How ESOPs Work

ESOPs are a recognized exit planning tool for business owners, as well as a vehicle for employees to own stock in their employer company. However, most business owners and their advisors are unfamiliar with how an ESOP works. The mechanics of an ESOP can vary somewhat, but there is a basic common functionality to all ESOPs. Below, we discuss the mechanics of leveraged and non-leveraged ESOPs.

Most ESOPs are leveraged and involve bank financed purchases of either newly issued shares, or more often, the stock of a selling shareholder. The Company funds its ESOP via annual contributions as a qualified retirement plan and the plan effectively uses those funds to repay the debt used for the purchase.

Leveraged ESOPs tend to be more complicated than non-leveraged ESOPs. A leveraged ESOP can be used to inject capital into the Company through the acquisition of newly issued shares of stock. Figure 1 illustrates how the initial leveraged ESOP transaction typically works.

Subsequent to the initial transaction, the Company makes annual tax deductible contributions to the ESOP, which in turn repays the loan. Stock is allocated to the participants’ accounts — just as it is in a non-leveraged ESOP — enabling employees to collect stock or cash when they retire or leave the Company. ESOP participants have accounts within the ESOP to which stock is allocated. Typically, the participant’s stock is acquired by contributions from the Company — the employees do not buy the stock with payroll deductions or make any personal contribution to acquire the stock. An exception to this norm could involve roll-overs of participant’s funds from alternative qualified plans sponsored by the Company. Plan participants generally accumulate account balances and begin a vesting process as defined in the plan. Contributions, either in cash or stock, accumulate in the ESOP until an employee quits, dies, is terminated, or retires. Distributions may be made in a lump sum or installments and may be immediate or deferred. The typical annual flow of funds for a leveraged ESOP is illustrated in Figure 2.
Although non-leveraged ESOPs have certain tax advantages to selling shareholders, they generally tend to be an employee benefit, a vehicle to create new equity, or a way for management to acquire existing shares. The Company establishes an ESOP and either makes annual contributions of cash, which are used to acquire shares of the Company’s stock, or makes annual contributions in stock. These contributions are tax deductible for the Company. As in a leveraged ESOP, the employee/participant vests according to a schedule defined in the plan document, and stock accumulates in the account until the employee/participant leaves the Company or retires. At that time the participant has the right to receive stock equivalent in value of his or her vested interest. Typically, ESOP documents contain a provision called a “put” option, which requires the plan or the Company to purchase the stock from the employee after distribution if there is no public market for it, thus enhancing the liquidity of the shares. Figure 3 illustrates a non-leveraged ESOP.

As ESOP participants roll out of the plan at termination or retirement, the ESOP or the Company purchases the employee’s plan shares based on the terms specified in the plan document. Plan design and administration are crucial to a successful ESOP experience and require the participation of specialized financial and legal advisors.

As with all qualified retirement plans, there are rules and requirements pertaining to annual contribution limits, vesting, share allocation, plan administration, and other functional aspects which are beyond the scope of this overview.

Sellers of stock to an ESOP may enjoy certain tax benefits related to their sale proceeds, and the Company (the sponsor) may enjoy tax benefits related to its contributions to the ESOP. Thus, ESOPs are often postured by business advisors as a tax advantaged exit strategy. Please refer to other articles on Mercer Capital’s website or contact me or Tim Lee for more information.

Mercer Capital is itself an employee-owned firm. We value scores of ESOPs annually and provide fairness opinions and other valuation services on a regular basis to many other plans. To discuss a valuation issue in confidence, give me a call at 901.322.9716.

Wendy S. Ingalls, CPA/ABV, CBA, ASA  
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**Figure 3**

**TYPICAL NON-LEVERAGED ESOP**

- **Company**
  - $Cash
  - Stock

- **Subject Company ESOP Trust**

- **Subject Company Participants**
  - $Cash
  - Stock

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**MOST RECENT TRANSACTION**

*CenterBank, Inc.*

Jacksonville, Florida

Fairness opinion on behalf of the CenterBank, Inc. Employee Stock Ownership Plan in connection with the sale of a controlling interest in CenterBank, Inc. to a new investor
Some (Unsolicited) Advice for CFOs and Controllers of Public Companies

Even if you are a veteran when it comes to goodwill impairment testing under SFAS 142, it’s important to understand that things are different in 2009. Most of us have never experienced a business climate like this before (and hopefully won’t again for a long time). The fair value standard is new, auditors are no longer content with some of the old answers, and reasonable fair value estimates are simply harder to make. We’ve mined our experience helping clients like you meet the new challenges of goodwill impairment testing for a few tips in advance of your annual goodwill impairment test.

INDUSTRY OVERVIEW

Value Focus: Insurance Industry

Mercer Capital’s Value Focus: Insurance Industry is a quarterly perspective on valuation issues pertinent to insurance agencies, brokerages, and underwriters. The 4th Quarter 2008 issue was recently issued and contains a segment focus on reinsurers, as well as market and M&A reviews and outlooks.

COMPLIMENTARY E-BOOK

The Capital Purchase Program Handbook

Written by Mercer Capital’s Financial Institutions Group, this complimentary handbook covers a number of topics related to the CPP, including the activity to date in the program, the advantages and disadvantages of participating, accounting issues raised, and the actual cost of the preferred stock after factoring in the warrants. Mercer Capital will endeavor to provide appropriate updates to this handbook as conditions evolve.

SELECTED LIST OF UPCOMING SPEAKING ENGAGEMENTS

April 23, 2009
“Discounts and Premiums in Valuations for Financial Statement Reporting”
ASA Business Valuation Discipline Meeting
Washington, D.C.
Travis W. Harms, CFA, CPA/ABV

April 29, 2009
“Buy-Sell Agreements”
Hoosier Hills Estate Planning Conference
Bloomington, Indiana
Z. Christopher Mercer, ASA, CFA

May 8, 2009
“Bank Valuation”
New York ASA Chapter Meeting
New York City, New York
Andrew K. Gibbs, CFA, CPA/ABV

May 27, 2009
“Discounts for Lack of Marketability” and “Subsequent Events”
2009 NACVA Annual Conference
Boston, Massachusetts
Z. Christopher Mercer, ASA, CFA

June 9, 2009
“Lack of Marketability and Lack of Control”
AICPA Fair Value Measurements Conference
Chicago, Illinois
Travis W. Harms, CFA, CPA/ABV

September 3, 2009
“Valuation for Gift and Estate Tax Purposes”
Birmingham Estate Planning Council
Birmingham, Alabama
Timothy R. Lee, ASA

To see a complete list, visit the Speaker’s Bureau section of our website at www.mercercapital.com. To inquire about engaging a professional from Mercer Capital to speak to your group, contact Barbara Walters Price at priceb@mercercapital.com, or by calling 901.322.9724.
Valuation issues intersect with a bank's affairs more often than you may imagine, and they are likely to arise during your tenure as a director or manager. These valuation issues might include merger and acquisition activity, an employee stock ownership plan, capital planning, litigation, or financial planning, among others. Mercer Capital has been working with financial institutions for over 25 years and has provided valuation and other financial consulting services to thousands of clients. We find that most of our clients have the same basic questions about these important valuation issues. This handbook is written to address many of these questions and to provide useful information for bank directors and managers when valuation needs emerge.

**SECTION ONE: INTRODUCTION TO VALUATION**
Chapter 1: The Valuation Process
Chapter 2: Core Valuation Concepts
Chapter 3: Financial Management & Performance Measurement

**SECTION TWO: COMPENSATION & EMPLOYEE BENEFIT PLANS**
Chapter 4: Employee Benefit Plans
Chapter 5: Stock Options, Restricted Stock, & Stock Appreciation Rights

**SECTION THREE: STOCK TRANSACTIONS**
Chapter 6: Estate & Gift Tax Issues
Chapter 7: Raising Capital
Chapter 8: Buy-Sell Agreements

**SECTION FOUR: STRATEGIC ALTERNATIVES**
Chapter 9: Mergers & Acquisitions
Chapter 10: Fairness Opinions
Chapter 11: Capital Gains & Dividends
Chapter 12: Sub-Chapter S Conversions

**SECTION FIVE: FINANCIAL REPORTING**
Chapter 13: Fair Value Accounting
Chapter 14: Fair Value Accounting In Business Combinations
Chapter 15: Share-Based Compensation

**SECTION SIX: STATUTORY & LEGAL CONCEPTS**
Chapter 16: A Primer on Litigation
Chapter 17: Statutory Fair Value
Chapter 18: Divorce of a Key Shareholder

**SECTION SEVEN: CONCLUSION**
Addendum: The Capital Purchase Program (CPP)
Addendum: IRS Provides New Tax Incentive for Banks

**THE BANK DIRECTOR'S VALUATION HANDBOOK**
What Every Director Must Know About Valuation

Valuation issues intersect with a bank's affairs more often than you may imagine, and they are likely to arise during your tenure as a director or manager. These valuation issues might include merger and acquisition activity, an employee stock ownership plan, capital planning, litigation, or financial planning, among others. Mercer Capital has been working with financial institutions for over 25 years and has provided valuation and other financial consulting services to thousands of clients. We find that most of our clients have the same basic questions about these important valuation issues. This handbook is written to address many of these questions and to provide useful information for bank directors and managers when valuation needs emerge.
Tagging a text with the label “classic” should not be done carelessly. But 50 years after its initial release, few would disagree that Revenue Ruling 59-60 deserves the title. Written in the spare, unadorned style of a government publication, the Ruling is a compact storehouse of enduring practical wisdom for business appraisers and the users of appraisal reports.

Our purpose in writing this book is twofold: first, to offer a guided tour through the Ruling, pointing out some of the most prominent features of the landscape (and providing the occasional warning about rough terrain); second, to pull back the curtain a bit, granting a non-technical view of how appraisers (at least this group) attempt to translate the guidance found in the Ruling into actual valuation engagements.

Published in January 2009, this 120+ page book is written for attorneys and other users of business appraisal reports. Order your copy today.

Chapter List

Chapter 1  A Summary of Revenue Ruling 59-60 from a Business Appraiser’s Perspective
Chapter 2  Fair Market Value Versus The Real World
Chapter 3  What Revenue Ruling 59-60 Means for Operating Companies
Chapter 4  Revenue Ruling 59-60’s Application to Asset-Holding Entities
Chapter 5  The Growing Influence of Intangible Assets
Chapter 6  Selecting a Business Appraiser
Chapter 7  Landmark Tax Court Cases
Appendix A  Revenue Ruling 59-60
Appendix B  Court Case Bibliography
Appendix C  The National Economy in 1959
We are responding to requests to put this 1992 book back into print and we are
Valuing Financial Institutions

Are S Corporations Worth More Than C Corporations?

Embedded Capital Gains

Rate & Flow: An Alternative Approach to Determining Active/Passive Appreciation in Marital Dissolutions

QMDM Fact Sheet

The QMDM Companion, Version 4.0 (2008)

This 33-page handbook covers a number of topics related to the CPP, including the activity to date in the program, the advantages and disadvantages of participating, accounting issues raised, and the actual cost of the preferred stock after factoring in the warrants. Mercer Capital will endeavor to provide appropriate updates to this handbook as conditions warrant.

The Quantitative Marketability Discount Model (QMDM) presents a practical model to assist business appraisers in developing, quantifying and defending marketability discounts under the income approach. The very latest version of the QMDM now includes a revised and expanded explanatory manual. The model and manual are delivered as a .zip file electronically via email.

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An e-booklet that adds to the S Corp vs. C Corp debate.

A closer look at the Embedded Capital Gains issue.

In this e-book, we present an alternative model for determining active / passive appreciation in a marital dissolution.

The latest information about the QMDM in a pdf format.

NEW E-BOOK

TITLE DESCRIPTION INVESTMENT RELEASE DATE
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- Valuation for Corporate Income Tax Issues
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- Purchase Price Allocations
- Valuation of Employee Options
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- Valuation of Intangible Assets
- Fairness Opinions

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