Appraisal Review Report

Concerning

The Business Appraisal Report Prepared by John E. S. Mitchell, Certified Public Accountant

As of

September 24, 2010

For

The Fair Market Value of a 100% controlling interest in Alpha Company, a 99% minority interest in Bravo Company and a 100% controlling interest in Bravo Company

Prepared By:

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Business Valuation ❶ Forensic Accounting ❶ Exit Planning Strategies

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March 31, 2011

Mr. Kenneth Higgins
1000 Brazil Street
Houston, Texas 77001

RE: Appraisal Review of Alpha Company, Bravo Company and Bravo Company

Dear Mr. Higgins:

In accordance with our engagement agreement, I have prepared and enclosed my review appraisal of the appraisal report prepared by Mr. John E. S. Mitchell, Certified Public Accountant, Accredited in Business Valuation, Certified in Financial Forensics, Certified Valuation Analyst, Certified Fraud Examiner and Candidate Member of the American Society of Appraisers ("The Appraiser"). That report was delivered by opinion cover letter dated September 24, 2010, stated to have a report date of September 24, 2010, and a valuation date of September 24, 2010.

Sincerely,

J. Richard Claywell, CPA, ABV, ASA, CBA, CVA, CM&AA, CFFA, CFD, ABAR

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1. Introduction

1.1 Background

The Appraiser was retained by John B. Smith Associates, PC and one of its shareholders, Ms. Mary Jones to perform a valuation engagement to develop an appraisal and conclusion of value, and to prepare a summary letter and appraisal report to assist the client, Ms. Mary Jones, in the determination of the fair market value of Ms. Jones's ownership interest in Alpha Company, Bravo Company and Bravo Company..[1] The Appraiser states that the ownership interests are "controlling", non marketable interests and that the valuation date is September 24, 2010.[2] The Appraiser also provided a summary table of the various companies and the ownership interest in each company.[3]

As of the date of the appraisal, Alpha Company is an S Corporation,[4] Bravo Company[5] is a Limited Partnership and the type of entity for Bravo Company is not disclosed in the report.

It is my understanding that the business valuation conclusion of value will be used for a possible marital dissolution.[6]

Alpha Company provides in-home health care with offices in Houston, Beaumont, Austin, Lubbock, Amarillo, Midland/Odessa, Eagle Pass, Longview, Corpus Christi and San Antonio.[7]

Bravo Company owns the land and building that will be the future site for the offices of Alpha Company. The building is under construction as of the valuation date but expected to be completed by December 31, 2010.[8] Bravo Company was established as the general partner and one percent owner of Bravo Company.[9]

The Appraiser prepared a 44 page written appraisal report (*Appraisal*) which was followed with 13 Exhibits.

The purpose of the appraisal review is to review the report and make an assessment as to the Relevance, Reliability, Generally Acceptability of Chosen Methodologies, Transparency, Adequate Disclosures, Non Advocacy and Completeness of the report of the business valuation report prepared by The Appraiser to determine whether The Appraiser's opinion of value would be relevant and probative in the ongoing matter.

1.2 Reviewer's Assignment

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[1] See The Appraisers report, cover page.
[2] See The Appraisers report, cover page.
[3] See The Appraisers report, cover page.
[4] See The Appraisers report, page 4.
[5] See The Appraisers report, cover page.
[6] See The Appraisers report, cover page
[7] See The Appraisers report, page 11.
[8] See The Appraisers report, page 29.
[9] See The Appraisers report, page 29.

I was retained by Mr. John Jones to review an appraisal report prepared by The Appraiser, delivered by opinion cover letter dated September 24, 2010 and stated to have a report date of September 24, 2010 and a valuation date of September 24, 2010. In this report I will refer to the Appraiser to mean Mr. John E. S. Mitchell, Certified Public Accountant, the firm and the individual signing the report.

1.3 Appraiser's Assignment

According to the Appraiser's cover letter, The Appraiser was retained by the Law Firm of John B. Smith to value the varying ownership interests in Alpha Company, Bravo Company and Bravo Company. The type of entity and ownership interest are disclosed on the cover page of the business valuation report prepared by The Appraiser.

The Premise of Value is a going concern[10], and the Standard of Value is Fair Market Value.[11]

The Opinion Letter stated that the fair market value of a 100% ownership interest in Alpha Company, an S Corporation is $1,539,000. The fair market value of a 99% minority ownership interest in Bravo Company, a Limited Partnership is $439,000. The fair market value of a 100% controlling ownership interest in Bravo Company is $5,000. The type of entity for Bravo Company is not disclosed in the report.

1.4 Definitions of Credibility

The Concept of Credibility as utilized in this engagement is grounded on consideration and inclusion of all known facts and circumstances in a business appraisal report. This also indicates that the report is worthy of belief.[12] Credibility can be defined by seven basic processes:[13]

1.4.1 Relevance:

Relevance refers to the specific relationship of an appraiser's analytical nexus to a particular business appraisal standard, method, or procedure forming a supportive and probative basis of the opinion of value offered by the appraiser.

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[10] See The Appraisers report, page 3.
[11] See The Appraisers report, page 3.
[12] Uniform Standards of Professional Practice, 2010 – 2011 Edition, p. U-3
[13] Business Appraisal Review Accreditation Workshop, Howard Lewis and Francisco Rosillo, Institute of Business Appraisers, 2010, page 10

1.4.2 Reliability:

Reliability requires that the business appraisal review procedures performed by a Reviewer allow for replication of the original results obtained by the Reviewer and that the methods used by the appraiser were determined to be reliably applied.

1.4.3 Generally Accepted Appraisal Practices in the United States of America

Generally Accepted Appraisal Practices in the United States of America are those approaches, related methodologies and procedures there under, which have been peer reviewed, exposed to publication, and which can be reasonably expected to be used by appraisers regularly conducting engagements under similar facts and circumstances.

1.4.4 Transparency:

Transparency refers to the inclusion and assessment of facts and circumstances known to the appraiser about the appraisal process without limitation.

1.4.5 Adequate Disclosures:

Adequate Disclosures refers to the requirement that the appraisal process must present information not only of all known facts and circumstances about the appraisal process undertaken, but it must also include sufficient, informative, and relevant disclosures to allow stakeholders in the appraisal process to understand the foundation of the appraiser's opinion.

1.4.6 Non Advocacy:

The Business Appraisal Standards (Standard 1.4) of The Institute of Business Appraiser and *The Uniform Standards of Professional Appraisal Practice*,[14] require that an appraiser maintain a high level of objectivity in the formulation of his/her own independent expert opinion throughout all aspects of the appraisal process undertaken. These requirements apply equally to the Reviewer and the review process undertaken.

1.4.7 Completeness:

Completeness requires that the sufficiency of the data, assumptions and explanations presented in the appraisal report are described in enough detail to allow a user to duplicate the appraisal results obtained by the appraiser in forming a basis for the opinion proffered by the appraiser.

[14] Uniform Standards of Professional Appraisal Practice, 2010 – 2011 Edition, p. U-2

2. Opinion

I was retained by Mr. John Jones to review the accompanying Appraisal Report prepared by The Appraiser, dated September 24, 2010.

This business appraisal review was conducted for the purpose of determining that the approaches and methodologies utilized by The Appraiser were relevant to the objectives and purpose, as stated in the Appraisal Report prepared by The Appraiser and applied on a reliable basis consistent with generally accepted appraisal practices in the United States of America as of September 24, 2010. This Business Appraisal Review does not entail the performance of an appraisal. Therefore, this Business Appraisal Review should not be construed to be an opinion of value.

In my opinion, subject to the assumptions an limiting conditions discussed in the Business Appraisal Review Report, the opinion presented by The Appraiser is not credible and is not in conformity with generally accepted appraisal practices normally relied upon by business appraises in the United States of America, as promulgated by the American Institute of Certified Public Accountants (AICPA) and the National Association of Certified Valuation Analysts, (NACVA).

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J. Richard Claywell, CPA, ABV, ASA, CBA, CVA, CM&AA, CFFA, CFD, ABAR

3. Objectives and Scope of Appraisal Review

The objectives and scope of the appraisal review are to justify the reviewers opinion as to whether The Appraiser has complied with what he purported to do within the valuation engagement.

3.1 Adequacy of the Statement of Purpose

The statement of purpose is contained in summary fashion that calls the determination of fair market value for a possible marital dissolution.[15]

I do not have a copy of the engagement letter but I am making the assumption that the purpose is adequately stated.

3.2 Appropriateness of the Definition of Value

The definition of value, Fair Market Value is stated in the report. It is defined in the Standard of Value section of the report.[16]

The definition of fair market value appears to be adequately stated.

3.3 Acceptability of the Appraisal Methods Utilized

The Appraiser utilized the Discounted Cash Flow method to value Alpha Company, and the Net Asset method to value both Bravo Company and Bravo Company.

The Discounted Cash Flow method used for Alpha Company is applied incorrectly. The Appraiser just applied a federal corporate income tax rate to a pass-through entity.

The discounts that were applied to Bravo Company were applied incorrectly.

The result is that the value estimates are not relevant, nor probative.

3.4 Reliability of the Selected Methodology

For Alpha Company, The Appraiser used the Income, Market and Asset Approaches to determine a value.[17] However, the Discounted Cash Flow Method is materially flawed in the technical aspect of the methodology used by simply applying a tax rate to the earnings and not recognizing the cash flows for a short year of the company.[18] The Adjusted Net Asset Method is materially flawed in that the

[15] See The Appraisers report, cover page.
[16] See The Appraisers report, page 2
[17] See The Appraisers report, Exhibit 9.
[18] See The Appraisers report Exhibit 4.

Accumulated Depreciation was not adjusted correctly.[19] The Market Approach using Pratt's Stats uses data that is not normally distributed.[20] The method used to determine a value is materially flawed because the data was not corrected to account for the skewed data. The Appraiser also failed to do a search for public companies that may have been comparable to the company.[21] The income approach, although an acceptable method, was incorrectly applied by the Appraiser and thus of no probative value.

For Bravo Company, The Appraiser did not use the Income or, the Market[22] approaches to determine a value. It is generally accepted valuation practice that all three approaches be considered. The Net Asset Value method was used to determine the final conclusion of value. However, the method is flawed in that the assets were not adjusted to their fair market value.[23] The Adjusted Net Asset method is not an acceptable method for the valuation of a minority interest in a company.

For Bravo Company, The Appraiser did not use the Income or, the Market approaches to determine a value. It is generally accepted valuation practice that all three approaches be considered. The Net Asset Value method was used to determine the final conclusion of value. However, the method is flawed in that the assets were not adjusted to their fair market value.[24] The Adjusted Net Asset method is not an acceptable method for the valuation of a minority interest in a company.

The Appraiser did not apply all methods to all of the companies. He has misapplied the methods that were used.

These omissions and exclusion of methods creates an analytical gap that cannot be bridged with the information provided in the report. As a result, the estimates of value under these methods are not relevant or probative.

[19] See The Appraisers report, Exhibit 7.
[20] See The Appraisers report, Exhibit 6
[21] Revenue Ruling 59-60, Section 4.02 (h)
[22] American Institute of Certified Public Accountants, Statement on Standards for Valuation Services #1, paragraph 31.
[23] See The Appraisers report, Exhibit 12
[24] See The Appraisers report, Exhibit 12

3.5 Comprehensiveness of the Financial Analysis

The appraiser fails to provide the reader with critical information on the company, its historical performance and its likely future performance. The financial analysis completed in the appraisal is inadequate.

The income statements for both Bravo Company and Bravo Company were excluded from the report. Therefore, it is impossible to determine the adequacy of other approaches used and compare it to the income approach that was excluded from both of these companies.

The financial analysis is incomplete, is not transparent, and not reliable as a result of inadequate disclosures.

The reader is unable to understand the basic components of value as a result of this lack of analysis.

3.6 Assessment of the Company Performance Presented Verses Industry Peers

The Appraiser performed a benchmark analysis only for the year 2009 - 2010. This lacks relevance and is not complete. The comparison to the Risk Management Association industry benchmark data is for only the 2009-2010 year, not 2006 - 2010. There is no analysis of the historical trends of the Balance Sheet or Income Statement data.[25] The appraisal report does not include a summary of the industry and how the company is being impacted by the current industry and economic conditions.

The lack of comparative analysis precludes an adequate assessment of the Company's strengths and weaknesses relative to its competitors.

Therefore, the analysis of the Company's performance as presented is not probative of the final Opinion of Value.

3.7 Adequacy of References and Support for the Industry Data Utilized

The Appraiser did not include any industry analysis in his report, even though he addresses some of the industry factors in his analysis of enterprise goodwill.[26] The industry analysis and outlook in an integral part of a business valuation[27] and should be discussed in a report. There is no indication that the Porter Model was considered in the analysis.[28]

[25] See The Appraisers report, Exhibit 3
[26] See The Appraisers report, Exhibit 10.
[27] Revenue Ruling 59-60, Section 4.01 (b)
[28] Hitchner, James R. "Financial Valuation Applications and Models", John Wiley & Sons, Inc. Second Edition, © 2006, p. 83

The lack of information in the report makes it impossible to assess the reasonableness of the company specific risk[29] that has been used. In fact, the industry analysis is not mentioned in the schedule to support the company specific risk.

3.8 Relevance and Credibility of the Value Conclusion

The Appraiser has not applied all of the appropriate valuation methods when appropriate and has failed to apply the methods used in a reliable manner.

For these reasons, the Appraisal lacks relevance and credibility

3.9 Conformance With Appraisal Standards

The American Institute of Certified Public Accountants has issued Statement on Standards for Valuation services #1 that applies to all Certified Public Accountants that perform a business valuation. Sections 21 to 42 discuss the development standards that must be performed for all business valuations. The lack of detail in the report does not provide sufficient support to indicate that the development standards were followed.

The American Institute of Certified Public Accountants Statement on Standards for Valuation services #1 states that there are two types of reports that can be issued for a valuation engagement; a detailed report or a summary report.[30] The Appraiser is not in compliance with the business valuation Standard from the perspective of the type of report that can be prepared. The SSVS#1 Standard does not provide for a "summary letter and appraisal report"[31].

The National Association of Certified Valuation Analysts (NACVA) business valuation Standard states that "a report expressing a Conclusion of Value may be presented in either a Summary or Detailed Report."[32] The NACVA Standard also states "The wording used in the report should effectively communicate important thoughts, methods and reasoning, as well as identify the supporting documentation in a simple and concise manner, so that the user of the report can *replicate the process* followed by the member".[33] (emphasis added)

Because of the lack of disclosures in the report, it is impossible to determine if The Appraiser is in compliance with the American Institute of Certified Public Accountants Statement on Standards for Valuation Services #1. Because of the incompleteness of the report, there is not sufficient information to replicate what has been included in the report. The Appraiser is not in compliance with the NACVA Standards.

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[29] See The Appraisers report, Exhibit 5.
[30] Statement on Standards for Valuation Services #1, Section 48.
[31] See The Appraisers report, cover page.
[32] NACVA Standards , Section 4.3
[33] NACVA Standards , Section 4.3.

4. Basis and Reasons for Opinion Offered

There are numerous errors and omissions contained within the Appraisal which support the reasoning for the opinion provided in this review. Below is a list of the more egregious errors and problems that were identified. This is not an exhaustive list of all errors in the Appraisal.

4.1 Alpha Company

4.1.1 Material Error in the Valuation Date

The Appraiser states that the valuation date is September 24, 2010[34] and also that the report date is September 24, 2010.[35] The Appraiser has not explained in the report how the report date and the valuation date can be the same. The Appraiser has not explained why the financial analysis for Alpha Company is as of May 31, 2010[36] when the valuation date is September 24, 2010.

The Appraiser states that the total assets for Alpha Company is "about $1.95 million as of September 24, 2010".[37] However, the financial statement that is being referenced is dated May 31, 2010.[38] The Appraiser has not explained this discrepancy.

This destroys the credibility of the underlying financial information used for the analysis of the company.

4.1.2 Alpha Company - Material Error in the Application of the Fixed Asset Adjustment using the Adjusted Net Book Value Approach

The Appraiser considered the Asset Approach in his valuation analysis.[39] There are a number of theoretical errors in his analysis of this approach. First, The Appraiser states that he had property tax assessments from Fort Bend County for the assets of the company.[40] None of the fixed assets were adjusted to their fair market value.[41] In fact, they remain the same as the historical accounting book value.

It is important to distinguish between the application of any asset-based approach valuation method and simple reliance on accounting "book value". To conclude a value estimate. under any standard of value, the true economic value of a business enterprise equals the company's accounting book value only by coincidence. More likely than not, the true economic value of a company will be either higher or lower than accounting book value. There is no theoretical support, conceptual reasoning, or

[34] See The Appraisers report, cover page and page 28.
[35] See The Appraisers report, cover page.
[36] See The Appraisers report, Exhibit 1.
[37] See The Appraisers report, page 15.
[38] See The Appraisers report, Exhibit 7.
[39] See The Appraisers report, page 22 and Exhibit 7.
[40] See The Appraisers report, page 22.
[41] See The Appraisers report, Exhibit 7

empirical data to suggest that the value of a business enterprise (under any standard of value) will necessarily equal the company's accounting book value.[42]

From a valuation perspective, the terms book value or net book value are merely accounting jargon. Net book value (often called book value, in the vernacular) is synonymous with the amount 'equity recorded on the company's cost-basis balance sheet. In fact, accounting book value is not a business valuation method at all, although it is popular in buy-sell agreement formulas. The values presented on the cost-based balance sheet are usually not representative of current economic value for business valuation purposes. Also, there may be one or more intangible asset accounts or contingent liability accounts that should be considered in a business valuation – but that are not presented on the cost-basis balance sheet at all.

The Adjusted Book Value Method is a method within the asset approach whereby all assets and liabilities (including off-balance sheet, intangible, and contingent items) are adjusted to their fair market value.[43] [44]

Generally accepted valuation practices state that the fixed assets should be adjusted to their fair market value, not accounting cost-basis estimates. Since the assets were not adjusted to their true economic value, [45]verses an accounting value, it is impossible to determine if the assets are over or understated in value.

The historical Balance Sheet shows Land and Improvements of $294,407 as of December 31, 2008 and $2,000 as of May 31, 2010. There is no explanation in the report as to what has caused the $292,407 decrease in the Land and Improvements.

The historical Balance Sheet shows Equipment of $85,388 as of December 31, 2008 and $38,229 as of May 31, 2010. There is no explanation in the report as to what has caused the $47,159 decrease in the Land and Improvements.

The unexplained changes in fixed assets leave unanswered questions as to gaining an understanding of how the company is operating and how the changes in fixed assets would have an impact on the final conclusion of value.

In summary, the unexplained changes in fixed assets are not reliable or probative to the report.

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[42] Pratt, Shannon P. & Niculita, Alina V., "Valuing a Business: The Analysis and Appraisal of Closely Held Companies", McGraw Hill, Fifth Edition, © 2008, p. 351 – 352.
[43] Pratt, Shannon P. & Niculita, Alina V., "Valuing a Business: The Analysis and Appraisal of Closely Held Companies", McGraw Hill, Fifth Edition, © 2008, p. 1070.
[44] See The Appraisers report, page 41.
[45] See The Appraisers report, Exhibit 7

4.1.3 Material Error in the Application of the Accumulated Depreciation Adjustment using the Adjusted Net Book Value Method

The Appraiser states that the "accumulated depreciation was adjusted upward to eliminate 20% of the accumulated depreciation associated with fixed assets". [46] The Appraiser did not provide any justification or analysis in order to allow for the 20% to be replicated. This is a violation of the NACVA Standard for business valuation.[47]

The assets are supposed to be adjusted to their fair market value. Since accumulated depreciation is an accounting concept, not an appraisal concept, 100% of the accumulated depreciation should be removed.

The Appraiser states that the "fixed assets are not an important part of the business model.[48] However, by not adjusting the fixed assets to their fair market value, this will under estimate the adjusted net asset values, thereby unjustly increasing the goodwill that has been calculated.[49]

4.1.4 Material Error in the Application of the Intangible Assets Adjustment using the Adjusted Net Book Value Method

The Appraiser states that the definition of Going Concern includes the valuing of "having a trained work force, an operational plant, and the necessary licenses, systems, and procedures in place".[50] There are a significant number of additional intangible assets that should be considered and valued.

None of these intangible assets were included on the adjusted balance sheet on Exhibit 7. This omission will under estimate the adjusted net asset values, thereby unjustly increasing the goodwill that has been calculated.[51]

4.1.5 Material Error in the Normalizing of Historical Expenses using the Discounted Cash Flow Method

When a company is valued, it is customary practice to analyze at least 5 years of data, if the data is available.

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[46] See The Appraisers report, page 22 and Exhibit 7.
[47] NACVA Standard 4.43
[48] See The Appraisers report, page 22.
[49] See The Appraisers report, Exhibit 7 and Exhibit 8.
[50] See William Be. Stewart, Jr. CPA report, page 3.
[51] See The Appraisers report, Exhibit 7 and Exhibit 8.

Revenue Ruling 59-60 states:

> "Detailed profit-and-loss statements should be obtained and considered for a representative period immediately prior to the required date of appraisal, preferably five or more years."[52]
>
> "…With profit and loss statements of this character available, the appraiser should be able to separate recurrent from non-recurrent items of income and expense, to distinguish between operating income and investment income, and to ascertain whether or not any line of business in which the company is engaged is operated consistently at a loss and might be abandoned with benefit to the company."[53]

The financial data from 2006 through 2010 is included in the report. However, only the 2010 year had been normalized.[54]

Exhibit 1 shows the normalized Income Statement. The only normalizing entry that was made was the one made to Officers Compensation. The analysis for the valuation was performed for the years 2006 through May 31, 2010.[55] The Appraiser has failed to explain why the accounting expense is for $52,190 in 2009 and there are no other accounting expenses for any other year. The Appraiser does not explain why in 2009 the Administrative Expenses are $139,914 and only $12,778 in 2007 and $36,234 for five months in 2010. The Appraiser does not explain why Amortization is only in 2010. The Appraiser does not explain why Benefits of $10,614 in 2009 and only $250 for the five months in 2010.

The Appraiser states that he used the RMA median officer's compensation to normalize the owner's salary.[56] However, the RMA industry data included in the report shows the officers compensation as being "National – All Regions".[57] This is not representation of what is included on page 13 of the report. In fact, RMA does not have data that is specifically for the Houston area.

The Appraiser stated that there were no related party transactions within the last five years.[58] The company was started in 1995. The Appraiser does not discuss any prior related party transactions that could have an impact on the company if more than five years of financial data was used or more than one year of financial data was used to make a forecast.

The Appraiser does not explain why abnormal, discretionary and one time operating expenses are not being normalized.[59] This will not make the future earning representative of future operations. The Appraiser has used the annualized earnings for 2010 to make his forecast of

[52] Revenue Ruling 59-60, Section 4.02(d)
[53] Revenue Ruling 59-60, Section 4.02(d)(6)
[54] See The Appraisers report, Exhibit 1
[55] See The Appraisers report, Exhibit 1
[56] See The Appraisers , report page 13.
[57] See The Appraisers report, Exhibit 3.
[58] See The Appraisers report, page 15.
[59] See The Appraisers report, Exhibit 1.

future operations[60] but does not explain why the 2010 year is the most appropriate year upon which to base a forecast.

The omission of normalizing expenses makes the adjusted operating expenses not relevant, not reliable nor probative.

4.1.6 Error in the Long-Term Growth Rate using the Discounted Cash Flow Method

The Appraiser has reduced the growth rate in the terminal year to 2.5% down from 3.5% in all of the previous years of projected revenues.[61] The Appraiser also states that IBISWorld believes that the growth for the five years is 5.5%, however, only 3.5% was used in the projection. The Appraiser does not explain why the lower percentage was used.

The omission of not explaining why the company has a lower growth rate than the industry, thereby reducing the value of the company makes the analysis not relevant, not reliable nor probative.

4.1.7 Material Error in the Application of Pass-Through Entity Earnings using the Discounted Cash Flow Method

The Appraiser states that the company is an S Corporation.[62] In the Discounted Cash Flow Earnings Base,[63] the Appraiser fails to make any adjustments that are indicative of pass-through entities. It is uncertain to the reader if the company is actually an S Corporation or a C Corporation. The different types of entities will produce a different conclusion of value. Since the Appraiser has created considerable confusion as to the entity type, this casts serious doubts on the conclusion of value. A pass-through entity will have a higher value than a C Corporation since it pays no taxes.

This analysis in not complete and therefore is not reliable.

4.1.8 Error in the Application of Weighted Average Cost of Capital – WACC using the Discounted Cash Flow

The weighted average cost of capital is a <u>combination of (1) the required rate of return on the equity of the company and (2) the required rate of return on the debt of a company.</u> The weighted average cost of capital is used when the Appraiser <u>uses a debt free method</u> to determine the value of invested capital of a company (invested capital = debt plus equity).[64]

The company's discount rate that includes the cost of both debt and equity is usually financed with both debt and equity. This is referred to as the weighted average cost of capital ("WACC").

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[60] See The Appraisers Exhibit 1 and Exhibit 4.
[61] See The Appraisers report, Exhibit 4.
[62] See page 6 of the Appraisal Report.
[63] See page 31 of the Appraisal Report.
[64] Gary R. Trugman, "Understanding Business Valuation – A Practical Guide to Valuing Small to Medium-Sized Businesses", American Institute of Certified Public Accountants, © 2002, p. 341.

The WACC reflects the combined cost of debt and equity with the weights of these capital sources based on their market value rather than book value. [65]

Since there is minimal debt for the company,[66] this raises the question as to why use a method of determining a discount rate that is designed to take debt into consideration. The Appraiser excludes the percentage of debt.

The theory behind a weighted average cost of capital is simple. Since a company is financed partly with debt and partially with equity, the return on investment should consider the risk of each element. Since the business owner is not directly responsible for the debt (assume no personal guarantee), the bank, not the business owner, is the one that is at risk for that portion of the invested capital. Therefore, if the benefit stream comprises part debt and part equity, it would seem logical that the risk is reduced on the overall capital for the investors.[67] Since market values should be used, the fair market value of equity should be used in the calculation. If the fair market value of the equity is known, what is the need for using the WACC?

Since no market exists for a private company's securities, market values must be estimated to assign weights to the capital structure components. To do this, the analyst may start with an initial estimate for capital structure weightings and plug through weights and accompanying estimated costs of capital into the Weighted Average Cost of Capital formula. Using the initial Weighted Average Cost of Capital to calculate the market value of total invested capital and subtracting the value of debt gives the first estimation of the market value of equity and a second (desired) capital structure. This iterative process can be repeated until a reasonable Weighted Average Cost of Capital and accompanying capital structure are derived.[68] The Appraiser did not do the iterative calculations that are required for using the Weighted Average Cost of Capital.

The Courts through the years has had an opportunity to review cases where the Weighted Average Cost of Capital model was used to determine discount rates for closely held companies.

In the case of Maud Furman v. Commissioner, [69] the Court stated:

> "We do not believe that CAPM and WACC are proper analytical tools to value small, closely held corporations."

The use of the Weighted Average Cost of Capital used to determine a discount rate is not relevant, not reliable nor probative.

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[65] Frank C. Evans & David M. Bishop, "Valuation for M&A", John Wiley & Sons, Inc., ©2001, p. 143.
[66] See The Appraisers report, Exhibit 5.
[67] Gary R. Trugman, "Understanding Business Valuation – A Practical Guide to Valuing Small to Medium-Sized Businesses", American Institute of Certified Public Accountants, © 2002, p. 341.
[68] Hitchner, James R., "Financial Valuation Applications and Models", John Wiley & Sons, Second Edition, © 2006, p. 190
[69] Maude Furman v Commissioner, TCM Dec. 52,679 (M) 4/30/98.

4.1.9 Material Errors in the Application of the Long-Term Sustainable Growth Rate used in the Discounted Cash Flow Method

The Appraiser uses a 1% real growth rate in revenues for the forecasted years 2010 through 2016.[70] The Appraiser states that the "long-term growth, used for the terminal value, is projected at the rate of forecast inflation".[71]

Over the past 80 years or so, inflation and gross domestic product have each grown on average approximately 2.5 to 3.0 percent and 3.0 to 3.5 percent, respectively. Therefore, a company with a long-term growth rate of lower than 2.5 to 3.0 percent will not keep up with inflation.[72]
The Appraiser has not explained why the company will not be able to keep up with inflation and in fact become stagnant in the future.

In summary, the use of the 2.5% long-term sustainable growth is not relevant, not reliable nor probative.

4.1.10 Error in the Equity Risk Premium reference used in the Discounted Cash Flow Method

The Appraiser states that he used a 5.2% "equity risk premium" in developing the discount rate. The Appraiser's reference was to the 2009 SBBI Year Book, p. 67.[73] However, the 5.2% equity risk premium is actually in the 2010 SBBI Year Book.

It is confusing to try to follow the appraisal report when there is minimal information provided. It is more difficult to follow when there are incorrect references.

This makes the report unclear and unreliable.

4.1.11 Error in the Safe Rate of Return reference used in the Discounted Cash Flow Method

The Appraiser states that the valuation date is September 24, 2010.[74] However, the safe rate of return utilized is for May 28, 2010.[75]

The Appraiser does not explain why the report date and valuation date are September 24, 201 but used the financial statement information as of May 31, 2010.

The financial statement information is not consistent with the reported valuation date. The reader is uncertain as to the correct valuation date.

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[70] See The Appraisers report, page 18 and Exhibit 4.
[71] See The Appraisers report, page 18.
[72] Hitchner, James R. "Financial Valuation Applications and Models", John Wiley & Sons, Inc. , Second Edition, © 2006, p. 117.
[73] See The Appraisers report, page 19 (Footnote).
[74] See The Appraisers report, cover page.
[75] See The Appraisers report, Exhibit 5.

This makes the report not reliable and not probative.

4.1.12 Material Error in Stub Year used in the Discounted Cash Flow Method

The Appraiser has used May 31, 2010 financial data to determine an opinion of value.[76] Assuming that this is the correct date to use, verses September 24, 2010, the company has completed its five month ending May 31, 2010 and has historic financial data to support the earnings. When performing a valuation, a forecast is made of the future months or years of operations, the historical financial information is not projected or forecasted. This means that a partial year of data will be projected or forecasted for the first period of the projection or forecast.[77] The Appraiser failed to estimate the earnings and or cash flows for the first period of the forecast.[78] The Appraiser also failed to adjust the first year present value factor for a stub year. This will result in an erroneous shift of the present value factors being applied to an incorrect year for each year of the forecast. The following table shows the shift in the present value factors.

	Annualized 2010	2011	2012	2013	2014	2015	2016	Term 2017
After Tax Cash Flow	892,830	924,429	957,135	990,984	1,026,019	1,062,279	1,099,809	1,127,554
Net Cash Flow Discount Rate 21.5%								
Present Value Factor		0.9071	0.7464	0.6142	0.5054	0.4158	0.3422	0.3422
Present Value of Discounted Net Operating Cash Flow to Equity (rounded)		838,556	714,410	608,637	518,517	441,736	376,321	2,027,400
Total Excluding Terminal Year	3,498,177							

Recognized Valuation Methodology for Short Periods

	Annualized 2010	2011	2012	2013	2014	2015	2016	Term 2017
After Tax Cash Flow	892,830	924,429	957,135	990,984	1,026,019	1,062,279	1,099,809	1,127,554
Net Cash Flow Discount Rate 21.5%								
Present Value Factor		0.907218	0.746682	0.614553	0.505805	0.416300	0.342634	0.342634
Present Value of Discounted Net Operating Cash Flow to Equity (rounded)		838,659	714,675	609,012	518,966	442,227	376,832	386,338
Present Value of Discounted Net Operating Cash Flow to Equity (rounded)	838,659	714,675	609,012	518,966	442,227	376,832	386,338	1,127,554
Total Excluding Terminal Year	3,500,371							
	0.5	1.5	2.5	3.5	4.5	5.5	6.5	7.5

	Annualized 2010	2011	2012	2013	2014	2015	2016	Term 2017
2010 at 7/12 of the year	520,818	924,429	957,135	990,984	1,026,019	1,062,279	1,099,809	1,127,554
Net Cash Flow Discount Rate 21.5%								
Present Value Factor	0.944800	0.809800	0.666500	0.548600	0.451500	0.371600	0.305800	0.305800
Present Value of Discounted Net Operating Cash Flow to Equity (rounded)	492,068	748,603	637,930	543,654	463,248	394,743	336,322	344,806
Present Value of Discounted Net Operating Cash Flow to Equity (rounded)	492,068	748,603	637,930	543,654	463,248	394,743	336,322	344,806
Total Excluding Terminal Year	3,616,567							

The omission of the forecasted cash flows for the first year and using the incorrect present value factor omits value from the final opinion of value.

[76] See The Appraisers report, Exhibit 4.
[77] Hitchner, James R. "Financial Valuation Applications and Models", John Wiley & Sons, Inc. , Second Edition, © 2006, p. 123 - 125.
[78] See The Appraisers report, Exhibit 4.

The Appraiser states that the projections are for five years.[79] However, the projections are from 2011 through 2016 with a terminal value which equates to six years of forecasted periods, not five.[80] If the 2010 year that was omitted from the calculations but disclosed in the analysis were included, there would be seven years of forecasted data.

I am unable to replicate the calculation for the terminal value. Therefore, I have not considered the impact of any changes on the value of the company.

The omission and shift in present value factors makes the Discounted Cash Flow Method irrelevant, not reliable and not probative.

4.1.13 Material Error in Excess Assets not used in the Discounted Cash Flow Method

When a company is valued, non-operating assets and excess assets are added to the final conclusion of value[81] unless management has a rationale for why they need the excess assets.

The Appraiser provides a table from Risk Management Associates that shows the industry has approximately 18.2% of its assets in cash. Alpha Company has 59.3% of its assets in cash.[82] The Appraiser not explain why the excess cash is not included in the final opinion of value.

	Alpha	RMA
Cash as a Percentage of Total Assets	59.3%	18.2%
Total Assets	1,939,211	1,939,211
	1,149,952	352,936
Actual Cash Balance	1,149,611	
Cash compared to RMA	(352,936)	
Excess Cash	796,675	

It appears that the value of the company is understated by at least the value of the omitted excess cash. This makes the analysis not relevant, not reliable nor probative.

4.1.14 Material Error in Working Capital in the Discounted Cash Flow Method

The Appraiser states that the "Working capital and capital expenditures needs were forecasted at about $5,000 per year each." These costs have been minimal in the past."[83] The Appraiser provides no support for the $5,000 for each item. The most common method of forecasting

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[79] See The Appraisers report, page 18.
[80] See The Appraisers report, Exhibit 4.
[81] Pratt, Shannon P. & Niculita, Alina V., "Valuing a Business: The Analysis and Appraisal of Closely Held Companies", McGraw Hill, Fifth Edition, © 2008, p. 551.
[82] See The Appraisers report, Exhibit 3
[83] See The Appraisers report, page 18.

working capital is to determine the relationship of working capital to sales. The tables below show the relationship of working capital and revenues based on the historical working capital and forecasted revenues. We do not have the working capital balance as of December 31, 2010, therefore the 2011 change in working capital cannot be supported. However, 2011 through 2016 represents the changes in working capital based on the most common approach for making this calculation. This calculation shows that the average changes in working capital would approximate $46,000. The Appraiser has not provided sufficient analysis to support a change in both changes in working capital and capital expenditures of $5,000.

	2006	2007	2008	2009	2010
Current Assets	79,216	55,136	506,773	1,486,482	1,890,017
Current Liabilities	239,799	225,409	205,318	339,578	365,533
Present Value Factor	------------------	---------------	---------------	-----------------	-----------------
Working Caapital	(160,583)	(170,273)	301,455	1,146,904	1,524,484
	==========	==========	==========	==========	==========
Revenues	3,572,762	4,621,341	6,675,859	8,766,908	3,744,617
Working Capital as a Percentage of Revenues	-4.5%	-3.7%	4.5%	13.1%	40.7%

	2010	2011	2012	2013	2014	2015	2016
Projected Revenues	9,059,081	9,376,149	9,704,314	10,043,965	10,395,504	10,759,346	11,135,923
Percdentagfe Change in revenues		3.5%	3.5%	3.5%	3.5%	3.5%	3.5%
Estimated Projected Working Capital		1,226,606	1,269,537	1,313,971	1,359,960	1,407,559	1,456,823
Prior Year Working Capital	1,524,484						
Estimated changes in Working Capital		(297,878)	42,931	44,434	45,989	47,599	49,265
		=========	=========	=========	=========	=========	=========
Average		46,043					
		=========					

This makes the analysis not relevant, not reliable nor probative.

The Appraiser does not explain why there is a significant change in the fixed assets of the company or how this would have an impact on the forecasted depreciation expense.

The lack of analysis of the fixed assets and related depreciation expense renders this section of the report not reliable or probative.

4.1.15 Error in Market Approach – Transaction Method

The Appraiser used the "Market Approach – Transaction Method" in the valuation of Alpha Company. The Appraiser states that he searched several transactions databases, including *Pratt's Stats*, *Public Stats*, *BizComp*s, *IBA* and *Done Deals* for transactions in the home healthcare industry, along with certain additional data drawn from the *Mergerstat Review*.[84]

[84] See The Appraisers report, page 21.

The Appraiser never discusses the results of his search of the *Public Stats*, *BizComp*s, *IBA, Done Deals* or *Mergerstat Review*.[85] Since the results of the searches are not disclosed, it is uncertain how they might have impacted the company.

The Appraiser had included fifteen transactions from the Pratt's Stats transaction database. It appears as though The Appraiser has just taken the fifteen transactions and calculated the high, low, mean, median and standard deviation of Price to Revenue, Price to Sellers Discretionary Earnings and Price to EBIT multiples. The Appraiser has applied the average Price to Revenue multiple of .63 to the company's revenues to arrive at a preliminary value of $5,609,000.[86] The Appraiser has not stated how or why the company is only average as compared to the industry. In fact, the company could be substantially higher or lower that the industry average but, that is not discussed in the report.

The Appraiser has not discussed how the company would in fact be comparable to any of the fifteen companies retrieved from the one database. The company's revenues for 2010 are estimated to be $9,059,081. The Appraiser does not explain how the company is comparable to the company that has revenues of $46,474,000 nor the company that has revenues of $450,000. There is no information related to the infrastructure or financial ratios to demonstrate any comparability between the companies in the transactions database.

The Appraiser has not addressed the issues of any outliers in the data that may skew the results of the multiples. In fact, the transaction for $46,474,000 is three standard deviations from the average of the other transactions in the database. This skews the data to the left of center and the bell curve from the distribution is too high (kurtosis) which invalidates the usage of the average or any of the ratios discussed in the report.

The Standard Deviation in the report has been calculated to be $32,543,882. In fact the Standard Deviation is $12,478,131. The Appraiser did not calculate the confidence interval for the market method used. The Appraiser is stating that the market method produces a value of $5,609,000 with a margin of error of plus or minus 130% (rounded) at a 68% confidence level and plus or minus 260% at a 95% confidence level. The Appraiser applied no weight to the market method used. The Appraiser states "The valued derived from the transaction multiples do, however, provide a benchmark for our analysis".[87] The Appraiser does not explain how the wide range in values has been used as a benchmark to determine a value.

The Appraiser has failed to explain why the average ratio was used when there is a kurtosis problem known as platykurtic in the data. The data tails are not normally distributed and therefore, the average of the data is not representative of the data and should not be used.

The Appraiser has failed to "adjust for any assets or liabilities included in the subject company valuation but not included in the guideline transactions".[88] These are typically assets and liabilities retained by a seller. They were not considered in determining the value of the

[85] See The Appraisers report, page 21.
[86] See The Appraisers report, Exhibit 6.
[87] See The Appraisers report, page 21.
[88] Pratt, Shannon P. "The Market Approach to Valuing a Business". John Wiley & Sons, Inc., © 2001, p. 41

company. The multiple derived only provides an indication of value based on the multiple used. It does not consider the entire value of a company. As a result, the company is undervalued by the amount of net assets not included.

This approach to a value is not reliable, nor probative.

4.1.16 Material Error in Development of the Discounted Cash Flows

The Appraiser used a 24% tax rate in the Discounted Cash Flow forecast and a Weighted Average Cost of Capital to develop the Discount Rate. The Appraiser has treated the company as if it were a C Corporation instead of treating it as an S Corporation[89]. The entire approach to treating an S Corporation as a C Corporation is incorrect.[90] Treating an S Corporation as a C Corporation has not been a recognized valuation practice for approximately ten years. Treating an S Corporation as a C Corporation does not consider the unique attributes of the S Corporation. The S Corporation does not have to pay a Federal Income Tax, has in increase or decrease in bases, depending on the current year's profit, or an asset amortization benefit for a controlling shareholder. These attributes will always make an S Corporation more valuable than a C Corporation. The omission of this analysis was not explained by The Appraiser.

The lack of analysis of the S Corporation Pass Through analysis renders this section of the report not reliable or probative. This is not a recognized practice in the valuation community.

4.1.17 Misapplication of Goodwill

The Appraiser used the Multiplicative Utility Model to make a determination of the Personal and Enterprise Goodwill.[91] I have requested that The Appraiser provide his workpapers, which he stated were available upon request, to assess the reasonableness of the analysis. The Appraiser states "In addition, the analysis used for the opinions and conclusions set forth in this report may be better understood using additional information in the appraiser's work files".[92] The Appraiser also states "Please note that our backup files and papers are an integral part of the analysis performed in the development of this assignment and may be viewed upon request".[93] The Appraiser has refused to make the workpapers available for inspection and review.

The Appraiser defines Personal Goodwill as "…the value of earnings or cash flows directly attributable to the **individual's** characteristics or attributes. Personal goodwill, sometimes referred to as professional goodwill, is a function of the earnings from repeat business that will patronize the individual as opposed to the business, new customers who will seek out the individual, and new referrals that will be made to the individual."[94]

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[89] See The Appraisers report, page 4.
[90] Delaware Open MRI Radiology Associates, P.A. v. Howard B. Kessler, et al., CA No. 275-N, (See full text at Business Valuation Review, © 2008
[91] See The Appraisers report, Exhibit 10 and Exhibit 11.
[92] See The Appraisers report, page 2.
[93] See The Appraisers report, page 6.
[94] See The Appraisers report, page 23.

The Appraiser has provided the lowest ranking in the Enterprise category for the Business Name, Business Location and Number of Business Locations and Marketing and Branding. The Appraiser has not explained how the sole owner of the company can be at all of the company's locations and meet all of the patients every day when they need to be seen in their homes by health care providers. Upon review of the company website, Ms. Jones' name cannot be found. This would indicate a Branding of the company name, not the individual's name.

The Appraiser does not indicate any personal goodwill that would be developed with the patients and their caretakers. The analysis is not comprehensive and does not provide enough detail to determine if it is reasonable. It does appear that because of the number of locations and the fact that caretakers are with the patients on a daily basis, the allocation of 80% to personal goodwill is excessive.

The lack of support in the report makes this section of the analysis not reliable or probative.

4.1.18 Inappropriate Application of Discount for Lack of Marketability for a Controlling Interest

The Appraiser has applied a 35% Discount for Lack of Marketability to a controlling interest in Alpha Company.[95] The Appraiser cites a range of 3% to 35% as a range for a Discount for Lack of Marketability for a controlling interest. This is based on Court cases that he has cited. Generally accepted valuation practices dictates that Court cases cannot be used to determine these types of discounts. The Court cases are fact specific and therefore not relevant to this specific company. It is the appraiser's job to instruct the Court on valuation issues, and not the reverse.[96] There are <u>no empirical studies</u> that support a Discount for Lack of Marketability of a controlling interest.

The Appraiser applied a 20% Lack of Marketability/Control to Bravo Company and a 20% Lack of Marketability Discount to Bravo Company. The Adjusted Net Asset Method was used for both companies. By definition, the assets are already stated at Fair Market Value.[97] There should not be a second marketability discount applied to the minority interest.

Some appraisers have attempted to define a discount applicable to controlling interests of companies. This discount is often called a "marketability discount" or a "discount for lack of marketability for controlling ownership interests."[98] If an appraiser adequately measures expected cash flow and the risks and growth of these cash flows, the result is an enterprise value.[99]

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[95] See The Appraisers report, page 26.
[96] Mercer, Z. Christopher, Valuing Enterprise and Shareholder Cash Flows, The Integrated Theory of Business valuation", Peabody Publishing LP © 2004, p. 129.
[97] Institute of Business Appraisers, © 1999, Workshop 8001, p. 3
[98] Mercer, Z. Christopher, Valuing Enterprise and Shareholder Cash Flows, The Integrated Theory of Business valuation", Peabody Publishing LP © 2004, p. 127.
[99] Pratt, Shannon P. "Reilly, Robert F. Schweihs, Robert P. "Valuing a Business The analysis and Appraisal of Closely Held Companies", McGraw-Hill, Fourth Edition, © 2000, p. 411-414.

The argument for the nonexistence of a marketability discount applicable to controlling interests is simple and elegant. If business value is determined based on expected cash flows, expected growth of those cash flows, and the riskiness of those cash flows, then proper consideration of these factors determines such value.[100]

The Appraiser provides no analysis or supporting evidence, or cites any empirical studies that support the Discount for Lack of Marketability or justification for a 35% Lack of Marketability, which is the average Marketability Discount for minority interests.

The lack of analysis of the Discount for Lack of Marketability in the report renders it not reliable or probative.

4.1.19 No Reasonableness of Value Conclusion

The Appraiser states that he used the Market Method as a benchmark for his conclusion of value.[101] However, as discussed above, it can be seen that it is flawed. The Appraiser does not provide any information on the reasonableness of the Discounted Cash Flow method, especially as compared to the market method with its wide margin of error.

After the discounts taken, the total value is $1,539,000. This would require an investor to have an internal rate of return of approximately 37% but The Appraiser has a rate of return of 21.5% for the Discounted Cash Flow Analysis. In order for a purchaser to acquire the company they would need to have a return of at least the cost of capital as stated by The Appraiser, 21.5%. With the cash flows projected by The Appraiser,, the initial investment to achieve a 21.5% return would be $2,840,000 (rounded). This is what a hypothetical investor would demand as a return. This would be more indicative of fair market value.

The Appraiser has not explained or reconciled this difference.

The lack reconciliation of the market and income approaches and the lack of analysis of the Internal Rate of Return in the report render it not reliable or probative.

4.2 Bravo Company

4.2.1 Material Error in Adjusting Assets and Liabilities to Fair Market Value

There is a brief description of the operations of the company on page 29 of the original appraisal report.

The Appraiser states that "We considered all valuation approaches and methods and applied the most appropriate methods from the income, asset and market approaches to derive an opinion of value of the subject equity interests, (controlling, non-marketable, fair market value interest).[102]

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[100] Mercer, Z. Christopher, Valuing Enterprise and Shareholder Cash Flows, The Integrated Theory of Business valuation", Peabody Publishing LP © 2004, p. 128.
[101] See The Appraisers report, page 21.
[102] See The Appraisers report, page 4.

In preparing a business valuation, the American Institute of Certified Public Accountants Statement on Standards for Valuation Standards #1 states:

> "In developing the valuation, the valuation analyst should consider the three most common valuation approaches: Income (Income-based) approach, Asset Asset-based) approach and Market (Market-based) approach.[103]

When performing a business valuation, it is generally accepted valuation practices to consider all three approaches.

The Appraiser has failed to adjust the assets and the notes payable to fair market value.[104]

4.2.2 Material Error in the Income Approach

The Appraiser has also failed to meet the development Standards as published by the American Institute of Certified Public Accountants. There is no discussion in the report and no conclusions of value for the Income or Market Approaches. Since the building is expected to be completed in December 2010, there should be rental income starting in 2011. This calculation has been omitted.

The lack not following generally accepted valuation procedures renders the report not reliable or probative.

4.2.3 Lack Of Control and Marketability Discounts

The Appraiser has taken a 20% combined discount for control and marketability.[105] It is generally accepted valuation practices to disclose, separately, the percentage discount for each discount.

Not disclosing the separate discounts makes it impossible to determine the magnitude and appropriateness of each discount. This makes the discounts not reliable not probative.

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[103] American Institute of Certified Public Accountants, Statement on Standards for Valuation Services #1, Section 31

[104] See The Appraisers report, Exhibit 11.

[105] See The Appraisers report, page 29 and Exhibit 12.

4.3 Bravo Company

4.3.1 Material Error in Not Recognizing Valuation Approaches

There is a brief description of the operations of the company on page 29 of the original appraisal report.

The Appraiser states that "We considered all valuation approaches and methods and applied the most appropriate methods from the income, asset and market approaches to derive an opinion of value of the subject equity interests, (controlling, non-marketable, fair market value interest).[106] In preparing a business valuation, the American Institute of Certified Public Accountants Statement on Standards for Valuation Standards #1 states:

> "In developing the valuation, the valuation analyst should consider the three most common valuation approaches: Income (Income-based) approach, Asset Asset-based) approach and Market (Market-based) approach.[107]

When performing a business valuation, it is generally accepted valuation practices to consider all three approaches.

The Appraiser has failed to provide any analysis to support the development of a value using either the market or asset approach. A management company typically has its owns asset above and apart from the investment in another company.

The lack not following generally accepted valuation procedures renders the not reliable or probative.

The partnership combined discounts of 20% include the elements for non–control and marketability. Bravo Company is owned 100% by Ms. Jones. The Appraiser has not explained how the discount of 20% for a minority interest is applicable to the "same" 20% for a controlling interest.

The mixing of the discounts is inappropriate. This makes the discounts not reliable not probative.

4.3.2 Material Error in Application of Marketability Discount

The Appraiser states that "We used the same 20% discount for lack of marketability that we used for the partnership".[108]

The mixing of the discounts is inappropriate. This makes the discounts not reliable not probative.

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[106] See The Appraisers report, page 4.

[107] American Institute of Certified Public Accountants, Statement on Standards for Valuation Services #1, Section 31

[108] See The Appraisers , report, page 29 and Exhibit 13.

4.4 Lack of Care in Producing Appraisal

Throughout the Appraisal, there are theoretical and careless errors. Most of these are relatively minor, however, some of them are major and destroy the credibility and reliability of the Appraisal. For example, the Appraiser does not use S Corporation Pass Through as a technique for determining the Discounted Cash Flows, omitted the short year in the Discounted Cash Flow analysis, has not adequately determined the changes in Working Capital, has the same date for the valuation and report, did not properly adjust the fixed assets to Fair Market Value and other issues discussed above in this report.

The Appraiser refers to the report as a "summary letter and appraisal report and a letter report".[109] The Business Valuation Standards of The National Association of Certified Valuation Analysts provides for a "Summary, Detailed, or Calculation" report. The professional standards do not provide for a "summary letter" report.[110] The American Institute of Certified Public Accountants Business Valuation Standard "Statement on Standards for Valuation Services #1 provides for a "Detailed,[111] Summary,[112] or Calculation" report. The language used to describe the type of report that was issued is inappropriate language that does not meet the professional standards.

Organization	Detailed	Summary
NACVA	Detailed Report - Section 4.3 b	Summary - Section 4.3 a
AICPA	Detailed Report - Section 5.1	Summary - Section 71

The Appraiser has failed to discuss the "business interest's ownership control characteristics".[113] This is a violation of the Summary Report minimum reporting standards.

The Appraiser states that the valuation date is September 24, 2010,[114] the report date is September 24, 2010[115] and the largest company, in value, is being analyzed as of May 31, 2010.[116] The Appraiser has not explained why the largest company, in value, has a different valuation date than the other companies. The Appraiser has also not explained how the valuation date and the report date can be the same.

The American Institute of Certified Public Accountants Business Valuation Standard, Statement on Standards for Valuation Services #1, has a minimum reporting Standard which states that "a section summarizing the reconciliation of the estimates and the conclusion of value as discussed

[109] See The Appraisers report, cover page.
[110] NACVA Professional Standards, Section 4.3
[111] AICPA Statement on Standards for Valuation Services #1, Section 48 a.
[112] AICPA Statement on Standards for Valuation Services #1, Section 48 b.
[113] AICPA Statement on Standards for Valuation Services #1, Section 71 f.
[114] See The Appraisers report, cover page
[115] See The Appraisers report, cover page
[116] See The Appraisers report, Exhibit 7.

in paragraphs 68 and 69".[117] For each of the three companies that were valued, The Appraiser has a schedule that shows the values arrived at using various methods.[118] This is just a listing of conclusions of value. Some appraisers choose to present the reconciliation of value, as required by the Business Valuation Standards, in narrative or mathematical format. The relevant point is to support, not proclaim the reconciled value. The Appraiser has just provided a listing of values and has not explained why one method is more appropriate than another method. The relevant point is to support, not proclaim the reconciled value.[119]

When a Certified Public Accountant is performing any type of work, they must exercise due professional care in the performance of professional services.[120] If the Certified Public Accountant has someone working for them, the Certified Public Accountant must adequately plan and supervise the performance of professional services.[121] With the number of errors contained in the report, anyone has to be concerned that there was adequate supervision of the employees that worked on this engagement.

5. Sources of Information Relied Upon by Reviewer

The sources of information relied upon by this reviewer included:

The Appraisal Report
The Opinion Letter
Institute of Business Appraiser's Code of Ethics
Institute of Business Appraiser's Business Appraisal Standards
Institute of Business Appraiser's Practice Aid for Business Appraisal Review
USPAP Standard 3, Rule 3 and Related Advisory Opinions
NACVA Standards
American Institute of Certified Public Accountants Statement on Standards for Valuation Services #1
Revenue Ruling 59-60
Various other Business Valuation resources footnoted in this report.

[117] AICPA Statement on Standards for Valuation Services #1, Section 71v.
[118] See The Appraisers report, Exhibit 9, 12 and 13.
[119] Bishop, David M., ""Reconciling The Indicated Value", Business Valuation Review, March 1998, page 13
[120] American Institute of Certified Public Accountants, ET Section General Standard 201.01 B.
[121] American Institute of Certified Public Accountants, ET Section General Standard 201.01 C.

6. Certification

I certify that, to the best of my knowledge and belief:

The statements of fact and data reported by the Reviewer and used in the review process are true and correct.

The reported analyses, opinions, and conclusions in this review report are limited only by the reported assumptions and limiting conditions and are my personal, impartial, and unbiased professional analyses, opinions, and conclusions.

I have no present or prospective interest in the property that is the subject of the work under review and no personal interest with respect to the parties involved.

I have no bias with respect to the Companies that is the subject of the work under review or to the parties involved with this review assignment, the Appraiser or any parties associated with any of these parties.

My compensation is not contingent on an action or event resulting from the analyses, opinions, or conclusions in this review or from its use.

My compensation for completing this assignment is not contingent upon the development or reporting of predetermined assignment results, or assignment results that favors the cause of the client, the attainment of a stipulated result, or the occurrence of a subsequent event directly related to the intended use of this appraisal review.

My analyses, opinion, and conclusions were developed and this review report was prepared in conformity with the *Uniform Standards of Professional Appraisal Practice.*

I have not made a personal inspection of the subject property under review.
No one provided significant appraisal, appraisal review, or appraisal consulting assistance to the person signing this certification.

____

J. Richard Claywell, CPA, ABV, ASA, CBA, CVA, CM&AA, CFFA, CFD, ABAR

Exhibit 1

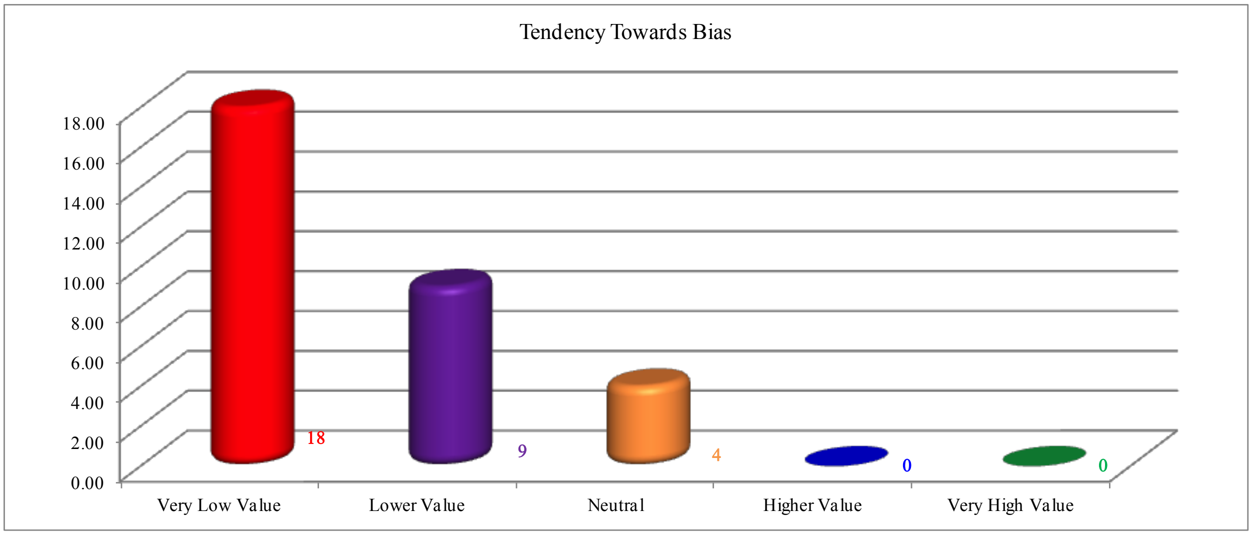
		Tendency on Value				
Pivotal Element	Explanation of Focus and Inquiry	Very Low Value	Lower Value	Neutral	Higher Value	Very High Value
	Alpha Company					
Expert's Business Valuation Credentials	This element will determine the technical capability of the opposing expert and whether he/she has met his/her own professional standards, and whether in fact he/she ascribes to any objective valuation standards. The preponderance of recent court cases clearly establishes the need for an expert to obtain requisite technical training. Also, determining the technical standards applied, e.g. NACVA, ASA, USPAP, AICPA, IBA, etc. gives an indication of capability.					
	The Appraiser has the Accredited in Business Valuation and Certified Valuation Analyst designations. The Appraiser appears to be well qualified to perform business valuations.			1		
Purpose and Use	This element should be clearly explained in the beginning of the document, and will "drive" the remaining results. For example, a valuation for the potential sale of a business may well have a different result than a valuation for the estate filing of a business. Consequently, the same set of facts used for different Purposes could conceivably result in different answers.					
	We found no disagreement with The Appraiser's statement of Purpose and Use.)					
	I do not have a copy of the Appraiser's engagement letter and cannot express an opinion as to the adequacy of the purpose and use of the appraisal report.			1		
Standard of Value	The "standard" of value is pertinent to the legal matter at bar, and is perhaps the most easily exploited element of a valuation. For example, an opposing expert applying a non-standard value, e.g. the "Estimate of Sales Price" used by business brokers,					
	We found no disagreement with The Appraiser's Standard of Value.			1		
	The Appraiser applied a legal standard of value inconsistent with the laws of this state. Specifically, the law requires a "fair value" standard for valuation in marital dissolution, but Mr. Expert has applied a "fair market value" standard. If Mr. Expert					
Normalizing Entries	These are adjustments made to the financial statements to account for non-operating, non-market and non-economic impacts. Common normalizations include Officers' Compensation and rent payments to related party properties.					
	The Appraiser only normalized the officers compensation and ignored other expenses that should have need normalized. See Section 4.1.5 of the Review Report.		1			
Valuation Approaches	Generally, 3 Approaches comprise all possible aspects of a valuation, and are typically described as Asset, Income and Market. Although not all valuations use all Approaches, they should at least be discussed and explained if they are not considered.					

		Tendency on Value				
Pivotal Element	Explanation of Focus and Inquiry	Very Low Value	Lower Value	Neutral	Higher Value	Very High Value
Valuation Methods - Assets	These Methods consists of restating a Company's Balance Sheet to fair market value, thus resulting in a Net Tangible Asset value. An inexperienced expert will include Liquidation Value, which is appropriate only for businesses actually intending to liquidated.					
	The fixed assets were not adjusted to Fair Market Value. This would understate the conclusion of this method. See Section 4.1.2 of the Review Report.		1			
	There is no explanation as to why there are major changes in the assets balances. Assets have disappeared with no explanation. See Section 4.1.2 of the Review Report.		1			
	The Appraiser did not adjust the Accumulated Depreciation correctly. A proper adjustment would have increased the value of the company. See Section 4.1.3 of the Review Report.		1			
	The Appraiser has not addressed the issue of the value of Intangible Assets that are discussed in the report. See Section 4.1.4 of the Review Report.		1			
	The Appraiser has failed to adjust the assets and note payable to their fair market value. See Section 4.2.1 of the Review Report.	1				
	Bravo Company					
	The Appraiser has failed to develop a value based on using a Asset Approach. See Section 4.3.1 of the Review Report.	1				

Pivotal Element	Explanation of Focus and Inquiry	Tendency on Value				
		Very Low Value	Lower Value	Neutral	Higher Value	Very High Value
Valuation Methods - Income	These Methods consist of estimating a single- or multiple-period “income stream” into the future, and discounting to today’s value. The income stream can be a wide variety of indicators, including net income, income before tax, cash flow, etc. (See also the Discount/Capitalization Rate comments, below.) The techniques used to estimate the income streams can be very telling about an expert’s capabilities.					
	The Appraiser only normalized the officers compensation. There were other expenses that appeared should have been normalized. See Section 4.1.5 of the Review Report.	1				
	The Appraiser does not explain why one-time or unusually large expenses in the years 2006 to 2009 were not normalized. See Section 4.1.5 of the Review report.	1				
	The Appraiser had deviated substantially from the IBISWorld Industry report growth rate and subsequently this results in a lower value for the company. See Section 4.1.6 of the review Report.	1				
	The Appraiser has treated the company as a C Corporation. It is common knowledge in the appraisal industry that this approach is not acceptable and will always result in a lower value for a company. See Section 4.1.7 of the Review Report.	1				
	The Appraiser applied a "hurdle" rate used for capital budgeting as a discount and capitalization rate. See Section 4.1.8 of the Review Report.		1			
	The Appraiser has not taken into consideration "real" growth in the long-term sustainable growth. The Appraiser has only allowed for inflation. See Section 4.1.9 of the Review Report.	1				
	The Appraiser cites incorrect reference in the report. See Section 4.1.10 of the Review Report.			1		
	The Appraiser has used a safe rate of return that differs from the valuation date. See Section 4.1.11 of the Review report.					
	The Appraiser has not included the first, short year, of cash flows in the value of the company. See Section 4.1.12 of the Review Report.		1			
	The Appraiser has not considered the excess cash that is normally considered in a valuation. See Section 4.1.13 of the Review Report.	1				
	The Appraiser has not adequately analyzed the working capital needs of the company. See Section 4.1.14 of the Review Report.	1				
	The Appraiser has treated a S Corporation as a C Corporation to determine a value. This practice has not been acceptable since 1999. See Section 4.1.16 of the Review Report.	1				
	The Appraiser has omitted future rental income from a building that is expected to be completed in December were 2010. See Section 4.2.2 of the Review Report.	1				

Pivotal Element	Explanation of Focus and Inquiry	Tendency on Value				
		Very Low Value	Lower Value	Neutral	Higher Value	Very High Value
Valuation Method - Market	These Methods consist of identifying and applying financial indicators of similar companies, e.g. per-share earnings as of the valuation date, or perhaps transaction indicators for entire sales of similar companies to the Company's financial measurements. Court cases are increasingly insisting on the use of Market Methods since those are perhaps the most objective indicators of value, assuming that they are properly applied to the Company.					
	The Appraiser has only applied minimal statistical analysis to the data set. There are additional statistical techniques such as skewness and kurtosis and margin of error rates that will add to the reliability of the conclusion reached. See Section 4.1.15 of the Review Report.	1				
	The Appraiser has not considered the "net assets" to be added to the revenue multiple results. See Section 4.1.15 of the Review Report.	1				
	The Appraiser has not considered the net assets to be retained by a seller upon the sale of a company. See Section 4.1.15 of the Review Report.	1				
	The Appraiser has failed to develop a value based on using a Market Approach. See Section 4.3.1 of the Review Report.	1				
Secondary Adjustments - Control Premium	This adjustment consists of adding a "premium" (usually in the form of a percentage) to the Company's enterprise value to reflect the amount that the "market" would pay for the rights to increase prices, set compensation, etc. The sources of premiums are well known, and even if not applied they should be discussed and explained. Premiums can range from 10% to 40% and more.					
	The Appraiser has failed to disclose separately the magnitude of the discounts for lack of control and lack of marketability. See Section 4.2.3 of the Review Report.		1			
Secondary Adjustments - Discount for Lack of Marketability	This adjustment consists of subtracting an amount (usually in the form of a percentage) from the Company's value, after adding a Control Premium, above (if any). This is a routinely disputed adjustment, based more on the amount than on the application. The opposing expert should cite all the studies (SEC, pre-IPO, etc.) and justify and substantiate his/her conclusion. The amount is often in the 35% range but has a wide variation, depending upon the facts and circumstances of the ownership interest.					
	The Appraiser has applied a 35% Lack of Marketability Discount. This is the average percentage discount for the minority interest discount studies. The Appraiser has provided no supporting evidence to support any Lack of Marketability Discount for a controlling interest. See Section 4.1.18 of the Review Report.	1				
	Charlie Management Inc.					
	The appraiser has inappropriately applied the "same" minority discounts to a controlling interest. See Section 4.3.2 of the Review Report.	1				

Pivotal Element	Explanation of Focus and Inquiry	Tendency on Value				
		Very Low Value	Lower Value	Neutral	Higher Value	Very High Value
Secondary Adjustments - Goodwill	This adjustment refers to the existence of business and personal goodwill. The personal goodwill of an individual is considered to belong only to the individual and is not an asset to be distributed to a spouse.					
	The Appraiser has not provided adequate explanations as to how Enterprise and Personal Goodwill were calculated and it results in an allocation of 80% Personal Goodwill. See Section 4.1.17 of the Review Report.	1				
Synthesis and Reconciliation	In order to arrive at a final conclusion the opposing expert should demonstrate a sound rationale, not merely taking a high, low or average. Also, he/she should use other techniques to validate the conclusion; some appraisers use the Justification of Purchase to achieve such validation.					
	The Appraiser has not adequately reconciled the Market and Income methods used and explained why there would be large margins of error in the Market method. See Section 4.1.19 of the Review Report.		1			
Total		18	9	4	0	0



J. Richard Claywell, CPA, ABV, ASA, CBA, CVA, CM&AA, CFFA, CFD, ABAR
Curriculum Vitae

First Certified Public Accountant in Texas to earn the Certified Valuation Analyst designation-February 1994

Accredited Senior Appraiser (ASA) 2010. Per a Carl Steffen, CPA, ABV, ASA, CBA, CVA study there are approximately 15-20 individuals that hold all four business valuation designations.

Certified in Merger & Acquisitions (2001) Alliance of Merger and Acquisition Advisors

Certified in Fraud Deterrence (January 2004) (Chairman of Fraud Deterrence Committee, 2004 to 2005, instructor for the Fraud Deterrence Program) (Chairman of Fraud Deterrence Board 2006-2007)

Certified Forensic Financial Analyst with Specialized training in Fraud Prevention and Detection 2007 (Litigation Forensic Board 2007 to present)

Accredited in Business Valuation (ABV) (AICPA) December 2006

Certified Business Appraiser, Institute of Business Appraisers (CBA) (2010)

NACVA Fraud Deterrence Board – May 2005 to 2007

Executive Board - National Association of Certified Valuation Analysts - became a member of NACVA's Executive Advisory Board (1994 to 1997)

International Association of Consultants, Valuators and Analysts (IACVA) - Board of Directors, 2010 to Present

Appointed by the Executive Advisory Board to the Government Valuation Analyst Board, May 1997 to present, (IRS Certification for Business Valuations). Supervises the accreditation and continuing education of government officials (IRS) in the business valuation field, (Chairman 1999 to 2001).

Chairman, Houston Chapter of CPA's Litigation Support Committee (1997 – 1999)
NACVA State Chapter President (1996 to 2007)
NACVA Exam & Grading Committee (1998 to present, Chairman (1998 to 2000)
Honored as NACVA Outstanding Member Award, May 1995
Honored as Outgoing Executive Advisory Board Member May 1997
Serves on the Certification Exam Grading Team (1995 to present)
Exam and Grading Committee Chair (1998 to 2000)
BS University of Houston - 1979
Valuing Businesses since 1985.

Director of Education - International Association of Certified Valuation Analysis. Responsible for updating all educational materials and examinations for all International Charter countries. 2008 to present.

Practitioners Publishing Company (PPC) Contributing Editor – Guide to Practical Estate Planning, 2008

International Association of Consultants, Valuators and Analysts (IACVA) – Director of Education (2008) Responsible for business valuation materials and examinations for all IACVA Country members.

International Association of Consultants, Valuators and Analysts

Co-Presenter of weeklong business valuation course for the Chinese Appraisal Society, November 2008, Beijing, China. A partial list of some of the topics instructed include: (1) remaining useful life analysis, (2) survivor curves, (3) valuing customer relationships, (4) valuing brands, (5) allocation of goodwill, valuing software, (6) quantifying synergies.

2009 Taipei International Conference: Valuation and Forensic Accounting. Presenter, Fraud Prevention and Detection.(November 2009)

Chinese Appraisal Society in Seattle Washington, **Presenter**, Using Income Approaches and Using Guideline Companies, August 2, 2010.

Shanghai University of Finance and Economics, **Co-Presenter**, The Relationships Between Risk and Value : The M & A Transaction, , Value and The Valuation Report: What Do You See?, Value, Fraud, Risk: From Valuation to Fraud, September 19 – 21, 2010.

Asian-Pacific Conference on Valuation and IFRS in Seoul South Korea, **Presenter**: Fraud, Risks and Valuations, December 3, 2010

Chinese Appraisal Society in Beijing China, **Presenter**, Fundamentals of Business Valuations and **Co-Presenter**, Valuing Intangible Assets, December 12-13, 2010.

Areas of Special Competence

Valuation and Litigation - Determination of value and economic damages and advice to litigants and legal counsel involving issues such as economic damages in areas of wrongful termination, business interruption, breach of contract, patents, trademarks, covenant not to compete, Estate and Gift Tax valuations, Family Limited Partnership valuations, buy-sell and merger and acquisitions and divorce property division. Engagements have involved construction, manufacturing, medical practices, accounting practices, financial institutions and retail businesses. Damage calculation for lost earning, lost profits and wrongful termination, computerized modeling and analysis, pension valuations for divorce, reasonable compensation analysis, valuations of various corporations, partnerships and litigation support services, tax research, planning and preparation (corporations, partnerships, individuals and not for profit), corporate reorganizations, economic, financial operational and management consulting for small to medium sized businesses.

Articles Published

Quantifying Financial Risk in Capitalization Rates - The Valuation Examiner, 2nd Quarter 1994
Viewpoint on value, Business Today, January 1995
Ground Rules Unique For Deprivation Appraisals, Business Today, March 1995
Planning a Successful Succession, Business Today, June 1995
Determining the Quality of Earnings, Business Today, August 1995
The Family Limited Partnership: A Tax-Savings Strategy, Business Today, October 1995
What and When to Discount In Estate and Gift Tax Valuations, the Texas Law Reporter, March 1996
Private Equity International - PEI Magazine
How Is The Goodwill Accounted For After The Acquisition?, 2009

Family Business Magazine
Setting Up a Family Limited Partnership (FLP): Is it the Best Option? 2010

Texas Law Reporter
Safeguarding Success - Finding Value For Non Compete Agreements - 2002
How To Evaluate Your Business Valuator – 6/1/2003
Real Estate Appraisers v Business Valuators – 6/26/03
Defend Yourself, Creating FLP Discounts That Withstand IRS scrutiny – 7/28/03
The Difference Between Discount and Capitalization Rates – 8/29/03
How Damage Calculations Can Recoup Your Losses – 9/29/03
Greater than the Sum of its Parts – 12/1/03
Discount Rates and Capitalization Rates Differ, Don't Make Mistakes – 12/29/03
Minority or Control Interest? The Answer is Clear as Mud – 1/31/04

Books Published

Capitalization and Discount Rates: The Value of Risk, an Advanced Course, Co-Author, Published by the National Association of Certified Valuation Analysts, 2001

Business Valuation Strategies, Co-Author with Practice Development Institute, Chicago, IL

Contributing author to the National Association of Certified Valuation Analysts
NACVA Fundamentals Theory & Techniques training materials (2003)

"Wiley Guide to Fair Value Under International Financial Reporting Standards", (IFRS) John Wiley, 2010, Author of Chapter 28 titled "Petroleum Properties" co-author of Chapter 3 The Market Approach and co-author of Chapter 10 Risk and Rewards .

Valuation of Intangible Assets, International Association of Certified Valuators & Analysts, Second Edition, © 2011, Co-Author

American Institute of Certified Public Accountants – Certificate of Educational Achievement

INSTRUCTOR for the Certificate of Educational Achievement in Business Valuations
Introduction to the Valuation of Businesses & Professional Practices
Data Research and the Market Approach to Valuation

Software Development
Responsible for all National Association of Certified Valuation Analysts software development (2002)

Business Valuation Manager Pro was designed by J. Richard Claywell, CPA CVA CM&A, and is marketed though the National Association of Certified Valuation Analysts and Wiley ValuSource.

Business Valuation Quality Control Editor was designed by J. Richard Claywell, CPA CVA CM&A and is marketed though the National Association of Certified Valuation Analysts.

Areas of Litigation / Expert Witness Experience (Partial)
Lender Liability
Business interruption for grocery store resulting from fire damage
Business interruption for appliance store resulting from fire damage
Business interruption for dry cleaning store resulting from fire damage
Loss of business value in contract dispute
Lost profits resulting from software theft
Business interruption for dental practice resulting from tropical storms
Damage calculations in a DMSO contract dispute
Lost profits in dispute over proprietary software contract dispute / trade secrets
Lost profits in cancellation of lease contract
Value of businesses for divorces
Value of business for dissenting shareholder disputes

Damage calculation for dispute in sale of company
Damage calculation for wrongful termination
Tracing of assets
Lost wages resulting from personal injury
Tax evasion, kiting, lapping, fraudulent loans, mail fraud

Have testified in:
Federal Court, Bankruptcy Court, Texas State District Courts, Texas County Courts

National Association of Certified Valuation Analysts Outstanding Member Award reads

"In recognition and appreciation of exceptional participation, through immeasurable contributions of advise and wisdom, always extending a hand as a reliable source of support, being dependable and responsive to the Association's needs and demonstrating the qualities that breed confidence and success with all those he touches. His guidance and support have been instrumental in helping NACVA achieve national prominence. (Award dated May 8, 1995)