

April 23, 2002

Mr. James Jones, Esq.
Jones & Jones
Anytown, New York

Re: Business Valuation
Smith's Auto Repair, Inc.

Dear Mr. Jones,

We have reviewed the business valuation report for the above referenced company, dated December 3, 2001 as prepared by John J. Doe, of J.H. Doe, CPAs. Following are our comments:

1. In general, the report is poorly structured, following no logical order. In many cases we are unable to follow the preparer's logic and reach similar conclusions due to insufficient documented analysis. Professional valuation ethics require a report that allows the reader to replicate the writer's conclusion of value, which cannot be done in this instance.
2. The preparer's curriculum vitae, which was not attached to the report and subsequently provided to us, evidences that the preparer of the report holds no professional business appraiser designations, is not a member of any professional business appraisal organization, and has no formal business appraisal education. Since the preparer does not have any valuation credentials, he is not professionally obligated to be bound by any professional valuation standards. However, the AICPA Rule 201 applies to any valuation work performed by a CPA, whether (s)he holds a valuation credential or not. It requires the CPA to possess a high degree of professional competence and due professional care, as well as sufficient and relevant data. Professional competence requires sufficient work experience in the specific area of formal business valuation. Due professional care requires sufficient research and documentation. Sufficient and relevant data requires the use of and access to sources of data (internal and external) in order to empirically support one's conclusion of value.
3. The report indicates on page two of the cover letter that it is prepared in "*conformity with standards as promulgated by the National Association of Certified Valuation Analysts (NACVA).*" We reviewed these standards, which can be found at the NACVA website [http://www.nacva.com/association/A_pro_stand.html] and make the following comments:
 - a. General and Ethical Standards, 2.1.3 Due Professional Care: The preparer may not have exercised due professional care in not performing economic, industry analysis, nor considering company trends, nor considering the market approach to value, and by copying the description of the company from our report.
 - b. Development Standards, 3.2 Fundamental Analysis:
 - i. Section b: *The economic outlook in general and the condition and outlook of the specific industry in particular* – missing.
 - ii. Section c: *The book value of the interest to be valued and the financial condition of the business* – opinion of the preparer not clearly stated in report.
 - iii. Section f: *Whether or not the enterprise has goodwill or other intangible value* – not discussed in report.
 - c. Development Standards, 3.6 Earnings Determination: was not performed in this report.
 - d. Development Standards, 3.7 Capitalization/Discount Rate – there are significant technical errors in the development of the capitalization and discount rates, see section 6(b)(ii)(6), below.
 - e. Reporting Standards, 4.3 Estimate of Value Reporting Standards: "*Valuation analysts may be requested to report a valuation conclusion where, in the professional judgment of the valuation analyst, an Opinion of Value cannot be expressed. In such instances, the valuation analyst may conclude that the value can be expressed as a range of values or a single number, and label the value conclusion 'Estimate of Value.'* Such a report must be in writing and include all the information required in a report on Opinion of Value plus the following statement: '**An Estimate of Value is not an Opinion of Value and such difference may be material.**'" – The preparer states on page one of his cover letter that he is providing an 'estimate of value.' He does not make the above professionally required disclosure.
4. It is readily apparent that there are significant technical errors in the report, as detailed below, in the application of valuation theory.

- a. We note that the company description was taken verbatim from our report dated August 23, 2001. It is obvious that the preparer did not independently prepare at least portions of the report but based his commentary on our report.
- b. Valuation Methodology choices:
 - i. **Net Asset Value Method.** [“NAV”] [page 3] and **Excess Earnings Method** [“EEM”][page 11]. The preparer comments that the Net Asset Value Method is inappropriate for an operating business. Further, on page 12 he states, *“The amount of earnings capitalized are those earnings which exceed a safe rate of return on the adjusted net assets of the business. Therefore this [EEM] method is not a method that would generate a reasonable value of Smith’s Auto Repair, Inc.”* Regardless of the fact that the comment itself makes no sense whatsoever, the Excess Earnings Method, in practice, encompasses the Net Asset Value Method. In layman’s terms, the NAV is appropriate when a company’s value is inherent only in the tangible assets: the market value of the assets, less the market value of the debt of the business equals the market value of the equity in the business. The EEM, however, considers intangible assets not recorded on the financial statements of a business, such as goodwill, patents, copyrights, customer lists, etc. which can be identified because the earnings of a business are greater than what one would expect from the tangible assets the business itself owns. Therefore the EEM is the NAV *plus* consideration of unrecorded intangible assets. Relating to the preparer’s comments on page 12, the fact that earnings which exceed a safe return on adjusted net assets exists is documentary *evidence* that the intangible assets do exist and support the approach, not invalidate it.
 - ii. **Capitalization of Earnings Method.**
 1. Page 4, third to last line, the preparer states that *“This method is more theoretically sound in valuing a profitable business where the investor’s intent is to provide for a return on investment, over and above a reasonable amount of compensation.”* This is true, but the preparer then ignores this assumption.
 - a. First, he does not consider reasonable compensation in his report. If he does not consider reasonable compensation, then how can he identify what the return on investment over reasonable compensation is?
 - b. Second, return on investment for small businesses is almost never defined by net income, the basis of his analysis. Without exception, the professional literature and the professional appraisal organizations look at some measurement of cash flow as the measurement of return.
 2. Calculation of owner-benefit stream On page 5, 2nd paragraph, the preparer discusses the potential for cash transactions, and then segues into a discussion of company paid personal expenses in paragraph 3, without a tie in. There is no discussion as to the need to adjust net income for cash.
 3. On page 5, 3rd paragraph, the preparer begins a lengthy discussion as to personal expenses paid through the business’s checkbook. We concur that this did happen, as illustrated in detail in our report, page 25, and supported in our Appendix F. However, the preparer did not consider that expenses were paid, but then credited to the Smith’s as distributions of profit to them as identified on their tax return. In other words, instead of waiting to the end of the year and seeing what profits were made, and then cutting a check for the distribution of profits, The Smith’s paid personal expenses over the year and their accountant then reconciled these personal expenses as distributions after-the-fact. They were not deducted as expenses that do not relate to the business; rather they were treated as distributions of profit. In our report we performed analytical tests of questionable expenses, after reviewing source documents, and, based on our analysis of what were personal expenses, added back only those expenses over and above the distributions already charged. To do otherwise is to add them back in twice; once by the Smith’s accountant in the distribution adjustment, and once again by the preparer of the Doe report.

Upon further review, based on the Doe report, we compared the 1999 general ledger to the list of expenses listed in the Doe report to identify how they were accounted for. The following is a summary of our analysis:

119,869.38	Total Doe Addback
(23,597.84)	Expenses deemed to be valid business expenses
(33,380.34)	Client's CPA adjusting entries to distributions not considered
(9,180.81)	Additional adjustments to distributions
(1,980.00)	Error in recording amount of Ck #1136
(830.00)	1997 expenses included in 1999 Doe data
<u>50,900.39</u>	Remaining unreconciled difference

This is evidence that, *at most*, \$50,900.39 in expenses were not able to be determined as to whether or not they were business or personal in nature, based on the amount of due diligence we performed in conformance with the scope of our engagement.

Regarding adjustments for other years, we believe it to be an inappropriate amount of speculation to assume all checks written for all expense categories are personal in nature, when it is clearly evident that, for the one year reviewed in more detail, nearly 60 percent of the 1999 expenses questioned were clearly adjusted inappropriately in the Doe report.

4. On page 5, the last paragraph, the preparer justifies his adjustment based on deposits into a ABC Financial Services account. However, the attachment to his report shows deposits in 1996 of \$4,000, 1997 of \$8,000, and 1998 of \$41,063.20, far short of the adjustments to income made by the preparer. Neither we, nor the preparer of the report, had access to 1994 and 1995 data to consider earlier deposits or adjustments thereto.
 5. We therefore believe that the adjustments made by the preparer of the report are unjustified and unsupported. The thought process is incomplete and the accounting theory erroneous.
 6. **Capitalization Rate.** The preparer of the report uses a capitalization rate of 21.3 percent. He develops this rate on pages 12 through 16 of his report.
 - a. Based on his calculations, the preparer actually uses a discount rate in error, rather than a capitalization rate to value the business. We assume he does not understand the difference between the two, as using the capitalization rate would have generated a higher value, given all his other assumptions. All professional valuation literature discusses the differences between capitalization rates and discount rates, and the appropriate circumstances to apply each. See our report, pages 27 to 29 regarding capitalization rates and discount rates.
 - b. The preparer goes through a detailed calculation of a 'risk premium factor' on pages 12 through 16 of his report, yet provides no support for his analysis. For example, he opines on the relative competitive strength of Smith's Auto Repair, but provides no discussion at all regarding the competitive environment. He discusses various financial and management risk factors, but provides no support for his analysis. For example he rates the riskiness in Smith's accounts receivable as a "4" out of "10", but the company has no accounts receivable. Further, he gives no risk factor to "Contracts" at all, yet the company is highly dependent on its relationships [contractual or not] with the insurance companies.
 - c. Intuitively, the discount rate appears low, given that long term historical rates of return on large publicly traded stocks have been in the high teens. Surely a small auto repair shop in rural New York is a much higher risk than any of the Fortune 500 companies. We often see small business discount rates in the 22 to 28 percent range.
 - d. The source or basis of the "safe rate of return" on page 16 is not identified.
- c. **Industry Specific Formulas.**
- i. Industry-specific formulas are not generally considered by the professional appraisal community as a valid methodology to value a business. Shannon Pratt, a leading business appraisal theorist, in his book *Valuing Small Businesses and Professional Practices*, states that "*there is rarely credible evidence as to how such rules [industry specific formulas] were developed or how well they actually relate to empirical transactional data. Rules of thumb are usually quite simplistic. Consequently they fail to recognize how differences in either operating characteristics or assets from one company to another affect the valuation. They also fail to recognize changes in conditions for companies in*

various industries from one time period to another. Furthermore, it is common for companies in many industries to sell on terms other than cash. In this way the “prices” generated by rules of thumb often are not cash equivalent values.” [page 317]

- ii. The preparer refers to the rules of thumb as identified in Glenn Desmond’s Handbook of Small Business Valuation Formulas and Rules of Thumb. Copies of the relevant pages [64-69] are attached. The preparer makes several errors in its application:
 - 1. The preparer chooses to apply an “Annual Owner’s Cash Flow [“OCF”] Multiple. The rule of thumb is to value businesses at one to three times a businesses OCF, and add current assets and subtract all liabilities.
 - a. The preparer chooses to use a multiple of 2 times and 2 ¼times OCF, indicating that the reasonable growth of the business commands above average multiples. However, the preparer does not identify in his report what the growth rate of the business has been, what reasonable growth should be, or how it compares to local economic growth factors or industry growth factors. Therefore his conclusion that the business should command above average multiples is unsupported. Our analysis, when comparing the Company to its industry peer group, shows that the Company is average, at best. Further, despite the preparer’s comment on page 7 that the average multiple is conservative, it is aggressive.
 - b. The preparer calculates a value at 2 times and 2 ¼times OCF, but fails to adjust the calculation by adding current assets and subtracting all debt, as required to appropriately apply this rule of thumb. Since there is more debt than current assets, this would require a downward adjustment to the preparer-concluded value.
 - c. The preparer incorrectly calculated OCF, as identified in the Desmond Book. OCF is identified as net revenues, less operating expenses, adjusted for depreciation, single owner compensation, and interest. The preparer merely uses reported net income, plus his determination of personal expense adjustments.
 - 2. The preparer ignored the other rule of thumb proffered in the Desmond book, the Monthly Net Revenue [“MNR”] Multiple. Using 1999 net revenue for Smith’s and assuming an average multiple, the value calculation is as follows:

1999 Annual Revenue	423,179
1999 Revenue on Monthly Basis	35,265
Multiple	<u>3.5</u>
	70,530
Plus Current Assets	16,475
Less Debt [not including shareholder debt]	<u>(40,596)</u>
Indicated Value	<u>46,409</u>

- 3. It is obvious that the Rule of Thumb approaches generate widely different value conclusions, even when applied correctly, and, if used at all, should be used merely as a sanity check and have little weight in the value conclusion.
- d. **Market Approach to Value:** The preparer does not address at all the Comparative Transaction Method [also referred to as the Direct Market Data Method] which is often a preferred methodology for valuing small operating businesses, and despite the fact that there are significant amounts of data available relating to the sale of similar businesses. He therefore did not consider “all relevant valuation approaches and methods” [Doe report, page 3].
- e. **Risk Assessment.** The preparer provides no analysis of the Company’s financial structure, historical operating performance, comparison to industry performance, an analysis of the economy, auto repair shop industry, or local competitive environment in order to determine the context necessary to reach many of his conclusions. These factors are called for in the definition of fair market value, as quoted from Revenue Ruling 59-60, which he references as the basis of his report in his cover letter and which has long been accepted by the Court as the basis of value. A willing and informed buyer of a business does not make a purchase decision in a vacuum. A willing and informed buyer makes that decision in the context of what the economy holds in the future, who the competition is, and how that competition may or may not be changing [look what happened to local lumber yards in any area where Lowe’s and Home Depot moved into town], and what trends are occurring in the industry, not just a three year weighted average on adjusted net income.

- f. **Discounts to Value.** The preparer provides a detailed analysis for the argument supporting a discount of a lack of marketability, but does not support the amount of the discount, based on his analysis, or relating the particular situation at Smith's to his analysis. In fact, he erroneously states on page 25 that "the subject Company has no dividend history" when in fact there were distributions to the owners each year. Distributions of profits are dividends. These distributions are clearly identified on the company's tax return each year.
 - g. **Reconciliation of Value.** The preparer makes no reconciliation of value, and has no discussion as to the relative merits of each of his approaches, or the different averaging methodologies used in each of his approaches. We cannot recreate his concluded value by using any mathematical averaging.
5. **In summary, the preparer overstates the value of Smith's Auto Repair, Inc. by:**
- a. Erroneously applying the income approach by adding back expenses that were, in part, already added back by the company's accountant, thus overstating normalized net income. An insupportably low discount rate is then applied incorrectly to the overstated normalized net income to reach an inflated number.
 - b. Erroneously applying industry rules of thumb, by incorrectly applying unjustifiably high multiples and by not adjusting for current assets and debt, and by ignoring the other rule of thumb proffered by his source, since it reaches a significantly lower value.

Sincerely,

William C. Quackenbush, MBA, ASA, CBA