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ESOP Due Diligence Checklist

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Guide to ESOP Valuation and Financial Advisory Services, 2nd Ed.

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

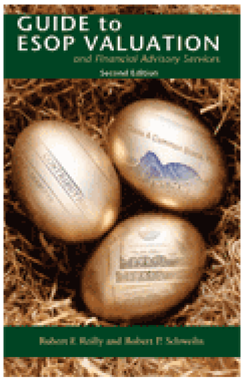

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Exhibit 25-1
Employer Stock Valuation and Financial Adviser Due Diligence Procedures

Analytical Procedures Typically Considered by an Independent Financial Adviser in an Employer Corporation Stock Valuation or Related Due Diligence Analysis	Procedure Performed by the Financial Adviser?
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:	_______

- 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 _______

- l. 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 or 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 asset s(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 contain 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

d. The earnings capacity of the employer corporation _______

e. The dividend-paying capacity of the employer corporation _______

f. Whether the employer corporation has goodwill or other intangible value _______

g. 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 _______

h. The marketability, or lack thereof, of the employer corporation securities _______

i. 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 _______