litigation
      b. Employment disputes
      c. Occupational and safety issues
      d. Environmental issues
      e. Income or property tax disputes
      f. Other matters

C. Conduct employer corporation plant/site inspections
   1. Inspect representative plants and sites; consider:
      a. Capacity limits and physical condition of existing plants, facilities, and equipment
      b. Functional and technological adequacy (and/or obsolescence)
   2. Discuss plants and sites with employer corporation management representatives; consider:
      a. Future facilities expansion and capital investment plans
      b. Competitive effects of planned plant and facility changes
      c. Expected operating cost effects of planned plant and facility changes

III. Economic Environment (as of Valuation Date)
   A. Consider the national and international (if relevant) economic environment—research and analyze the national and international economic environment and outlook (as relevant)
   B. Consider the regional and local (if relevant) economic environment—research and analyze the regional and local economic environments and outlook (as relevant)
   C. Consider the historical and expected relationship of the relevant economic environment to the performance of the employer corporation—identify and quantify (if possible) significant relationships of the performance of the relevant economic environment with the performance of the employer corporation
IV. Industry Environment (as of Valuation Date)
A. Consider the industry in which the employer corporation operates—research and analyze the nature and history of the employer corporation industry
B. Consider the current outlook for the employer corporation industry—research and analyze the current outlook for the employer corporation industry

V. Fundamental Position of the Employer Corporation (as of Valuation Date)
A. Analyze the employer corporation capitalization and ownership—analyze all classes of outstanding stock, including:
   1. Rights, seniority, voting, etc. of each class
   2. Total number of outstanding shares and percentage distribution of ownership of each class
B. Consider the subject employer corporation history and operations:
   1. Review employer corporation history
   2. Review and analyze current employer corporation business operations, including:
      a. Locations and markets served
      b. Product lines, service lines, and customer base
      c. Competition
         1) Current and projected market size
         2) Position of the employer corporation within the subject industry
         3) The employer corporation competitive strengths and weaknesses, both on an absolute basis and relative to competitors
      d. Management and workforce
      e. Overall positive and negative aspects of the employer corporation operations
      f. Strengths, weaknesses, opportunities, and threats of the employer corporation, compared to the employer corporation industry in general and compared to direct competitors in particular
C. Consider the outlook for the employer corporation—review current strategic plans, business projections, and the current business outlook

VI. Financial Statement Normalization Adjustments and Analysis
A. Make appropriate financial statement normalization adjustments, including:
   1. Adjust the value of inventory, as appropriate
      a. LIFO vs. FIFO basis of inventory cost accounting
      b. Inventory write-offs and/or write-downs, including assessment of reasons for shrinkage, obsolescence, etc.
   2. Adjust for excessive or insufficient shareholder/management compensation, as appropriate
3. Adjust for nonrecurring financial statement items as appropriate, including:
   a. Nonrecurring gains/losses, insurance proceeds, nonrecurring revenues, and/or expenses, etc.
   b. Results of the effects of changes in accounting principles or methods

B. Perform historical financial statement analysis
   1. Calculate and analyze commons-size financial statements
   2. Compute and analyze financial and operating performance ratios, including:
      a. Size ratios
      b. Growth ratios
      c. Liquidity ratios
      d. Profitability ratios
      e. Turnover/activity ratios
      f. Leverage ratios
   3. Identify and explain any significant financial trends

C. Perform prospective financial statement analysis
   1. Identify key financial variables (e.g., capacity constraints, cost/volume/profit relationships, etc.) for prospective results of operations
   2. Obtain (if available) and analyze projections/budgets/forecast/plans for prospective results of operations
   3. Assess the reasonableness of employer corporation projections relative to historical employer corporation results of operations
   4. Assess the reasonableness of employer corporation projections relative to industry data

VII. Business/Security Valuation Analysis
   A. Consider and select appropriate business/security valuation approaches—identify and select appropriate valuation approaches (i.e., market approach, income approach, or asset-based approach)
   B. Perform a market approach—guideline company method, if appropriate
      1. Identify guideline publicly traded companies; consider:
         a. Same or a similar line of business
         b. Size
         c. Trading activity/pricing evidence
         d. Financial condition
      2. Normalize the financial statements of the guideline publicly traded companies (i.e., adjust guideline companies to make them more comparable to the employer corporation, that is, "apples to apples")
      3. Identify appropriate financial and operating fundamentals
      4. Calculate market-derived pricing multiples for selected guideline publicly traded companies
5. Analyze the range of market-derived guideline company valuation pricing multiples
   a. Statistical analysis of range of valuation pricing multiples
   b. Correlation of valuation pricing multiples with performance factors (e.g., growth rates, rates of return, profit margins, etc.)

6. Compute and analyze financial and operating ratios for the selected guideline publicly traded companies, including:
   a. Size ratios
   b. Growth ratios
   c. Liquidity ratios
   d. Profitability ratios
   e. Turnover/activity ratios
   f. Leverage ratios

7. Compare the employer corporation to the selected guideline publicly traded companies

8. Select the appropriate market-derived valuation pricing multiples for the employer corporation

9. Apply the selected valuation pricing multiples to the appropriate subject company financial and operating fundamentals

10. Synthesize an estimate of value
    a. Subtract the market value of employer corporation outstanding long-term debt if invested capital valuation analyses are used
    b. Estimate a value of the employer corporation equity

11. Identify appropriate valuation premiums/discounts (for the specific level of employer security subject to analysis)

12. Quantify appropriate valuation premiums/discounts (for the specific level of employer security subject to analysis)

13. Apply appropriate valuation premiums/discounts (for the specific level of employer security subject to analysis)

C. Perform a market approach—guideline merged and acquired company method, if appropriate

1. Identify guideline merged or acquired companies/transactions, consider:
   a. Same or a similar line of business
   b. Size
   c. Financial condition
   d. Relevant time frame
   e. Availability of pricing information

2. Normalize financial statements of the selected guideline merged and acquired companies (that is, adjust guideline companies to make them more comparable to the employer corporation, that is, “apples to apples”)

3. Identify appropriate financial and operating fundamentals
4. Calculate transaction valuation pricing multiples for the selected guideline merged and acquired companies

5. Analyze the range of market-derived guideline company transaction valuation pricing multiples
   a. Statistical analysis of range of valuation pricing multiples
   b. Correlation of valuation pricing multiples with performance factors (growth rates, rates of return, profit margins, etc.)

6. Compute and analyze financial and operating ratios for the selected guideline merged and acquired companies, including:
   a. Size ratios
   b. Growth ratios
   c. Liquidity ratios
   d. Profitability ratios
   e. Turnover/activity ratios
   f. Leverage ratios

7. Compare the employer corporation to the guideline merged and acquired companies

8. Select the appropriate market-derived, transaction-based valuation pricing multiples for the employer corporation

9. Apply the selected valuation pricing multiples to the appropriate employer corporation earnings and operating fundamentals

10. Synthesize an estimate of value: Subtract the market value of employer corporation debt in invested capital valuation analyses

11. Identify appropriate valuation premiums/discounts (for the specific level of employer security subject to analysis)

12. Quantify appropriate valuation premiums/discounts (for the specific level of employer security subject to analysis)

13. Apply appropriate valuation premiums/discounts (for the specific level of employer security subject to analysis)

D. Perform an income approach—discounted economic income method, if appropriate

1. Review and analyze financial projections related to prospective results of employer corporation operations for a relevant (e.g., five-year) discrete projection period

2. Develop the appropriate economic income fundamentals for analysis, for example, net cash flow, which consider:
   a. Earnings
   b. Noncash expenditures (e.g., depreciation expense, amortization expense, etc.)
   c. Capital expenditures
   d. Net working capital requirements

3. Develop the appropriate yield capitalization discount
rate for the present value calculation with consideration to:

a. Current capital market investment and rate of return environment, including:
   1) Risk-free rates of return
   2) Equity rates of return (and/or equity risk premiums)
   3) Employer corporation-specific risks/required rates of return, with consideration to:
      a) Expected attainability of employer corporation financial projections
      b) Degree of employer corporation financial/operating leverage
      c) Degree of diversification of the employer corporation business base

b. Capital structure
   1) Capital structure (i.e., mix of debt and equity components of invested capital) of the employer corporation
   2) Typical capital structure in the employer corporation subject industry

4. Develop an estimate of the terminal/residual value, with consideration to:
   a. Terminal/residual year financial fundamentals (e.g., net cash flow projection for terminal/residual year)
   b. Terminal/residual year direct capitalization rate (e.g., as derived from the Gordon dividend growth model)

5. Apply the derived yield capitalization discount rate to the discrete period estimated economic income projection (e.g., net cash flow); include:
   a. The discrete projection period of periodic economic income
   b. The terminal/residual value estimate

6. Calculate an estimate of value: Subtract the market value of employer corporation outstanding long-term if invested capital valuation analyses are used

7. Identify appropriate valuation premiums/discounts (for the specific level of employer security subject to analysis)

8. Quantify appropriate valuation premiums/discounts (for the specific level of employer security subject to analysis)

9. Apply appropriate valuation premiums/discounts (for the specific level of employer security subject to analysis)

E. Perform an asset-based approach—adjusted net asset method, if appropriate
   1. Adjust all on-balance-sheet assets to current market value (including all current asset accounts, tangible asset accounts, investment accounts, etc.)
2. Identify all off-balance-sheet intangible assets

3. Estimate the fair market value of all off-balance-sheet intangible assets

4. Estimate the fair market value of the total of all of the on-balance-sheets and off-balance-sheet tangible and intangible assets

5. Adjust all liability accounts to current market value (including consideration of any off-balance sheet and contingent liabilities)

6. Calculate an estimate of the employer corporation total equity value as the fair market value of all assets (both tangible and intangible) less the fair market value of all liabilities (both recorded and contingent)

7. Identify appropriate valuation premiums/discounts (for the specific level of employer security subject to analysis)

8. Quantify appropriate valuation premiums/discounts (for the specific level of employer security subject to analysis)

9. Apply appropriate valuation premiums/discounts (for the specific level of employer security subject to analysis)

F. Consider any other relevant business/security valuation approaches

1. Consider the application of any alternative valuation approaches

2. Perform the appropriate alternative valuation approach methods or document why such alternative approaches are not applicable

G. Prepare a synthesis of value

1. Determine the relevance of each of the respective valuation approaches used in the analysis

2. Weight the alternative estimates of value

H. Reach a conclusion of value—conclude the appropriate fair market value estimate for the employer corporation security

VIII. Reporting the Results of the Employer Corporation Valuation and ESOP Financial Advisory Service Due Diligence

A. Prepare a transactional fairness opinion, as requested

1. Describe the proposed employer corporation securities purchase transactions

2. Analyze the proposed employer corporation securities purchase transaction in order to conclude whether the ESOP is paying no more for the employer securities than any other typical willing buyer would pay

3. Opine on the fairness of the proposed employer corporation securities purchase transaction from a financial point of view, with consideration of the concluded fair market value of the employer securities.

IX. Documentation of the Employer Corporation Valuation and ESOP Financial Advisory Service Due Diligence
A. Prepare engagement analysis work papers—prepare and maintain work papers and files that document the employer corporation valuation analysis and the ESOP financial advisory service due diligence.

B. Prepare a valuation opinion and/or a narrative valuation report:
   1. Opine on the adequate consideration with regard to the employer corporation securities consistent with the Department of Labor proposed regulation.
   2. Opine on the fair market value of the employer corporation securities consistent with the Department of Labor proposed regulation.
   3. Prepare a narrative valuation report in compliance with the fair market value requirement of the Department of Labor proposed regulation containing the following information:
      a. A summary of the qualification of the financial adviser to perform the valuation of the employer corporation securities.
      b. A statement of the employer corporation securities value, a statement of the methods used in estimating that value, and the reasons for the employer corporation securities value conclusion in light of those methods.
      c. A full description of the employer corporation securities being valued.
      d. The factors taken into account in making the valuation, including any restrictions, understandings, agreements or obligations limiting the use or disposition of the subject employer corporation securities.
      e. The purpose for which the employer corporation valuation was made.
      f. The relevance or significance accorded to the valuation methods taken into account.
      g. The effective date of the valuation.
      h. In cases where a valuation report has been prepared, the signature of the person making the valuation and the date the report was signed.

4. Include in any written valuation report an assessment of the following factors, consistent with the Department of Labor proposed regulation:
   a. The nature of the employer corporation and the history from its inception.
   b. The economic outlook in general and the condition and outlook of the employer corporation industry in particular.
   c. The book value of the employer corporation securities and the financial condition of the
Employer corporation

- The earnings capacity of the employer corporation
- The dividend-paying capacity of the employer corporation
- Whether the employer corporation has goodwill or other intangible value
- The market price of securities of corporations engaged in the same or a similar line of business, which are actively traded in a free and open market
- The marketability, or lack thereof, of the employer corporation securities
- Whether the seller would be able to obtain an ownership control price premium with regard to the employer corporation securities; in cases where an ownership control price premium is added, confirm that:
  1) Actual control (both in form and in substance) is passed to the ESOP with the employer corporation stock sale (or will pass to the ESOP within a reasonable time)
  2) It is reasonable to assume that the ESOP ownership control will not be dissipated within a short period of time after the employer corporation stock purchase