

ESOP Financial Advisory Services Insights

THE INDEPENDENT FINANCIAL ADVISER'S SOLVENCY OPINION IN AN ESOP EMPLOYER CORPORATION LEVERAGED STOCK PURCHASE TRANSACTION

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Secured lenders often require that a transactional solvency opinion be issued at the time of a leveraged ESOP purchase of employer corporation stock. These ESOP employer stock purchase transactions may include the leveraged acquisition of a noncontrolling block of employer stock, of a controlling block of employer stock, or of 100 percent of the employer corporation stock. Typically, in such leveraged transactions, the lending institution will want assurance that the subject transaction does not involve a fraudulent conveyance. With regard to the leveraged ESOP employer stock purchase transaction, these solvency opinions are typically prepared by an independent financial adviser. This discussion presents a "checklist" of due diligence procedures that the financial adviser will typically consider in a transactional solvency analysis. This particular checklist relates to a leveraged ESOP sponsor company stock acquisition transaction solvency analysis. This checklist can be used as a procedural guide by the independent financial adviser. Or, this checklist can be used by the employer corporation management, the secured lender, the ESOP trustee, or the selling shareholders involved in the process of reviewing the independent financial adviser's solvency analysis and/or solvency opinion.

INTRODUCTION

Independent financial advisers perform solvency analyses and issue solvency opinions for various transaction, financing, bankruptcy, taxation, and litigation purposes. In a solvency opinion, the financial adviser opines on the solvency of a debtor corporation at the time of a specific corporate action.

With regard to a leveraged ESOP stock purchase transaction, the financial adviser opines on the solvency of the employer corporation at the time that (1) the sponsor company assumes the outside loan from the lending institution and (2) the ESOP trust purchases the sponsor company stock (typically from the selling stockholders).

Typically, the solvency opinion is intended to demonstrate that the subject debtor corporation (e.g., the employer corporation) is solvent at the time that a debt is incurred (e.g., the outside stock acquisition debt is assumed). In addition, a solvency opinion may also be relevant to demonstrate the solvency of a debtor corporation at the time that a dividend is disbursed, a distribution is made, an expense or liability is paid, an asset is purchased, a security claim is issued, a class of equity security is redeemed, one class of security is exchanged for another class, and so forth.

Sometimes, the solvency opinion may be intended to demonstrate that the subject debtor corporation is insolvent on a specific date or at the time of a specific event. An example of an "insolvency" analysis relates to when a corporate taxpayer may (or may not) recognize cancellation of debt (COD) income for federal income tax purposes.

This discussion will focus on the solvency analysis and the solvency opinion related to a corporate financing transaction related to a leveraged ESOP employer stock acquisition. For example, a solvency opinion is often prepared at the time of the employer corporation's financing of the ESOP trust employer stock purchase.

In such instances, the financing institution will want protection against claims of an avoidable fraudulent conveyance related to the leveraged transaction. In the leveraged ESOP stock purchase transaction solvency opinion, the financial adviser will typically perform the three generally accepted solvency tests.

Related to a leveraged ESOP stock purchase transaction, the three generally accepted solvency tests are:

1. the balance sheet test,
2. the cash flow test, and

3. the capital adequacy test.

First, this discussion will summarize the objectives of the three generally accepted solvency tests. And, this discussion will describe the practical application of the three solvency opinion tests.

Second, this discussion will present a checklist of the due diligence and analytical procedures that the independent financial adviser will typically consider when performing a solvency analysis.

This procedural checklist may also be used by the employer corporation management, the secured lender financial institution, the ESOP trustee, the selling shareholders, and other parties to the leveraged ESOP stock purchase transaction. These parties may use this due diligence procedural checklist in their good-faith assessment of the financial adviser's solvency opinion.

OVERVIEW OF THE SOLVENCY OPINION

A solvency opinion is a financial adviser's opinion that the employer corporation will not become insolvent as a result of the proposed ESOP financing transaction. For purposes of this discussion, we will consider the case where the proposed transaction is a leveraged employer stock acquisition transaction.

The objective of the solvency analysis is to determine whether the leveraged ESOP stock purchase transaction will result in any one of the three specified financial conditions. The importance of these three specified conditions is that they can be the basis for a claim that a fraudulent transfer occurred at the time of the proposed employer corporation financing transaction.

The three conditions that are typically studied in the solvency analysis are defined in the United States Bankruptcy Code (Section 548), the Uniform Fraudulent Transfer Act, and the Uniform Fraudulent Conveyance act.

THE SOLVENCY OPINION TESTS

A solvency opinion analyzes whether any of the following three conditions exist at the time of the leverage ESOP employer stock purchase transaction (after giving effect to the proposed stock transaction financing):

1. The Balance Sheet Test: Does the recorded amount of the employer corporation liabilities (specifically including the proposed leveraged ESOP stock purchase financing) exceed the fair value of the employer corporation assets?
2. The Cash Flow Test: Does the employer corporation have adequate cash flow to service all of its liabilities (specifically including the proposed leveraged ESOP stock purchase financing) as those liabilities come due?
3. The Capital Adequacy Test: Does the employer corporation have an unreasonably small amount of capital to run its business operations (after the proposed leveraged ESOP stock purchase transaction)?

"A solvency opinion is a financial adviser's opinion that the employer corporation will not become insolvent as a result of the proposed ESOP financing transaction."

Together, these three tests are identified as the solvency tests. In order to be considered solvent for purposes of a leveraged ESOP stock purchase transaction, an employer corporation must pass all three tests.

It is important to note that a solvency opinion is based on the information that is available to—or reasonably foreseeable by—the financial adviser as of the proposed leveraged ESOP stock purchase transaction date.

Next, this discussion will summarize the principal procedures that the financial adviser will typically consider in the performance of each of these three solvency analysis tests.

"In order to be considered solvent for purposes of a leveraged ESOP stock purchase transaction, an employer corporation must pass all three tests."

The Balance Sheet Test

The balance sheet test determines whether, at the time of the proposed leveraged ESOP stock purchase transaction, the fair value of the employer corporation assets (both tangible and intangible) is greater than the recorded balance of the employer corporation liabilities.

For purposes of the solvency opinion balance sheet test, the employer corporation tangible and intangible assets are valued based on the fair value (and not the fair market value) standard of value. And, for purposes of the balance sheet test, the outside debt assumed by the sponsor company (and loaned as a "mirror loan" to the ESOP trust) is considered as part of the employer corporation liabilities.

First, for the purpose of the balance sheet test, the independent financial adviser will typically analyze the highest and best use of the employer corporation assets. The highest and best use analysis will indicate the appropriate

premise of value for the fair value analysis of the employer corporation assets. The premise of value that the financial adviser will typically conclude for a solvency analysis is value in continued use, as part of a going-concern business enterprise.

For purposes of a solvency analysis, fair value is typically defined as 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, with both parties having reasonable knowledge of the relevant facts.

This definition of fair value is similar to the Revenue Ruling 59-60 definition of fair market value. Nonetheless, it is important to the financial adviser to conclude the fair value (and not the fair market value) of the employer corporation assets in the balance sheet test.

Second, the financial adviser will estimate the fair value of the employer corporation assets as of the date of the leveraged ESOP stock purchase transaction. This fair value analysis includes consideration of all of the employer corporation financial assets, real estate, tangible personal property, and intangible assets. It is noteworthy that the inside loan (or “mirror loan”) note receivable from the ESOP trust is not recorded as an asset of the employer corporation.

Third, the financial adviser will consider the recorded balance of the employer corporation liabilities. The employer corporation liabilities include all current liabilities and all long-term liabilities. The employer corporation liabilities include the leveraged ESOP stock acquisition debt outside loan.

Fourth, the financial adviser will subtract the recorded amount of the employer corporation total liabilities from the fair value of the employer corporation total assets. To reiterate, the amount of the employer corporation liabilities includes the debt related to the proposed leveraged stock purchase transaction.

The balance sheet test is “passed” if the fair value of the employer corporation total assets is greater than the recorded balance of the employer corporation total liabilities.

There are three generally accepted approaches (i.e., the income approach, the market approach, and the asset-based approach) that the financial adviser may consider in the aggregate valuation of the employer corporation total

operating assets. Within each of the generally accepted approaches to the collective valuation of the employer corporation assets, the financial adviser will consider one or more generally accepted valuation methods.

A detailed description of each generally accepted valuation approach and method is beyond the scope of this discussion. However, the Exhibit 1 checklist accompanying this discussion includes the procedures that the financial adviser will typically consider with respect to each of the generally accepted valuation approaches and methods.

Obviously, the financial adviser performing the balance sheet test should be familiar with both the conceptual foundation and the practical application of all three generally accepted valuation approaches.

The income approach, market approach, and asset-based approach may all be applicable to the aggregate valuation of the employer corporation total operating assets. Each of these three generally accepted approaches can be used to perform the balance sheet test.

However, the component analyses of the income approach will also be applicable to both (1) the cash flow test and (2) the capital adequacy test. Therefore, the income approach is typically used in every solvency analysis. The income approach is used in order to (1) perform

each of the three solvency tests and (2) ensure the consistency within the three tests of the valuation (and other financial) variables used in the solvency analysis.

The Cash Flow Test

The cash flow test analyzes the employer corporation ability to meet its debt obligations as they become due. The financial adviser will typically project the employer corporation’s expected cash flow for several periods into the future. The term of the projection period usually corresponds to the repayment period for the proposed outside loan financing.

The cash flow test analysis will consider the repayment of all of the employer corporation debt (both principal and interest) obligations, including the proposed leveraged ESOP stock purchase financing.

Next, the financial adviser will analyze the employer corporation cash flow available to meet the corporation debt obligations by estimating:

“The balance sheet test is ‘passed’ if the fair value of the employer corporation total assets is greater than the recorded balance of the employer corporation total liabilities.”

“. . . the financial adviser performing the balance sheet test should be familiar with both the conceptual foundation and the practical application of all three generally accepted valuation approaches.”

1. any excess employer corporation cash balance available on the solvency test date,
2. the available cash flow expected to be generated by the employer corporation during the projection period, and
3. the availability of any unused credit commitments available to the employer corporation.

The cash flow test is “passed” if, in each prospective period, the employer corporation can pay its projected debt obligations from one of the three aforementioned sources of cash. As part of the solvency analysis, the financial adviser will typically perform sensitivity (or “stress test”) analyses as part of the cash flow test.

In the sensitivity analysis, the financial adviser will “sensitize” or “stress test” the various cash flow projection variables. The objective of the sensitivity analysis is to determine whether the employer corporation can meet its debt obligations under a variety of alternative industry competition circumstances and general economic conditions.

The Capital Adequacy Test

The capital adequacy test (sometimes also referred to as the reasonable capital test) determines whether the employer corporation is engaged in (or is about to be engaged in) a business or a transaction for which it has an unreasonably small amount of capital.

The capital adequacy test determines whether the employer corporation will have an adequate amount of capital to meet its:

1. operating expenses,
2. capital expenditure requirements, and
3. debt repayment obligations.

The capital adequacy test is related to the cash flow test. The cash flow test encompasses a long-term sources and uses of funds analysis. Typically, the term of the cash flow test is the term of the proposed outside loan financing.

In contrast, the capital adequacy test encompasses a short-term sources and uses of funds analysis. Typically, the period analyzed in the capital adequacy test includes the four fiscal quarters after the solvency date.

If the employer corporation has a reasonable (i.e., adequate) level of capital, then it will be able to meet its financial obligations as they come due under various operating scenarios. The objective of the capital adequacy test is to assess whether the employer corporation is likely to survive, assuming reasonable future business fluctuations.

The financial adviser will typically assess and analyze various employer corporation operating scenarios, including the following:

1. the employer corporation management’s best estimate of the company’s future financial and operational performance,
2. no change from the employer corporation recent historical financial performance, and
3. reasonable variations (both positive and negative) in the employer corporation revenue growth rate and profit margin assumptions.

The capital adequacy test is “passed” if the employer corporation is expected to have sufficient cash on hand to pay its:

1. operating expenses,
2. capital expenditures, and
3. current liabilities/current portion of long-term debt.

In other words, after the proposed leveraged ESOP stock purchase transaction, the employer corporation should be able to fund its ongoing business operations for the foreseeable future.

“In the sensitivity analysis, the financial adviser will ‘sensitize’ or ‘stress test’ the various cash flow projection variables.”

CAVEATS FOR FINANCIAL ADVISERS REGARDING RELIANCE ON ANY PROCEDURAL CHECKLIST

It is important for any independent financial adviser to consider several caveats regarding the use of any checklist of due diligence procedures.

First, no checklist should ever substitute for the independent financial adviser’s professional judgment.

Second, the checklist presented in Exhibit 1 is not intended to be a comprehensive and all-inclusive procedural list that should be followed without exception.

Third, the terminology (i.e., names of valuation methods and/or analytical procedures) used in the checklist presented in Exhibit 1 may have several interpretations.

Fourth, the facts and circumstances regarding a specific leveraged ESOP stock purchase transaction and a specific employer corporation should always be considered when determining the appropriateness of any procedure on any checklist.

Finally, the Exhibit 1 checklist should not be used to derive a “quantitative score” to evaluate the quality (1) of a solvency analysis or (2) of a financial adviser’s solvency opinion.

For example, the fact that a particular solvency analysis did not receive a “score” of 100 percent does not imply that the financial adviser’s solvency analysis is (1) not complete or (2) not in compliance with generally accepted professional practices and procedures.

Also, the fact that a particular solvency analysis does receive a “high score” does not necessarily imply that the financial adviser’s solvency analysis is complete and in conformance with generally accepted professional practices. Such a “high scoring” analysis may still be lacking in professional competence or may be inadequate for the assessment of the employer corporation solvency.

The checklist presented in Exhibit 1 is a practice aid that the financial adviser can use as a procedural reminder in conducting a solvency opinion analysis. However, no checklist can evaluate the analytical quality and the professional judgment involved in the performance of the solvency analysis procedures.

The checklist presented in Exhibit 1 is not a substitute for the due diligence, prudence, and rigorous analysis that the independent financial adviser should perform.

Finally, the experienced independent financial adviser will understand that not all of the listed procedures are applicable (or even possible) for every solvency analysis. The professional judgment of the experienced financial adviser will determine which procedures are appropriate in each case.

It is noteworthy that the Exhibit 1 checklist generally excludes a description of the asset-based approach valuation procedures in the balance sheet test discussion. This is because, in practice, the asset-based approach is the least commonly used valuation approach for a solvency opinion balance sheet test.

However, this exclusion does not imply that the asset-based approach is inappropriate to use in a solvency analysis. Rather, the asset-based approach asset accumulation method and/or adjusted net asset value method certainly may be used in a solvency analysis balance sheet test.

Practically, due to data constraints and other reasons, these asset-based approach valuation methods are performed in the solvency opinion balance sheet test much less frequently than either:

2. market approach valuation methods.

SUMMARY AND CONCLUSION

The legal and financial issues related to a leveraged ESOP stock acquisition transaction fraudulent conveyance analysis and/or an employer corporation solvency are complicated. A contemporaneously prepared solvency opinion from an experienced independent financial adviser is an important component in the defense against claims of a voidable capital transaction fraudulent conveyance.

This defense against a fraudulent conveyance are important to:

1. the secured outside debt lending institution,
2. the selling stockholders,
3. the ESOP trustee and the ESOP participants, and
4. the employer corporation.

“. . . no checklist can evaluate the analytical quality and the professional judgment involved in the performance of the solvency analysis procedures.”

The Exhibit 1 checklist enumerates the due diligence procedures that are typically considered by an independent financial adviser in the preparation of an employer corporation solvency opinion.

This Exhibit 1 solvency analysis procedural checklist should serve as a useful tool to the independent financial adviser, the employer corporation management, the secured lender involved in the leveraged stock purchase transaction, and the ESOP trustee.

In particular, the Exhibit 1 procedural checklist is intended to be applicable to the solvency analysis of a leveraged ESOP employer stock acquisition transaction. However, this solvency opinion procedural checklist should never substitute for the professional expertise and the reasoned judgment of the experienced

ESOP independent financial adviser.

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“A contemporaneously prepared solvency opinion from an experienced independent financial adviser is an important component in the defense against claims of a voidable capital transaction fraudulent conveyance.”

1. income approach valuation methods or

Exhibit 1
Checklist of Solvency Analysis Analytical Procedures Typically Considered by the Independent Financial Adviser in the Preparation of a Leveraged ESOP Employer Stock Acquisition Transaction Solvency Opinion

	Was this Procedure Performed?		Financial Adviser's Initials
	Yes	No	
A. Solvency Opinion Engagement Purpose and Objective			
1. Identify the purpose of the solvency opinion (i.e., the reason to conduct the solvency analysis)	_____	_____	_____
2. Identify the objective of the solvency opinion	_____	_____	_____
3. Define the solvency analysis assignment			
a. Identify the parties who will rely on the solvency opinion	_____	_____	_____
b. Identify the effective date of the solvency opinion	_____	_____	_____
c. Identify the solvency tests that apply to the subject assignment	_____	_____	_____
4. Define the engagement fee structure, solvency opinion content, delivery date, and professional qualifications of the engagement analysts in a written client engagement letter	_____	_____	_____
B. Due Diligence Procedures and Collection of Data (as of the Solvency Date)			
1. Collect and review the proposed stock purchase transaction documents related to the subject leveraged ESOP stock acquisition transaction	_____	_____	_____
2. Collect and review the credit facility documents related to the subject ESOP stock acquisition transaction	_____	_____	_____
3. Collect and review the employer corporation documents including:			
a. Historical financial information (typically, the last five fiscal years and any interim period financial statements) including:			
i. income statements	_____	_____	_____
ii. balance sheets	_____	_____	_____
iii. statements of cash flow	_____	_____	_____
iv. statements of changes in stockholders' equity	_____	_____	_____
b. Pre-ESOP transaction and post-ESOP transaction employer corporation debt structure	_____	_____	_____
c. Any current employer corporation financial and/or operational plans, budgets, projections, and forecasts	_____	_____	_____
d. Description of the employer corporation business operations	_____	_____	_____
e. Employer corporation equity ownership structure (consider both the pre-ESOP transaction structure and the post-ESOP transaction structure)	_____	_____	_____
f. Legal documents relevant to the proposed ESOP stock acquisition transaction	_____	_____	_____
g. Other relevant employer corporation operational information including, but not limited to:			
i. products and/or services information and brochures	_____	_____	_____
ii. list of major customers/clients	_____	_____	_____

	Was this Procedure Performed?		Financial Adviser's Initials
	Yes	No	
iii. list of major competitors	_____	_____	_____
iv. list of senior management personnel	_____	_____	_____
v. list of the locations in which the employer corporation operates	_____	_____	_____
vi. detailed description of any off-balance sheet intangible assets and off-balance sheet contingent liabilities	_____	_____	_____
4. Conduct employer corporation management interviews in all relevant functional areas, regarding:			
a. historical results of operations financial position	_____	_____	_____
b. current results of operations and financial position	_____	_____	_____
c. prospective results of operations and financial positions	_____	_____	_____
d. the competitive environment	_____	_____	_____
e. the industry outlook	_____	_____	_____
f. recent and expected technological changes/developments	_____	_____	_____
g. pending employer corporation litigation and/or contingent liabilities	_____	_____	_____
5. Conduct employer corporation plant/site inspections			
a. Inspect employer representative employer corporation plants/sites and consider:			
i. any capacity limits and the physical condition of the existing plants, facilities, and equipment	_____	_____	_____
ii. the current and expected future functional and technological adequacy of the existing plants, facilities, and equipment	_____	_____	_____
b. Discuss the plant/site inspections with employer corporation management representatives and consider:			
i. any current/future facilities expansions and capital investment plans	_____	_____	_____
ii. the competitive effects of any planned plant/facility changes	_____	_____	_____
iii. the expected operating cost effects of any planned plant and/or facility changes	_____	_____	_____
C. Economic Environment (as of the Solvency Date)			
1. Consider the national and international (if relevant) economic environment	_____	_____	_____
2. Research and analyze the national and international economic trends and expected outlook	_____	_____	_____
3. Consider the historical and expected relationship of the relevant economic indicators to the historical and expected performance of the employer corporation	_____	_____	_____
D. Industry Environment (as of the Solvency Date)			
1. Research and analyze the history and nature of the industry in which the employer corporation operates	_____	_____	_____
2. Research the expected outlook for the subject industry	_____	_____	_____
3. Consider the impact of trends in the subject industry on the employer corporation expected results of operations	_____	_____	_____

	Was this Procedure Performed?		Financial Adviser's Initials
	Yes	No	
E. Fundamental Position of the Employer Corporation (as of the Solvency Date)			
1. Consider the employer corporation debt to equity capitalization ratio and the equity ownership (both pre-ESOP transaction and post-ESOP transaction)	_____	_____	_____
2. Review the employer corporation historical financial position (typically for one business cycle or for a five-year period)	_____	_____	_____
3. Review and analyze the employer corporation current business operations and current financial position	_____	_____	_____
4. Consider the employer corporation expected financial plans and strategic outlook	_____	_____	_____
5. Perform a competitive position analysis of the employer corporation, with consideration to its relative strategic SWOT analysis:			
a. strengths	_____	_____	_____
b. weaknesses	_____	_____	_____
c. opportunities, and	_____	_____	_____
d. threats	_____	_____	_____
6. Perform a historical financial statement analysis			
a. Consider a financial ratio analysis for one business cycle or a five-year period	_____	_____	_____
b. Consider a trendline analysis for one business cycle or a five-year period	_____	_____	_____
c. Consider a common size analysis for one business cycle or a five-year period	_____	_____	_____
d. Consider a benchmark (industry or guideline company data) comparative analysis	_____	_____	_____
7. Perform historical financial statement normalization adjustments, as necessary			
a. Consider any nonrecurring financial statement adjustments	_____	_____	_____
b. Consider any non-operating financial statement adjustments	_____	_____	_____
c. Consider any extraordinary financial statement adjustments	_____	_____	_____
d. Consider any changes in accounting principles financial statement adjustments	_____	_____	_____
8. Perform a prospective financial statement analysis			
a. Identify the key financial variables that drive the employer corporation prospective results of operations	_____	_____	_____
b. Analyze any employer corporation management-prepared projections/budgets/forecasts/plans	_____	_____	_____
c. Assess the reasonableness of the financial projections/budgets/forecasts/plans relative to the historical employer corporation results	_____	_____	_____
d. Assess the reasonableness of the financial projections/budgets/forecasts/plans relative to the subject industry data	_____	_____	_____

	Was this Procedure Performed?		Financial Adviser's Initials
	Yes	No	
F. Solvency Analysis Procedures (as of the Solvency Date)			
1. Consider and document the appropriate solvency tests that may be required for the subject solvency opinion	_____	_____	_____
2. Perform the cash flow test to determine if the debt incurred in the leveraged ESOP stock acquisition transaction is within the employer corporation's ability to pay as such debt matures	_____	_____	_____
3. Review the terms of the leveraged ESOP stock acquisition transaction debt obligations	_____	_____	_____
4. Review any notes and security agreements related to the leveraged ESOP stock acquisition debt	_____	_____	_____
5. Prepare a detailed employer corporation cash flow projection through the term date of the secured credit facilities	_____	_____	_____
6. Prepare cash flow projections as follows:			
a. monthly or quarterly cash flow projections for several periods after the proposed ESOP stock acquisition transaction and	_____	_____	_____
b. annual cash flow projections thereafter	_____	_____	_____
7. Develop the appropriate economic income fundamentals for the analysis of the employer corporation cash flow available for debt service, including:			
a. revenue from products or services	_____	_____	_____
b. cost of goods sold	_____	_____	_____
c. operating expenses	_____	_____	_____
d. capital expenditures	_____	_____	_____
e. net working capital requirements	_____	_____	_____
f. depreciation and amortization expense	_____	_____	_____
g. interest income and interest expense	_____	_____	_____
h. federal and state income taxes	_____	_____	_____
i. debt principal payments	_____	_____	_____
j. dividend payments	_____	_____	_____
k. annual cash balances	_____	_____	_____
8. Determine the employer corporation quarterly/annual ability to meet its projected:			
a. operating expense requirements	_____	_____	_____
b. capital expenditure requirements	_____	_____	_____
c. net working capital requirements	_____	_____	_____
d. interest expense requirements	_____	_____	_____
e. debt principal payments requirements	_____	_____	_____
9. Perform a series of sensitivity (stress test) analyses related to the cash flow projections to test the sensitivity of the employer corporation expected financial performance			
a. Test all relevant fundamental financial variables, such as:			
i. revenue growth rate	_____	_____	_____
ii. revenue unit volume and unit price increase	_____	_____	_____
iii. EBITDA profit margin	_____	_____	_____
iv. EBIT profit margin	_____	_____	_____
v. capital expenditure requirements	_____	_____	_____

	Was this Procedure Performed?		Financial Adviser's Initials
	Yes	No	
vi. net working capital requirements	_____	_____	_____
vii. weighted average cost of capital/present value discount rate	_____	_____	_____
viii. terminal year cash flow direct capitalization rate	_____	_____	_____
b. Consider the employer corporation past financial performance, current financial position and expected future financial performance in the sensitivity analyses	_____	_____	_____
c. Review and assess the employer corporation's ability to meet its financial obligations under each sensitivity analysis scenario	_____	_____	_____
10. Analyze, for each discrete projection period in the cash flow projection analysis:			
a. excess cash on hand	_____	_____	_____
b. available net cash flow	_____	_____	_____
c. employer corporation unused credit availability	_____	_____	_____
11. Consider the terms of the debt covenants of all secured lenders and determine whether employer corporation can meet its debt covenants in each future year of the cash flow test	_____	_____	_____
12. Conclude whether or not the employer corporation "passed" the cash flow test	_____	_____	_____
13. Perform the balance sheet test	_____	_____	_____
14. Estimate the fair value of the employer corporation total operating assets			
a. Identify and consider all relevant generally accepted valuation approaches and methods	_____	_____	_____
b. Select the valuation approaches and methods appropriate to the subject employer corporation total unit of operating assets	_____	_____	_____
15. Perform an income approach valuation analysis—such as a discounted cash flow method analysis	_____	_____	_____
16. Review and analyze financial projections related to the employer corporation prospective results of operations for a relevant (e.g., one business cycle or a five-year period) discrete projection period	_____	_____	_____
17. Develop the appropriate economic income fundamentals for the analysis of the invested capital (i.e., total long-term debt and total stockholders' equity) net cash flow, which considers:			
a. net income	_____	_____	_____
b. noncash expenditures (e.g., depreciation expense, amortization expense, etc.)	_____	_____	_____
c. capital expenditures	_____	_____	_____
d. net working capital requirements	_____	_____	_____
18. Develop a discounted net cash flow method analytical model, with projection variables that are consistent with the cash flow/debt repayment model developed in the cash flow test	_____	_____	_____
19. Develop the appropriate yield capitalization rate/discount value for the present value calculation, with consideration to:			
a. the risk-free rate of return	_____	_____	_____
b. general equity rates of return (and/or general equity risk premiums)	_____	_____	_____
c. systematic risk factors (e.g., beta)	_____	_____	_____

	Was this Procedure Performed?		Financial Adviser's Initials
	Yes	No	
d. company-specific risk premiums/required rates of return, with consideration to:			
i. the expected attainability of the employer corporation financial projections	_____	_____	_____
ii. the degree of post-leveraged ESOP transaction employer corporation financial/operating leverage	_____	_____	_____
iii. degree of diversification of the employer corporation business/product base	_____	_____	_____
e. capital structure analysis			
i. the mix of debt and equity components of the employer corporation total invested capital	_____	_____	_____
ii. the typical capital structure in the subject industry	_____	_____	_____
20. Develop an estimate of the cash flow projection terminal/residual value, with consideration to:			
a. terminal/residual year financial fundamentals (e.g., net cash flow projection for the terminal year)	_____	_____	_____
b. terminal/residual year direct capitalization rate (e.g., using the dividend discount model or the selected discount rate minus the selected long-term growth rate)	_____	_____	_____
c. terminal/residual year market-derived pricing multiple (derived from capital market information of companies sufficiently similar to the employer corporation)	_____	_____	_____
21. Apply the market-derived yield capitalization discount rate to the discrete period estimated economic income projections (e.g., net cash flow) and the terminal/residual value estimate	_____	_____	_____
22. Perform an income approach valuation analysis—such as a direct capitalization method analysis	_____	_____	_____
23. Analyze the appropriate measure of economic income subject to direct capitalization	_____	_____	_____
24. Estimate a normalized (or stabilized) amount of future period economic income subject to direct capitalization	_____	_____	_____
25. Estimate the appropriate market-derived direct capitalization rate, with consideration to:			
a. the employer corporation yield capitalization rate for the selected measure of economic income	_____	_____	_____
b. the employer corporation expected long-term growth rate in the selected measure of economic income	_____	_____	_____
26. Divide the employer corporation normalized future period economic income by the selected market-derived direct capitalization rate, to conclude a direct capitalization method value indication	_____	_____	_____
27. Calculate an income approach estimate of the employer corporation total operating assets value (i.e., total invested capital) that considers:			
a. the value of total invested capital as the value of all interest-bearing debt, plus the value of total stockholders' equity	_____	_____	_____
b. the value of total operating assets as equal to the value of total invested capital	_____	_____	_____
28. Perform a market approach valuation analysis—such as a guideline publicly traded company method analysis	_____	_____	_____

	Was this Procedure Performed?		Financial Adviser's Initials
	Yes	No	
29. Identify and select the appropriate guideline publicly traded companies; consider the following risk and expected return guideline company selection criteria:			
a. same or similar line of business	_____	_____	_____
b. same or similar industry/economic risk factors	_____	_____	_____
c. same or similar growth rates	_____	_____	_____
d. same or similar rate of return metrics	_____	_____	_____
e. same or similar profit margin metrics	_____	_____	_____
g. size	_____	_____	_____
h. active security trading activity/security pricing evidence	_____	_____	_____
i. relative financial condition	_____	_____	_____
30. Perform normalization adjustments to the financial statements of the selected guideline publicly traded companies, if applicable	_____	_____	_____
31. Identify the appropriate financial and operating fundamentals for comparison of the employer corporation to the guideline companies	_____	_____	_____
32. Calculate market-derived valuation pricing multiples for the selected guideline publicly traded companies	_____	_____	_____
33. Analyze the range (e.g., means, medians, modes, quartiles, etc.) of guideline company market-derived valuation pricing multiples	_____	_____	_____
34. Compute and analyze financial ratios and operating ratios for the selected guideline publicly traded companies, including:			
a. size ratios	_____	_____	_____
b. growth ratios	_____	_____	_____
c. liquidity ratios	_____	_____	_____
d. profitability ratios	_____	_____	_____
e. return on investment ratios	_____	_____	_____
f. turnover/activity ratios	_____	_____	_____
g. leverage ratios	_____	_____	_____
35. Compare the employer corporation to the selected guideline publicly traded companies, based on:			
a. calculated financial and operational ratios, and	_____	_____	_____
b. growth rate, rate of return, and profit margin factors	_____	_____	_____
36. For each relevant financial fundamental, select the appropriate market-derived valuation pricing multiples for the subject employer corporation; the selected market-derived pricing multiples may be:			
a. mean, median, or mode pricing multiples from the guideline company pricing data	_____	_____	_____
b. other pricing multiples extracted from within the range of the market-derived pricing multiples	_____	_____	_____
c. other pricing multiples derived from outside the range of the market-derived pricing multiples	_____	_____	_____
37. Apply the selected valuation pricing multiples to the appropriate employer corporation financial and operational fundamentals	_____	_____	_____
38. Calculate a market approach estimate of the employer corporation total operating assets (i.e., total invested capital) based on the selected, guideline publicly traded company pricing multiples	_____	_____	_____
a. the calculated financial ratios	_____	_____	_____

	Was this Procedure Performed?		Financial Adviser's Initials
	Yes	No	
b. historical and/or expected growth rates	_____	_____	_____
c. historical and/or expected rate of return metrics	_____	_____	_____
d. historical and/or expected profit margin metrics	_____	_____	_____
39. Perform a market approach valuation analysis—such as a guideline merged and acquired company method analysis	_____	_____	_____
40. Identify and select guideline merged and acquired company transactions; consider the following risk and expected return guideline company selection criteria:			
a. acquired company in same or similar line of business	_____	_____	_____
b. same or similar industry/economic risk factors	_____	_____	_____
c. same or similar growth rates	_____	_____	_____
d. same or similar rate of return metrics	_____	_____	_____
e. same or similar profit margin metrics	_____	_____	_____
f. size of acquired company	_____	_____	_____
g. date of transaction	_____	_____	_____
41. Identify the merged and acquired company financial and operational ratios, including:			
a. size ratios	_____	_____	_____
b. growth ratios	_____	_____	_____
c. liquidity ratios	_____	_____	_____
d. profitability ratios	_____	_____	_____
e. return on investment ratios	_____	_____	_____
f. turnover/activity ratios	_____	_____	_____
g. leverage ratios	_____	_____	_____
42. Calculate market-derived valuation pricing multiples for the selected merged and acquired companies	_____	_____	_____
43. Analyze the range (e.g., mean, median, mode, quartiles, etc.) of market-derived guideline transaction valuation pricing multiples	_____	_____	_____
44. Calculate financial and operational ratios for the subject employer corporation and for the selected guideline companies transactions, including:			
a. growth rates	_____	_____	_____
b. profit margins	_____	_____	_____
c. return on investment ratios	_____	_____	_____
45. Compare the employer corporation to the selected guideline company based on:			
a. calculated financial and operational ratios	_____	_____	_____
b. growth rate, rate of return, and profit margin factors	_____	_____	_____
46. Select the appropriate market-derived valuation pricing multiples for the subject employer corporation	_____	_____	_____
47. Apply the selected valuation pricing multiples to the appropriate employer corporation financial and operational fundamentals	_____	_____	_____

	Was this Procedure Performed?		Financial Adviser's Initials
	Yes	No	
48. Synthesize a market approach estimate of the employer corporation total operating asset value (i.e., total invested capital value) that considers:			
a. the employer corporation yield capitalization rate for the selected measure of economic income	_____	_____	_____
b. the employer corporation expected long-term growth rate in the selected measure of economic income	_____	_____	_____
49. Consider the application of an asset-based approach valuation analysis			
a. consider an adjusted net asset value valuation method	_____	_____	_____
b. consider an asset accumulation valuation method	_____	_____	_____
50. If an asset-based approach valuation analysis is performed, consider the valuation of the following categories of employer corporation assets and liabilities:			
a. current or financial assets	_____	_____	_____
b. real estate	_____	_____	_____
c. tangible personal property	_____	_____	_____
d. discrete intangible assets	_____	_____	_____
e. intangible value in the nature of goodwill	_____	_____	_____
f. other assets and investment assets	_____	_____	_____
g. current liabilities	_____	_____	_____
h. long-term liabilities	_____	_____	_____
i. contingent liabilities	_____	_____	_____
51. If an asset-based approach valuation analysis is performed, synthesize an asset-based approach estimate of the employer corporation total operating asset value (i.e., total invested capital value).	_____	_____	_____
52. Ensure that all employer corporation total operating asset value indications (i.e., total invested capital value indications) are presented on the same level of value basis			
a. Consider that, typically, a marketable, controlling ownership interest level of value is appropriate for a solvency analysis balance sheet test	_____	_____	_____
b. Apply all appropriate systematic valuation adjustments (i.e., discounts and premiums) to each value indication in order to conclude a consistent (and appropriate) level of value	_____	_____	_____
53. Consider any appropriate nonsystematic (i.e., company-specific) valuation adjustments appropriate to the specific employer corporation invested capital value indication			
a. Consider such nonsystematic valuation adjustments as key person dependence, key supplier dependence, key customer dependence, etc.	_____	_____	_____
b. Apply any appropriate nonsystematic valuation adjustments either:			
1. within each individual valuation method analysis or	_____	_____	_____
2. as an overall adjustment to an overall synthesized value indication	_____	_____	_____
54. Prepare a synthesis of all applicable value indications from all application valuation approaches and methods (including all applicable income approach, market approach, and asset-based approach valuation methods):			
a. Determine the relevance of each valuation approach and method used in the balance sheet test	_____	_____	_____

	Was this Procedure Performed?		Financial Adviser's Initials
	Yes	No	
b. Conclude the appropriate fair value of the employer corporation total operating assets (i.e., total invested capital)	_____	_____	_____
55. Estimate the aggregate fair value of the employer corporation total operating assets; consider the following procedures:			
a. Add the recorded value of the employer corporation current liabilities to the fair value of the total invested capital to estimate the fair value of employer corporation total liabilities and total stockholders' equity	_____	_____	_____
b. Calculate the "stepped up" total operating asset value adjustment, using the following equation:			
i. fair value of total liabilities and total stockholders' equity	_____	_____	_____
ii. minus: accounting book value of the total operating assets	_____	_____	_____
iii. plus/minus: any other accounting adjustments (if applicable)	_____	_____	_____
iv. equals: aggregate fair value of the employer corporation total operating assets	_____	_____	_____
56. Compare the aggregate fair value of the employer corporation total operating assets to the recorded value of the employer corporation total liabilities in order to evaluate the positive or negative balance of the employer corporation total net assets	_____	_____	_____
57. Determine whether the aggregate fair value of the employer corporation total operating assets exceeds the recorded balance of its employer corporation total liabilities	_____	_____	_____
58. Determine if the employer corporation "passes" the balance sheet test on the solvency date	_____	_____	_____
59. Perform the capital adequacy test	_____	_____	_____
60. Review the cash flow/debt repayment analysis performed in the cash flow test to determine whether the employer corporation has adequate capital to meet its short-term:			
a. operating expense requirements	_____	_____	_____
b. capital expenditure requirements	_____	_____	_____
c. debt service interest payment obligations	_____	_____	_____
d. debt service principal payment obligations	_____	_____	_____
61. Review the sensitivity analysis (i.e., stress test) scenarios of the cash flow/debt repayment analysis to determine whether the employer corporation has adequate capital to meet its short-term:			
a. operating expense requirements	_____	_____	_____
b. capital expenditure requirements	_____	_____	_____
c. debt service interest payment obligations	_____	_____	_____
d. debt service principal payment obligations	_____	_____	_____
62. Determine if the employer corporation has adequate capital to conduct its business operations under a range of financial circumstances and economic conditions	_____	_____	_____
63. Review each valuation approach and method performed for the balance sheet test to determine if the employer corporation has an unreasonably small amount of capital in order for the employer corporation to meet its operating needs in the short term	_____	_____	_____
64. Review and consider the level, nature, and sources of funds for expected capital reinvestments	_____	_____	_____
65. Determine if, in the short-term, the employer corporation can:			
a. pay its current liabilities and the current portion of its long-term liabilities	_____	_____	_____

	Was this Procedure Performed?		Financial Adviser's Initials
	Yes	No	
b. pay its payroll, research and development, and other operating expenses	_____	_____	_____
c. make required capital expenditure investments	_____	_____	_____
66. Determine whether or not the employer corporation "passes" the capital adequacy test	_____	_____	_____
67. Document whether or not the employer corporation "passed" all three solvency tests, including:			
a. the balance sheet test	_____	_____	_____
b. the cash flow test	_____	_____	_____
c. the capital adequacy test	_____	_____	_____
G. Reporting the Results of the Solvency Analysis			
1. Prepare a leveraged employer stock purchase transaction solvency opinion, as requested	_____	_____	_____
2. State the purpose and objective of the solvency opinion	_____	_____	_____
3. State the effective date of the solvency opinion	_____	_____	_____
4. Define the standard of value and the premise of value used in the solvency analysis	_____	_____	_____
5. Describe the proposed leveraged ESOP employer stock purchase transaction	_____	_____	_____
6. Describe each of the solvency analysis methods used	_____	_____	_____
7. Describe the financial, operational, economic, and industry information considered	_____	_____	_____
8. Define any limiting conditions or engagement scope restrictions that may affect the solvency analysis and/or the solvency conclusion	_____	_____	_____
9. Include a summary of the professional qualifications of the principal analyst(s) performing the solvency analysis	_____	_____	_____
10. Opine on the solvency of the employer corporation immediately after, and giving effect to, the consummation of the proposed leveraged ESOP employer stock purchase transaction	_____	_____	_____
H. Documentation of the Solvency Analysis			
1. Prepare and maintain solvency analysis engagement workpaper files	_____	_____	_____
2. Include a copy of the signed engagement letter/statement of scope of work	_____	_____	_____
3. Document the financial adviser's due diligence procedures performed in the solvency analysis	_____	_____	_____
4. Document the information considered by the financial adviser in the solvency analysis	_____	_____	_____
5. Document the analytical models created by the financial adviser in the solvency analysis	_____	_____	_____
6. Document the reasoning that supports the solvency conclusions reached by the financial adviser	_____	_____	_____
7. Include in the engagement workpapers sufficient analytical detail so that the subject solvency analysis can be replicated at a later date, if necessary	_____	_____	_____
8. Include a copy of the final, signed solvency opinion in the engagement workpaper files	_____	_____	_____