THE VALUATION OF QUALIFYING EMPLOYER SECURITIES

for

Employee Stock Ownership Plans

(ESOP)

Prepared

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Introduction

The wounds inflicted by the Employee Retirement Income Security Act of 1974 (ERISA) are beginning to swell. Some minor but delicate surgery might have saved defined benefit pension plans from the ravages of inflation and a depressed economy. However, the implementation of ERISA, it appears, will practically insure their early demise as a result of excessive and constantly escalating costs to maintain them. For this reason many business owners are looking enviously at the profit sharing plan although benefits for the higher paid and older employees will generally be less attractive than benefits under a defined benefit pension plan. Yet the profit sharing plan can be maintained because of the flexibility inherent in its structure.

As might be expected ERISA has delivered a few blows at the profit sharing plan. For example: Many companies in the past have indirectly used profit sharing funds for working capital which before ERISA was entirely legal. The company had given its plan a good guaranteed return with adequate security and everyone was happy. The arrangement created sufficient incentive for the company to maximize its contributions which pleased all of the employees. Now ERISA has created a new class of bad guys - "the party-in-interest" and "the disqualified person" to put an end to such a happy arrangement.

However, ERISA is not all bad and to prove our point one need only to pick up a recent tax journal or insurance publication to find an article attempting to excel a previous article concerning the magic virtues of the Employee Stock Ownership Plan (ESOP). Cash-free tax deductions, tax-deductible capital financing, a market for closely-held stock, tax-deductible acquisitions, continued voting control and improved employee morale and identification with the company are all possible with the magic of the ESOP. But let us not be too grateful to ERISA for it only codified the ESOP and therefore one might ask why all the recent interest in the ESOP? After all, it is not yet oldfashioned to resist giving away the store for a few tax deductions. One answer might be that ERISA took away all other previously available incentives for a growing capital-hungry company to provide its employees with a qualified plan while satisfying the capital needs of the company. Also, the legislative future for the ESOP is favorable in that the legislators with traditional capitalistic ideals and those of a socialistic mind seem to have found a concept which appeals to each.

And so, business owners, a fearless breed, search in the hazy dawn of ERISA without the help of the long promised Regulations for the key to unlock the magic of the ESOP - the value of their company stock. Each business owner knows that a minority interest (less than 50%) of the company stock has questionable value in that its ownership can only benefit the holder through its nuisance factor. Even a threat by minority stockholders to sell to a

competitor would generally be avoided by proper stock endorsement restrictions (legend) as to its disposition. Only in the case where a minority stockholder dissents to a merger, consolidation or sale of substantially all the corporate assets is he entitled, in the State of Texas, to demand fair value for his stock (V.A.T.S. Bus. Corp. Act, Art. 5.12). How, then, can a minority block of stock of a closely held corporation have any significant value for ESOP purposes where there is no trading and established market for the stock?

The Internal Revenue Service has provided a substantial part of the answer by virtue of the fact that a great deal of precedence may be found in the valuation of minority interests of a closely held corporation for Federal Estate Tax and Federal Gift Tax purposes. Estate Tax Regulation 20.2031-1(b) sets the stage for the valuation of property in the following definition:

> "Fair market value is the price at which the property would change hands between a willing buyer and a willing seller when the former is not under any compulsion to buy and the latter is not under any compulsion to sell, both parties having reasonable knowledge of relevant facts."

Estate Tax Regulation 20.2031-2(f) expounds on the valuation of stock where selling prices or bid and asked prices or unavailable, as follows:

> "If the provisions of paragraphs (b), (c), and (d) of this section are inapplicable because actual sale prices and bona fide bid and asked prices are lacking, then the fair market value is to be determined by taking the following factors into consideration:
>
> (1) In the case of corporate or other bonds, the soundness of the security, the interest yield, the date of maturity, and other relevant factors; and
>
> (2) In the case of shares of stock, the company's net worth, prospective earning power and dividend-paying capacity, and other relevant factors.
>
> "Some of the 'other relevant factors' referred to in subparagraphs (1) and (2) of this paragraph are: the goodwill of the business; the economic outlook in the particular industry; the company's position in the industry and its management; the degree of control of the business represented by the block of stock to be valued; and the values of securities of corporations engaged in the same or similar lines of business which are listed on a stock exchange. However, the weight to be accorded such comparisons or any other evidentiary factors considered in the determination of a value depends upon the facts of each case. Complete financial and other data upon which the valuation is based should be submitted with the return, including copies of reports of any examinations of the company made by accountants, engineers, or any technical experts as of or near the applicable valuation date."

Further, such stock has value because a properly designed ESOP plan should provide the employees and/or their beneficiaries a market for the stock in the form of a "put" to the plan and/or company. A "put" in this context is a provision of the plan which provides that the plan or company shall purchase the stock received by members of the plan at its fair value.

It is reasonable to assume that the tax collector will not challenge the value of a stock when such value is based upon accepted techniques and objective consideration of all pertinent facts. An arbitrary attempt by the Internal Revenue Service to fix a low value for the stock would not only be detrimental to employees and their beneficiaries, but it would also reduce future tax revenues with respect to income, gift and estate taxes applicable to the stock.

The stock has value but how is the value to be determined to satisfy the interests of all parties concerned? It appears that the most readily acceptable approach in valuing the stock of a company for ESOP purposes is the application of the methods used for estate and gift tax purposes. The basic guidelines are set forth in Rev. Rule 59-60 with particular emphasis on Paragraph .01 of Sec. 3 in which the use of formulas is described as follows:

> "A determination of fair market value, being a question of fact, will depend upon the circumstances in each case. No formula can be devised that will be generally applicable to the multitude of different valuation issues arising in estate and gift tax cases. Often an appraiser will find wide differences of opinion as to the fair market value of a particular stock. In resolving such differences, he should maintain a reasonable attitude in recognition of the fact that valuation is not an exact science. A sound valuation will be based upon all the relevant facts, but the elements of common sense, informed judgment and reasonableness must enter into the process of weighing those facts and determining their aggregate significance."

Any valuation methodology will perhaps unavoidable resemble a formula in order to establish a pattern upon which periodic analysis of the relevant facts will produce consistent and comparable results. As indicated in the Ruling, a raw formula per se is not acceptable but when tempered with appropriate value judgments, it is an acceptable valuation procedure. The results of such an approach will tend to be consistent and thus provide an acceptable price for ESOP holders of the stock in their exercise of a "put." Note: Observe that the "put" is not a restrictive agreement; rather it is an option which the ESOP stock owner may exercise. Thus the "put" will not necessarily settle the valuation issue. (See Sec. 8 of the Rev. Rul. 59-60.)

In the foregoing we have sketched on a large canvas the important valuation problems relating to corporate stock for ESOP purposes. The next step is a precise examination of valuation procedures which are acceptable to the Internal Revenue Service. "Acceptable," that is, if the appraiser evidences a high degree of objectivity and skill in considering and weighing all pertinent facts. Our primary exploration will be the closely held corporation for the following reasons:

1. ESOP allows several forms of equity financing in funding the company's employees' deferred compensation programs. In periods of tight money, volatile interest rates and accelerating inflation, this benefit is particularly attractive to the closely held corporation. Even in more normal times this aspect of ESOP will permit capital, which heretofore would be absorbed in pension funding, to flow into operations and expansion.

2. The management of publicly held corporations will generally consider independent valuation studies to be unnecessary since the company's stock is valued through periodic, if not daily, sales of common shares. Such a decision is, no doubt, valid for many large companies that enjoy active trading on the exchanges. However for companies of the second or third tier level whose stock enjoys only sporadic trading, the independent valuation described in this discussion may be required if the advantages of ESOP are desired by the company.

Valuation of a Closely Held Company

Methods of Valuation

The Estate Tax Regulation 20.2031-2(f) lists three main factors to be considered in valuing a closely held company; namely, (1) the comany's net worth, (2) the earning power and (3) the dividend-paying capacity. Based upon established precedent in connection with gift and federal estate taxes, another concept must be added, "comparison with comparable companies," particularly with those companies that have achieved an acceptable and readily available valuation, such as listed stocks which enjoy active trading. Also, the Year's Purchase Method may be used in some situations. Therefore, we shall examine these methods in the following order:

I. Capitalization of Earnings
II. Net Worth
III. Year's Purchase Method
IV. Comparison of Comparable Companies
V. Capitalization of Dividends

I. Capitalization of Earnings

In its simplest form, the Capitalization of Earnings Method is easy to understand and mechanically simple to calculate. It includes two variables: (1) an earnings factor and (2) a capitalization rate. The multiplication of the earnings factor times the capitalization rate will result in valuation of the company, and this figure divided by the number of shares outstanding will determine the value per share of stock for purposes of contributions, "puts" and/or distributions. While the arithmetic is simple the determination of the two variables is not only difficult to ascertain but subject to innumerable interpretations.

The use of this method will generally be more appropriate for companies whose "going concern value" is a significant part of their total value. In such cases the liquidating value of the physical assets would usually represent only a nominal percentage of the original purchase price.

A. Trend in Earnings

The "Earnings Factor" should be representative and indicative of a trend in earnings. It is preferable to use annual earnings for the latest fiscal year in determining the earnings factor provided such figures are, in fact, representative. However, just as the latest fiscal quarter earnings may not be indicative of the whole year's earnings, the latest annual earnings may not truly represent the trend of future earnings. Therefore, "Earnings Factor" should be representative of the current earnings picture and also be sufficiently typical to serve as a basis for predicting future earnings. If it fails on either count, then the price arrived at by applying the formula will not be a realistic "going concern value" of the business.

B. Adjustments

Representative earnings should take into account certain adjustments such as:

(1) nonrecurring sales, such as the sale of a capital asset,
(2) unusually large bad debts,
(3) inventory write-offs, and
(4) income or losses from nonoperating business ventures.

Also other specific circumstances may require adjustments in order to determine accurately a net earnings figure that is only attributable to the ordinary and operating earnings of the company. Of course, such nonrecurring income and losses will not be ignored as they should be reflected in the valuation of the company but these items should not be capitalized at the same rate as the operating earnings.

C. Net Operating Earnings

The capitalization rate should only be applied to "net" operating earnings defined as "gross sales less returns and allowances less costs of goods sold, less all ordinary business expenses also described as selling, general and administrative expenses, less federal and state income taxes paid." An after-tax figure should be used because the true earning capacity of the business and the extent to which it is reflected in the value of the stock is measured in terms of the amount of earnings paid in dividends and/or retained as earned surplus.

D. Trend in Growth

Is the latest annual earnings statement indicative of the company's long term growth trend? The answer to this question is extremely important because "growth" or "lack of growth" have a direct bearing upon current as well as future valuations of the company which, in turn, constitutes the very foundation of ESOP regarding company contributions, "puts" and distributions.

If the latest earnings statement does indicate the company's long term growth trend, then the valuation problem is relatively simple; if such earnings are not indicative of such growth, then further extensive investigation will be necessary. (See Paragraph (E), "Averaging Income"). In this connection it should be noted that in the past smaller successful companies have appeared to be the masters of their destiny but today they must deal with the whims of the political environment, the buffeting of the recurring waves of monetary and fiscal policy, the volatility of business and credit cycles and the instability of the capital markets. These roadblocks to growth confront the managers of such companies with difficult and sometimes seemingly insolvable problems. Happily, ESOP may provide some of the needed answers.

E. Averaging Income

The latest annual net earnings statement is very important; however, the "average annual net earnings" figure will in many cases prove to be more important in most valuations. In ascertaining this key figure, the average of several years' earnings should be based on the selection of a period that is long enough to minimize temporary income fluctuations, but short enough to be representative of the current earnings situation. Five years of financial data will generally be more than sufficient for purposes of valuations. Typically, investment bankers and even the Internal Revenue Service have not required more than five years of data. Furthermore, the estate and gift tax regulations mention five years as being sufficient for most valuations. In the final analysis the selected earnings figure must necessarily depend upon the individual company and on the specific circumstances of their financial statements.

F. Capitalization Rate

The second half of the capitalization of earnings method is the capitalization factor, also called the capitalization rate or the multiplier; this often discussed and talked about factor is not well understood. It represents just one more financial ratio but its misuse and abuse have lead many to be wary wherever it appears. Section 6 of Rev. Rul. 59-60 deals with capitalization rates as follows:

> "In the application of certain fundamental valuation factors, such as earnings and dividends, it is necessary to capitalize the average or current results at some appropriate rate. A determination of the proper capitalization rate presents one of the most difficult problems in valuation. That there is no ready or simple solution will become apparent by a cursory check of the rates of return and dividend yields in terms of the selling prices of corporate shares listed on the major exchanges of the country. Wide variations will be found even for companies in the same industry. Moreover, the ratio will fluctuate from year to year depending upon economic conditions. Thus, no standard tables of capitalization rates applicable to closely held corporations can be formulated. Among the more important factors to be taken into consideration in deciding upon a capitalization rate in a particular case are: (1) the nature of the business, (2) the risk involved; and (3) the stability or irregularity of earnings."

As noted in the above-quoted Regulation, "a determination of the proper capitalization rate presents one of the most difficult problems in valuation." Nevertheless, it is an important and useful tool in solving the valuation problem for closely held companies. The following quotation from ACQUISITIONS AND MERGERS by George D. McCarthy will illustrate a couple of important points.

> "By contrast there were, at that time and at the close of 1961, many stocks listed on national exchanges selling from five to fifteen times net assets and 40 to 80 times earnings. The yield on some of these stocks ran from 0 to 1%. It is quite evident that many such stocks had not only discounted the foreseeable future but also the hereafter.
>
> "Undoubtedly, the large amount of funds that have become available for savings and investment during the period since World War II have had an influence on market prices. Such funds have been large relative to available investments and have stimulated many initial public offerings of securities.
>
> "In the frenzied rush to buy during recent years, people forgot the time-honored principle of investing and speculated on a

continued market rise, particularly in so-called glamour stocks. However, the oldest and soundest principle has not changed; that is, investment is the productive employment of capital, the ultimate purpose of which should be a return commensurate with the risk assumed."

1. Comparison of Price-Earnings Ratio and Capitalization Rate

While the price-earnings ratio is mechanically calculated exactly the same as the capitalization rate, they differ from one another on several counts. First, the appropriate capitalization rate is a rate passed down through the best judgment of an appraiser who has based his decision on the analysis and assimilation of a host of current and past factual data on the company in question. While the only concrete evidence in the price-earnings ratio is the earnings part, if the ratio includes past or current earnings, the other half of the ratio is determined solely by the demand for and supply of stock available at any one time. If all the demand and supply factors are in close proximity to one another and both the buyer and seller are equally knowledgeable about the company and not unduly influenced by outside forces then the P/E ratio may be very close to the capitalization rate which an objective and independent appraiser would assign to the company.

However, in recent years the supply of and demand for investment funds have not been in equilibrium. And even in this day and age of full disclosure it is doubtful if either the buyer or seller are as knowledgeable as an independent appraiser. In essence the derivation of the P/E ratio is the result of psychological as well as outside market forces that may or may not have anything to do with the fundamental growth of a single company. So the capitalization rate may or may not take into account P/E ratios of comparable companies that are publicly held, but the capitalization rate should not be unqualifiedly equated with P/E ratios through the same set of glasses because of the factors listed above.

2. Nature of Price-Earnings Ratios

The second point which the McCarthy quotation illustrates is that by their very nature P/E ratios of publicly held companies approach various levels, some high and some low, and fluctuate around these levels because of (but not limited to) the liquidity or illiquidity of the stock in general and of the specific purchase or sale. Such astronomical P/E's as 40 to 60 may prove to be very beneficial to a company in the midst of an acquisition program and appear attractive to a closely held company involved in the same or similar products or services. Actually very few companies and still fewer industries have been able to maintain high P/E ratios for a

number of years and by and large such ratios represent at best a temporary aberration from a more normal P/E ratio that is more representative of the capitalization rate. So the very fact that a company is publicly held adds a liquidity factor to the P/E ratio that is not available to the closely held company. Because of this lack of liquidity smaller private companies cannot and should not have a capitalization rate that approximates the higher average P/E ratios of their public-owned competitors.

3. Risk Factor

The third point which the quotation makes and one that may be all too often forgotten is that the capitalization rate should be inversely proportional to the degree of risk involved. The greater the risk, the lower the multiplier; the smaller the risk, the higher the multiplier. This element of risk brings into play a factor not heretofore discussed - the fact that the increase of the capitalization rate is the earnings yield or rate of return demanded by the investor for making the investment. Stated in another way, the capitalization of average annual net earnings simply is the capital sum which, at the capitalization rate used, would yield such earnings, or the number of years which must elapse before the total of after-tax annual earnings will equal the purchase price.

The risk involved in realizing the projected future earnings will be dependent on, but not limited to, the following factors:

(1) the nature of the business
(2) past growth, the trend and stability
(3) volatility of sales and earnings

Based upon the foregoing discussion, it should be clear that the appropriate capitalization rate for each closely held company can be determined only after a thorough investigation of all pertinent current and historical financial as well as nonfinancial information. Some companies have concluded that a high P/E ratio attached to the similar publicly held companies may indicate a high capitalization rate for their own company. As we have tried to show, P/E ratios and capitalization rates should not be equated. Irrespective of the P/E ratios achieved by comparable public companies, the appropriate capitalization rate must ultimately rest on the specific circumstances surrounding a particular company.

II. Net Worth Method

As a factor in the valuation process the balance sheet (book value) serves an indispensable function; namely, it provides the foundation or a starting point for the precise measurement of a company's value.

A. Nature and Purpose of the Balance Sheet

An understanding of the nature and purpose of the balance sheet will contribute toward the proper and efficient utilization of the information contained in it.

1. While the balance sheet lists, at least by categories, the company's tangible assets, such listing does not purport to represent the actual or market value of such assets. "Cost," remaining "depreciated value" and similar categories provide no clues concerning current market value.

2. The surplus account and the additions thereto for the specified period are recorded. While this information indicates the direction the company is headed, it does not reveal the rate of growth.

3. The list of liabilities shows the amount owed but the dollars remaining after subtracting the liabilities from the assets will rarely, if ever, reveal the true net worth of the company.

4. What then is the purpose of the balance sheet? Its primary thrust is influenced and shaped by the impact of taxes - income, ad valorem, sales, franchise, etc. A document thus oriented effectively serves the company's number one need - the production of spendable income.

B. Reason for the Adjusted Book Value

If the balance sheet serves the primary needs of the company so well, what is the rationale for revisions and adjustments to ascertain the true market value? It should be noted that the deductions and accounting methods chosen to maximize profits while minimizing taxable income tend to deflate the true net worth of the company. In order to ascertain the real value it is necessary to appraise the underlying assets.

C. Balance Sheet Items to be Adjusted

In determining the true market value of a company, the items that require adjustment will depend upon the accounting practices of the particular company being studied. Listed below are some of the most common as well as the most important of these items.

1. Items that Tend to Deflate Value

Perhaps the most important in this category are:

(a) The depreciable assets, irrespective of whether treated as "straight-line" or "accelerated" depreciation, will generally be understated in relation to their true current market value.

(b) Non-depreciable assets, such as land, are frequently carried on the balance sheet at cost whereas the actual market value is generally much greater.

2. Items that May Deflate or Inflate Value

(a) The treatment of reserves can work both ways, for example: If reserves for bad accounts are inadequate the result would be an overstatement of value. Conversely, if such reserves are excessive the balance sheet value would accordingly be understated.

(b) The treatment of inventory can also work both ways. In a period of rising costs for raw materials, and if the company's practice is "first in-first out," (FIFO) the net result will be a temporarily inflated earnings figure which, in turn, would offset the amount of retained earnings in the surplus account.

Similarly, in periods of falling prices FIFO leads to an understatement of profit. But as to ending inventories, the effect of FIFO is to mark up inventories to about current replacement cost. Therefore with companies using FIFO inventory accounting, the ending inventory figure would probably be acceptable for valuation purposes.

On the other hand, "last in-first out" (LIFO) inventory accounting, while not incorporating inventory profits or losses into operating earnings, will hold down the carrying value of the ending inventory to a low level. In this case it would be preferable to have the company revalue its ending inventory for purposes of valuation.

3. Items with High Potential but Speculative Value

Needless to say, these unusual items require microscopic examination by the analyst and some capacity for reliable prophecy. In this category are such items as:

(a) a prospective favorable development anticipated for the near future;

(b) the foreseeable maturity of a project in which the company has invested time, funds and effort; and

(c) a potential windfall - these and like situations may be taken into account if the analyst exercises extreme caution in weighing all the available facts. Admittedly this area is fraught with the possibility of error in judgment at best and misuse or even fraud at worst.

D. Situations where the Net Worth Method is Particularly Applicable

There are many companies among industries such as steel, cement, petroleum and paper where large capital investments and continuing outlays for fixed assets and equipment are required to produce sales and earnings. Also there are some companies that may have a current operating loss or a high break-even level due to a large base of assets which may produce satisfactory income in the future or such assets can be liquidated at a substantial value. The net worth method is more appropriate for these companies.

III. Year's Purchase Method (Goodwill) Formula

Every successful company possesses some intangible assets frequently referred to as "goodwill." Most of the valuation methods described herein take into account in varying degrees this intangible value but the emphasis is incidental and hidden under the cloak of the selected capitalization rate (with respect to earnings or dividends), the established P/E ratio used in the comparison of comparables and, perhaps, only in the psychology of the appraiser for the net worth method. However, there are many companies where special treatment is required because of the high percentage of the company's income attributable to the intangible assets. With respect to companies where intangible assets consisting of goodwill, trademarks, patents, copyrights and franchises comprise more than an incidental portion of the total assets, the year's purchase method should be considered to determine their real value.

A. The Mechanics

Essentially this formula is a modification of the capitalization of earnings method and requires a like degree of objectivity and skill in the selection of the capitalization rate, in the evaluation of the risk factor and in the determination of that portion of company income which is attributable to the intangibles. Within this framework the procedure is as follows:

(1) Determine that portion of the company's income which is properly attributable to the intangibles.

(2) Capitalize the income attributable to the intangible assets by the selected rate.

(3) Add the amount determined in (2) to the company's net worth. (See Net Worth discussion.) The resulting total is the value of the company. <u>Note</u>: The Income Tax Method documented in Sec. 5 of Section 1001, Rev. Rul. 65-192 is the same as the Year's Purchase Method described above except that the tangible assets only are used to calculate the fair return rather than book value.

IV. Comparison of Comparable Companies

Simply stated this method is just a comparison of the subject company with a similar company whose stock is listed on an exchange and then attributing to the subject company a similar or an adjusted P/E ratio which the listed stock has achieved. For the uninitiated this concept is marvelous; for the knowledgeable analyst it is a mountain of headaches. Some of the well nigh insolvable problems inherent in the concept may be briefly described as follows:

A. Finding a Comparable Company

With several thousand companies listed on the various exchanges it would appear to be a simple matter to select one whose operations are similar to the subject company. However, having located the comparable company the analyst's job has just begun because similarity of operations will not provide the needed answer unless a host of other factors are also present.

B. Analysis of the Selected Comparable Company

The sum total of the analyst's problems adds up to a comprehensive study of the selected comparable company, but in many instances only a portion of the financial data is available unless the subject company has access to data not readily available to the analyst. Therefore, many questions remain unanswered inspite of what appears at first glance to be extensive published financial data with respect to the listed company. Reference to the foregoing discussion of Net Worth Method will indicate some of the needed data which may not be readily available for the listed company. With respect to the published data a review of the discussion of the Capitalization of Earnings Method should highlight some additional problems to be solved.

C. Comment

The foregoing to the contrary notwithstanding the Comparison of Comparable Companies Method may, in some special situations, serve a useful purpose.

V. Capitalization of Dividends

This method of valuation is appropriate for a company that has a long history of dividend payments (a) at regular intervals, (b) at established rates and (c) where total dividends are a large percentage of total earnings. The capitalization rate would depend upon the yield demanded by investors which will generally be related to current short-term interest rates, as for example, the Treasury Bill rate and the prime rate, with appropriate adjustments for risk and other factors involved.

Although Rev. Rul. 59-60 indicates the relevance of dividend histories as a factor in the valuation process and the business community frequently gives such histories priority in its pricing and lending activities, the use of the Capitalization of Dividends Method will have very limited application for companies that are interested in securing the benefits of ESOP. The rationale supporting this conclusion is set forth below:

A. Capital Needs

The capital needs of such companies for expansion and debt management exceed the cash available from net earnings. Hence, there is no sound reason for paying dividends. Therefore few companies of this kind will pay any dividends.

In the exceptional case of a private closely held company or a small public corporation that does pay dividends, two facts are generally apparent:

(1) The dividend pay out will comprise a relatively small percentage of total earnings, or

(2) In the isolated cases where dividend payments have been made at a higher level, the company may be forced to reduce or eliminate dividends in order to satisfy operating and expansion needs for cash.

B. Lack of Motivation

The private closely held company and to a considerable extent the small public corporation can usually satisfy the income needs of the principal owners without subjecting them to the double taxation inherent in dividend payments. The payment of bonuses will, in most situations, be the answer.

In this connection, it should be noted that the payment of dividends is made at the direction of the Board of Directors. Whereas, company earnings are the result of many factors of which the management skill of the owners is the most important. Thus the element of motivation constitutes a controlling factor in decisions relating to the company's dividend policy.

VI. Other Valuation Factors

In the preceding discussions, we have been concerned with valuation methods which embrace consideration of both tangible and intangible assets. Certainly the value of goodwill is very real but such value must necessarily rest upon the assumption profitable operations will continue. Some of the forces that bear upon "continued profitable operations" are beyond the control of a Company's management, such as a worldwide economic depression; however, many of the relevant factors can be controlled through careful planning. Therefore, a valuation should take into account an evaluation as to the quality of a Company's management. Although the evaluation of management is primarily a qualitative undertaking, the most convincing evidence of its superior ability is its demonstrated performance as measured by such quantitative factors such as rate of return on net worth, share of the industry business, and margin of profit. Three of the important areas to consider in evaluating management are discussed in more detail below.

A. Executive Understudy Training

With few exceptions the principal owners of closely held companies are the executives whose skills create and maintain profitable operations. In event of the loss of these skills through death or disability, the Company may be liquidated based upon the current market value of its tangible assets. Such liquidation could represent substantial loss to the stockholders.* Therefore, it is pertinent in determining the valuation of a Company to take into account the attitude and practice of management in solving the problems such as:

1. Does the Company have an Executive Understudy Training program?
2. If such a program is in effect, is it for real or in name only? Can the junior executive know in advance that if his performance is good he will be given the top position at a specified or predictable future date?
3. Is such trainee given (or permitted to purchase on a favorable base) substantial company stock?
4. Does the training program encompass more than the top position?
5. If the Company does not have such a program in operation, what is the attitude of management about adopting one?

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* Rev. Rul. 59-60, Sec. 4.02(b) recognizes that "...a lack of trained personnel capable of succeeding to the management of the enterprise." and "...the absence of management-succession potentialities..." should be considered pertinent in valuing a closely held company.

B. Financial Loss of Executive Skills

If executive skills are lost* before the trainee is ready to assume top executive duties, does the Company own insurance on the top executive which will in some measure compensate the Company for such loss? If not, are there any other solutions to the problem - adequate surplus, access to credit, etc?

Note: In this area it is pertinent to ascertain the present condition of the chief executive's health.

C. Employee Morale

Employee morale is a multi-faceted subject, but it can have a significant impact upon profitable operations - some of the relevant factors are: compensation comparable in similar businesses, working conditions, recognition (promotion practice), adequate tools (machines and equipment) and fringe benefits. In this latter category it is very important to consider employee retirement, profit sharing and/or ESOP.

Comment

The key question is, "How can the analyst assign value to the programs discussed in this section?" The answer is very simple - value judgments. If the Company's profit history is good but these programs are either absent or inadequately implemented, there must be a reason for successful performance and it is the job of the analyst to find out what it is. He might learn that the performance record is a fluke and one that may suddenly evaporate or he may discover that the chief executive is sacrificing his longevity with overwork and strain which may in the long run prove to be very costly. Though these factors do not lend themselves to positive measurement, to the trained observer they frequently yield fairly reliable answers when considered in conjunction with the objective tests.

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* Rev. Rul. 59-60, Sec. 4.02(b) specifically states that the loss of the manager or a key employee, "... may have a depressing effect upon the value of the stock of such business..." and that such a loss is a pertinent factor to be taken into consideration in valuing the company.

Summary

The ESOP is a qualified plan under Section 401(a) of the Internal Revenue Code and as such falls within the same category as pension plans, profit sharing plans, and stock bonus plans. However, qualitatively it is different in its concepts and applications.

Because of the special rights and exemptions, the ESOP has a special status and unique advantages not possessed by other qualified plans. In addition to employee retirement, severance benefits, executive deferred compensation, etc., the ESOP can provide a corporate finance plan. The determination of the proper value of plan assets is important in the administration of all qualified plans but for the ESOP, it is especially significant - Valuation is in fact the key to a successful ESOP. For this reason, we shall briefly review the history leading up to the ESOP and indicate the key differences between the ESOP and profit sharing plans.

The ESOP is based on the use of a qualified stock bonus plan within the concept of qualified retirement plans as provided by the Internal Revenue Code. Stock bonus plans have been in existence for over fifty years and have provided deferred compensation prior to the existence of pension and profit sharing plans. However, between 1955 and 1970, only 300 stock-bonus plans were qualified as compared to 93,000 profit-sharing plans and over 100,000 pension plans. The important point to keep in mind is that the ESOP which has its very foundation in stock bonus plans is not a new form of deferred compensation. With few exceptions, practicing pension consultants believe that the ESOP is a very useful form of employee deferred compensation.

Under Section 407(a)(6) of ERISA, the term "Employee Stock Ownership Plan" is defined to mean an individual account plan; "which is a stock bonus plan which is qualified"......"and which is designed to invest primarily in qualifying employer securities. Internal Revenue Code Regulation Sec. 1.401-1 (b)(1)(iii) establishes the primary differences between a profit sharing plan and an ESOP (or Stock Bonus Plan). While the contributions to both a profit-sharing plan and the ESOP are calculated as a percentage of total wages, a contribution to a profit sharing plan cannot be made unless there are profits, whereas there is no need for profits in order to make a contribution to an ESOP. A second key difference is that benefits from an ESOP must be distributable in stock of the employer corporation, where a profit sharing allows distribution in cash or marketable obligations. The third key difference is that ERISA (Section 407 (b)(1) specifically allows ESOP to own stock of a closely held corporation and therefore contributions to a stock bonus plan may be in closely held stock of the contributing corporation. While ERISA Section 407 allows profit sharing plans to acquire Qualifying Employer Securities, in actuality few closely held corporations will find this avenue open

when approached. Yet through an ESOP the same close corporation may invest up to 100% of plan assets in their own corporate stock.

Under Rev. Rul. 69-494, a qualified plan must be for the "exclusive benefit of the employees" and any investment by the Trustee will violate the "exclusive benefit" rule unless the investment follows certain defined guidelines:

(1) The cost of the investment must not exceed its fair market value.

(2) A fair return must be provided.

(3) Sufficient liquidity must be maintained to permit distributions in accordance with the terms of the plan.

(4) Safeguards, including diversity of investment, to which a prudent investor must adhere, must be maintained.

Where an ESOP plan is used, the requirement of a fair return is specifically waived by Rev. Rul. 69-65. Since ESOP's are designed to invest up to 100% in employer securities and they are required to distribute benefits in employer securities, the third and fourth requirements are eliminated. Through the process of elimination, the only investment guideline left is number one: the cost of the investment must not exceed its fair market value. Thus valuation must necessarily be closely representative of the fair market value.

Typically owners of closely held companies have used outside appraisals only to satisfy gift or estate valuations for the IRS or for litigation purposes. So periodic and recurring valuations have been more the exception than the rule. As always, the burden of the proof in establishing a valuation rests with the taxpayer.

While the IRS may not take the opposite tact (as it does in seeking the maximum value for estate tax purposes), it will seek to determine that the ESOP is for the "exclusive benefit of the employees" by determining that the valuation of the stock contributed "does not exceed its fair market value." Therefore, care must be exercised not to overvalue the securities.

Whether the close corporation is desirous of installing an ESOP to increase cash flow, provide liquidity for major shareholders, or an incentive to company employees, an annual appraisal of the value of the stock will be necessary to efficiently administer the plan. By virtue of the fact that annual contributions to an ESOP or any qualified plan are limited to a maximum of 15% or 25% of employee-member compensation, depending on the plan or plans selected, all of the benefits of an ESOP cannot be realized in any one year. Thus a company should not adopt an ESOP unless it is prepared to make ongoing contributions which will accrue to the benefit of owners and employees alike. Therefore, all