

Robert B. Jackson and Milton D. Thompson, Jr., both Individually, and as former Officers and Directors of ABC Jail Company, Inc., and as former Trustees of the ABC Jail Company, Inc. Employee Stock Ownership Plan v. Green and Smith, P.S.C. and Steven A. Fisher and John J. Fox and Sherry P. Crain and Prison Systems, Ltd. and Tennet Axelrod & Bressler, P.S.C. and Michael Axelrod and Stephen Jones

VALUATION MALPRACTICE REPORT

April 26, 2006

Lawrence C. Caldwell III, Esq.
The Caldwell Law Firm
6700 Main Street
Jacksonville, AK 68974

Re: *Malpractice action against Tennet, Axelrod & Bressler*

Dear Mr. Caldwell:

In accordance with your request, we have reviewed a substantial amount of material with respect to the matter entitled *Robert B. Jackson and Milton D. Thompson, Jr., both Individually, and as former Officers and Directors of ABC Jail Company, Inc., and as former Trustees of the ABC Jail Company, Inc. Employee Stock Ownership Plan v. Green and Smith, P.S.C. and Steven A. Fisher and John J. Fox and Sherry P. Crain and Prison Systems, Ltd. and Tennet Axelrod & Bressler, P.S.C. and Michael Axelrod and Stephen Jones* for the purpose of providing you with an opinion as to whether or not the valuation that was performed for the ABC Jail Company, Inc.'s ESOP was performed in a negligent fashion.

As explained more fully in the attached report, it is my opinion that negligence was committed. The defendants were unqualified and lacked the necessary familiarity with proper valuation methods and procedures, and as a result made significant errors in the performance of their duties.

My professional qualifications are attached to this report and I will be prepared to testify regarding my findings.

Respectfully submitted,

TRUGMAN VALUATION ASSOCIATES, INC.

Gary R. Trugman
CPA/ABV, MCBA, ASA, MVS

GRT/kag
Attachment

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INTRODUCTION

Trugman Valuation Associates, Inc. was retained in the matter of *Robert B. Jackson and Milton D. Thompson, Jr., both Individually, and as former Officers and Directors of ABC Jail Company, Inc., and as former Trustees of the ABC Jail Company, Inc. Employee Stock Ownership Plan v. Green and Smith, P.S.C. and Steven A. Fisher and John J. Fox and Sherry P. Crain and Prison Systems, Ltd. and Tennet Axelrod & Bressler, P.S.C. and Michael Axelrod and Stephen Jones*, in the State of Arkansas, Washington Circuit Court, Division One, Case No. 12-123456 to opine on the allegations of accounting malpractice against the firm of Tennet Axelrod & Bressler, P.S.C., Michael Axelrod and Stephen Jones with respect to certain business valuation services that were rendered on behalf of ABC Jail Company, Inc. (hereafter referred to as ABC) and/or the ABC Jail Company, Inc. Employee Stock Ownership Plan (hereafter referred to as the ABC ESOP).

BACKGROUND AND ALLEGATIONS

According to the Second Amended Complaint and Petition for Declaration of Rights (only selected sections quoted are believed to be relevant to this report):

10. At all times relevant hereto, Tennet Axelrod & Bressler, P.S.C., successor-in-interest to Tennet & Axelrod, P.S.C., and all relevant shareholders, agents, employees and partners thereof (hereinafter collectively "T&A"), were, and is, an accounting firm with its principal place of business in Washington County, Jacksonville, Arkansas, consisting of licensed, practicing accountants, as well as other agents

and employees, all offering accounting and professional services on behalf of T&A.

11. At all times relevant hereto, T&A held itself out to the public, and represented to the Plaintiffs herein, that it was an accounting firm which possessed special expertise and knowledge concerning correct and lawful fair market valuations for purposes of the formation and establishment of ESOPs so that any such valuation would be in conformance with all Generally Accepted Accounting Practices, and all applicable laws, including but not limited to, ERISA § 406, 29 U.S.C. § 1106(a).
12. At all times relevant hereto, Stephen Jones (hereinafter “Jones”) was a licensed, certified public accountant and a partner, shareholder and/or employee of T&A.
13. At all times relevant hereto, Jones held himself out to the public, and represented to the Plaintiffs herein, that he was an accountant who possessed special expertise and knowledge concerning correct and lawful fair market valuations for purposes of the formation and establishment of ESOPs so that any such ESOP valuation would be in conformance with all Generally Accepted Accounting Practices, and all applicable laws, including but not limited to, ERISA § 406, 29 U.S.C. § 1106(a).
14. At all times relevant hereto, Michael Axelrod (hereinafter “Axelrod”) was a licensed, certified public accountant and a partner, shareholder and/or employee of T&A.

15. At all times relevant hereto, Axelrod held himself out to the public, and represented to the Plaintiffs herein, that he was an accountant who possessed special expertise and knowledge concerning correct and lawful fair market valuations for purposes of the formation and establishment of ESOPs so that any such ESOP valuation would be in conformance with all Generally Accepted Accounting Practices, and all applicable laws, including but not limited to, ERISA § 406, 29 U.S.C. § 1106(a).
17. In November 1993, Fisher and Jones met with Plaintiffs for the purposes of presenting Plaintiffs with the benefits of forming an ABC ESOP.
18. On or about December 7, 1993, ABC by and through Plaintiffs, as officers of ABC, in reliance on the advice and representations of Green and Smith, Fisher, T&A, and Jones, decided to form an ESOP.
20. The ESOP was formally established on December 23, 1993.
22. Based upon Fisher's advice, Plaintiffs also retained the services of T&A and Jones to perform a correct and lawful fair market valuation of ABC for purposes of the ESOP.
24. Jones gave advice and provided services to Plaintiffs, both in their capacities as Trustees of the ESOP and officers of ABC.
25. Plaintiffs relied on the advice of Fisher and Jones, and Fisher and Jones were well aware that they relied on their advice when the ESOP was formed. In fact, Fisher and Jones represented to the Plaintiffs that if Plaintiffs followed their advice and counsel, the ESOP

would conform with all applicable laws, including but not limited to ERISA § 406, 29 U.S.C. § 1106(a).

27. One purpose of the ESOP was to effectuate the purchase of the outstanding ABC shares of Clifford Morris (hereinafter "Morris"), a co-founder of ABC, who personally and along with various family members, at that time, owned approximately 47% (forty-seven percent) of ABC's shares.
28. Another purpose of the ESOP was to restructure ABC's corporate debt, whereby the ESOP would, for practical purposes, assume said debt to take advantage of certain tax benefits.
31. Jones and T&A were retained to perform a correct fair market valuation of ABC so that the ESOP did not unlawfully pay more than adequate consideration for Morris' ABC shares or the newly-issued ABC shares pursuant to ERISA § 406, 29 U.S.C. § 1106(a).
32. Jones and T&A's final valuation was dated March 15, 1994, and should have incorporated information available to them as of that date.
33. Axelrod served as an independent reviewer of the valuation prepared by Jones.
34. On March 15, 1994, based upon the valuation performed by T&A and Jones, and reviewed by Axelrod, and arrangements made by Green and Smith and Crain and Crain, the two SPAs (Stock Purchase Agreements - added by author for clarification) were closed. The Plaintiffs, as Trustees, participated in the closing of the SPAs in

reliance of the representations of said Defendants that the ESOP transaction comported with all applicable laws, including but not limited to, ERISA § 406, 29 U.S.C. § 1106(a).

39. On September 14, 1998, *Thomas Sacks, et al. v. Robert B. Jackson, et al.* United States District Court, W.D.KY, Jacksonville Division, Civil Action No. 3:WP-591-C, (hereinafter the “Sacks Complaint” or “Sacks litigation”) was filed, with claims arising, in relevant part, out of Plaintiffs’ roles as former Trustees of the ESOP.
41. The Sacks Complaint alleged that Plaintiffs violated their fiduciary duties by agreeing to cause the ESOP to purchase ABC stock from Morris and his family and ABC at more than the fair market value, causing financial loss to the ESOP and Plaintiffs in the Sacks litigation who were beneficiaries of the ESOP.
58. After a bench trial lasting over ten trial days, which spanned the period of April 16, 2001 to February 26, 2002, on or about July 30, 2002, United States District Court Judge Jennifer Ronstadt issued a Memorandum, Opinion and Order in the Sacks litigation which held *inter alia*, that Plaintiffs had violated their duties as Trustee of the ESOP. However, at that time Judge Ronstadt did not decide whether the ESOP had sustained any monetary loss as a result, and appointed a Special Master to determine damages, if any.
60. On January 26, 2004, the Special Master in the Sacks litigation issued an Opinion which estimated that the damages sustained to the ESOP were approximately 9.9 million dollars, plus interest and attorneys fees.

According to the Order of the United States District Court, Western District of Arkansas, Jacksonville Division, dated December 1, 2004, and signed by the Honorable Jennifer B. Ronstadt in the matter of *Thomas Sacks, et al. v. Robert Jackson et al.*, Civil Action No. 97-123-C.

On July 29, 2002, this court found the defendants liable for breach of fiduciary duty in their roles as trustees of an employee stock ownership plan ("ESOP") in violation of ERISA § 406, 29 U.S.C. § 1106. *Sacks v. Jackson*. The court determined that in the case of such a breach, 'loss will be measured as the difference between what the ESOP paid for the ABC stock and its fair market value at the time of transaction, plus interest.' *Id.* at 881. (footnote omitted).

A Special Master was appointed to review the reports and testimony of several valuation professionals, Mr. Jones being one of them. The Court adopted the Special Master's findings and commented "Having found the special master's final report, with its supplement to be thorough and well reasoned, the court will adopt the special master's findings in their entirety."

The Court's Order, citing the Special Master's report was extremely critical of the T&A report. Findings were that the conclusions were "not credible" and that "the valuation methods were applied improperly in his report SMR at 7,19." While discussing the "discounted future earnings" method, The Court noted "The special master found Jones' testimony that such an adjustment¹ was unnecessary not credible. SMR at 16."

We are not going to reiterate the Court's or the Special Master's findings in this report by analyzing the Order or the Special Master's report. However, our independent analysis of the T&A report indicates that there were substantially more problems than were pointed out in the earlier litigation. We will highlight these problems as we proceed in this report.

1

The adjustment had to do with the subtraction of debt from the value to determine the equity value of ABC.

Clearly, Mr. Jones' opinions were discarded as lacking credibility, validity and reasonableness. In a footnote on page 7 of the Order, The Court stated:

With regard to Jones' testimony, the court in its liability opinion expressed its own concerns about the credibility of Jones' testimony, including his downplaying of time restraints, his testimony concerning the existence of a lower draft valuation, the vagueness of his testimony, and his inability to recall whether evidence of preliminary calculations was contained in the files.

OPINIONS

In our opinion, T&A, Steven Jones and Michael Axelrod (hereafter collectively referred to as T&A, Mr. Jones or Mr. Axelrod) have breached their duty to render various services in a manner that is consistent with the standard of care required of professional accountants and advisors in the rendering of valuation services to ABC and the ABC ESOP.

In our opinion, the valuation services performed by T&A for ABC and the ABC ESOP violated accounting and valuation standards. In our opinion, Rule 201 of the American Institute of Certified Public Accountants' (AICPA) Code of Professional Conduct was violated as T&A did not comply with the following:

- A. Professional Competence. Undertake only those professional services that the member or the member's firm can reasonably expect to be completed with professional competence.
- B. Due Professional Care. Exercise due professional care in the performance of professional services.
- C. Planning and Supervision. Adequately plan and supervise the performance of professional services.
- D. Sufficient Relevant Data. Obtain sufficient relevant data to afford a reasonable basis for conclusions or recommendations in relation to any professional services performed.

In addition, T&A failed to comply with the *Uniform Standards of Professional Appraisal Practice* (USPAP), an industry standard that all appraisers are guided to follow in publications of the AICPA, with respect to the following:

STANDARD 9

In developing a business or intangible asset appraisal, an appraiser must be aware of, understand, and correctly employ those recognized methods and procedures that are necessary to produce a credible appraisal.

Standards Rule 9-1

In developing a business or intangible asset appraisal, an appraiser must:

- (a) be aware of, understand, and correctly employ those recognized methods and procedures that are necessary to produce a credible appraisal;
- (b) not commit a substantial error of omission or commission that significantly affects an appraisal;
- (c) not render appraisal services in a careless or negligent manner, such as a series of errors that, considered individually, may not significantly affect the results of an appraisal, but which, when considered in the aggregate, would be misleading.

Standards Rule 9-2

In developing a business or intangible asset appraisal, an appraiser must observe the following specific appraisal guidelines:

- (a) adequately identify the business enterprise, assets, or equity under consideration, define the purpose and the intended use of the appraisal, consider the elements of the appraisal investigation, consider any special limiting conditions, and identify the effective date of the appraisal;
- (b) define the value being considered.
 - (i) if the appraisal concerns a business enterprise or equity interests, consider any buy-sell agreements, investment letter stock restrictions, restrictive corporate charter or partnership agreement clauses, and any similar features or factors that may have an influence on value.
 - (ii) if the appraisal concerns assets, the appraiser must consider whether the assets are:
 - (1) appraised separately; or
 - (2) appraised as parts of a going concern.

- (iii) if the appraisal concerns equity interests in a business enterprise, consider the extent to which the interests do or do not contain elements of ownership control.

Standards Rule 9-3

In developing a business or intangible asset appraisal relating to an equity interest with the ability to cause liquidation of the enterprise, an appraiser must investigate the possibility that the business enterprise may have a higher value in liquidation than for continued operation as a going concern absent contrary provisions of law of a competent jurisdiction. If liquidation is the indicated basis of valuation, any real estate or personal property to be liquidated must be valued under the appropriate standard.

Standards Rule 9-4

In developing a business or intangible asset appraisal, an appraiser must observe the following specific appraisal guidelines when applicable:

- (a) consider all appropriate valuation methods and procedures.
- (b) collect and analyze relevant data regarding:
 - (i) the nature and history of the business;
 - (ii) financial and economic conditions affecting the business enterprise, its industry, and the general economy;
 - (iii) past results, current operations, and future prospects of the business enterprise;
 - (iv) past sales of capital stock or other ownership interests in the business enterprise being appraised;
 - (v) sales of similar businesses or capital stock of publicly held similar businesses;
 - (vi) prices, terms and conditions affecting past sales of similar business assets;

Standards Rule 9-5

In developing a business or intangible asset appraisal, an appraiser must;

- (a) select and employ one or more approaches that apply to the specific appraisal assignments.
- (b) consider and reconcile the indications of value resulting from the various approaches to arrive at the value conclusion.

STANDARD 10

In reporting the results of a business or intangible asset appraisal an appraiser must communicate each analysis, opinion, and conclusion in a manner that is not misleading.

Standards Rule 10-1

Each written or oral business or intangible asset appraisal report must:

- (a) clearly and accurately set forth the appraisal in a manner that will not be misleading.
- (b) contain sufficient information to enable the intended user(s) to understand it. Any specific limiting conditions concerning information should be noted.
- (c) clearly and accurately disclose any extraordinary assumption that directly affects the appraisal and indicate its impact on value.

Standards Rule 10-2

Each written business or intangible asset appraisal report must comply with the following specific reporting guidelines:

- (a) identify and describe the business enterprise, assets or equity being appraised.
- (b) state the purpose and intended use of the appraisal.
- (c) define the value to be estimated.
- (d) set forth the effective date of the appraisal and the date of the report.
- (e) describe the extent of the appraisal process employed.
- (f) set forth all assumptions and limiting conditions that affect the analyses, opinions, and conclusions.
- (g) set forth the information considered, the appraisal procedures followed, and the reasoning that supports the analyses, opinions and conclusions.

- (h) set forth any additional information that may be appropriate to show compliance with, or clearly identify and explain permitted departures from, the requirements of Standard 9.
- (l) set forth the rationale for the valuation methods and procedures considered and employed.

Each of these provisions will be addressed in detail within our report.

But for the negligence of T&A, Mr. Jones and Mr. Axelrod, the plaintiffs have suffered significant economic damages. Judge Ronstadt found that the ABC ESOP overpaid \$8,139,116 for the stock, based on a valuation at \$26.31 million. In addition, prejudgment interest was also added to this amount.

BASIS FOR OUR OPINIONS

In order for Trugman Valuation Associates, Inc. to form our opinions in this matter, numerous documents were reviewed. In addition, Gary R. Trugman CPA/ABV, MCBA, ASA, MVS, principal in charge of this engagement, attended the deposition of Steven Jones on January 24, 25, 27 and 28, 2005. The documents reviewed in this matter include the following:

1. Second Amended Complaint and Petition for Declaration of Rights in the matter of *Robert B. Jackson and Milton D. Thompson, Jr. v. Goldberg and Simpson, P.S.C. and Steven A. Crain and John J. Fox and Sherry P. Crain and Prison Systems, Ltd. and Tennet Axelrod & Bressler, P.S.C. and Michael Axelrod and Stephen Jones* in Washington Circuit Court, Division 1, Jacksonville, Arkansas, Case Number 12-123456.
2. Valuation report of ABC Jail Company, Inc. as of November 30, 1993 as prepared by Tennet & Axelrod, P.S.C. (TA 159 - TA 218).

3. Letter of March 15, 1994 from Tennet & Axelrod, P.S.C. to Board of Directors and Trustees of ABC Jail Company, Inc., updating the valuation of ABC Jail Company, Inc. to March 15, 1994 (TA 155).
4. Memorandum from Steve Jones dated December 1, 1993 regarding ABC Jail Company, Inc.'s establishment of an employee stock ownership plan (TA 676 - TA 694).
5. A representation letter dated March 7, 1994 to Tennet & Axelrod, P.S.C. referencing the valuation of ABC Jail Company, Inc., Inc. (no specific valuation report indicated) signed by J. Clifford Morris, Milton Thompson and Robert B. Jackson on March 10, 1994.
6. Valuation Report Checklist from the workpapers of Tennet & Axelrod, P.S.C. relating to the valuation as of November 30, 1993 dated March 7, 1994 (TA 485 - TA 489).
7. Report of the Special Master in the matter of *Thomas Sacks, et al. v. Robert Jackson, et al.* in the United States District Court, Western District of Arkansas at Jacksonville Division, Civil Action: 6:97:CV-123-C.
8. Amended Special Master report in the matter of *Thomas Sacks, et al. v. Robert Jackson, et al.* in the United States District Court, Western District of Arkansas at Jacksonville Division, Civil Action: 6:97:CV-123-C.
9. Memorandum Opinion and Order in the matter *Thomas Sacks, et al. v. Robert Jackson, et al.* in the United States District Court, Western District of Arkansas at Jacksonville Division, Civil Action: 97-123, signed by the Honorable Jennifer B. Ronstadt on July 29, 2002.
10. Order in the matter of *Thomas Sacks, et al. v. Robert Jackson, et al.* in the United States District Court, Western District of Arkansas at Jacksonville Division, Civil Action: 97-123, signed by the Honorable Jennifer B. Ronstadt on December 1, 2004.
11. Correspondence dated April 26, 1996 from Stephen D. Jones to Steve Crain (GS 106-0900).
12. Deposition transcript of Stephen D. Jones in the matter of *Thomas Sacks, et al. v. Robert Jackson, et al.* in the United States District Court, Weston District of Arkansas at Jacksonville Division, Civil Action: 3:WS-667-C dated February 25, 2000.

13. Deposition transcript of Stephen D. Jones in the matter of *Thomas Sacks, et al. v. Robert Jackson, et al.* in the United States District Court, Western District of Arkansas at Jacksonville Division, Civil Action: 3:WS-667-C dated March 23, 2000.
14. Trial transcript, Day II, in the matter of *Thomas Sacks and Ferman Houston v. Robert E. Jackson and Milton Thompson*, in the United States District Court, Western District of Arkansas at Jacksonville Division, Case Number 3:97-CV-1234 from April 17, 2001, testimony of Stephen Jones.
15. Trial transcript, Day VIII, in the matter of *Thomas Sacks and Ferman Houston v. Robert E. Jackson and Milton Thompson*, in the United States District Court, Western District of Arkansas at Jacksonville Division, Case Number 3:97-CV-1234 from July 18, 2001, testimony of Stephen Jones.
16. Trial transcript, Day IX, in the matter of *Thomas Sacks and Ferman Houston v. Robert E. Jackson and Milton Thompson*, in the United States District Court, Western District of Arkansas at Jacksonville Division, Case Number 3:97-CV-1234 from October 9, 2001, testimony of Stephen Jones.
17. Copies of the proposed regulations of the Department of Labor, Pension Welfare Benefits Administration, 29CFR Part 2510 faxed from Steve Crain to Stephen Jones (TA 490 - TA 501).
18. An engagement letter between Tennet & Axelrod, P.S.C. and ABC Jail Company, Inc. regarding the possibility of forming an employee stock ownership plan, dated November 30, 1993 and signed on December 13, 1993.
19. A presentation for ABC Jail Company, Inc. about the employee stock ownership plan, dated December 6, 1993 as faxed from Steve Crain to Stephen Jones (TA 695 - TA 707).
20. Various research materials regarding valuation of stock for an ESOP (some of which appears to be from Tax Management, Inc.) (TA 708 - TA 715).
21. Hand written notes from Tennet & Axelrod, P.S.C.'s workpapers regarding a meeting on November 30, 1993 (TA 750 - TA 752).
22. Deposition transcript of the testimony of Stephen Jones in the matter *Robert v. Jackson, et al. v. Green and Smith, P.S.C., et al.*, Washington Circuit Court, Division One, Case Number 12-123456 dated January 24, 2005.
23. Deposition transcript of the testimony of Stephen Jones in the matter *Robert v. Jackson, et al. v. Green and Smith, P.S.C., et al.*, Washington Circuit Court, Division One, Case Number 12-123456 dated January 25, 2005.

24. Deposition transcript of the testimony of Stephen Jones in the matter *Robert v. Jackson, et al. v. Green and Smith, P.S.C., et al.*, Washington Circuit Court, Division One, Case Number 12-123456 dated January 27, 2005.
25. Deposition transcript of the testimony of Stephen Jones in the matter *Robert v. Jackson, et al. v. Green and Smith, P.S.C., et al.*, Washington Circuit Court, Division One, Case Number 12-123456 dated January 28, 2005.
26. Financial results of Prison Systems, Ltd. for the third quarter 1993 (TA 4 - TA 18).
27. Illegible workpaper indicating market price of Prison Systems, Ltd. from March 2, 1994 (TA 19).
28. Prospectus of Esmor Correctional Services, Inc. (TA 54 - TA 112).
29. Research materials faxed from Smith Barney to Stephen Jones on March 7, 1994 regarding the Esmor initial public offering.
30. Two page summary of financial highlights of Prison Systems, Ltd. for the period ended December 31, 1993 and 1992 (TA 116 - TA 117).
31. Information about ABC Jail Company, Inc. entitled *ABC - A Public/Private Partnership* (TA 118 - TA 153).
32. Correspondence from Stephen D. Jones to Gary Harper at ABC Jail Company, Inc. dated July 12, 1994 (TA 154).
33. Fax transmittal form with confirmation dated April 22, 1997 (TA 156 - TA 157).
34. Business valuation processing instructions (TA 158).
35. Cover letter dated December 17, 1993 from Milton Thompson to Stephen Jones transmitting requested information from the company (TA 220).
36. Balance Sheet of ABC Jail Company, Inc. as of October 31, 1993 with building and land at appraised values (TA 221 - TA 222).
37. Balance Sheet of ABC Jail Company, Inc. as of October 31, 1993 (TA 223 - TA 224).
38. Income Statement of ABC Jail Company, Inc. as of October 31, 1993 (TA 225 - TA 231).
39. Audited financial statements of ABC Jail Company, Inc. for December 31, 1992 and 1991 as audited by We Do Numbers, CPAs (TA 232 - TA 243).

40. Audited financial statements of ABC Jail Company, Inc. for December 31, 1991 and 1990 as audited by We Do Numbers, CPAs (TA 244 - TA 253).
41. Audited financial statements of ABC Jail Company, Inc. for December 31, 1990 as audited by We Do Numbers, CPAs (TA 254 - TA 23).
42. Audited financial statements of ABC Jail Company, Inc. for February 28, 1990 and 1989 as audited by We Do Numbers, CPAs (TA 264 - TA 277).
43. Audited financial statements of ABC Jail Company, Inc. for February 28, 1989 and 1988 as audited by We Do Numbers, CPAs (TA 278 - TA 290).
44. Form 1120S, U.S. Income Tax Return for an S Corporation for ABC Jail Company, Inc. for 1993 (TA 292 - TA 329).
45. Form 1120S, U.S. Income Tax Return for an S Corporation for ABC Jail Company, Inc. for 1992 (TA 330 - TA 372).
46. Form 1120S, U.S. Income Tax Return for an S Corporation for ABC Jail Company, Inc. for 1991 (TA 373 - TA 376) (all attached schedules are not included).
47. Form 1120S, U.S. Income Tax Return for an S Corporation for ABC Jail Company, Inc. for 1990 (TA 377 - TA 380) (all attached schedules are not included).
48. Form 1120S, U.S. Income Tax Return for an S Corporation for ABC Jail Company, Inc. for 1989 (TA 381 - TA 386) (all attached schedules are not included).
49. Miscellaneous Schedules K-1, Form 1120S for 1992 (TA 387 - TA 392).
50. Hand written notes from the Tennet & Axelrod, P.S.C. workpapers (TA 394 - TA 395).
51. Stock Purchase Agreement by and between ABC Jail Company, Inc. Employee Stock Ownership Plan and Trust and ABC Jail Company, Inc. as of December 1993 (no date) (TA 396 - TA 422).
52. Hand written notes from the Tennet & Axelrod, P.S.C. file relating to consulting and non compete agreement of Cliff Morris (TA 424).
53. Consulting and Non-Competition Agreement by and between ABC Jail Company, Inc. and J. Clifford Morris dated January 1, 1994 (TA 425 - TA 429).
54. Employment Agreement by and between ABC Jail Company, Inc. and Milton Thompson as of January 1, 1994 (TA 431 - TA 436).

55. Employment Agreement by and between ABC Jail Company, Inc. and J. Clifford Morris as of January 1, 1994 (TA 437 - TA 442).
56. Employment Agreement by and between ABC Jail Company, Inc. and Robert Jackson as of January 1, 1994 (TA 443 - TA 448).
57. Various hand written workpapers from Tennet & Axelrod, P.S.C.'s files (TA 449 - TA 454).
58. Correspondence dated March 11, 1994 between the Bank of Jacksonville and The ABC Jail Company, Inc. and the ABC ESOP (TA 468 - TA 478).
59. Transmittal letter with correspondence dated March 8, 1994 from Stephen Jones to James C. Ferran at the Bank of Jacksonville, providing an opinion of the value of the ABC Jail Company, Inc. stock to be acquired by the ESOP.
60. Fax transmittal sheet and account workpapers under cover dated March 14, 1994 to Stephen Jones from Charles T. Mitchell Company (TA 481 - TA 484).
61. An engagement letter between Tennet & Axelrod, P.S.C. and the ABC Jail Company, Inc. dated December 6, 1993 regarding the valuation of the common equity in ABC as of November 30, 1993 (TA 503 - TA 504).
62. ABC Jail Company, Inc. ESOP summary (TA 508 - TA 510).
63. Research material from CCH - *Standard Federal Tax Reporter* regarding interest on certain loans used to acquire employees' securities (TA 522 - TA 535).
64. Miscellaneous workpapers from Tennet & Axelrod, P.S.C.'s files (TA 536 - TA 538).
65. Cover letter dated March 7, 1994 from Paul E. Donough to James C. Ferran at the Bank of Jacksonville regarding real estate appraisals (TA 539).
66. Correspondence dated March 4, 1994 from Charles A. Brown, Jr. to James C. Ferran, Jr. at the Bank of Jacksonville regarding real estate appraisals (TA 540 - TA 552).
67. Miscellaneous workpapers from Tennet & Axelrod, P.S.C.'s files (TA 553 - TA 554).
68. A summary of ABC facility operations (TA 555 - TA 556).
69. Correspondence dated January 7, 1994 from Steven A. Crain to Stephen Jones regarding a preliminary offer to purchase the business of ABC Jail Company, Inc. (TA 557).

70. Proposal to recapitalize ABC Jail Company, Inc. (TA 558).
71. Workpapers regarding ABC revenue/cost from the periods 1991 through 1996, both actual and projected (TA 559 - TA 572).
72. Correspondence dated December 10, 1993 from Stephen Jones to Milton Roberts relating to additional items needed to complete the valuation (TA 573 - TA 574).
73. Schedule of officers' compensation from 1989 through 1992 (TA 575).
74. Article entitled "Are 'Doing Well' and 'Doing Good' Contradictory Goals of Privatization?" (TA 576 - TA 586).
75. Depreciation report for ABC Jail Company, Inc. (TA 587 - TA 595).
76. A partial contract relating to facilities in Arkansas (TA 596 - TA 634).
77. A memorandum of understanding with the Department of Correction from the State of Florida dated November 9, 1993 (TA 635 - TA 637).
78. A copy of Florida Legislation (TA 638 - TA 640).
79. Correspondence from Robert Studebaker of Mahoney & Company, P.C. to Stephen Jones regarding the ESOP valuation of privately operated prisons (TA 641 - TA 645).
80. Hand written notes from the workpapers of Tennet & Axelrod, P.S.C. (TA 646 - TA 651).
81. A blank valuation information request form (TA 652 - TA 657).
82. Life insurance cost summary for ESOP plan (TA 658 - TA 660).
83. Newspaper articles regarding prisons (TA 661 - TA 672).
84. Agenda for November 30, 1993 ESOP meeting (TA 675).
85. Workpaper contents from Tennet & Axelrod, P.S.C. files dated June 30, 1994 (TA 753 - TA 862).
86. Valuation workpapers from Tennet & Axelrod, P.S.C. files dated December 31, 1994 (TA 863 - TA 1016).
87. Valuation report of ABC as of December 31, 1994 (TA 865 - TA 920).

88. Valuation report checklist dated June 21, 1995 (TA 1017 - TA 1021).
89. Miscellaneous workpapers relating to 1995 and 1996 valuations (TA 1022 - TA 1269).
90. Workpapers of Tennet & Axelrod, P.S.C. relating to the ABC forecast engagement from 1994 to 2003 (TA 1270 - TA 1349).
91. Miscellaneous workpapers from Tennet & Axelrod, P.S.C.'s files (TA 1410 - TA 1472).
92. Printout of the schedules from the ValuSource computer system relating to the November 30, 1993 valuation (TA 1464 - TA 1561).
93. Valuation report as of November 30, 1993 by Tennet & Axelrod, P.S.C. (TA 1563 - TA 1623).
94. Financial statement processing instructions for the year ended December 31, 1995 with financial statements for the ABC Jail Company, Inc.'s ESOP (TA 1626 - TA 1634).
95. A checklist for financial reporting regarding defined contribution retirement plans (TA 1635 - TA 1641).
96. Other Tennet & Axelrod, P.S.C. workpapers relating to services performed for the ABC ESOP (TA 1642 - TA 8799).

In order to address the various issues in the T&A reports, as well as the conduct of this assignment that are problematic, we will cite the page reference, where possible, based on the bates stamp on each page.

First and foremost, the lack of qualifications of the appraiser must be noted. In our opinion, T&A and Messrs. Jones and Axelrod lacked the requisite skills, knowledge and credentials that demonstrate professional competence required to perform the valuation portion of their engagement. According to the T&A report (TA 173):

QUALIFICATIONS OF APPRAISER

Since founding in 1980, Tennet & Axelrod, PSC has performed numerous valuations of closely held entities. A significant number of valuations are performed in our Jacksonville and Lexington, Arkansas, offices for clients throughout the region. Valuation opinions have been rendered for a variety of purposes including mergers and acquisitions, employee stock ownership plans, marital dissolutions and estate and gift tax purposes.

Our clients include other business professionals, individuals, and closely held entities representing many different types of industries. Industries represented include professional practices, financial institutions, manufacturing and distribution concerns, retail industries, and various other service industries.

Several Tennet & Axelrod personnel have completed various courses concerning the valuations of closely held businesses and professional practices. In addition to this technical training, we have substantial experience with respect to the buying and selling of businesses through years of working with our clients. This combination provides us with the combination of technical training and practical experience of dealing with "willing buyers and sellers" and the ability to value businesses.

Tennet & Axelrod, PSC personnel have qualified and testified as expert witnesses in numerous courts. Additionally, they have assisted many large legal and accounting firms throughout the country with their valuation experience. Our reports are prepared in accordance with standards as promulgated by the American Institute of Certified Public Accountants. Biographical and qualifications information on our individual professionals is available upon request.

At the time of the acceptance of this engagement, it is our belief that none of the personnel, and particularly the partner in charge of the engagement, Steven Jones, had any credentials in business valuation. When questioned about his qualifications at his deposition, Mr. Jones responded as follows (January 24, 2005, beginning at page 22, line 18):

Q. Okay. Now, on the time – at the time you took on this assignment to value ABC Jail Company, were you a certified business appraiser designated by the Institute of Business Appraisers?

A. No.

Q. At the time you took on the valuation assignment of ABC, were you an accredited senior appraiser designated by the American Society of Appraisers?

A. No.

Q. At the time you took on the valuation assignment for ABC Jail Company, Inc., were you a certified valuation analyst designated by the National Association of Certified Valuation Analysts?

A. No.

Q. At the time you took on the valuation assignment for ABC Jail Company, Inc., did you hold a degree from any university or college in valuation sciences?

A. No.

Not only did Mr. Jones not have any credentials in business valuation, he did not belong to any appraisal organizations at the time of this valuation. His testimony was as follows (January 24, 2005, beginning on page 24, line 12):

Q. Now, at the time you took on the valuation assignment of ABC, did you have any credentials that qualified you specifically in the field of business valuation?

A. No specific credentials, no.

Q. At the time you took on the assignment to value ABC, what professional business valuation organizations did you belong to?

A. At the time, I don't -- I don't recall in '93 what, if any, we belonged to at that point in time.

Q. Sitting here today, you can't think of any organizations you belonged to in 1993?

A. Not from a valuation standpoint.

Q. Okay. Did you belong, in 1993, upon taking this assignment to value ABC in 1993, belong to the Institute of Business Appraisers?

A. No.

Q. Upon taking on this valuation assignment in 1993, did you belong to the American Society of Appraisers?

A. No.

Q. Upon taking on this assignment in 1993, did you belong to the National Association of Certified Valuation Analysts?

A. No.

When questioned about business valuation education, Mr. Jones was unable to provide any information about the courses that he had taken to get educated in this field. His response was (January 24, 2005, beginning at page 25, line 13):

Q. Now, at the time you took on this assignment to value ABC, what business valuation courses had you attended, if any?

A. Oh, we -- yes, I had attended some that were sponsored by either the Arkansas Society of CPAs and/or the AICPA. And probably others. I don't recall the --

Q. Need you to list them for me, Mr. Jones. I need the year you took business valuation courses that you attended prior to November 1993.

A. I don't know if we have those records still at the -- in our files at the office. I can check.

Q. Is there anything in your work papers that would show you that?

A. No.

Q. Now, you mentioned the Arkansas Society of CPAs. Do you recall anybody from the Arkansas Society of CPAs who put on such a course?

- A. Well, most of their courses are, I'll say national courses developed by the AICPA that the various state societies contract with to have instructors come down and give the courses.

During that time frame, there were a limited number of courses that were sponsored by the AICPA, and in turn, the state CPA societies offered limited educational courses in business valuation. The Arkansas Society of CPAs only offered one course during 1992 and no courses during 1993. On September 3, 1992, an AICPA course was offered by the Arkansas Society of CPAs entitled *Developing Your Business Valuation Skills: An Engagement Approach*. Unless there were other courses that Mr. Jones took, which he could not document, his education during this time frame was almost nonexistent.

One more item is worth noting regarding the qualifications of the appraiser. T&A indicates "Our reports are prepared in accordance with standards as promulgated by the American Institute of Certified Public Accountants." This statement is not only false, but when questioned about it, Mr. Jones, once again, demonstrated his lack of knowledge of business valuation. His deposition testimony included the following (January 24, 2005, beginning at page 42, line 9):

- Q. Okay. Now, continuing with Exhibit 307 on the page of qualifications of appraisal -- appraiser, page 173, last paragraph, do you see where you have written "our reports are prepared in accordance with standards as promulgated by the American Institute of Certified Public Accountants." Do you see that?
- A. Yes, sir.
- Q. Tell me -- what I'd ask you to do here is would you list those standards for me?
- A. Off the top of my head, I'm not for sure I can quote them verbatim, but the standards that are outlined in the code of conduct that state exercise due care, that you obviously not take on engagements that you're not qualified to do, and that you follow all the necessary guidelines of the American Institute in preparing your report.

The AICPA did not have specific standards that related to business valuation assignments in 1993. However, the AICPA had issued *Statement on Standards for Consulting Services No. 1* that referenced Rule 201 of the *AICPA Code of Professional Conduct*. Furthermore, at that time, the AICPA had published Practice Aid 93-3, *Conducting A Valuation of a Closely Held Business*, which stated the following:

13/115 BUSINESS VALUATION EDUCATION

.01 In performing business valuation engagements, practitioners are advised to determine whether the competency provisions of rule 201, General Standards of the AICPA Code of Professional Conduct, are met. Although accountants have a thorough understanding of financial statements and related matters, they also need to be proficient in the area of appraisals to competently complete an engagement. Usually, being proficient requires an in-depth knowledge of finance, economics, and security analysis and an understanding of appraisal principles and methods.

.02 In order for the practitioner to obtain the competency required to accept a business valuation engagement, appropriate education is required. Courses sponsored by the AICPA, the American Society of Appraisers (ASA), and The Institute of Business Appraisers Inc. (IBA) will provide practitioners with the minimum education necessary to perform there types of engagements. Self-study courses may help reinforce a level of knowledge; however, they are usually insufficient as the sole method of education.

A statement that the report is in accordance with standards promulgated by the AICPA was T&A's attempt to copy a portion of the certification that is required by the appraisal organizations, as well as the *Uniform Standards of Professional Appraisal Practice* (USPAP), which appeared in most of the valuation treatises that were published at that time. USPAP was also addressed in the AICPA Practice Aid 93-3, where it stated:

.06 Standards 1 through 8 of USPAP, which are broad standards, must be adhered to when an appraisal is performed for a federally related transaction involving real estate and other tangible property. The Preamble and Standards 9 and 10 of USPAP provide specific guidelines for developing and reporting business valuations. **Professional valuers recommend that**

USPAP be followed for all types of engagements, even if they are not federally related. (Emphasis added).

As will be pointed out in much more detail throughout this report, T&A used software and attempted to provide a business valuation report without understanding the principles of valuation, what the correct inputs into the valuation software programs it was using should have been, what the outputs from the software meant, or the amount of research and analysis that was required to produce a credible valuation report. Mr. Jones, almost 11 years later, sat in his deposition and was unable to answer questions about standards with any certainty. This comes from an individual who claimed to have “substantial” experience in performing business valuations. When he was asked how many appraisals he would have to do to have “substantial experience,” his response was “Fifteen, twenty.” (January 24, Page 37, line 19). This would equate to substantially less than a full year of experience assuming that the average assignment takes 60 hours to complete. The American Society of Appraisers, at that time, and subsequently, The Institute of Business Appraisers, required five full years of business valuation experience (10,000 work hours) to earn a credential (in addition to passing examinations and submitting work product for peer review).

Mr. Jones also could not recall which business valuation treatises he relied on. One reason for this is because his workpapers lacked any documentation from these treatises to support what he did in performing the ABC valuation. An experienced appraiser knows exactly what resources are in its reference library. This is especially true in business valuation because there are a limited number of authors and texts that would be regularly referred to as reference materials. Not knowing which publications were relied on is an indication that he probably did not consult any of these materials. In fact, if he did consult the materials, he may have avoided making many of the errors in judgement that will be pointed out in this report.

Based on our review of the T&A report and workpapers, it is obvious that they did little more than enter data into a computer program and use management as justification for not

fulfilling their obligations as a business valuer. Throughout the deposition, Mr. Jones kept stating that he discussed things with management, the directors or the trustees. However, he has little-to-no notes of all of these *supposed* conversations that took place. The first thing that accountants are taught is the importance of documentation, particularly when the data received is oral versus written. Part of the standard involving *Sufficient Relevant Data* is not only gathering the information, but also documenting it in the workpapers. T&A failed in this regard.

T&A did little more than rely on a software program to end up with a result that was improper, illogical and unsupported. Although there is nothing in the standards that precludes an appraiser from using a valuation software package, the appraiser must accept responsibility for all tools that are used in the application of the assignment. T&A, Mr. Jones and Mr. Axelrod failed to exercise due professional care by not being familiar with the tool that was relied on in this assignment. Furthermore, they failed to adequately supervise either each other or others while performing this assignment.

Despite Mr. Jones testifying to having substantial experience in valuation, he testified at the original trial that “We were using a package I believe it was just called Bank Source, which is nationally marketed, sold to various practitioners, CPAs other business valuers throughout the country” (July 18, 2001, Page 50, line 24). The actual name of this software package is Valusource and not Bank Source. Mr. Jones was unfamiliar with the computer product that was being used in his everyday practice.

Mr. Jones also testified that he considered this to be state of the art software. However, the software producer suggested that this package was not to be blindly used, and assumed that the practitioner understood enough about business valuation to make the necessary determinations that a software package cannot make for the practitioner. This would include, but not be limited to, the correct methodologies that apply to a particular valuation, the correct inputs to determine discount rates, whether to use a weighted average, a simple average or some other basis to reflect probable future earnings, and

more. An experienced practitioner would also understand the limitations that this, or any, software package has. The practitioner would also test the software to make certain that the mathematical calculations are correct.

T&A was unaware of a major calculation error in the discounted future earnings method (discussed later in this report), blindly printed every schedule that the software package had to offer, even if inappropriate for the ABC valuation, and used inappropriate valuation methodologies in reaching its final conclusion.

Another major problem with the T&A assignment is that this firm lacked independence. Furthermore, because of the valuation incompetence, the lack of independence became more obvious as T&A conducted several simultaneous assignments, causing it to mix assignments and violate proper appraisal practice. T&A allowed itself to (1) help plan the ESOP transaction, (2) value the ESOP transaction, and (3) assist in the forecasts that were required by the Bank of Jacksonville to demonstrate that ABC could pay for the financing. These three assignments became so intertwined that data was inconsistently used between the assignments. For example, the forecast for the Bank of Jacksonville has different figures in it than the forecast that was used in the Discounted Future Earnings method in the valuation report. Furthermore, T&A represented ABC in some of its engagements and should have represented the ABC ESOP (trustees) in the valuation. This is a clear conflict of interest.

An underlying problem that exists throughout the initial T&A report and updates is that a valuation was never performed as of the date of the transaction with the ESOP, which is the most important date that should have been used to value the ABC stock. The initial valuation date had an effective date of November 30, 1993. However, the initial and subsequent valuations leading up to the ESOP transaction only utilized financial information through October 31, 1993. Even the March 15, 1994 update did not use any additional information other than distributions to the shareholders. T&A never considered the impact on the valuation of more than four months of economic and industry changes,

nor the impact on ABC of removing more than \$1.5 million of cash from the company as distributions.

The balance of this report will be specifically referenced to the T&A report.

TA 160

Page TA 160 is the cover page to the valuation report that was issued by T&A. The date of this report is March 7, 1994. The report is addressed to the Board of Directors and Trustees of ABC, but T&A was only retained by ABC. The engagement letter was with ABC and not the trustees. There were no changes made to the engagement letter and therefore, the report should not be addressed to the trustees. The trustees never became the client even though they should have. T&A should have been familiar with the ESOP rules about who it should represent.

According to the report, T&A valued ABC as of November 30, 1993. However, in reaching its conclusion, T&A included information in this report that assumed that an ESOP transaction had taken place. At November 30, no such transaction took place. That causes this valuation to be hypothetical, although it is not labeled as such. We will reiterate this point as we review the valuation schedules that are attached to the report.

The standard of value, known as fair market value, takes into consideration that which is “known or knowable” as of the valuation date. The purpose of the T&A report was to establish the fair market value of the ABC stock to determine the “adequate consideration” to be paid by the ESOP for these shares. At the valuation date, November 30 1993, there was no ESOP. Using the proposed ESOP transaction to value ABC is circular logic. The appraiser must value the company as it exists at the appraisal date to establish the correct price to be paid for the stock. After the transaction, the value may change as a result of how the transaction is consummated.

Frequently, appraisers are requested to perform some preliminary valuation calculations for the purpose of assisting a client in a decision. For example, in this instance ABC was contemplating the implementation of an ESOP. A preliminary valuation would be requested by management of ABC to help them determine if it would make economic sense. What appears to have happened here is that ABC needed some preliminary numbers as of November 30, 1993, and T&A was engaged in December 1993 to assist in this process. At the time, the October 1993 figures were the most recent figures available. This was confirmed by Mr. Jones in his deposition (January 24, 2005, beginning at page 56, line23).

Q. Okay. Thank you. What I don't understand -- maybe you can explain it -- why is the valuation as of November 30th, '93, when the second paragraph says, "The information utilized to perform the valuation includes tax returns and financial statements of ABC Jail Company, Inc. through October 31, '93." Can you explain that?

A. Well, they wanted us to -- "they" being the trustees, wanted us to do the valuation in the latter part of '93 based on the information that the company had available at that point in time. Now, they would not have the full year-end information available to us until sometime into '94, so they wanted us to proceed with the information that they had available at that time.

Q. Well, but by March 7, 1994, you certainly had the financial information through November 30th, 1993, did you not?

A. I don't know if they had provided that to us or not. We -- we had been given the October number, certainly.

Q. Well, I mean, March 7, '94 is about, my goodness, three months after October 31, '93. Did you ever ask for the November financial data, Mr. Jones?

A. I don't remember if we asked for the November data. We ended up getting some preliminary December information, which they -- they being the company also indicated that there had not been any major changes between their operations -- between the October 31st and December matters.

- Q. Well, I'm just trying to understand. It's obvious – well, it seems obvious -- is it true that you never issued a full report using financial data as of November 30th, '93? Is that true?
- A. Well, the -- the November 30th information wouldn't have been -- would not have been available November 30th.
- Q. Well, again, you issued the report on March 7th, '94. My question is, anytime, as of March 7th, '94 or thereafter, through March 15th, '94, did you ever issue a full report using financial data as of November 30th, '93?
- A. We did not because we used the October 31st information.

Although T&A was engaged to value ABC as of November 30, 1993, they never did. In fact, Mr. Jones testified that he never asked for the data as of the valuation date, November 30, 1993. While appraisers use data near a valuation date, there is no excuse not to at least ask for the data that would impact the report. T&A did not request sufficient relevant data to allow them to perform their assignment properly.

T&A makes reference to the information that they used to perform the valuation. Most business valuation treatises have document checklists that can be used to assist in the gathering of the required information to perform a proper valuation. In the Practitioners Publishing Company (PPC) *Guide to Business Valuations*, Third Edition, May 1993, the authors state:

115.14 Collect Data Appropriate for the Valuation Methods Used. In order to establish a value for a company, a consultant must generally gather a great deal of information about the company, its industry, the economy in which the company operates, and other comparative companies. In order to be useful, the information must be timely, accurate, and comparable to similar companies against which comparisons will be made. This information is usually gathered during the early stages of field work.

115.15 The specific types of information needed will vary from engagement to engagement and are primarily based on the valuation methods that are appropriate for a particular project. The data gathering process usually

involves an analysis of historical financial information, interviews with company management, and extensive research on comparative companies, economic and industry trends, and market price data. Financial information must often be adjusted and analyzed before it can be used in the valuation process. Comprehensive data gathering checklists and questionnaires are presented in the Practice Aids sections in Volume 2 of the *Guide*.

In addition to collecting the appropriate data, the authors of the *Guide to Business Valuations* also advise the reader to:

115.19 Document All Work Performed and Conclusions Reached. A consultant should prepare a set of workpapers for each valuation engagement. The workpapers should include not only the completed work programs, but also all data, calculations, and key assumptions made by the engagement team, as well as all conclusions reached.

This publication was the only treatise that Mr. Jones was sure that he had in T&A's library at the time the valuation was performed. In fact, Mr. Jones used the report checklist from this publication, but no others. We will discuss the report checklist later in this report.

TA 161

The narrative report is approximately 11 pages beginning at TA 161. Besides the fact that there is little substance in the narrative, there is no connection between the narrative report and the schedules that are attached to it. The report lacks explanation, analysis, references and almost anything else that would permit the reader to gain a proper understanding of the basis for the appraiser's valuation. Furthermore, there is a lack of discussion of key assumptions and explanations, and as such, this report cannot be replicated. The narrative also is contradictory throughout, which will be pointed out as we proceed.

The first paragraph on this page is incorrect. The valuation that was done as of November 30, 1993, was to assist management in determining, as part of the implementation of an

ESOP, how much ABC and the ESOP should consummate transactions for with Mr. Morris and for newly issued shares. T&A states:

The purpose of this study was to arrive at a value to be used by the ESOP trustees for the establishment of the ABC Jail Company, Inc. Employee Stock Ownership Plan, whereby immediately following the acquisition of the stock, the ESOP would own more than a fifty percent interest of all outstanding corporate stock.

Since the ESOP did not exist at November 30, 1993, it would have been more accurate to state that the purpose of the valuation was to assist the ESOP trustees, once the ESOP was formed, in establishing the adequate consideration that must be paid by the ABC ESOP for the shares in ABC as of the transaction date. It should also have stated that this report may have to be updated to get closer to the actual transaction date.

At the bottom of this page, T&A references Revenue Ruling 59-60 and indicates that this Revenue Ruling “sets forth in some detail the following factors (not all inclusive), which generally are believed to be fundamental enough to the valuation of a closely held corporate stock that analysis of each is required.” The report then proceeds to list ten factors. However, these ten factors do not all come from Revenue Ruling 59-60. In Mr. Jones’ deposition, he was asked the following (January 24, 2004, beginning at page 82, line 14):

Q. And you’ve got ten items attributed to Revenue Ruling 59-60, correct?

A. There’s ten items listed there, yes.

Q. And my question is, where do you get this ninth and tenth item if it's not in Revenue Ruling 59-60?

A. Well, from -- probably from other materials that we consider when we evaluate a company because I think those are -- these are relevant facts. 59-60 is -- Revenue Ruling 59-60 is a guideline stipulated by the IRS.

- Q. I agree. I'm just asking you where you got these other two points, item 9 and 10, since it's not in Revenue Ruling 59-60. Can you tell me what authoritative source you used for those two items?
- A. Off the top of my head, I'm not -- I don't recall an authoritative source such as an IRS Revenue Ruling.
- Q. Well, give me any authoritative source --.
- A. Well, the --.
- Q. Doesn't have to be IRS.
- A. -- the judgment of the -- the valuator when performing a valuation analysis.

Once again, despite Mr. Jones' claim of having substantial experience, he was unfamiliar with Revenue Ruling 59-60, which is a cornerstone ruling in the profession. It is the most widely cited revenue ruling by business appraisers, and possibly the most widely cited document in business valuation. What makes these responses even worse is that Mr. Jones did not know where he took the ninth and tenth factors from. To give the response that it was the judgement of the valuator, further supports the lack of professional competence applied in this assignment. The deposition was approximately 11 years later, and he still did not know, without additional prompting in subsequent questions, that these two additional factors came from the Department of Labor Regulations relating to ESOPs. T&A held itself out as having substantial experience in ESOP valuations. Throughout Mr. Jones' deposition, he kept referring to *the subjective judgment of the appraiser* to compensate for his lack of documentation or knowledge of the appraisal literature. This was one more instance where this took place.

TA 163

At the top of this page, the T&A report states:

We have relied heavily in our valuation upon known operating results and the financial condition of ABC for the prior five fiscal years. Additionally, we have analyzed projections as prepared by management for future years. We believe that this is the most satisfactory method of valuing the stock of a closely held corporation such as ABC.

However, T&A ultimately used valuation methods in its final analysis that are inconsistent with this statement. This will be pointed out as we review the schedules at the back of its report.

Beginning on this page, the T&A report begins to address the 10 items from Revenue Ruling 59-60 and the Department of Labor Regulations. Each of these sections is woefully inadequate to accomplish its intended purpose. In the *History and Nature of the Business* section there is very little information to allow a reader to truly understand the history and nature of ABC. In fact, this entire narrative section only takes up one half of one page. The valuation report omits important items such as the legal form of the entity, the state of incorporation, information about company management, competition, information about key employees, sensitivity to seasonal or cyclical factors, and strengths and weaknesses.

The small amount of information that is included in the report includes the ownership of the corporation including the proposed transaction, which as of November 30, 1993 should not be considered in the valuation of ABC. The process of valuing ABC was to determine what the value should be for a transaction. Including information about the transaction makes this valuation hypothetical. Hypothetical valuations are defined as those that are contrary to fact. There is nothing in the Department of Labor Regulations that permits hypothetical appraisals to be performed for an actual ESOP transaction. This is one more instance where T&A mixes up its assignments. Either this report is for planning purposes to demonstrate what would happen after the ESOP transaction takes place, or it is a valuation of ABC stock for the purpose of meeting the adequate consideration requirements in an actual transaction. The same report cannot be used for both purposes.

Not only should the history and nature of the business section of the report provide the reader with an explanation of information about the company, but some of the items discussed in this section should ultimately be used by the appraiser to support some of the *subjective* judgment that enters into the valuation process. For example, in the development of the discount rate, the lack of depth of management, or having inadequate management, would be a risk factor that should be considered. Since there is no information in this section to discuss the strengths and weaknesses of management, it would be impossible for the appraiser to support any adjustment to a discount rate relating to this item. Later in the report, T&A assigns a significant risk factor to the *continuity of management*, which is totally unsupported.

Revenue Ruling 59-60 in Section 4, Paragraph .02 states the following:

The history of a corporate enterprise will show its past stability or instability, its growth or lack of growth, the diversity or lack of diversity of its operations, and other facts needed to form an opinion of the degree of risk involved in the business. For an enterprise which changed its form of organization but carried on the same or closely similar operations of its predecessor, the history of the former enterprise should be considered. The detail to be considered should increase with approach to the required date of appraisal, since recent events are of greatest help in predicting the future; but a study of gross and net income, and of dividends covering a long prior period, is highly desirable. The history to be studied should include, but need not be limited to, **the nature of the business, its products or services, its operating and investment assets, capital structure, plant facilities, sales records and management**, all of which should be considered **as of the date of the appraisal**, with due regard for recent significant changes. Events of the past that are unlikely to recur in the future should be discounted, since value has a close relation to future expectancy. (Emphasis added).

TA 164

The next section addressed in the T&A report is the *Economic and Industry Outlook*. Once again, this section lacks substance. Furthermore, it is irrelevant to ABC. There are three paragraphs regarding the economy dealing with slow economic growth, deficit reduction

and health care legislation. There is also no mention about consumer and business confidence and speculation about interest rates, but none of this is discussed with respect to ABC or users of its services.

The industry data consists of two paragraphs, but also lacks sufficient information to assist an appraiser in determining a prospective growth rate or industry risk. Here also, by taking a shortcut approach to performing the valuation, T&A missed the intent of Revenue Ruling 59-60, when it states in Section 4, Paragraph .02:

A sound appraisal of a closely held stock must consider current and prospective economic conditions as of the date of appraisal, both in the national economy and in the industry or industries with which the corporation is allied. It is important to know that the company is more or less successful than its competitors in the same industry, or that it is maintaining a stable position with respect to competitors. Equal or even greater significance may attach to the ability of the industry with which the company is allied to compete with other industries. Prospective competition which has not been a factor in prior years should be given careful attention. For example, high profits due to the novelty of its product and the lack of competition often lead to increasing competition. The public's appraisal of the future prospects of competitive industries or of competitors within an industry may be indicated by price trends in the markets for commodities and for securities. The loss of the manager of a so-called "one-man" business may have a depressing effect upon the value of the stock of such business, particularly if there is a lack of trained personnel capable of succeeding to the management of the enterprise. In valuing the stock of this type of business, therefore, the effect of the loss of the manager on the future expectancy of the business, and the absence of management-succession potentialities are pertinent factors to be taken into consideration. On the other hand, there may be factors which offset, in whole or in part, the loss of the manager's services. For instance, the nature of the business and of its assets may be such that they will not be impaired by the loss of the manager. Furthermore, the loss may be adequately covered by life insurance, or competent management might be employed on the basis of the consideration paid for the former manager's services. These, or other offsetting factors, if found to exist, should be carefully weighed against the loss of the manager's services in valuing the stock of the enterprise.

During Mr. Jones' deposition, he was questioned about information that he says he learned during his management interview, in particular about the company's expansion into projects in Australia and England. Since Mr. Jones described ABC as an industry leader, questions were asked regarding its ranking in terms of other private prison companies. To this, he responded (January 24, Page 90, line 5):

A. I don't recall us having a ranking of one, two, three, four.

When he was asked to produce his workpapers that support the management interview, his answer was (January 24, Page 90, line 5):

A. Well, I'm not -- I don't have notes from that discussion when management said that their -- they were a leader, but I think the other information contained in our file infers that they are in a leadership position in the industry.

Once again, when Mr. Jones was questioned in his deposition about the economic and industry section of his report, his answers were generalities that he considered the overall economy, but not once was he able to get specific. In fact, at one point he answered a question as follows (January 24, Page 103, line 6):

A. I think one of the factors that was good for the company, again, I recollection, was -- were some stricter sentencing guidelines that were coming into play during this time period. Now, whether or not that's relating to the economy in general, I can't speak, but I'm sure that there is obviously some studies out there how the economy effects crime.

Q. But you don't have any of those studies, do you, on how the economy effects crime in your workpapers, do you?

A. Not in my workpapers, no.

Once again, Mr. Jones attempts to make up for the fact that his workpapers were deficient and that the T&A report does not address pertinent data that should have been included

therein. When he was asked whether health care legislation and deficit reduction would be positive or negative factors for ABC's valuation he responded (January 24, Page 105, line 1):

- A. Generally speaking, I would say that those factors in itself would not necessarily a large impact one way or the other.

In a discussion of industry players, the T&A report lists companies such as Concepts, Inc., Esmor, Inc., Wackenhut Corrections Corporation and Prison Systems, Ltd. Despite mentioning these competitors, T&A used no information from these companies' public filings or annual reports to support its opinions throughout the report. Mr. Jones was questioned about this and responded as follows (January 24, Page 128, line 11):

- Q. Okay. What I'm wondering about is where in your work papers, if any, do you analyze these companies in the same industry that you've just named to analyze their growth rates, their strengths and weaknesses of one company versus another in terms of you developing your valuation of fair market value of ABC? Did you do that?
- A. Well, we -- we thought about it, considered it and decided that that was not the best approach to use in valuing the business.
- Q. Okay. I appreciate your answer, but that really wasn't my question?
- Q. Where in your work papers, if any, do you analyze these companies in the same industry that you've just named to analyze their growth rates, their strengths and weaknesses of one company versus another in developing your valuation of the fair market value of ABC?
- A. I don't know that there's any documentation in our work papers that -- that specifically go to that, although we thought about it and discussed it with management team, et cetera.

Once again, not only did T&A ignore the main industry players, which would be an essential part of the analysis in valuing ABC, but Mr. Jones claims that this information was considered, but there was no documentation in the workpapers. The workpapers did not contain any level of documentation to meet the *sufficient relevant data* standard. Once

again, Mr. Jones is relying on his statement of discussing it with management as justification for not using this information. While there is no doubt that an appraiser will ask management questions, it is up to the appraiser to perform his or her own analysis, and where necessary, due diligence to test the information that management is providing. That is one of many reasons why an independent appraiser is hired.

The T&A report contained too little information about the economy and industry, and the little bit of information that was included in the report was irrelevant to the valuation of ABC.

TA 165

On this page of the T&A report, an attempt to discuss the *Book Value and Financial Condition* of ABC takes place. T&A indicates which balance sheets it used in its analysis and states:

Book value is generally defined as the total net value of the Corporation's assets on a (sic) historical cost basis of accounting, less total liabilities. The Corporation's book value is indicated in the summary of the valuation methods, however, this value indication is seldom considered definitive in nature.

Despite this statement, Schedule XXI allocates some weight to book value as a method of appraisal. Book value is not an appropriate method. It is merely an accounting concept that should not have been used in the valuation of ABC.

When questioned why the definition of book value is included in the report, and what T&A was attempting to express to the reader of the valuation, Mr. Jones responded (January 24, Page 109, line 16):

- A. That there's this concept of -- of book value which is not necessarily -- and that term is a lot in a lot of circles, accounting circles, you know, investment circles, et cetera, that is not necessarily indicative of being the fair market value of an entity.

Q. Right.

A. That's what we were saying in that paragraph.

Despite knowing that book value is **not necessarily indicative of being the fair market value of an entity**, T&A include this method in the valuation and assigned weight to it in reaching its final conclusion.

In the last paragraph of this section, the T&A report states “When valuing the stock of a closely held corporation, we believe the adjusted book value of the Corporation’s stock is important in determining the actual current fair market value.” When Mr. Jones was questioned in his deposition about this statement, he answered (January 24, Page 110, line 24):

A. It's one of the factors we consider, yes. It's one of the many important factors.

Once again, Mr. Jones’ lack of understanding of business valuation principles becomes apparent. When he was asked to show where in Revenue Ruling 59-60 it states that adjusted book value is important in determining the fair market value of a company such as ABC, his response indicated Paragraph 4-C of the Revenue Ruling as his justification. When he was further asked where in Paragraph 4-C, he read from this paragraph as follows (January 24, Page 111, line 24):

A. Sorry. “In computing the book value per share of stock, assets of the investment type should be revalued on the basis of their market price and the book value adjusted accordingly.”

The problem with Mr. Jones’ response is that the assets of ABC are operating assets and not assets of the investment type. A simple reading of Revenue Ruling 59-60 makes it very obvious that the Revenue Ruling distinguishes between investment type assets and operating type assets. An investment asset is one that a company would invest in such as marketable securities, excess real estate, etc. An operating asset is one that is used

in the business operations to permit the company to perform services or sells goods, and therefore, earn a return based on its day to day business operations. When Mr. Jones was questioned about what assets on the balance sheet are of the investment type in this valuation, his response was (January 24, Page 112, line 18):

- A. Well, I would consider all of the assets to be investments of the company.
- Q. Well, it says assets of the investment type should be revalued. Are you saying that that's referring to all assets?
- A. Well, all assets are invested in by the company. They have to make investment in all their assets.

However, upon further questioning, he gave the following answers (January 24, Page 113, line 14):

- Q. Okay. That's what you're telling me. What is the difference, if any, between an investment type asset and an operating asset of a company?
- A. Well, an operating asset would be one that used in the -- as by definition the operations of the -- of the day-to-day operations of the business.
- Q. So for example -- go ahead.
- A. And the investment type would be generally -- generally speaking, on that is held for investment purposes only.
- Q. Okay. So in the situation with ABC Jail Company, Inc., obviously the prisons would be an operating asset, not an investment type asset.
- A. The prisons would be used in operations, yes.

The significance of Mr. Jones not understanding the difference between an investment type asset and an operating asset is a critical error in applying the spirit of Revenue Ruling 59-60. In section 5 of this very important Revenue Ruling, it states the following:

Sec. 5. Weight to Be Accorded Various Factors.

The valuation of closely held corporate stock entails the consideration of all relevant factors as stated in section 4. Depending upon the circumstances in each case, certain factors may carry more weight than others because of the nature of the company's business. To illustrate:

1. Earnings may be the most important criterion of value in some cases whereas asset value will receive primary consideration in others. In general, the appraiser will accord primary consideration to earnings when valuing stocks of companies which sell products or services to the public; conversely, in the investment or holding type of company, the appraiser may accord the greatest weight to the assets underlying the security to be valued.
2. The value of the stock of a closely held investment or real estate holding company, whether or not family owned, is closely related to the value of the assets underlying the stock. For companies of this type the appraiser should determine the fair values of the assets of the company. Operating expenses of such a company and the cost of liquidating it, if any, merit consideration when appraising the relative values of the stock and the underlying assets. The market values of the underlying assets give due weight to potential earnings and dividends of the particular items of property underlying the stock, capitalized at rates deemed proper by the investing public at the date of appraisal. A current appraisal by the investing public should be superior to the retrospective opinion of an individual. For these reasons, adjusted net worth should be accorded greater weight in valuing the stock of a closely held investment or real estate holding company, whether or not family owned, than any of the other customary yardsticks of appraisal, such as earnings and dividend paying capacity.

Based on the above quote, earnings would be the most important consideration in the valuation of ABC. Despite this, the T&A report places a significant amount of weight on methodologies that rely heavily on adjusted book value and/or book value. While it would be appropriate to consider these methods, they should have been eliminated based on the nature of ABC's business. Furthermore, the manner in which the various methodologies were applied, even those that should not have been used in the valuation of ABC, was incorrect.

In calculating the adjusted book value, the only adjustment made to the balance sheet was a write up of the real estate values to fair market value based on appraisals performed by an outside real estate appraiser. No other assets or liabilities were discussed regarding any potential adjustments. Furthermore, T&A failed to take into consideration any intangible assets that may need to be reflected to properly adjust the balance sheet to fair market value. Nowhere in its report, does T&A discuss the fact that it is determining adjusted book value with only the tangible assets and liabilities. When asked where in the literature Mr. Jones could point to for support of the adjusted book value not including intangible assets, his response was (January 24, Page 126, line 20):

A. I can't specifically say that I have a source to cite you off the top of my head.

At the bottom of this page, the T&A report discusses the *Earning Capacity* of ABC. T&A discusses annualized revenues growing from \$4.7 million to approximately \$13.7 million. However, there is no further analysis beyond this. In this section, they also indicate that "Net earnings of an ongoing corporation are, in our opinion, one of the most important factors available in determining the fair market value of a closely held corporation's stock." The report continues with:

We believe the potential investors in the stock of a corporation would place more emphasis on the most recent years' earnings when valuing the corporation. Therefore, when using the net earnings method in determining the fair market value of ABC's stock, we have weighted the most recent years' net earnings more heavily than the prior years' earnings.

Reading the T&A report, thus far, leaves the reader with the feeling that adjusted book value is very important, but so are earnings. T&A contradicts itself by stating that these methods are both very important in this assignment. ABC was an operating company, and as such earning capacity is much more important than its assets and liabilities.

As a general rule, most appraisers are much more concerned with cash flow than they are earnings. Although Revenue Ruling 59-60 discusses earning capacity, the interpretation in the appraisal industry is that this does not necessarily mean net earnings. In a growing company, cash flow is much more important than earnings since many profitable companies go out of business because they do not have the necessary cash flow to fund their growth. No consideration is made in this valuation as to how ABC would fund the extraordinary growth that was being projected for the company.

TA 166

Continuing the discussion about Earning Capacity, T&A indicates that:

We made adjustments for excess compensation of officers over what would be a “normalized amount.” This amount has been determined for what has been calculated as the amount necessary to pay unrelated third parties for the management of the Corporation.

However, there is no explanation in the report as to how this information was derived, nor is there any documentation in the T&A workpapers. When asked about the workpapers, Mr. Jones responded (January 24, Page 138, line 2):

- A. I don't recall a specific work paper in our file about that; however, we did discuss with them what the appropriate level of compensation would be for someone to provide the services that -- that was being provided by the shareholders.
- Q. Okay. Where in you work -- I'm sorry, I don't want to cut you off.
- A. Well, I was just saying that based on our discussions with them and our general knowledge of businesses that we've worked with through -- over the -- throughout the years that we concluded that 200,000 per stockholder would be indicative of what they would have to go out and hire somebody to do their jobs.
- Q. Okay. Show me in your work papers where you documented that conversation and your general knowledge of the business?

A. I don't believe it's in our work papers.

Once again, Mr. Jones attempted to respond in general terms regarding T&A's or his knowledge about management compensation, but he fails to demonstrate that any analysis or research was performed including what other individuals in the field were earning. A \$200,000 per officer figure appears to be pulled out of the air and remains unsupported. There is no discussion in the report as to management's jobs duties, the hours worked, or the experience required to perform the particular function of each officer. Therefore, there is no basis upon which to estimate reasonable compensation. This adjustment is supposed to be well supported, and in this instance, it is totally unsupported. T&A lacks sufficient relevant data to support this item.

The next section of the report is a discussion of the *Dividend Paying Capacity*. Despite indicating that distributions have been made to permit the shareholders to pay their respective federal and state income taxes, there is no quantification of the amounts that were paid. Rather than properly addressing the dividend paying capacity, the T&A report states:

Considering the nature of the industry and its potential growth as well as the Corporation's size and method of operation, it does not appear the Corporation's dividend paying capacity is greatly in excess of the current rate of dividends being paid. The Corporation will retain substantially all its equity in order to support anticipated growth, debt service requirements and operations. As a closely held entity, the Corporation does not have the access to equity markets which are available to publicly held corporations to finance anticipated growth.

This statement has no analysis associated with it in the report or in the workpapers from which T&A was able to reach the conclusion that it wrote in its report. In his deposition, Mr. Jones stated (January 24, Page 142, line 5):

We knew that they were going to be needing capital to expand -- to finance the expansion of their operations, so they were probably going to be retaining as much as they could in order to finance those growth operations and to -- and to service the existing debt that they had prior to the transaction.

The ironic part about Mr. Jones' statement is that T&A assisted management in producing a forecast for the Bank of Jacksonville. In that forecast, however, there was no provision for capital expenditures, which indicates that the projected cash flow would be significantly overstated. The possibility of ABC continuing its operations without capital expenditures is impossible. Therefore, while net cash flow is sometimes considered to be dividend paying capacity, T&A never calculated the net cash flow that would be available after a proper reinvestment of its cash was provided for to grow ABC. As a result, the dividend paying capacity section, while included in the report, was omitted from the analysis.

The next section of the report discusses *Goodwill and Intangible Value*. Once again, T&A demonstrates that it did not have the professional competence to undertake the assignment. In this section, T&A states "...goodwill has many definitions, and for valuation purposes is sometimes considered to be value in excess of book value." This statement is absolutely incorrect in a business valuation context. Goodwill is never a value in excess of book value. Goodwill is a value in excess of the net tangible and identifiable intangible assets. Book value is an accounting concept that does not reflect the fair market value of the assets and liabilities. The difference between the tangible assets and liabilities and the total value of the company would be the intangible value, not all of which is attributable to goodwill. T&A also states that "Goodwill in the context of Rev. Ruling 59-60, whether positive or negative, is determined by the overall valuation of the Corporation's equity in relation to its book value." The very mention of negative goodwill must be questioned. A company either has goodwill or does not have goodwill. If it has goodwill, frequently the role of the appraiser is to determine if that goodwill has value. The value cannot be less than zero. There is no such valuation concept as negative goodwill.

TA 167

At the top of this page, there is a discussion about *Comparable Stock Values*. Despite identifying its procedure to develop a group of public corporations that could be used in this part of the assignment, T&A did not do what it said it did. When Mr. Jones was questioned about the procedures and analysis, the following discussion took place (January 24, Page 149, line 12):

- Q. Okay. Now, can you point out again in your work papers, Exhibit 368, where you have the detailed criteria that you use to identify the comparable companies and detail what you use to perform any analysis on the companies that were located?
- A. Your question again is with respect to our work paper?
- Q. Yes. I want you to go to your work papers, Exhibit 368, and show me where, if anywhere, you have your criteria that you used to identify the comparable companies and detail what you used perform any analysis of those companies.
- A. I don't think we have a work -- work paper that is in detailed format that outlines the -- the criteria, I think you referred to --
- Q. Right?
- A. -- that at the end of the page there's a handwritten conclusion that we're not going to use these -- this methodology. So I don't believe there's a work paper to that effect.
- Q. Okay. So even though you have in -- on page 167 of Exhibit 307 that you say "Entities obtained in our search, while having many similarities" -- just stop right there. You can't really even point me to any entities obtained in your search, is that right, from your work papers?
- A. Well, we considered some of the other entities that were in the industry.
- Q. Okay. But you didn't put a work paper in about why you decided that you could not use them as a comparable company. Is that what you're telling me?

A. We did not put together a work paper.

This is one more instance where sufficient relevant data was not obtained by the appraiser. Besides the fact that T&A mislead the reader of its report by stating that it did certain procedures that it did not do, there was nothing contained in the workpapers to support that there was even a proper attempt to apply the market approach in the valuation of ABC. Fair market value comes from the market. The market approach is the most fundamental approach to valuation in a fair market value analysis.

The T&A report states “Entities obtained in our search, while having many similarities tend to be much more widely held in ownership which in turn indicates the stock being traded publicly would have substantial minority interests discounts applied.” Besides there being no search, this statement demonstrates either T&A’s desire to specifically eliminate this methodology or its complete lack of understanding of the methodology. There is no question that a publicly traded stock is generally more widely held than a closely held stock; that is the nature of the security. To use this as an excuse for not using this data to value ABC defies logic. In fact, minority values are used from the public market on a regular basis in the valuation process. There are numerous studies that measure the control premiums paid above the minority price that could have been used had this methodology been properly considered. Based on Mr. Jones’ testimony, we believe that no one at T&A had sufficient knowledge as to the proper application of this method, which is the reason why it was eliminated from consideration. In a niche industry, such as the one in which ABC operated within, the most likely purchaser would be an industry player. In fact, that is exactly what happened several years later. Therefore, the best companies to be considered in the application of the market approach would be the potential purchasers of this company. Eliminating this methodology and ignoring the industry players, as few as there were, was negligent on the part of T&A.

Despite indicating that a search of entities was conducted, T&A did not do this. When asked about this, Mr. Jones stated in his deposition (January 24, Page 169, line 9):

A. We -- we discussed with management other entities that are in the business. We -- we got some information about those businesses --.

Q. Okay.

A. -- and did a preliminary review.

When specifically asked whether or not Mr. Jones did an independent search for comparable companies he answered (January 24, Page 170, line 3):

A. Well, we asked them for the names of the others in the industry. And some of the articles we previously referred to referred to some of the other entities that were in -- in the similar business --.

In essence, T&A inaccurately portrayed in its report the attempt to apply the market approach. The eighth factor of Revenue Ruling 59-60 states the following:

Section 2031(b) of the Code states, in effect, that in valuing unlisted securities the value of stock or securities of corporations engaged in the same or a similar line of business which are listed on an exchange should be taken into consideration along with all other factors. An important consideration is that the corporations to be used for comparisons have capital stocks which are actively traded by the public. In accordance with section 2031(b) of the Code, stocks listed on an exchange are to be considered first. However, if sufficient comparable companies whose stocks are listed on an exchange cannot be found, other comparable companies which have stocks actively traded on the over-the-counter market also may be used. The essential factor is that whether the stocks are sold on an exchange or over-the-counter there is evidence of an active, free public market for the stock as of the valuation date. In selecting corporations for comparative purposes, care should be taken to use only comparable companies. Although the only restrictive requirement as to comparable corporations specified in the statute is that their lines of business be the same or similar, yet it is obvious that consideration must be given to other relevant factors in order that the most valid comparison possible will be obtained. For illustration, a corporation having one or more issues of preferred stock, bonds or debentures in addition to its common stock should not be considered to be directly comparable to one having only common stock outstanding. In like manner, a company with a declining business and decreasing markets is not comparable to one with a record of current progress and market expansion.

The market approach is considered to be the best indication of fair market value since this type of value comes from the market. While determining good comparable companies is at times difficult, that is never a reason to dismiss the approach without attempting its application. In fact, the standards of all appraisal organizations tell the appraiser to consider all applicable approaches and methods for any valuation that is performed. To merely say that I considered it and I ruled it out is not in the spirit of appraisal standards. The appraiser has an obligation to properly apply valuation procedures.

Since an ESOP valuation is so closely tied to the spirit of Revenue Ruling 59-60 and the Department of Labor Regulations, omission of the market approach in this fashion was negligent. Even in Mr. Jones' deposition he admitted that a possible comparable would be "rehab" facilities (January 24, Page 171, line 12), but they were not identified in his report or in his workpapers.

At the bottom of this page, the T&A report includes boilerplate about valuation methodologies. It starts off by indicating "There are four general methods of valuation to be considered in any valuation assignment, they are the asset, income, market data and cost methodologies." When asked in his deposition, Mr. Jones could not point to an authoritative source that discusses these four general methods of valuation. The valuation literature indicates that there are only three approaches to business valuation. They are the market approach, the income approach and the asset based approach. The asset based approach, formerly had been known as the cost approach, but the terminology was changed a number of years ago. T&A refers to methods, however the appraisal literature calls these approaches. Methods exist within the approaches. Despite the incorrect terminology, there are not four general methods (approaches), but only three. It appears that T&A merely lifted boilerplate from somewhere without verifying or understanding whether or not it was correct.

The cost approach is predominately used in the valuation of intangible assets in a business valuation setting. It is sometimes known as the cost to create approach, which is the

recreation of a business asset from scratch. It is certainly not one of the approaches to valuing an entire business. This would not only be impractical, it would also be cost prohibitive for most businesses as every asset would have to have analysis performed about it to recreate it from scratch.

Once again, at the bottom of this page, in a discussion of the asset approaches, T&A indicates “Book value represents the accounting net equity of the business. According to generally accepted accounting principles (GAAP), book value is composed of the historic cost of assets minus liabilities, and is therefore not considered a measure of value.” Despite this comment, T&A nevertheless used book value as one of the methods to value ABC.

TA 168

Continuing in the same paragraph as above, T&A indicates “Conversely, adjusted book value represents the fair market of the tangible assets and liabilities of the business. For operating businesses, this is considered a good measure of the bare minimum bench mark price.” The adjusted book value method if properly performed should include intangible assets, otherwise only a portion of the company is being valued. At the end of the discussion of the asset approach the T&A report discusses liquidation value. In fact, it states “This value is most often used when the business has no current earnings or prospects thereof.” However, not only did T&A use this method, they used it incorrectly. Once again, using methods that have no appropriate application in a valuation further demonstrates negligence in the valuation of ABC.

The next section discussed in this report is the income approach. T&A indicates:

The most common techniques under this methodology are : (sic) the Price/Earnings Ratio Analysis, the Discounted Future Earnings, the Capitalization of Excess Earnings, Capitalization of Earnings, the Dividend Payout Ratio and a multiple of Gross Receipts.

Once again, there is no valuation treatise that would support all of these methods under the income approach. A price/earnings analysis, a multiple of gross receipts and using a dividend payout ratio are all market approach applications, not income approach methodologies. This is one more instance where T&A demonstrates its lack of knowledge of business valuation. Even its report boilerplate is incorrect. To further support our position, when asked in his deposition about price/earnings ratios and multiple of gross receipts being part of the market approach as opposed to the income approach, Mr. Jones stated (January 24, Page 178, line 12):

A. I would say that that – that is in the wrong paragraph, if that's your questions.

When asked about the multiple of gross receipts, he stated (January 24. Page 178, line 25):

A. I would agree with you on the gross receipts part. That is, again, in the wrong paragraph.

At the bottom of this page is a discussion about the cost method. As previously mentioned, this method is applied to particular assets. The description included in this business valuation report would be correct if it were being applied to a particular asset such as a piece of equipment. Functional, economic, and physical depreciation are the types of depreciation that are considered by a machinery and equipment or real estate appraiser. If this method were being applied to value specific tangible assets, it would be correct, as stated. However, it is totally out of context in the T&A report.

TA 169

This page lists all of the methods that were used in this valuation, many of which are inappropriate for the valuation of ABC. Book value, adjusted book value and liquidation value have no place in the valuation of ABC. Single period capitalization models such as the capitalization of earnings or the capitalization of earnings before interest were incorrectly applied. The capitalization of excess earnings is also incorrectly applied. The discounted future earnings methods were inconsistently applied and are totally unsupported. Each of these methods will be discussed in our report as we reach the appropriate schedule at the back of the T&A report.

TA 170

In the discussion of the capitalization of excess earnings method, T&A states “The capitalization of excess earnings method is the most widely used valuation technique.” This statement in the T&A report is inaccurate. While this method was widely used, it was certainly not the *most* widely used method of valuation. In fact, this method is predominately used for small businesses and professional practices, hardly applicable to a business such as ABC. Mr. Jones testified in his deposition (January 24, Page 195, line 12) that “I’ve seen it in small and large businesses.” However, not only did T&A apply this method incorrectly, it used the method despite the language that appears in Revenue Ruling 68-609 regarding this method.

Revenue Ruling 68-609 is the outgrowth of Appellate Review Memorandum 34, C.B.2, 31 (1920). It was originally promulgated due to prohibition and the lost intangible value that would have to be measured for distilleries and breweries. Known also as the formula approach, Revenue Ruling 68-609 states “The ‘formula’ approach should not be used if there is better evidence available from which the value of intangibles can be determined.” The revenue ruling states “accordingly, the ‘formula’ approach may be used for determining the fair market value of intangible assets of a business only if there is no better basis

therefore available.” Despite the fact that even the originator of this revenue ruling says it should not be used, individuals use it and misuse it on a regular basis.

The description in the T&A report, item number three, of the capitalization of excess earnings method deviates from the calculation performed on Schedule IX on page TA 191. The write up discusses the fact that a return on the *adjusted book value* should be taken but the mathematical calculation included in the report is based on a return on *book value*. Mr. Jones was questioned about this computation at the *Sacks* trial. Mr. Jones was asked and answered the following (Trial Transcript, Page 91, line 7):

- Q. Tell the Court what net book value is.
- A. Net book value is the stockholders equity, if you will, of the company's balance sheet based on what amount of money is the asset value minus the liabilities.
- Q. And is the net book value equivalent to the stockholder equity?
- A. Yes.
- Q. And is that a commonly used number for determining excess earnings?
- A. Yes.
- Q. Is it generally accepted?
- A. Yeah, yes.

In this instance, T&A violates proper valuation practice. Mr. Jones testified that using *book value* as part of the excess earnings calculation is generally accepted. This is an incorrect statement. The use of *adjusted book value* is generally accepted.

Step 2 in PPC's *Guide to Business Valuations* states “Determine the value of the company's net tangible assets.” This publication then continues “the model for the excess

earnings method computes the company's equity value based on the 'appraised' value of tangible assets, plus an additional amount for intangible assets."

At Mr. Jones' deposition on January 24, 2005, he was asked about this method being applicable to only small businesses and professional practices. He responded by stating that it is also applicable to larger businesses. According to *Guide to Business Valuations*, in section 720.26, entitled *Limitation of the Method*,

The excess earnings method is often criticized because it applies primarily to smaller businesses. It generally is not suited to larger or more complex businesses because of its mechanical nature.

Once again, T&A demonstrates its lack of professional competence by not being aware of the valuation literature.

TA 171

In a very short section entitled *Conclusion on Valuation Factors Discussed*, T&A tells the reader that it placed more emphasis on certain methods than others. However, there is no justification as to why this was done. The T&A workpapers are also nonexistent in that regard. This is problematic for the reader, particularly since the various methodologies reflected in the T&A report resulted in such a wide disparity of values.

The next paragraph discusses the *Marketability Discount*. Once again, T&A relies on management for representations that there were discussions with other entities that were interested in acquiring an interest in ABC. However, there is no analysis included in the report or in the T&A workpapers. When questioned about this in his deposition, Mr. Jones indicated that there were two offers, one before the valuation date and one after the valuation date. Since fair market value is suppose to be based on what is known or knowable as of the valuation date, using subsequent information in the consideration of the fair market value of ABC is incorrect. There also would need to be due diligence

performed regarding such offers if they were to be used, rather than merely relying on management's representations. T&A also states that "...because of the 'put option' on stock held by an ESOP, the lack of marketability appears to be substantially mitigated." The problem with this statement is that as of November 30, 1993, there was no ESOP. This means that at the valuation date, there was no ESOP and therefore, there was no put option.

Even if T&A wanted to consider the put option, an employee census should have been reviewed to determine any potential repurchase liability on behalf of the company. T&A's workpapers did not include any such census, or any other analysis relating to the marketability of these shares. While no marketability discount has been considered in the valuation calculations, there is inadequate support for this position. Using letters of intent which Mr. Jones did not see, and considering only a unilateral offer that was rejected, either by ABC or by the possible acquirer, would make poor justification to support the marketability of ABC.

The last section on this page discusses *Previous ABC Stock Transactions*. T&A indicates:

Management has indicated that there has not been any recent transaction involving the Corporation's stock. The most recent transaction was in 1991 when the Corporation redeemed a less than five percent shareholder no longer employed by the Corporation.

Since 1991 was only two years prior to the valuation date, this may have been relevant to at least test the value of ABC. Ignoring a stock transaction involving the company's own stock violates the seventh factor that Revenue Ruling 59-60 suggests be considered. Revenue Ruling 59-60 discusses this as follows:

Sales of stock of a closely held corporation should be carefully investigated to determine whether they represent transactions at arm's length. Forced or distress sales do not ordinarily reflect fair market value nor do isolated sales in small amounts necessarily control as the measure of value. This is especially true in the valuation of a controlling interest in a corporation.

Since, in the case of closely held stocks, no prevailing market prices are available, there is no basis for making an adjustment for blockage. It follows, therefore, that such stocks should be valued upon a consideration of all the evidence affecting the fair market value. The size of the block of stock itself is a relevant factor to be considered. Although it is true that a minority interest in an unlisted corporation's stock is more difficult to sell than a similar block of listed stock, it is equally true that control of a corporation, either actual or in effect, representing as it does an added element of value, may justify a higher value for a specific block of stock.

Since the nature of a closely held business is that there are generally very few transactions in the company's own stock, using the assistance of internal transactions, particularly close enough to the valuation date, would be extremely helpful in testing a valuation conclusion. Recognizing that a minority interest value may not be reflective of a controlling interest value, it can nevertheless be used to test the reasonableness of the appraiser's conclusion. There is no analysis included in the T&A workpapers, but this transaction is outright dismissed as not being useful. To take this one step further, upon review of the T&A workpapers, we did not see any agreements regarding the buyout of this shareholder. This would be a normal document requested in the valuation process.

TA 176

Beginning at this stage of the T&A report are schedules that were printed from the ValuSource computer program. T&A attached every schedule that the computer program was capable of generating, whether or not applicable to the valuation of ABC. Some schedules had computational errors, but since T&A failed to review the calculations for reasonableness, and since T&A was unfamiliar with the workings of the software, these schedules were also included in the report. The erroneous calculations also were included in T&A's final indication of value. We will point these out when we get to the appropriate schedules.

When Mr. Jones was asked in his deposition about his workpapers and whether there is a narrative explaining his analysis and conclusions, based on all of the schedules that were produced as part of the report, he stated (January 25, 2005 page 8, line 14):

- A. I don't recall a narrative including -- or included in our work papers; however, there are various calculations within our work papers.

Despite this statement, no workpapers were produced that include any analysis that is covered by a narrative in the report.

TA 177

This schedule includes the historic balance sheet comparison that is merely input into the computer software from the company's financial statements. There is no discussion in the T&A report about the schedule. There are no T&A workpapers that reflect an analysis of this schedule. Revenue Ruling 59-60 states the following:

Balance sheets should be obtained, preferably in the form of comparative annual statements for two or more years immediately preceding the date of appraisal, together with a balance sheet at the end of the month preceding that date, if corporate accounting will permit. Any balance sheet descriptions that are not self-explanatory, and balance sheet items comprehending diverse assets or liabilities, should be clarified in essential detail by supporting supplemental schedules. These statements usually will disclose to the appraiser (1) liquid position (ratio of current assets to current liabilities); (2) gross and net book value of principal classes of fixed assets; (3) working capital; (4) long-term indebtedness; (5) capital structure; and (6) net worth. Consideration also should be given to any assets not essential to the operation of the business, such as investments in securities, real estate, etc. In general, such nonoperating assets will command a lower rate of return than do the operating assets, although in exceptional cases the reverse may be true. In computing the book value per share of stock, assets of the investment type should be revalued on the basis of their market price and the book value adjusted accordingly. Comparison of the company's balance sheets over several years may reveal, among other facts, such developments as the acquisition of additional production facilities or subsidiary companies, improvement in financial position, and details as to

recapitalization and other changes in the capital structure of the corporation. If the corporation has more than one class of stock outstanding, the charter or certificate of incorporation should be examined to ascertain the explicit rights and privileges of the various stock issues including: (1) voting powers, (2) preference as to dividends, and (3) preference as to assets in the event of liquidation.

Despite the clear discussion in Revenue Ruling 59-60, T&A failed to analyze this balance sheet. Mr. Jones was asked in his deposition what the reason was that cash, reflected in the December 1991 financial statements as \$961,000, was considerably higher than any other year in the five years presented. Without proper workpapers, he could only respond as follows (January 25, 2005, Page 9, line 3):

A. I don't recall a specific reason for that.

When being pressed as to whether or not any analysis was done to determine why cash was so high in this period, the questions and answers were as follows (January 25, Page 9, line 19):

A. Well, we obviously looked at the trends and the relationships between the assets. Also, the -- the current liabilities went up a significant amount during that same period of time, effectively a borrowing.

Q. That wasn't my question. My question is, did you determine why cash was so high in December 1991, and if so, is there an analysis of that in your work papers?

A. There would not be a specific analysis for that individual line item in our work paper.

What became obvious in our review of the T&A workpapers is the fact that little-to-no analysis was done by T&A in performing this valuation. This was little more than an exercise of inputting numbers into a computer system that they were unfamiliar with, and seeing what the result was that came out. It appears that they then massaged the

weightings of different methodologies, even if inappropriate to do so, to derive a value that had already been determined through the scenarios that were performed prior to being hired to perform the valuation assignment.

Regarding the same schedule, Mr. Jones was asked why accounts payable-trade increased so substantially over the other years. His response was (January 25, Page 12, line 13):

- A. Again, I – that number came from their audited financial statements that we used to input – we didn't enquire specifically about that one account.

One of the reasons why appraisers create a comparative spreadsheet with multiple years is to examine the trends that took place. This allows the appraiser to question management about items that may be considered to be inconsistent or an aberration. T&A blindly accepted the financial statements without performing any analysis. This schedule also lists non-operating assets, but, once again, there is no documentation in the T&A workpapers for this item. Mr. Jones stated (January 25, Page 15, line 11):

- A. Not a specific workpaper, again. Just based on the information they had provided from their financial statements, that's what we were told it was. It was property held for expansion.

TA 178

Schedule III is a Summary Historic Income Statement Comparison that contains mislabeled columns. The dates in the first two columns indicate December 1989 and December 1990, when the time periods actually reflected February 1989 and 1990. There is no footnote or discussion that allows the reader to know that ABC changed its fiscal year from February to December, and as a result, there is a gap in the five year period covered by these financial statements.

TA 179

This is continuation of Schedule III reflecting the Adjusted Summary Income Statement Comparison. As discussed previously, T&A made adjustments to officers' compensation. This schedule reflects the adjusted level of compensation. There is no justification for the adjustment to officers' salaries and there are no workpapers to support any such level of compensation. Furthermore, there is no analysis in the report, or in the workpapers, that explains the fact that the adjusted net income increases from \$442,000 to almost \$4.8 million over this five year period. There is no discussion about the trend in earnings or what the impact would be of this type of growth on the net income of ABC. What appears to be extremely unusual, and yet it is not discussed in the report or the workpapers, is the fact that from 1992 to 1993, revenues are approximately \$350,000 different, and yet the profitability almost doubled. Operating expenses dropped from \$7,892,000 to \$5,683,000 without any discussion as to what caused these expenses to drop so significantly. There is clearly a lack of analysis regarding this schedule.

TA 180

This schedule reflects the adjustments made to the historical financial figures to arrive at the adjusted net income. In this instance, officers' salaries were adjusted anywhere from \$519,000 to almost \$3 million for a single year. When asked about his expertise as a compensation specialist, Mr. Jones, admitted in his deposition that he was not an employment expert nor a vocational expert (January 25, Page 25, lines 14 and 16). Mr. Jones was questioned about the level of compensation that was estimated in light of the extraordinary level of profitability of ABC (January 25, Page 26, line 17):

- Q. Okay. My only question is it looks like the officers are doing a good job by increasing adjusted net income, but you don't increase any officers salary, do you?
- A. We didn't, because, again, it was assuming what you would pay the unrelated – an unrelated individual to come in and do their job.

This does not reflect what happens in the real world. When officers are doing an extraordinary job, there is generally a bonus that is tied to some level of profitability. To expect the officers to work for \$600,000 when they are generating \$4.8 million of net income, more than double that of the year before, does not make sense.

It should also be noted that T&A uses a marginal tax rate 34 percent to adjust the expense adjustments made in this schedule. Elsewhere in the report, T&A uses different tax rates. This is one more inconsistency in the T&A report.

There are no workpapers for the non-operating asset. There are also no workpapers to discuss any expenses or income that relate to the non-operating asset. The non-operating asset was eventually described as real estate, which indicates, at a minimum, that there must be real estate taxes and some costs associated with holding the property. If non-operating assets are removed from the balance sheet, non-operating expenses should be removed from the income statement. This would not be a necessary expense in the normal course of operations by its very definition. However, T&A ignored this item.

TA 182

Schedule IV is an Historic Simple Cash Flow Comparison, comparing the owners' discretionary cash flow over the five years input into the computer system. Once again, there is no narrative or workpaper analysis that indicates why T&A used this information. By using owners' discretionary cash flow, a knowledgeable reader of this report would assume that ABC is a very small *mom and pop* type of company. However, Mr. Jones indicates (January 25, Page 32, line 4) "I've seen it used -- cash flow analysis used for small as well as large businesses." T&A may have used this level of income in the past, but owner's discretionary cash flow is used for the *mom and pop* business. Also known as sellers' discretionary cash flow, the *PPC Guide to Business Valuations* describes this method as follows:

215.22 Sellers' Discretionary Cash Flow. This method can be a good way to value a small, owner-managed business, such as a single-store ice cream shop. The method assumes that a buyer would be purchasing both a business and a job. Sellers' discretionary cash flow is defined as the company's pretax earnings plus owners' compensation and benefits, interest expense, and noncash expenses, less the amount of any expected capital expenditures. To determine the company's value, the consultant would multiply sellers' discretionary cash flow by a value multiple derived from sales in the market. The value indicated by this method generally represents the value of the business to a prospective owner/manager. This method is discussed in Section 725.

Despite Mr. Jones' representation that he has seen this method used for large businesses, it is clear that the authors of the *Guide to Business Valuations* think otherwise. In fact, the *Guide to Business Valuations* is consistent with other publications in the field. This is one more instance where a clear lack of professional competence becomes obvious.

Another error in this schedule is the fact that the owner's salary addback in this method assumes a single owner. For ABC, there were three officers. Therefore, the amount added back is an incorrect amount. Because the computer software program assumes that this would only be used in an appropriate situation, it adds back 100 percent of the compensation assuming that there would only be a single owner. Once again, T&A did not know how to use the software to produce a credible calculation.

TA 183

This schedule is an Historic Statement of Cash Flows. There is no analysis in the report nor in the workpapers. It is a schedule that is merely put into the report. There is no discussion as to why net operating cash flow was so inconsistent increasing from \$355,000 in 1990 to \$932,000 in 1991 and then dropping again to \$364,000, before rising to \$609,000. This type of inconsistency reflects risk relating to the cash flows, and yet there is no mention anywhere in the T&A report or in its workpapers about the risk associated with this result.

TA 184

Schedule V contains a very limited ratio analysis, with more zero's on this page than any other numbers. There is no industry data, as no comparison was made to any industry information. One of the reasons for a ratio analysis is not only to look at the trends of the subject company, but also to be able to compare the subject company to its industry peer group. This is one manner in which to determine whether or not the subject company is better or worse than its peer group. It assists the appraiser in supporting subjective judgments involving discount rates, capitalization rates and multiples.

There is no analysis in the T&A report or in the workpapers discussing or analyzing the fact that the current ratio (defined as the current assets divided by the current liabilities) is well below 1.0. This might indicate that ABC could have a difficult time meeting its current financial obligations as they become due. Once again, this is a risk element that is not discussed at all, but merely appears on a schedule that is included in the valuation. By including this type of schedule in the report, as well as many of the other schedules, T&A effectively has provided a report to potential users of this report, whether it be management, trustees or the prison guards that become part of the ESOP, and T&A effectively is requiring the reader to figure out why this information is in the report, as well as what its relevance is. Nowhere in the report does this schedule tie back to any of the decisions that are made throughout the valuation process. Furthermore, it would have been easier to read if all of the lines with all zeros on them were eliminated. Since the computer generated this information, it was included because it was there.

TA 185

This is a Common Size Income Statement Comparison, indicating trends for use in comparing ABC to the industry. However, there is no industry data included on this schedule. There are numerous lines that have zeros on them because the software generated them. There is no discussion in the report, nor do the workpapers show why net

income is so volatile, reflecting a low of 0.57 percent to a high of 20.67 percent. The discussion of this schedule is nonexistent in the report and there is no mention of the relevance of this schedule.

A simple review of this schedule should have caused T&A to question certain line items that were in the financial statements. For example, relating back to the question discussed earlier about excess cash in 1991, the common size balance sheet comparison indicates that cash and equivalents were 6.30 percent of total assets in 1991, while in all of the other years it was roughly 3 percent or less. Had T&A reviewed the information that its computer program generated, T&A would have realized that it should have asked more appropriate questions of management. Instead, T&A tries to hide behind management as if they would understand all of these schedules.

TA 186

This schedule is part of Schedule V, entitled Historic Adjusted Income Account Growth. It shows the year-to-year percentage change in the income statement line items. The first line indicates total revenue changing by 75.56 percent growth in 1990 followed by three significantly declining years. By the most recent date, the growth in revenue is only 2.64 percent, a rate much lower than what is used in the forecast of future operations of ABC. Since there is no discussion of this trend in the report or in the workpapers, nor is there a discussion comparing this trend in growth rates to the forecast that was performed, a reader cannot possibly come to a determination as to the reasonableness of the information presented in this report. Other line items have also changed significantly in this report. With no discussion or use of this data, this becomes an irrelevant schedule. However, it should have been a very relevant schedule in performing the analysis of ABC.

TA 187

Schedule VI is a schedule that would relate to a preferred stock valuation. ABC had no preferred shares, and therefore, there are zero's on this schedule. T&A included this irrelevant schedule because the software program generated it. It is irrelevant to the ABC valuation and should not have been included in the report.

TA 188

This part of Schedule VI relates to the determination of discount and capitalization rates, a very important schedule that relates to the various income approach calculations included in the T&A report. There is no discussion about these figures, and there is no documentation included in the T&A workpapers that supports any of the figures used. In fact, many of these figures are generated by the computer software. Mr. Jones could not explain how these figures were derived. Using the information that is most commonly used in the industry to determine a discount rate, we performed a review of information in the public domain. The 20-year Treasury Bond rate on November 26, 1993, the date most recently available prior to the valuation date, was 6.47 percent, and not 6 percent as reflected in the T&A report. To this figure, an equity risk premium is added, most commonly obtained from Ibbotson Associates' *Stocks, Bonds, Bills and Inflation Annual Yearbook*. In this instance, the 1993 yearbook would have been available at the valuation date. The equity risk premium reflected in this publication is 7.3 percent, the difference between the total returns on common stocks (12.4 percent) and the income returns on long-term government bonds (5.1 percent).

The next item that should be included in the build-up is a small company stock premium, which, once again, would be obtained from *Stocks, Bonds, Bills and Inflation*. In this instance, this would have been 5.2 percent, the difference between small company stocks (17.6 percent) and large company stocks (12.4 percent). Next, a specific company risk premium would be considered, which could be positive or negative, depending on all of the

analysis performed relating to the appraisal subject. Clearly ABC was much smaller than even the small companies in the public market, it had less depth in management, its net income was somewhat volatile on a common size basis, and its cash flow was somewhat erratic. Management's forecast was also pretty aggressive. Given all of these factors, it appears that some level of risk should have been assessed. This means that the minimum discount rate would have been calculated as follows:

Treasury Rate	6.47%
Equity Risk Premium	7.30%
Small Company Risk Premium	5.20%
Specific Company Risk Premium	<u> ?</u>
Discount Rate	<u> 18.97%</u>

If one were to assume that the specific company risk premium would fall in a 3 to 5 percent range, the discount rate determined would have been approximately 22 to 24 percent, which would also been applicable to *net cash flow*. The computer program incorrectly calculated a discount rate on *future earnings* when the discount rate is actually related to *cash flow*. In order to apply a discount rate to earnings instead of cash flow, an adjustment is generally necessary to reflect a differential between net cash flow and net earnings of the company. Typically a 3 to 6 percent spread between these discount rates is seen in practice. The authors of the *Guide to Business Valuations* indicate "...many experienced practitioners feel that this difference most typically ranges from 3% to 6%." What they also indicate is that judgment is necessary to determine the correct increment. They state that "The higher the expected growth rate of the company, the higher the increment." This is because higher growth lowers the payout ratio (more cash must be retained in the company to support the growth).

Schedule VI of the T&A report indicates that expected growth is approximately 9 percent. With this type of growth rate, you would expect at least the upper range, or 6 percent, to be the differential in the discount rate to be applied to earnings. Therefore, adding 6 percent to the range would indicate a discount rate in the 28 to 30 percent range, rather than the 20 percent reflected in the T&A report. While we are not opining on what the correct discount rate should have been in the ABC valuation, the documentation suggests that the 20 percent rate used by T&A is wrong. The higher rate would reduce the value estimates by approximately one third. Once again, because of the lack of documentation by T&A, it is impossible to know how T&A supports the rates that were included in this schedule.

The growth rate used by T&A of 9 percent is also problematic. The difference between a discount rate and a capitalization rate is long term sustainable growth. Most finance text books indicate that a company can hardly grow into perpetuity, beyond the rate of inflation and population growth. More often than not, this rate is in the 3 to 5 percent range. Valuation theory discusses that the reason an appraiser will use a discounting model versus a capitalization model will depend upon the stability of the income stream that is being discounted or capitalized. The theory that appears in valuation treatises is that one uses a discounting model when growth is uncertain, or less stable, and a capitalization model when the future income stream will be somewhat predictable and at a stable level.

Using both models in the same report is somewhat contradictory because the same income stream cannot be stable and unstable at the same time. Despite this, T&A used both models. The problem with using a 9 percent growth rate in the capitalization model is that this would indicate that ABC is expected to grow at such an extraordinary pace, that the company would outpace the Gross National Product of the world. This also means that ABC would be growing faster than the prison population. This does not make sense. The use of this growth rate is one more instance where T&A demonstrates its lack of professional competence.

T&A also added a 5 percent excess earnings premium into the computer system, which recognized that excess earnings, attributable to intangible assets, are more risky than the total earnings stream of the company. Since there is no discussion, analysis or workpapers to support this amount, it is difficult to determine why T&A chose 5 percent. A 5 percent excess earnings premium seems very low given the large amount of tangible assets owned by ABC. This figure is most likely incorrect.

Also included on this schedule is a 10 percent premium for management continuity. As previously discussed, there is no discussion in the narrative of the report, nor is there an analysis in the T&A workpapers, discussing management. Therefore, there is no justification for this figure. Based on the adjustment that T&A made to officers' compensation, it would seem that ABC could replace management pretty easily and inexpensively, which would reduce the risk rather than increase the risk relating to management.

Overall, none of the figures on this page are supported. There was no industry data in the common size financial statements, nor the financial ratio schedules that were reflected earlier in the report. Despite this, there is an industry return on equity at a median and high level of 10 percent and 15 percent, respectively, used in the report. If T&A could get this industry data, why couldn't it get other data? With that said, there is no support in the workpapers for these industry numbers. This could mean that either the computer generated them or they were made up by the appraiser.

Our recollection of how this computer program worked, was that the excess earnings premium in the software package was calculated by taking the differential between the median and high rates of return ($15\% - 10\% = 5\%$). The item on the schedule in the T&A report that is called *quantitative risk premium* of 4 percent, is the differential between the median industry return on equity and the long term Treasury Bond rate of 6 percent. These were calculated figures based on the unsupported inputs into the computer

program. Not understanding how the computer generated its figures is negligence on the part of T&A. They are responsible for the tools that they use.

At the bottom of this page, there is a blended rate of 8.1 percent, which represents a rate used for earnings before interest and taxes. There is also a return on net assets of 10 percent, which is generated from the industry return on equity. These computer generated figures are unsupported by T&A. When asked a series of questions about how T&A supports these various items, various answers in Mr. Jones' deposition were as follows:

- A. There is not a specific workpaper that addresses that rate (January 25, Page 50, line 17).
- A. Again, not on these specific workpapers. And that would have been developed through our reference material if you will, to look at various rates of returns for investors over a period of time. Again, various sources were cited -- not cited, but referred to for rates of return for hypothetical investors. (January 25, Page 50, line 23).
- A. There is not a separate workpaper in our file (January 25, Page 51, lines 10).
- A. No specific workpaper in there. (January 25, Page 51, line 17).
- A. There's not a specific reference to 10 percent in our workpapers (January 25, Page 52, line 12).

The same theme took place over and over again during Mr. Jones' deposition. T&A did not have any workpapers to support many of the figures that were included in the report. When questioned about these rates and when the report drafts were reviewed with ABC representatives, Mr. Jones indicated (January 25, Page 53, line 18):

- A. Well, there's not a specific formula. But again, based on our discussions and when we reviewed the reports, drafts of the reports with them and we went over the various factors that we considered in developing our -- our rates, we discussed with them -- "them" being the trustees, that -- that these were appropriate rates that they believe were achievable.

It is inconceivable to think that anyone, including the trustees, could have had enough knowledge of business valuation to determine the reasonableness of these rates in light of the unsupported information that was presented to them. In this instance, the trustees probably relied on the professionals who they were hiring, assumed that they understood what they were doing, and that rates in the 15 to 20 percent range seemed reasonable. Clearly, the rates are unsupported, undocumented and illogical when considering the appropriate components that should have gone into the development of the discount rate.

One other point relating to this schedule is the fact that T&A says that the business growth will be 15 percent, while the industry is growing at 6 percent. This means that ABC will grow at a rate approximately 250 percent greater than the industry. This would require ABC to take over many of its competitors. Mr. Jones had indicated that there were no comparables because these other companies were much larger than ABC. If that were the case, how could growth expectations be justified?

When asked in his deposition about whether the discount rate derived on TA 188 in Schedule VI applied to earnings or cash flow, Mr. Jones answered (January 25, Page 67, line 21):

- A. They would be applied to earnings, but in our analysis we assumed that earnings and cash flows were approximately the same so we applied it to both, I believe, in some of our analyses.

This response illustrates a lack of professional competence. Any experienced appraiser knows that in a growing company, cash flow will generally be less than earnings, primarily because of the amount of money needed to reinvest into the company to meet the growth expectations. In this instance, the T&A report reflects business growth of 15 percent, an extraordinarily impossible rate to achieve into perpetuity. Despite this, T&A indicates that cash flow and earnings would be the same. That is not possible. To make a broad assumption that the discount rate can be applied to both earnings and cash flow in a company that is growing in this fashion, is not only incorrect, but it demonstrates a total

lack of understanding of what these rates represent. T&A uses the same rates to apply to tangible assets, intangible assets, capitalization models and discounting models, all of which should be different rates of return because of the risk profile. Therefore, this too, violates proper appraisal practice.

TA 189

Schedule VII reflects the adjusted book value and liquidation value methods as applied in the T&A report. Once again, there is no discussion, other than the fact that the fixed assets were being increased by \$29,911,000 based on the appraised value. An adjustment was made to remove the intangibles from the balance sheet and yet there is no discussion in the report as to why this item was removed. Furthermore, there is no discussion about the non-operating assets that are reflected as part of this methodology.

Despite this schedule calculating what is purported to be liquidation value, the liquidation value is the exact same value as the adjusted book value. This is illogical. However, both of these methods were inappropriate for the ABC valuation, and even if appropriate, they were applied incorrectly.

The first problem with the adjusted book value method as presented, is the fact that there is no discussion that mentions that this method only includes the tangible assets and liabilities of ABC. Any intangible value that may exist pertaining to ABC is not reflected in this schedule. Therefore, the methodology does not capture the full value of ABC, assuming that it has intangible value. Reconciling a methodology, that is not inclusive of all components of value, to other methodologies that would be inclusive of the intangible value does not allow a proper comparison of values in determining a final conclusion. This is like comparing apples and oranges.

The liquidation value methodology, as applied by T&A, ignores costs of liquidation and the time value of liquidation, and the schedule omits any reduction in value of the assets

and/or liabilities for orderly liquidation. It assumes that 100 percent of the adjusted book value would be received upon liquidation of these assets. In practice, this does not happen for many of the asset categories. If it were to happen, it could potentially take an extraordinary amount of time to receive full value, in which case liquidity would suffer terribly and there would be a discount for lack of marketability.

Revenue Ruling 59-60 suggests that earnings be considered for an operating company as an investor would look to the earnings or cash flow of the business in order to measure its value. In Mr. Jones' deposition testimony, he acknowledged that the non-operating assets consisted of land held for investment. This item has been on the books for a number of years, and yet, there was no adjustment for the fair market value for this asset. We can only assume that over a number of years the value of this asset would have increased. There are no workpapers indicating that this asset was appraised or that T&A specifically asked any questions about the appraised value of this asset. Here also, sufficient relevant data was not obtained.

TA 190

Although Schedule VIII is labeled *Capitalization of Earnings*, it is actually a capitalization of owners' cash flow. We have previously commented about the use of owners' cash flow being inappropriate, so we will not repeat that discussion here. However, in deriving owners' cash flow, the schedule starts with the adjusted net income, which is derived from Schedule III (TA 170) and then adds the depreciation expense and subtracts owners' perquisites. However, the amount of owner perquisites is unexplained. Typically, owners' compensation and perquisites would be removed from the adjusted net income. The line that is labeled *Owners Perk's* contains different figures than officers' salary on Schedule III. Therefore, some additional adjustment has been made without explanation. Once again, there are no workpapers in the T&A file that would indicate what these numbers consist of. Therefore, not only does the reader not know why these numbers are being subtracted, it is impossible to recreate what they consist of.

The computer program also had a line to subtract dividends in deriving owners' cash flow, but there are zeros on that line. Mr. Jones testified that distributions were made in the past. Therefore, there should have been figures included on this schedule.

The next problem with this schedule is that the T&A report weighted the cash flow amounts by putting the most weight on the most recent period. Conceptually while this would not be a problem, it would only be correct if the result of the weighting represents the probable future earnings (or in this schedule, owners' cash flow) for the company. Reviewing the 1989 through 1993 cash flows reflect a substantial growth over this five year period. The owners' cash flows increase from \$1,087,000 to \$2,024,000, to \$3,725,000, to \$4,714,000 to \$6,250,000, in the most recent period. Yet, the T&A report uses a weighted average of these amounts to come up with a weighted average cash flow of \$4,428,000. Clearly, with the historical trend that is indicated in this report, and assuming the same 15 percent growth rate reflected in an earlier schedule, the likelihood of probable future earnings being \$4,428,000 would be highly doubtful. This weighted average would significantly understate the earnings stream that would be representative of the future for ABC. While we are not commenting as to whether or not the figures are correct, the result in Schedule VIII is inconsistent with the rest of the T&A report.

To compound the problem further, the weighted average earnings on this schedule is divided by a capitalization rate of 11 percent. While this capitalization rate is derived in Schedule VI (TA 188), it not only assumes a 9 percent long term perpetual growth of the company but the schedule indicates that it should be an historic earnings capitalization rate. This capitalization rate should not be applied to cash flow. Earnings and cash flow would have different capitalization rates applied for the reasons discussed previously. Here too, T&A violates proper appraisal practice and therefore, breaches its professional obligation to the client.

When asked in his deposition about the title of the schedule *Capitalization of Earnings* being an inaccurate heading for the methodology, Mr. Jones stated (January 25, Page 74, line 7):

A. Its incorrectly stated, yes.

When questioned in his deposition about using the historic results as a predictor of future operations, Mr. Jones responded as follows (January 25, Page 82, line 16):

Q. Do you expect that – the five-year history of ABC to be a good predictor of future operations of ABC?

A. I believe it was as good as the – is more indicative of what was likely to happen. It was an indicator of value, yes, but I think we weighted the pro – the discounted future cash flows more heavily than the historic method.

Q. Well, is it representatives of the future or not? I'm not sure I understand – you said, "I believe" – "I believe it was as good as the – is more indicative of what was likely to happen." I don't understand your answer. My questions I thought was pretty simple. Did you expect the five-year history of ABC to be a good predictor of future operations of ABC?

A. It was a predictor.

Clearly, even Mr. Jones refused to say that it would be a good predictor of the future operations. He merely said "It was a predictor." When questioned about the results and the trend in terms of earnings, Mr. Jones indicated the following (January 25, Page 83, line 19):

Q. Assuming that ABC is going to be able to take advantage of the growth that you've indicated in your report, i.e., 15 percent long-term business growth, do you believe that the earnings of ABC will go up, go down or remain flat?

- A. I believe they would go up.
- Q. Okay. Well, if that's the case, why have you used the weighted average forecast of 4,428 as a basis for capitalization when it is lower than the results from the last two historic time periods of 4,714 and 6,250?
- A. Well, again, we use a weighted average to encompass more years as opposed to looking at just one year because we believe that that was a more representative sample or analysis that a hypothetical willing buyer would review.

While we do not disagree with Mr. Jones that a hypothetical buyer would review historic periods for the same reason that the appraiser reviews them to determine trends, we totally disagree that weight should be placed on any prior year when it is not going to be representative of the future. In this particular instance, while the willing buyer may look at multiple years going backward, the willing seller who is a very important party to the hypothetical transaction looks at this trend and says to the buyer, "We are on a significant upward trend and our last year far out paces all of the earlier years." Therefore, the perspective willing seller would demand to be compensated for the results that the company has achieved. Using a weighted average of history demonstrates a lack of experience dealing with buyers and sellers in the real world. When boasting about the qualifications of T&A (TA 173), it states:

In addition to this technical training, we have substantial experience with respect to the buying and selling of businesses through years of working with our clients. This combination provides us with the combination of technical training and practical experiences dealing with 'willing buyers and sellers' and the ability to value businesses.

T&A has overstated its qualifications. Maybe the firm has worked with buyers and sellers, but they clearly do not have the requisite knowledge of the marketplace, if they are merely looking at a weighted average of history in a company that has significant growth opportunities. When asked why any weight was given to 1989 and 1990, Mr. Jones responded (January 25, Page 84, line 17):

A. Well, as part of your analysis, you have to review the – the past as well as the future. And as part of reviewing the past, we concluded that we should go back five years.

Q. What's the basis for that?

A. Just normal procedures in doing a business valuation.

The fact of the matter is that T&A's lack of understanding of the business valuation process confuses the period to review for analysis purposes and the period that ultimately ends up being chosen in performing the valuation calculations.

TA 191

Schedule IX is entitled *Capitalization of Excess Earnings*. We have previously addressed the fact that this methodology is frowned upon by the promulgator of Revenue Ruling 68-609. Not only was this an inappropriate method to use in this valuation, but it was applied incorrectly. In this schedule, T&A begins with a pretax adjusted net income. There is no rational basis as to why a pretax level of earnings was used rather than the after tax adjusted net income, which is more appropriately used in the profession. According to the *Guide to Business Valuations* "because of its relative ease of application and conceptual basis, the excess earnings method is commonly used in valuing small business. It can also be used to value professional practices." In describing the steps in applying the method, the very first step indicates

720.03 The excess earnings method typically consists of the following basic steps:

Obtain the company's financial statements. Apply necessary GAAP and normalization adjustments (including adjustments for non-operating assets) as discussed in section 420. Recompute federal and state income taxes, if necessary, based on normalized pretax earnings.

Had T&A followed the book in its library, it would have realized that one of the steps in calculating excess earnings is to "recompute federal and state income taxes..." If pretax

income streams are going to be used, an adjustment would be necessary to convert the capitalization rates used to pretax capitalization rates. This was not done by T&A since the computer software did not have the capability of making this adjustment. Therefore, using pretax income as a starting point was incorrect, but T&A also used an after tax capitalization rate with a pretax earnings figure.

There is also a question as to whether the capitalization rate used is a cash flow capitalization rate or an earnings capitalization rate since the computer system used a very unorthodox methodology that was undocumented and did not comply with most appraisal theory.

The next problem with this schedule was the fact that a return was taken on book value rather than adjusted book value. There is no support in the appraisal literature for taking an adjustment on book value. When asked whether book value was the appropriate measure of the return on tangible assets to be used in the method, Mr. Jones responded (January 25, Page 92, line 8):

- A. Well, I think there's -- there's many variations -- or variations of how to apply this method, and until -- utilization of the book value method is a common variation of that.

When he was asked for his authority for that statement, he indicated (January 25, Page 92, line 14):

- A. Don't have a specific one.

A weighted average of the excess earnings was used to calculate the value under this methodology, as was used previously. In this methodology, excess earnings had a significantly increasing trend from \$653,000 to \$5,382,000. The weighted average excess earnings of \$3,289,000 was inappropriate based on the trend of this business. When questioned about whether the average excess earnings of \$3,289,000 was representative

of the future excess earnings for ABC, Mr. Jones responded (January 25, Page 96, line 11):

- A. Again, it is an indication. Based on this calculation, take into account these five years that we considered into our analysis.

Once again, Mr. Jones indicates that this is an indication, but he cannot indicate that is a good indication for the future excess earnings. Revenue Ruling 68-609 clearly states that “The past earnings to which the formula is applied should fairly reflect the probable future earnings.” When questioned about whether or not the calculation in this schedule is inconsistent with Revenue Ruling 68-609, Mr. Jones testified in his deposition as follows (January 25, Page 100, line 15):

- A. I would say no, because that is one method to try to project the probable future earnings, and that’s methodology to use to calculate that.

When further questioned about this point, Mr. Jones indicated (January 25, Page 101, line 1):

- A. I’m testifying that past earnings in this calculations are used to --in the analysis to hopefully predict a probable future earnings.
- Q. Well, it can be more than that. It should fairly reflect their probable future earnings according to Revenue Ruling 68-609, correct?
- A. That’s correct.

When questioned about whether the 16 percent capitalization rate is a pretax or after tax capitalization rate, Mr. Jones responded (January 25, Page 102, line 14):

- A. That would be based on a pre-tax income stream, pre-tax.

When asked what makes it a pretax capitalization rate, his response was (January 25, Page 102, line 18):

- A. Well, its based on the – well, were applying it to a pre-tax income stream. And in developing our – our rates that we have used on page 188, those are considered pre-tax rates.

Mr. Jones' response indicates that he does not understand what makes a capitalization rate pretax or after tax; it is the source used to derive these rates and not what they get applied to. A common error in business valuation, one that T&A has made over and over in this report, is to apply a capitalization or discount rate to an inappropriate stream of income. In this instance, since T&A has no workpapers to support how the rates were derived, Mr. Jones cannot possibly understand whether they were pretax or after tax rates. In his deposition testimony, when asked about these rates, he referred to publications such as Ibbotson that were in his library, that he most likely would have gone to. However, our review of the Ibbotson rates was discussed previously. Not only were the rates different, but the appraisal literature is very clear that the Ibbotson rates are after tax net cash flow rates and not pretax rates. Therefore, if Mr. Jones' testimony was accurate regarding his use of Ibbotson's publication, then his answer is incorrect regarding whether his 16 percent capitalization rate is pretax or after tax.

TA 192

Schedule X is the Comparable Business Sale Database Methodology. This is another relatively blank schedule that was included in the valuation report. However, there are selected multiples for the P/E ratio, the percent of sales multiple and the multiple of book. There is no narrative that discusses these multiples or where they came from, and no workpapers that support these numbers. Based on the fact that Mr. Jones testified that he relied on two offers to purchase ABC, he should have been aware that there may have been other transactions in the market place that could be used in the application of this methodology. This would have required a significant amount of research, which based on

T&A's workpapers and Mr. Jones' testimony was not done. Putting this schedule in the report is one more instance where it demonstrates that the computer software was deriving this valuation, including the report presentation, and not the appraiser.

Schedule X is continued on the next several pages in the report, with page TA 193 being all zeros, but TA 194 reaches a conclusion under a price to earnings methodology. There is no discussion in the report that this method is being used and without having comparative data, the use of the arbitrary price to earnings ratio reflecting an entity value is not only inappropriate, but negligent. The same applies to pages TA 195 and 196, as the arbitrary multiples are carried forward in reflecting total entity values for ABC under these methodologies.

To put one more issue into perspective, the price to earnings ratio used in Schedule X is 5.00. There is a mathematical relationship between the price to earnings ratio and a capitalization rate as applied to earnings. They are the mathematical inverse of each other. When asked about this relationship in his deposition, Mr. Jones was specifically asked if there is relationship between these two items, and his response was (January 25, Page 109, line 18):

A. Not directly.

This is absolutely an incorrect answer and demonstrates a lack of professional competence.

The calculation on TA 196 contains another error caused by the computer software. The non-operating assets were included in the book value that was multiplied by 1.25 and added back a second time as a non-operating asset. The correct calculation would have been to remove the non-operating asset from the book value before applying the multiple. This would have avoided more than double counting the non-operating asset. When questioned about TA 196, his response was (January 25, Page 116, line 5):

- A. That would be included in both of those numbers, and it would have been -- counted. However, we didn't utilized that method.

Once again, this schedule was included in the report that was being used to assist the trustees in making a decision as to whether or not to go ahead with a transaction, but also would ultimately be available for inspection by all of the ESOP participants without finance or accounting degrees, who would have to interpret this information for themselves.

There is no way that a reader of this report could have known, without having the technical knowledge of business valuation, that there was an error included in this calculation. Merely suggesting that the result was not used, although presented in the report, demonstrates a total disregard for the reader of the report. Due professional care was not exercised in this instance. When finally questioned about reviewing the information, Mr. Jones responded (January 25, Page 116, line 13):

- A. Well, it should -- it was not caught. Obviously if we -- had caught it, we would have changed that.

TA 197

Schedule XI is a Proforma Income Statement Adjustments schedule. This schedule includes a \$1,000 adjustment to revenue. When Mr. Jones was questioned about this adjustment, since there was a lack of workpapers, he could only respond (January 25, Page 118, line 20):

- A. It was either inputted or brought forward from some other place, but I'm not exactly sure how that number one got in there.

When questioned about this schedule Mr. Jones acknowledged that it was for information only and that the schedule wasn't used. Without a narrative in the report, how would anyone know this? Furthermore, this is one more irrelevant schedule that was included in the valuation report. Even Mr. Jones acknowledged (January 25, Page 120, line 21):

A. It would be worthless, I guess.

TA 198

Schedule XII reflects Income Statement Forecasting and reflects the proforma income statement from the previous schedule, with several percentages reflecting the growth rate of sales, operating expenses as a percent of sales, officers' salaries as a percent of sales and a marginal tax rate. When questioned about the 62.34 percent annual growth rate for revenue, Mr. Jones testified (January 25, Page 121, line 24):

A. I don't recall reviewing that specific calculation.

Without workpapers, there is no documentation to show that anything was explained or reviewed in this valuation. When asked whether there was anything in the workpapers that would support the growth rate, Mr. Jones responded (January 25, Page 122, line 4):

A. Not in our -- not in any workpapers other than the report itself.

When Mr. Jones was asked if the recent year's workpapers are intended to reconstruct where numbers came from, his response was (January 25, Page 124, line 2):

A. And to document the information that you deem appropriate that -- that you would have a separate workpaper for.

Clearly there are no workpapers to support the calculations that are included in the T&A report. Furthermore, based on Mr. Jones' testimony, T&A must have deemed it inappropriate to need workpapers to document anything that went into its valuation report, as their workpapers are almost non-existent. This is a clear violation of sufficient relevant data.

One other item that's worth noting is that the marginal tax rate in this forecast is 17.32 percent. However, elsewhere in the report, 34 percent is used. This is an inconsistent application of tax rates leading to inconsistent results throughout the report.

TA 199

Page TA 199 reflects additional variables used in the projection in Schedule XII. In actuality, these figures were not used, but they were computer generated as a result of the manual inputs in a different schedule. Therefore, although Mr. Jones indicates in his deposition that this was for informational purposes, it is once again an irrelevant schedule in the report.

TA 200

Schedule XIII is a Fixed Asset Budget to be used in the projection. It shows that the adjusted book value is greater than \$50 million, but there are zero fixed asset purchases being projected. This defies logic. As a Certified Public Accountant, Mr. Jones should have known that a company of this type could not grow without either building additional prison facilities or replacing existing assets, at some point in the future. The explanation given in his deposition testimony was (January 25, Page 139, line 16):

- A. No, because again, on pages -- or schedules contained in the back from pages 203, 204, there are other -- there's other information again that was given to us by Mr. Harbin and management to assume in preparing these calculations for the projections of the company. And they projected whatever fixed asset additions that they were going to have. I do not also they were telling us that the states would be providing the new facilities and they would not necessarily have to reinvest any significant amounts into the prisons themselves.

Mr. Jones' explanation defies logic and proper practice. T&A blindly accepted a projection without ever questioning the fact that the information being provided is lacking a significant

piece of information. ABC is in the private prison business and what apparently gave them broad appeal is that it had facilities that were used by the states, without the states having to fund the building of the facility. As a Certified Public Accountant, it is negligent to accept a client's representation when it should be known that it is contrary to fact. Furthermore, there is no discussion in the report nor is there a discussion in the workpapers that supports the "so called" representation that the states would be providing the facilities. Here also, sufficient relevant data is lacking to support Mr. Jones' position.

When questioned about any due diligence that may have been performed by checking with third parties about the reasonableness of these assumptions, Mr. Jones responded (January 25, Page 144, line 21):

- A. We didn't contact any of the other states -- or any of the states as far as that matter, to confirm -- don't believe we were required to confirm what there pending engagements were with the various states.

However, a simple review of pending contracts would have determined whether or not the states were going to provide fixed assets. There would not have been a reason to directly contact the states, but certainly documentation could have been reviewed to corroborate any representations. Furthermore, there was no separate analysis performed that would corroborate whether or not these projections could be reasonably achieved (January 25, Page 147, line 16).

TA 201

Schedule XIV is a financial statement projection for the income statement and operating cash flow for ABC. This schedule extends to TA 202, as it is a 10-year projection covering the period 1994 through 2002. The headings on these schedules are actually in error, as fiscal year ended (FYE) 8 and 9 are both labeled December 2001. The first one should be 2001 and the second should be 2002, resulting in the final year being 2003. Once again, the computer system generated incorrect dates and T&A did not proof these schedules.

The valuation report contains no analysis of this projection and no list of assumptions that went into the projection. A reader of this valuation report would have no basis for understanding how the company was going to grow from \$13.7 million in revenues to \$69.5 million in revenues over this period of time. The operating cash flow was forecasted to grow from \$4.6 million to \$16.5 million, with a reduction in the final year to \$13.6 million, once again, with no explanation at all.

This schedule shows no purchase of fixed assets, no dividends and no change in long term debt. The interest expense is zero. All of these items indicate that this analysis was performed on a debt free basis. This means that the valuation of both debt and equity would be derived in discounting these figures to present value. When questioned whether or not this was a debt free methodology, Mr. Jones in his deposition responded (January 25, Page 157, line 10):

- A. – under that analysis, yes it would be considered to be debt free because they are – in order for them to get the 66 percent ownership that was being purposed, they would have sell – the company would have sell some outstanding shares that weren't previously outstanding.

When questioned whether he kept the company debt free for the next 10 years, he indicated (January 25, Page 157, line 19):

- A. That's correct.

The schedule is labeled as being a financial statement projection. Normally, a financial forecast is used in a valuation rather than a projection. Although this may seem like semantics, there is a clear distinction between a projection and a forecast in the accounting literature. According to the *Guide to Business Valuations*, step one in the discounted future returns approach, "is to obtain or prepare a *financial forecast*." (Emphasis added). The distinction between a forecast and projection is explained as follows:

Step 1 - Obtain (or Prepare) a Financial Forecast

525.04 What is a Financial Forecast? The AICPA Statement on Standards for Accountants' Services on Prospective Financial Information titled *Financial Forecast and Projections* defines a financial forecast as follows:

Financial Forecast. Prospective financial statements that present, to the best of the responsible party's knowledge and belief, an entity's expected financial position, results of operations, and changes in financial position. A financial forecast is based on the responsible party's assumptions reflecting conditions it expects to exist and the course of action it expects to take.

A forecast should therefore represent what the responsible party (preferably the management of the company being valued) expects to occur in the future based on the company's existing business plan.

525.05 How Does a Forecast Differ from a Projection? The terms, forecast and projection, are often used interchangeably, but they are defined differently by the American Institute of Certified Public Accountants (AICPA). A financial forecast is based on actual conditions that are expected to exist during the forecast period. This differs from a projection which, by definition of the AICPA, is based on expected conditions given one or more hypothetical assumptions. For example, a company might prepare a projection based on the hypothetical assumption that a new production plant will be built. That projection might then be used by management to help decide whether a new plant should indeed be built. Another way to differentiate a projection from a forecast is that a projection normally tries to answer a "what if" question. For example, what would future operations look like of the company took a particular action or changed specific conditions? A forecast, on the other hand, presents a company's future operations based on the actual plans of the company's management as of a given point in time (such as the valuation date).

Clearly, as Certified Public Accountants, T&A should be following the *AICPA Statement on Standards for Accountants' Services on Prospective Financial Information*. Therefore, T&A should have been aware of the difference between a forecast and a projection. As a valuation professional, a forecast should be used if we are valuing a company as of a specific date, other than if the valuation is intended to be hypothetical. The *Guide to*

Business Valuations indicates “A forecast, on the other hand, presents a company’s future operations based on the actual plans of the company’s management as of a given point in time (such as the valuation date).” The fact that T&A included assumptions that relate to the new ESOP in the projections, the valuation is an hypothetical valuation. These projections would have been fine if the assignment was to determine what ABC would be valued at if it had the ESOP in place. However, that was not the assignment. It was to value ABC to meet the adequate consideration standard of the DOL Regulations. The T&A report is invalid by using these projections. T&A should have used a financial forecast in determining the fair market value of ABC for meeting the adequate consideration requirements of the Department of Labor. This would have excluded the ESOP debt from the forecast. This is a negligent act on the part of T&A.

In his deposition, Mr. Jones was asked if as an accountant it is customary to list all of the assumptions that go into a valuation report. He responded (January 25, Page 159, line 4):

- A. I don’t believe it would be practical to list all the assumptions that would go into a valuation report.

He was then asked if it was customary to list the major assumptions that go into a report and his answer was (January 25, Page 159, line 10):

- A. Well, there’s a lot discretion and what you need to list or disclose in your report. And, yes, I would think some of the major assumptions would included in your report.

Despite his answer, there are no assumptions, major or minor, listed in the narrative of the valuation report. The *Guide to Business Valuations* addresses this issue as follows:

252.09 Key Factors and Assumptions Must Be Identified. Key factors and assumptions are those significant matters upon which an entity’s future results are expected to depend. They are primary building blocks upon which the entire forecast is built, and they should obviously be carefully

identified. While key factors vary by company and industry, they often include the following factors:

- a. Assumptions about Revenue and Receivables.
- b. Assumptions about Cost of Sales and Inventory.
- c. Assumptions about Other Costs.
- d. Assumptions about Property and Equipment and Related Depreciation.
- e. Assumptions about Debt and Equity.
- f. Assumptions about Income Taxes.

The consultant must exercise a great deal of judgment in deciding how each of these factors is likely to impact the future earnings or cash flow of the company being valued.

It is clear that the valuation literature suggests that documentation and identification of key assumptions be made. Mr. Jones' testimony shows T&A's disregard of standards. He says major assumptions should be included in the report, but they were not.

TA 203 and 204

These pages include the financial statement projection for the balance sheet for the same period of time as the prior two pages. TA 204 also contains the same error regarding the mislabeling of the dates as the previous pages.

There are also other problems that exist with the financial statement projection included on these pages. In the first column, considered to be the base year 1993, the level of cash differs from the cash that was included on Schedule II. On Schedule II (TA 177), cash was \$599,000. However, it was \$800,000 on this schedule. There is no explanation for this change in the opening balance. Furthermore, cash is projected to grow from this level to \$86,375,000 in the last year. No reasonable forecast would include cash at this level.

Once again, T&A clearly accepted projections without questioning any of the line items or analyzing the impact of these figures. This is negligent on the part of the appraiser.

In his deposition, Mr. Jones was questioned about the build up of cash. His answers demonstrate that no analysis was performed by T&A in rendering its opinion of the value of ABC. The discussion was as follows (January 25, Page 163, line 14):

Q. Okay. Now, on page 203, does it seem reasonable to you that ABC would keep cash -- see that December of '97, the fiscal year ending 4? Does it seem reasonable to you that ABC would keep cash of over 21,600,000 in the company in '97 and then have it grow to over \$86 million at the end of 2002, which is the end of the forecast period? Does that seem reasonable to you as an accountant?

A. Well, given the projections that they were providing to us, we obviously discussed that with them, and that there was some uncertainty as to how that -- those excess funds would be invested. And for the -- again, I'd like to go back and look at my files to see if there's anything to refresh my memory on that, but that they did not have any other plans at the time for that cash. And as opposed to listing in into investments or some other category, that's where it stayed.

Q. So you're telling me that holding -- building up cash from -- from 1997 to 2002, from 21 million to over 86 million was reasonable to you as a valuator; is that right?

A. Well, whether it was cash or reclassified into some other asset, it didn't -- they didn't -- they didn't indicate to me that they were going to pay it out as a dividend or anything else.

Q. Well, you have it listed here as cash and the equivalent -- cash equivalents, correct?

A. Correct.

Q. And so you're telling me that whatever they told you, you accepted as reasonable.

A. It appeared reasonable to me, yes.

- Q. Okay. What about distributions to shareholders? Did it appear reasonable to you that ABC would be accumulating enormous sums of cash up to \$86 million and not distribute anything to shareholders? Did that seem reasonable?
- A. Didn't strike me as being unreasonable.
- Q. Well, if it doesn't strike you as unreasonable, it must strike you as reasonable. Is that fair, Mr. Jones?
- A. Well, again, I think that the presumption was when they gave us this information that they would be generating substantial profits and accordingly cash. And they had not yet decided how to either distribute or reinvest that cash into other project or to pay it out in the form of dividends, that they hadn't made those decisions yet.
- Q. And because they hadn't made those decisions yet, you're telling me that it was a reasonable position that you accepted that they would accumulate that much cash.
- A. That's correct.

Another inconsistency in this schedule is the fact that fixed assets are projected at \$52,505,000. This is the adjusted value after considering the real estate appraisal. Schedule II (TA 177) reflects fixed assets at \$20,288,000. A financial forecast, when used in this type of methodology, is supposed to be prepared in accordance with generally accepted accounting principles. This means that the fixed assets would not be written up to fair market value. Furthermore, as discussed previously, fixed assets remain the same throughout the entire forecast. There is no provision for additional fixed assets being purchased, and even in the methodology that will be discussed shortly, using a net asset residual method, there is no appreciation of these assets either. This renders this projection worthless as a proper result cannot occur when the fixed assets are so misstated.

Intangible assets are kept at the same level and so are non-operating assets, which once again, should have been removed from the balance sheet in order to perform this methodology. Notes payable goes down in the first year, takes a considerable jump

thereafter, and then decreases until the final year when it increases substantially. Considering the fact that this was supposed to be a debt free approach, recording these notes makes no sense. Furthermore, there is no discussion in the report and there were no workpapers in the T&A file that would support these figures. Obviously, there was no analysis performed by T&A to determine the appropriateness of this information.

TA 206

Schedule XVI is the discounted future earnings - income residual method. Although a 10 year projection was made, T&A chose to use only five years in the valuation. However, ABC had not reached a stable state as it was continuing to grow by astronomical measures according to the projections that were included in the valuation report. Therefore, the period of time should have been extended beyond five years. In a multi-period discounting model, the interim periods are forecasted until the company reaches stability. Then, a terminal value is calculated. Mr. Jones testified that this was a debt free methodology, and yet, T&A committed a fatal error of not subtracting debt from the value as of the valuation date. Furthermore, the discount rate used was an equity discount rate and not a weighted average cost of capital (WACC), as it should have been. This results in an inaccurate value. Although we were not retained to determine the appropriate WACC, it would have to be lower than the 20 percent discount rate used by T&A (assuming that the 20 percent rate was a proper equity discount rate).

In addition to this error, there are other significant errors as well. First of all, the debt that should have been subtracted from the end result would be \$14,926,000, based on Schedule II (TA 177). This means that there is an almost \$15 million error on this schedule, from this mistake alone.

Second, Mr. Jones was questioned in his deposition about the calculation of the terminal value. He was asked to perform a calculation to replicate the present value figure of \$26,942,000 that was derived on this schedule in the T&A report. Despite this request, he

never was able to replicate this calculation. He attempted to explain what the calculation was, but he was unaware that there was a serious bug in the computer program in this schedule.

Using an income residual methodology, generally involves using what is know as the Gordon Growth Model. This model was discussed in the *Guide to Business Valuations*, as well as many other textbooks on the subject. In order to illustrate the fatal flaw in this schedule, we will first present an illustration of this methodology as presented in Exhibit 5-23 of the *Guide to Business Valuations*. This appears below:

EXHIBIT 5-23
ILLUSTRATION OF DISCOUNTED FUTURE RETURNS APPROACH
USING PRESENT VALUE TABLES

	Forecasted Net Cash Flows	x	23% Present Value Factors	=	Present Value of Future Cash Flows
Year 1	\$ 26,900	x	.81301	=	\$ 21,870
Year 2	35,200	x	.66098	=	23,266
Year 3	38,100	x	.53738	=	20,474
Year 4	46,700	x	.43690	=	20,403
Terminal Value at the end of Year 4	291,200 *	x	.43.690**	=	127,225
					<u><u>\$ 213,238</u></u>

* The terminal value was determined by increasing the Year 4 cash flows by 6% (to reflect normal growth) and capitalizing the new cash flows at a 17% rate (which represents the discount rate less the growth rate as explained in Paragraph 505.22). The actual terminal value of \$291,188 was rounded to \$291,200 in this illustration.

** The terminal value should usually be discounted at the same rate as that applied to the last year of the forecast (Year 4 in this example.)

Using the above illustration, we will demonstrate the error that appears in Schedule XVI. The calculation of the terminal value should have been performed by taking the last year of earnings in the forecast, in this instance \$13,408,000 and multiplying it by 9 percent, the growth rate used in the development of the capitalization rates in Schedule VI (TA 188). Once that is grown, the result would be capitalized by 11 percent, which was the capitalization rate determined in Schedule VI. That amount would then be discounted using the same discount factor that would have been used in the last period of the forecast. Mathematically this would be as follows:

$$\begin{array}{r} \$ 13,408,000 \\ \times 1.09 \\ \hline \\ \$ 14,614,720 \\ \div 11\% \\ \hline \\ \$ 132,861,091 \\ \times .4018496^2 \\ \hline \\ \$ 53,390,176 \\ \hline \hline \end{array}$$

The calculation of the terminal value should have resulted in a value of \$53,390,176. Instead, the valuation software package calculated \$26,942,000, resulting in an understatement of value in the amount of \$26,448,176. This is a significant error that was not caught by T&A due to its lack knowledge of how the software worked. The bug that existed in the computer software that it was relying on calculated the terminal value by dividing the last period's earnings by the discount rate and then calculated the present value as follows:

² $\$5,388 \div 13,408 = .4018496$
Present value factor from last forecast period.

- 95 -

$$\begin{array}{r} \$ 13,408,000 \\ \div 20\% \\ \hline \$ 67,040,000 \\ \times .4018496 \\ \hline \\ \hline \$ 26,939,997 \end{array}$$

As can be seen from the above calculation, the terminal value is calculated as \$26,939,997, slightly different from the computer program's figure due to rounding. However, the important point is that T&A failed to review these figures for reasonableness, which resulted in an error of approximately \$26 million. The error that the computer software made, which was subsequently corrected in a newer version, was that not only did it fail to grow the last period by the growth rate, but it capitalized that amount using a discount rate rather than a capitalization rate. This was a bug in the software that should have been discovered due to the sheer magnitude of the dollars. Once again T&A merely accepted the calculations of the computer program, despite this significant error.

TA 207

Schedule XVI, is a discounted future earnings-net asset residual method. This is another methodology that should not have been employed in the valuation of ABC. The difference between this methodology and the previous one is the manner in which the terminal value is calculated. A net asset residual method is generally used in an application where there will be a liquidation at the end of the forecast period. Since ABC was being valued as a going concern, an income residual model would be the correct methodology to be used. The net asset residual method is typically used where you have a limited life venture, and at the end of the life of the venture, any assets and liabilities would be distributed or sold. This is one more schedule that the computer generated and was relied on by T&A. In fact, the net residual assets of \$66,081,000 comes from the first column of page TA 204, which

represents the total equity at the end of forecast year five. However, as previously discussed, this amount does not include any provision for five years of appreciation of real estate that is included on the balance sheet. It also assumes that there was only \$100,000 of goodwill for the company since intangible value was being carried at an insignificant level of value. Even if this methodology was appropriate, using a net residual asset value significantly understates the value of ABC. Therefore, once again, T&A is negligent in performing these calculations.

TA 208

Schedule XVII is called a Professional Practice Appraisal. ABC is not a professional practice. Therefore, this schedule should never have been included in the report. However, once again, since the computer generated the schedule, T&A felt it necessary to include it in the report. There is no discussion in the report and there are no workpapers that discuss what the schedule represents. Even Mr. Jones, in his deposition states (January 25, Page 200, line 19):

- A. It may not be there because of – it has no relevance to this particular valuation.

TA 209

Schedule XVIII is called the Dividend Payout Ratio. While the top of the page contains mostly zeros and a few computer generated figures, the bottom of the page contains a dividend payout conclusion. This schedule was not explained in the report nor in the workpapers, but it results in an indication of value for ABC. When asked what use was made of this schedule of the valuation of ABC, Mr. Jones answered (January 25, Page 204, line 14):

- A. Again, we didn't place any weight on this valuation methodology in our conclusion for US Corrections.

TA 210

Schedule XIX represents the cost approach. We previously discussed the fact that the cost approach is a cost to recreate the business, or at least some of its assets. Besides being impractical, it has no relevance to the valuation of ABC. This schedule has one computer generated figure for the assemblage of fixed assets and the adjusted net tangible assets resulting in a total entity value of \$36,440,000. However, it excludes organizational costs, assemblage of personnel, acquisition of lease, leasehold value and intangible assets. Mr. Jones in his deposition testified (January 25, Page 207, line 2):

- A. We concluded that we were not going to place any significant reliance on this approach, so we did not finish completing this schedule.

Despite the testimony of not completing the schedule, some weight was put on this value in the valuation summary that appears in Schedule XXI (TA 213). Using this value, not only demonstrates the lack of professional competence of the appraiser in determining proper methodologies, but it further demonstrates the negligence in using an incomplete analysis and then putting weight on it as an indication of value.

TA 211

The next page is a continuation of Schedule XIX used to determine the value of the leasehold. This was one of the schedules that was not completed by T&A. What is shown however, is that the computer program generated a discount rate of 20 percent, the same rate that T&A used in other methodologies. Typically, the value of an intangible asset is considered to be more risky than the value of a tangible asset. Therefore, discount rates usually vary in the application of this methodology by type of asset. However, even though there was no calculation performed, this schedule indicates that T&A was ready to accept whatever the computer generated as a discount rate. Once again, a lack of knowledge in valuing intangible assets is apparent.

TA 212

Schedule XX is an industry benchmark of value. Once again, there is no analysis in the report nor the workpapers to support the figures reached on this schedule. When asked where the industry benchmarks came from that were included in this schedule, Mr. Jones responded (January 25, Page 225, line 22):

A. I don't recall.

There were no workpapers to support this, so he could not look at his file to answer questions about this schedule.

TA 213

Schedule XXI is the valuation summary that lists the conclusions reached under all of the different methodologies that were generated by the computer system. It also indicates the weights assigned to each methodology by T&A in determining a final indication of value. In our opinion, even if the methodologies were appropriate, the weights assigned were clearly results oriented.

Although there is no explanation in the report or in the workpapers as to how these weights were concluded, all one has to do is look at them to realize that these would not be normal weights used by an appraiser. Just as a weighted average was calculated based on the last five years' income using a 5-4-3-2-1 weighting system, the weights assigned in the valuation summary included .25, .50, 2.0, 9.5 and 7.5. We believe that these figures were manipulated to derive a total value of \$53,694,000 because that is what was needed to support the value that was in the memo that was issued in the separate engagement relating to alternatives for implementing the ESOP.

When asked if there was a rationale to the weights, it was once again confirmed that there were no workpapers to address this. When considering the methodologies used, book value had no relevance and should not have been used at all. Liquidation value was the same as the adjusted book value, but it was known that there were no intangible assets included in the value. Therefore, it may have been inappropriate as well. The capitalization of earnings is actually the capitalization of owners' discretionary cash flow and as such, should not have been used for a company this size. Furthermore, the adjustments for owners' compensation was incorrect and there are serious questions about the capitalization rate. The capitalization of excess earnings methodology resulted in a value that was incorrect because pretax earnings and a return on book value were used. The capitalization rate used is also suspect. The discounted future earnings methodologies were weighted equally but there was a \$26 million error in the net income residual method and the net asset residual method should not have been used because it was inappropriate in this valuation. Plus, it understated the net asset values were understated in this method by not including an inflationary increment for the appreciation of the real estate. Finally, the cost to create approach was weighted, although it was an incomplete methodology based on Mr. Jones' own admission in his deposition.

As a result, there is no question as to why the Special Master who was appointed by Judge Ronstadt in the *Sacks* litigation lacked confidence in the T&A valuation report. It was negligent, it was unsupported, and it was plagued with errors, including using a projection rather than a forecast that included debt of an ESOP transaction in order to determine adequate consideration for the very transaction that was being considered. T&A was negligent and irresponsible. There can be no confidence in the value determined in this summary.

TA 214 to TA 218

The balance of this report contains miscellaneous schedules that the computer generated that are supposed to be used by T&A to perform sanity checks on the valuation result.

None of these schedules were used by T&A, nor is there any discussion about them in the report or in the workpapers. The contents of these schedules make little sense and have no relationship to reality. Once again, they were schedules generated by the computer and were included as part of this valuation.

Miscellaneous

According to Mr. Jones, the covenant not to compete granted by Mr. Morris to ABC was considered in the forecast (January 27, 2005, Page 18, line 9). However, this appears to be somewhat illogical, since the valuation would also be establishing the buyout price for the Morris stock. Mr. Jones answered that by stating (January 27, Page 19, line 19):

- A. It was going to be used to determine the value for Mr. Morris' stock as well as the other stock that was going to be sold from the company to form the ESOP.

The fact that this valuation was going to be used to assist in the buyout of Mr. Morris' stock, using a covenant not to compete for a transaction that had not taken place yet is circular logic. Furthermore, this does not value ABC for the purpose of this transaction. The value is impacted by the very transaction that ABC is being valued for. According to Mr. Jones, the non-competition and employment agreements with Mr. Morris would not take effect until January 1, 1994. Therefore, to use this in the valuation as of November 30, 1993 is improper.

After reviewing the T&A report with its numerous problems, we went back and focused on some additional items that need to be mentioned. On page TA 163, T&A indicates "Additionally, we have analyzed projections as prepared by management for future years." The workpapers however, reflect no analysis of the projections. In Mr. Jones' deposition, a second group of workpapers were submitted that were labeled as Exhibit 379. They are bates stamped TA 1270 through TA 1472. A review of these workpapers does not reflect any analysis. The valuation files, as well, do not reflect any analysis. While Mr. Jones

attempts to rely on the forecast engagement to support the valuation, they are in fact two separate engagements. Furthermore, these engagements created a terrible conflict of interest because they were for very different purposes. T&A's use of a part of the other engagement has created significant valuation issues. Despite T&A considering this engagement to be a forecast, it is in fact a projection as defined by the American Institute of CPAs. The purpose of that engagement was to determine what the financial statements would look like assuming that the ESOP was in place. This was being done for the financial institution that was going to fund the ESOP loan. Furthermore, the lack of analysis that is admitted to by Mr. Jones in his deposition is problematic. When asked about his workpapers for the analysis, he claimed (January 27, Page 79, line 21):

- A. We don't have a specific workpaper that says that we did this, this, this and this. But throughout our context of our files, its obvious that we had discussions with management and valued their – assumptions and the projections.

While Mr. Jones says that is *obvious*, the question becomes who is it obvious to, since there are no notes regarding these projections. There is only some information that was provided by the outside accounting firm and management of ABC, with no further analysis or questions contained in the file. Furthermore, Mr. Jones attempts to hide behind the representation letter that T&A received from management in the forecast file. However, it should be noted that the engagement letter dated January 31, 1994 (TA 1285 and 1286) is as of the same date as the representation letter (TA 1287). This is an indication that T&A received the representation letter at the same they were engaged. In fact, both documents are signed on February 3, 1994 by Milton Roberts. Typically, a representation letter is obtained at the end of the process. In this instance, a representation letter was received at the beginning of the process, so T&A was asking management of ABC to represent things to them before they would have had an opportunity to ask pertinent questions about the information that was supplied to them.

The workpapers indicate that certain schedules were prepared at the end of January and the first couple of days of February 1994. This was before the company engaged T&A. Despite certain workpapers being prepared at the beginning of February, the accountants' report attached to the forecasted financial statements (TA 1325) has a date of January 31, 1994. Typically, this is the date that the field work was completed. However, the first page of the forecasted balance sheet (TA 1326) has a February 3, 1994 date on it.

Further proof of the errors made by T&A in the valuation is the fact that on March 7, 1994, they issued their valuation report with a stock value per share of \$136,385, yet on March 8, 1994, the very next day they provided information to the Bank of Jacksonville that indicated that the value was \$138,888.88. There was no new report issued, nor were there any updated schedules provided that would support the valuation for the ESOP. On March 15, 1994, another estimate of value was determined based on the distribution of retained earnings of \$1,540,000. However, nothing else was updated to reflect the value at March 15, 1994. When asked whether the removal of \$1,540,000 would impact the balance sheet of the company when applying a discounted future earnings net asset residual balance, even Mr. Jones had to admit (January 27, Page 114, line 20):

A. That would have an impact.

Ultimately, there is no valuation report that would have been issued as of the transaction date that the members of the ESOP could cogently review indicating the value of ABC prior to the ESOP transaction. All of these variations of value did nothing more than play with the number of shares and the weightings to ultimately get the same conclusion that was reached in the December 1, 1993 memo written by Mr. Jones.

Our review of the T&A workpapers reflected a valuation report checklist that came from the *Guide to Business Valuations*. This was labeled as Exhibit 381 of Mr. Jones' deposition. Despite all of the checklists that would have been available as workpapers from the *Guide to Business Valuations*, T&A chose not to document its files and only used this report

checklist. In fact, in our opinion Mr. Jones ran through this checklist and did nothing more than check boxes without giving any true consideration to what the impact was of what he was checking off. For example, item number two asks “Are all calculations mathematically correct?” Mr. Jones checked “yes.” However, as we have previously pointed out, because of a bug in the program, the discounted future earnings methodology included a \$26 million math error.

Question number 3 asks “Do the data and the analysis in the report lead logically to a well supported conclusion?” Once again, Mr. Jones checked off “yes.” The fact that there is limited analysis in the report, there are numerous irrelevant schedules in the report, there are several incomplete schedules in the report, and there are calculation errors does not make this a well supported report. It is not possible for the data and the analysis in the report to lead anyone to a well supported conclusion. Mr. Jones himself in his deposition testified many times that there were irrelevant or incomplete schedules. The next item on the checklist asks “Does the report contain all relevant factors and data?” Here also, Mr. Jones checked “yes.” However, Mr. Jones admitted during his deposition that he did not include studies about criminals in his report, nor are there any assumptions and explanations about the data.

Question number 7 asks “Does the report consider all the requirements relating to the circumstances of the engagement (IRS requirements, DOL regulations, legal precedence, etc.)?” Mr. Jones checked “yes.” However, the adequate consideration requirement under the DOL regulations would not have the calculation of value being performed based on projections that would include the hypothetical transaction that had yet to take place. Furthermore, IRS Revenue Ruling 59-60 suggests that internal transactions be reviewed, but they were not, and many other factors mentioned previously in this report have been ignored.

Item 8(c) of this checklist asks if information was disclosed pertaining to “any special rights or restrictions relating to the subject interest.” Mr. Jones checked “yes.” However, there

is no discussion about the state of incorporation which would determine any shareholder rights. When questioned about the state of incorporation of ABC, Mr. Jones did not initially know what state the company was incorporated in. This is an important factor because it determines the rights of the shareholders under state shareholder laws. This item is also listed in item 9 under company background, and Mr. Jones fails to discuss the legal form, the state of incorporation, company management, competition, sensitivity to seasonal or cyclical factors, or strength and weaknesses. However, he checked “yes” to everyone of those items on this checklist, except for state of incorporation, which he checked “no.”

Question 12 asks if the financial statement data was adjusted and are all the adjustments explained and Mr. Jones answers “yes” once again. However, there is little explanation in the report about why these adjustments were made or how they are justified. Regarding prospective financial information that was used in the report, this checklist asks “Are key underlined assumptions discussed?” Not only does Mr. Jones check “yes” on the checklist, but he indicates that it is based on discussions with management. Clearly this is not disclosed in the report, as discussing assumptions with management is very different than including them in a business valuation report. The users of the report cannot possibly be expected to know what took place during the management interview unless it is transcribed into the report.

Questions in the checklist regarding economic and industry data were also checked yes, but there is no regional and local economic data, there is very little in the way of industry trends or financial data including comparisons to company data, etc. In the section about searching for comparative companies, the checklist asks “Does the report discuss what steps were taken to search for comparative companies, the sources used, and the results of that search?” Mr. Jones checked “yes,” but his own testimony disputes this item.

Over all, Mr. Jones filled out a checklist, and despite his answers, he did not have the requisite knowledge to understand enough about what the checklist was asking to allow him to answer correctly. Mr. Axelrod, the reviewer of the file, clearly accepted Mr. Jones’

representations without ever questioning why certain things were not included in the report. Overall, T&A was negligent, as they not only did not have sufficient relevant data, they did not exercise due professional care and they lacked the professional competence necessary to perform this assignment.

Valuation Report - ABC - December 31, 1994

To further corroborate all of the problems that existed in the November 30, 1993 report, we reviewed the subsequent report prepared by T&A. This report was as of December 31, 1994. The narrative through the top of page three is the same boilerplate as used in the previous year. In the history and nature of the business section, the only portion that changed is the ownership of the corporation. There is no discussion about the ESOP becoming a shareholder, nor is there a discussion about the buyout of the Morris family stock.

The economic and industry outlook section is actually shorter than it was the previous year. In fact, the same wording exists in the industry section leading us to believe that no additional research had been done as part of this valuation. The rest of the narrative appears to be boilerplate from the previous year. This report differs slightly from the previous year in that there is now a page entitled assumptions and limiting conditions. Most significantly, the schedules that were attached to this report come from a newer version of ValuSource. The software was updated and it is obvious that the new version was used. Many of the same errors that were made in the previous valuation exist in this report also regarding choice of methodology, substantiation and lack of analysis. However, we are only going to address what we consider to be a few items to further support our position regarding the 1993 report. Schedule IX (TA 899) is the build up of the capitalization rate. In this instance, numbers appear to be plugged once again, but the format changed from the previous software. As we discussed, the build up starts with a risk free rate, adding to it an equity risk premium, a small stock equity risk premium, a subjective company premium and a cash flow to net income conversion factor.

Although, Mr. Jones does not use each of these items, the format in the software confirms what we stated earlier. What is also note worthy is that the excess earnings risk premium in this valuation is 25 percent, whereas it was only 5 percent in the previous period. The excess earnings capitalization rate was 36 percent in this valuation, versus 16 percent in the previous year. However, when reviewing Schedule XI (TA 902 and 903), there are once again items worth pointing out. The adjusted net income is the after tax net income and not the pretax income that was used in the prior year. In the calculation of a return on tangible assets (page TA 903), the software calculates this using the adjusted book value and not book value. In the 1993 valuation, not only did the software use the incorrect value for the return, but Mr. Jones testified that it was perfectly acceptable. Clearly, it was an error because even the software changed in the following year.

What is also worth pointing out on this particular page is that the excess earnings were actually divided by a 9 percent capitalization rate, even though the capitalization rate calculated previously was 36 percent. This caused a \$19 million error in the intangible value in this valuation. It should be noted that capitalization of excess earnings was weighted more than twice that of the adjusted book value and 500 percent of the liquidation value, capitalization of earnings value and discounted future earnings value. 50 percent of the weight in this valuation was placed on the capitalization of excess earnings that included a \$19 million error.

Schedule X (TA 900) reflects a capitalization of earnings. Unlike the prior valuation, it is not a capitalization of sellers' discretionary cash flow, but actually a capitalization of earnings. This further demonstrates the inconsistency between the years. This report also contains numerous schedules that are irrelevant, but once again, the level of professional negligence is indicated when reviewing this appraisal report.

Overall, it is our opinion that T&A was negligent, and but for its negligence, the judgment against the Plaintiffs in this matter would not exist.

CONCLUSION

In our opinion, T&A, Steven Jones and Michael Axelrod (hereafter collectively referred to as T&A, Mr. Jones or Mr. Axelrod) have breached their duty to render various services in a manner that is consistent with the standard of care required of professional accountants and advisors in the rendering of valuation services to ABC and the ABC ESOP.

In our opinion, the valuation services performed by T&A for ABC and the ABC ESOP violated accounting and valuation standards. In our opinion, Rule 201 of the American Institute of Certified Public Accountants' (AICPA) Code of Professional Conduct was violated as T&A did not comply with the following:

- A. Professional Competence. Undertake only those professional services that the member or the member's firm can reasonably expect to be completed with professional competence.
- B. Due Professional Care. Exercise due professional care in the performance of professional services.
- C. Planning and Supervision. Adequately plan and supervise the performance of professional services.
- D. Sufficient Relevant Data. Obtain sufficient relevant data to afford a reasonable basis for conclusions or recommendations in relation to any professional services performed.

In addition, T&A failed to comply with the *Uniform Standards of Professional Appraisal Practice* (USPAP), an industry standard that all appraisers are guided to follow in publications of the AICPA, with respect to the following:

STANDARD 9

In developing a business or intangible asset appraisal, an appraiser must be aware of, understand, and correctly employ those recognized methods and procedures that are necessary to produce a credible appraisal.

Standards Rule 9-1

In developing a business or intangible asset appraisal, an appraiser must:

- (a) be aware of, understand, and correctly employ those recognized methods and procedures that are necessary to produce a credible appraisal;
- (b) not commit a substantial error of omission or commission that significantly affects an appraisal;
- (c) not render appraisal services in a careless or negligent manner, such as a series of errors that, considered individually, may not significantly affect the results of an appraisal, but which, when considered in the aggregate, would be misleading.

Standards Rule 9-2

In developing a business or intangible asset appraisal, an appraiser must observe the following specific appraisal guidelines:

- (a) adequately identify the business enterprise, assets, or equity under consideration, define the purpose and the intended use of the appraisal, consider the elements of the appraisal investigation, consider any special limiting conditions, and identify the effective date of the appraisal;
- (b) define the value being considered.
 - (i) if the appraisal concerns a business enterprise or equity interests, consider any buy-sell agreements, investment letter stock restrictions, restrictive corporate charter or partnership agreement clauses, and any similar features or factors that may have an influence on value.
 - (ii) if the appraisal concerns assets, the appraiser must consider whether the assets are:
 - (1) appraised separately; or
 - (2) appraised as parts of a going concern.

- (iii) if the appraisal concerns equity interests in a business enterprise, consider the extent to which the interests do or do not contain elements of ownership control.

Standards Rule 9-3

In developing a business or intangible asset appraisal relating to an equity interest with the ability to cause liquidation of the enterprise, an appraiser must investigate the possibility that the business enterprise may have a higher value in liquidation than for continued operation as a going concern absent contrary provisions of law of a competent jurisdiction. If liquidation is the indicated basis of valuation, any real estate or personal property to be liquidated must be valued under the appropriate standard.

Standards Rule 9-4

In developing a business or intangible asset appraisal, an appraiser must observe the following specific appraisal guidelines when applicable:

- (a) consider all appropriate valuation methods and procedures.
- (b) collect and analyze relevant data regarding:
 - (i) the nature and history of the business
 - (ii) financial and economic conditions affecting the business enterprise, its industry, and the general economy;
 - (iii) past results, current operations, and future prospects of the business enterprise;
 - (iv) past sales of capital stock or other ownership interests in the business enterprise being appraised;
 - (v) sales of similar businesses or capital stock of publicly held similar businesses;
 - (vi) prices, terms and conditions affecting past sales of similar business assets;

Standards Rule 9-5

In developing a business or intangible asset appraisal, an appraiser must;

- (a) select and employ one or more approaches that apply to the specific appraisal assignments.
- (b) consider and reconcile the indications of value resulting from the various approaches to arrive at the value conclusion.

STANDARD 10

In reporting the results of a business or intangible asset appraisal an appraiser must communicate each analysis, opinion, and conclusion in a manner that is not misleading.

Standards Rule 10-1

Each written or oral business or intangible asset appraisal report must:

- (a) clearly and accurately set forth the appraisal in a manner that will not be misleading.
- (b) contain sufficient information to enable the intended user(s) to understand it. Any specific limiting conditions concerning information should be noted.
- (c) clearly and accurately disclose any extraordinary assumption that directly affects the appraisal and indicate its impact on value.

Standards Rule 10-2

Each written business or intangible asset appraisal report must comply with the following specific reporting guidelines:

- (a) identify and describe the business enterprise, assets or equity being appraised.
- (b) state the purpose and intended use of the appraisal.
- (c) define the value to be estimated.
- (d) set forth the effective date of the appraisal and the date of the report.
- (e) describe the extent of the appraisal process employed;
- (f) set forth all assumptions and limiting conditions that affect the analyses, opinions, and conclusions.
- (g) set forth the information considered, the appraisal procedures followed, and the reasoning that supports the analyses, opinions and conclusions.

- (h) set forth any additional information that may be appropriate to show compliance with, or clearly identify and explain permitted departures from, the requirements of Standard 9.
- (l) set forth the rationale for the valuation methods and procedures considered and employed.

But for the negligence of T&A, Mr. Jones and Mr. Axelrod, the plaintiffs have suffered significant economic damages. Judge Ronstadt found that the ABC ESOP overpaid for the stock in the amount of \$8,139,116, based on a valuation of \$26.31 million. In addition, prejudgment interest was also added to this amount.

GARY R. TRUGMAN, C.P.A.* / A.B.V., M.C.B.A., A.S.A., M.V.S. PROFESSIONAL QUALIFICATIONS

Experience

President of Trugman Valuation Associates, Inc., a firm specializing in business valuation and litigation support services. Business valuation experience includes a wide variety of assignments including closely-held businesses, professional practices and thinly traded public companies. Industries include but are not limited to security, automotive, funeral homes, health care, securities brokerage and financial institutions, retail, manufacturing, service, and professional business establishments. Assignments have also included the valuation of stock options and various types of intangible assets.

Business valuation and litigation support services have been rendered for a variety of purposes including, but not limited to family law matters, business damages, lender liability litigation, buy-sell agreements, shareholder litigation, estate and gift tax matters, buying and selling businesses, malpractice litigation, wrongful death, sexual discrimination, age discrimination, wrongful termination, and breach of contract. Representation in litigation includes plaintiff, defendant, mutual, and court-appointed neutral.

Court Testimony. Has been qualified as an expert witness in State Courts of New Jersey, New York, Pennsylvania, Connecticut, Florida, Michigan and Federal District Court in Newark, New Jersey and Hammond, Indiana, and has performed extensive services relating to court testimony. Testimony has also been provided in arbitration cases before the National Association of Securities Dealers and the American Stock Exchange, as well as other forms of arbitration.

Court Appearances. Has appeared in the following courts: *New Jersey* • Morris, Atlantic, Sussex, Bergen, Burlington, Passaic, Mercer, Middlesex, Monmouth, Essex, Hunterdon, Warren, Hudson, and Union. *New York* • Bronx • Westchester. *Florida* • Palm Beach. Polk, Lee, Broward, Miami-Dade and Leon. *Connecticut* • Fairfield, Milford/Ansonia, Middlesex. *Pennsylvania* • Montgomery, Lehigh. *Massachusetts* • Middlesex. *Indiana* • Marion. *California* • San Jose. *Michigan* • Ottawa.

Court Appointments. Has been court appointed in New Jersey's Morris, Sussex, Essex, Union, Hunterdon, Somerset, Monmouth, Middlesex, Passaic, Warren, Bergen, and Hudson counties by numerous judges, as well as Orange County, Florida.

Mutual Expert. Regularly serves as a mutually-agreed upon expert.

Early Settlement Panel. Has served on the Blue Ribbon Early Settlement Panel in Sussex County.

Professional Designations

- ***CPA:** Licensed in Florida (1996), New Jersey (1978) and New York (1977).

GARY R. TRUGMAN, C.P.A.*/A.B.V., M.C.B.A., A.S.A., M.V.S.
PROFESSIONAL QUALIFICATIONS

Professional Designations

- **ABV:** Accredited in Business Valuation designated by The American Institute of Certified Public Accountants (1998).
- **MCBA:** Master Certified Business Appraiser designated by The Institute of Business Appraisers, Inc. (1999). Original certification (CBA) in 1987.
- **ASA:** Accredited Senior Appraiser designated by the American Society of Appraisers (1991). Reaccredited in 2006.

Education

- Masters in Valuation Sciences - Lindenwood College, St. Charles, MO (1990). Thesis topic: Equitable Distribution Value of Closely-Held Businesses and Professional Practices.
- B.B.A. in Accountancy - Bernard M. Baruch College, New York, NY (1977).

Faculty

- *National Judicial College*, Reno, Nevada since 1997.

Appraisal Education

- *AICPA National Business Valuation Conference*. Austin, TX, American Institute of Certified Public Accountants, 2006.
- *FCG Conference*. Austin, TX, Financial Consulting Group, 2006.
- *Personal Goodwill*. BV Resources Telephone Conference, 2006.
- *FICPA Valuation, Accounting and Litigation Services Conference*. Ft. Lauderdale, FL, Florida Institute of Certified Public Accountants, 2006.
- *Valuation*². Las Vegas, NV, American Institute of Certified Public Accountants and American Society of Appraisers, 2005.
- *AICPA National Business Valuation Conference*. Orlando, FL, American Institute of Certified Public Accountants, 2004.
- *23rd Annual Advanced Business Valuation Conference*. San Antonio, TX, American Society of Appraisers, 2004.

GARY R. TRUGMAN, C.P.A.*/A.B.V., M.C.B.A., A.S.A., M.V.S.
PROFESSIONAL QUALIFICATIONS

Appraisal Education

- *2004 National Business Valuation Conference.* Las Vegas, NV, Institute of Business Appraisers, 2004.
- *New Jersey Law and Ethics Course.* Parsippany, NJ, New Jersey Society of Certified Public Accountants, 2004.
- *22nd Annual Advanced Business Valuation Conference.* Chicago, IL, American Society of Appraisers, 2003.
- *AICPA National Business Valuation Conference.* New Orleans, LA, American Institute of Certified Public Accountants, 2002.
- *Brown v. Brown: The Most Important Equitable Distribution Decision Since Painter.* Fairfield, NJ, New Jersey Institute for Continuing Legal Education, 2002.
- *2001 National Business Valuation Conference.* Las Vegas, NV, American Institute of Certified Public Accountants, 2001.
- *2001 Share the Wealth Conference.* Orlando, FL, The Institute of Business Appraisers, 2001.
- *2000 National Conference on Business Valuation,* Miami, FL, American Institute of Certified Public Accountants, 2000.
- *19th Annual Advanced Business Valuation Conference,* Philadelphia, PA, American Society of Appraisers, 2000.
- *Hot Issues in Estate and Gift Tax Returns: What do the Auditors Look For?* Fairfield, NJ, New Jersey Institute for Continuing Legal Education, 2000.
- *Pulling Ahead of the Pack - The Institute of Business Appraisers' 2000 National Conference.* Phoenix, AZ, The Institute of Business Appraisers, 2000.
- *Business Valuation Conference.* Las Vegas, NV, American Institute of Certified Public Accountants, 1999.
- *1999 International Appraisal Conference.* Boston, MA, American Society of Appraisers, 1999
- *1999 Annual Conference: The Future of Business Valuation.* Orlando, FL, The Institute of Business Appraisers, Inc., 1999.
- *1998 Joint Business Valuation Conference.* Montreal, Canada, American Society of Appraisers and Canadian Institute of Chartered Business Valuators, 1998.

GARY R. TRUGMAN, C.P.A.*/A.B.V., M.C.B.A., A.S.A., M.V.S.
PROFESSIONAL QUALIFICATIONS

Appraisal Education

- *The Future of Business Valuation Annual Conference.* San Antonio, TX, The Institute of Business Appraisers, Inc., 1998.
- *Business Valuation Conference.* San Diego, CA, American Institute of Certified Public Accountants, 1997.
- *16th Annual Advanced Business Valuation Conference.* San Francisco, CA, American Society of Appraisers, 1997.
- *Quantifying Marketability Discounts.* San Francisco, CA, Mercer Capital, 1997.
- *Introduction to Machinery & Equipment Valuation.* Chicago, IL, American Society of Appraisers, 1997.
- *National Conference on Appraising Closely-Held Businesses.* San Diego, CA, The Institute of Business Appraisers, Inc., 1997.
- *Business Valuation Conference.* Phoenix, AZ, American Institute of Certified Public Accountants, 1996.
- *15th Annual Business Valuation Conference.* Memphis, TN, American Society of Appraisers, 1996.
- *1996 Business Valuation Conference.* Holmdel, NJ, NJ Society of Certified Public Accountants, 1996.
- *National Conference on Appraising Closely-Held Businesses.* Orlando, FL, The Institute of Business Appraisers, Inc., 1996.
- *Business Valuation Conference.* New Orleans, LA, American Institute of Certified Public Accountants, 1995.
- *14th Annual Business Valuation Conference.* Boston, MA, American Society of Appraisers, 1995.
- *1995 Matrimonial Conference.* Holmdel, NJ, New Jersey Society of Certified Public Accountants, 1995.
- *Joint Business Valuation Conference.* San Diego, CA, American Institute of Certified Public Accountants - The Institute of Business Appraisers, Inc., 1995.
- *1995 Business Valuation Conference.* Holmdel, NJ, New Jersey Society of Certified Public Accountants, 1995.
- *National Conference on Appraising Closely-Held Businesses.* Las Vegas, NV, The Institute of Business Appraisers, Inc., 1995.

**GARY R. TRUGMAN, C.P.A.*/A.B.V., M.C.B.A., A.S.A., M.V.S.
PROFESSIONAL QUALIFICATIONS**

Appraisal Education

- *1994 International Conference.* Chicago, IL., American Society of Appraisers, 1994.
- *National Conference on Appraising Closely-Held Businesses.* Orlando, FL, The Institute of Business Appraisers, Inc., 1994.
- *1993 International Conference.* Seattle, WA, American Society of Appraisers, 1993.
- *Uniform Standards of Professional Appraisal Practice and Professional Appraisal Ethics.* Seattle, WA, American Society of Appraisers, 1993.
- *11th Annual Business Valuation Conference.* Atlanta, GA, American Society of Appraisers, 1992.
- *1992 International Conference.* New Orleans, LA, American Society of Appraisers 1992.
- *National Conference on Appraising Closely-Held Businesses.* Orlando, FL, The Institute of Business Appraisers, Inc., 1992.
- *10th Annual Business Valuation Conference.* Scottsdale, AZ, American Society of Appraisers, 1991.
- *1991 International Conference.* Philadelphia, PA, American Society of Appraisers, 1991.
- *Appraising Closely-Held Businesses.* Orlando, FL, The Institute of Business Appraisers, Inc., 1991.
- *Principles of Valuation-Business Valuation Case Study.* New Orleans, LA, American Society of Appraisers, 1989.
- *Principles of Valuation–Business Valuation Methodology.* New Orleans, LA, American Society of Appraisers, 1988.
- *Divorce Tax Planning.* American Institute of Certified Public Accountants, 1988.
- *Valuation of Closely-Held Businesses.* Total Tape Inc., 1987.
- *Business Valuation for Accountants.* Paramus, NJ, The Institute of Business Appraisers, Inc., 1986.
- *Valuation of Closely-Held Businesses.* American Institute of Certified Public Accountants, 1986.
- Has performed extensive reading and research on business valuation and related topics.

**GARY R. TRUGMAN, C.P.A.* / A.B.V., M.C.B.A., A.S.A., M.V.S.
PROFESSIONAL QUALIFICATIONS**

Lecturer

- *Valuing Small Businesses for Divorce*, Austin, TX, AICPA National Business Valuation Conference, 2006.
- *Ask the Experts*, Austin, TX, AICPA National Business Valuation Conference, 2006.
- *Changes to the 2006 USPAP*, Overland Park, KS, Kansas Valuation Conference, 2006.
- *Tax Effecting S Corporations and Other Flow Through Entities*, Overland Park, KS, Kansas Society of CPAs Valuation Conference, 2006.
- *Valuation Discounts*, Minneapolis, MN, MN Society of CPAs Valuation Conference, 2006.
- *Malpractice and Business Valuation*, Minneapolis, MN, MN Society of CPAs Valuation Conference, 2006.
- *Mock Trial - Being an Expert Witness*, Woodbridge, NJ, NJ Divorce Conference, 2006.
- *Expert Reports Used in Divorce*, Las Vegas, AICPA Divorce Conference, 2006.
- *Ask the Expert*, Ft. Lauderdale, FL, FICPA Valuation, Accounting and Litigation Services Conference, 2006.
- *Valuing the Very Small Company*, Las Vegas, NV, Valuation², American Institute of Certified Public Accountants and American Society of Appraisers, 2005.
- *Being an Effective Witness*, Las Vegas, NV, Valuation², American Institute of Certified Public Accountants and American Society of Appraisers, 2005.
- *Divorce Valuation versus Other Valuations*, Richmond, VA, Virginia Society of CPA's Conference, 2005.
- *Hot Topics in Business Valuation*, Cleveland, OH, SSG, 2005.
- *Valuing Small Businesses and Professional Practices*. Atlanta, GA, George Society of CPAs' Super Conference, 2005.
- *Personal Goodwill in a Divorce Setting*. Ft. Lauderdale, FL, Florida Institute of Certified Public Accountants' Valuation & Litigation Services Conference, 2005.
- *The Market Approach: Case Study*. Orlando, FL, American Institute of CPAs, 2004.
- *Valuing Professional Practices*, Orlando, FL, American Institute of CPAs, 2004.
- *How to Develop Discount Rates*. Ft. Lauderdale, FL, Florida Institute of CPAs Valuation and Litigation Conference, 2004; Detroit, Michigan, MI Valuation Conference, 2004.

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PROFESSIONAL QUALIFICATIONS**

Lecturer

- *To Tax or Not to Tax - That is the Question: Tax Effecting S Corporations*, Chicago, IL, Illinois Business Valuation Conference, 2004.
- *Controversial Topics*. Richmond, VA, VA Valuation and Litigation Conference, 2004.
- *Guideline Company Methods: Levels of Value Issues, Telephone Panel*, Business Valuation Resources, 2004.
- *Small Business Case Study*. Phoenix, AZ, American Institute of Certified Public Accountants National Business Valuation Conference, 2003; Ft. Lauderdale, FL, Florida Institute of CPAs, 2004.
- *Valuation Issues - What You Need to Know*. San Antonio, TX, AICPA National Auto Dealer Conference, 2003.
- *Professional Practice Valuations*. Tampa, FL, The Florida Bar - Family Law Section, 2003.
- *Business Valuation Basics*. Orlando, FL, The Florida Bar Annual Meeting, 2003.
- *Business Valuation for Divorce*. Orlando, FL, The Florida Bar Annual Meeting, 2003.
- *Business Valuation in a Litigation Setting*. Las Vegas, NV, CPAmerica International, 2003.
- *The Transaction Approach - How Do We Really Use It?* Tampa, FL, American Society of Appraisers International Conference, 2003.
- *Advanced Testimony Techniques*. Chicago, IL, Illinois Business Valuation Conference, 2003.
- *To Tax or Not to Tax? Issues Relating to S Corps and Built-In Gains Taxes*. Washington, DC, Internal Revenue Service, 2003.
- *Issues for CPAs in Business Valuation Reports*. New Orleans, LA, American Institute of Certified Public Accountants, 2002.
- *Guideline Public Company Method: Minority Versus Control – Dueling Experts*. New Orleans, LA, American Institute of Certified Public Accountants, 2002.
- *To Tax or Not To Tax? - That Is The Question*. Minneapolis, MN, Minnesota Society of Certified Public Accountants, 2002.
- *Pressing Problems and Savvy Solutions When Retained by the Non-Propertied Spouse*. Las Vegas, NV, American Institute of Certified Public Accountants/American Academy of Matrimonial Lawyers, 2002.

GARY R. TRUGMAN, C.P.A.* / A.B.V., M.C.B.A., A.S.A., M.V.S.
PROFESSIONAL QUALIFICATIONS

Lecturer

- *The Transaction Method - IBA Database.* Atlanta, GA, Financial Consulting Group, 2002.
- *Valuation Landmines - How Not To Get In Trouble.* Washington, DC, 2002 Annual Business Valuation Conference, The Institute of Business Appraisers, 2002.
- *Guest Lecturer on Business Valuation.* New York, NY, Fordham Law School, 2002.
- *Guideline Company Analysis.* Chicago, IL, Illinois CPA Foundation, 2002.
- *Guideline Company Analysis.* Las Vegas, NV, American Institute of Certified Public Accountants, 2001.
- *Discount and Capitalization Rates.* Bloomington, MN, Minnesota Society of CPAs, 2001.
- *Valuation Premiums and Discounts.* Louisville, KY, Kentucky Tax Institute, 2001.
- *Business Valuation.* St. Louis, MO, Edward Jones, 2001.
- *Business Valuation for Marital Dissolutions.* Dublin, OH, Ohio Supreme Court, 2001.
- *Testimony Techniques.* Chicago, IL, Illinois CPA Society, 2001.
- *Valuing the Very Small Business.* Chicago, IL, Illinois CPA Society, 2001.
- *Valuations in Divorce.* Ft. Lauderdale, FL, Florida Institute of Certified Public Accountants, 2001.
- *Valuation Land Mines To Watch Out For.* Miami, FL, American Institute of Certified Public Accountants, 2000.
- *Ask the Experts - Discounts and Premia.* Miami, FL, American Institute of Certified Public Accountants, 2000.
- *Understanding a Financial Report.* Columbia, SC, South Carolina Bar Association, 2000.
- *Business Damages.* Columbia, SC, South Carolina Bar Association, 2000.
- *A Fresh Look at Revenue Rulings 59-60 and 68-609.* New Orleans, LA, Practice Valuation Study Group, 2000.
- *Business Valuation: What's It Really All About?* New York, NY, New York State Society of Certified Public Accountants, 1999.
- *Understanding and Increasing the Value of Your Business.* Phoenix, AZ, Inc. Growth Conference, 1999.

GARY R. TRUGMAN, C.P.A.* / A.B.V., M.C.B.A., A.S.A., M.V.S.
PROFESSIONAL QUALIFICATIONS

Lecturer

- *Equitable Distribution of Closely-Held Businesses – Fair Market Value or Fair Value?* Atlantic City, NJ, Association of Trial Lawyers of America -- New Jersey, 1999.
- *Controversial Topics In Business Valuation.* Orlando, FL, The Institute of Business Appraisers, Inc., 1999; Ft. Lauderdale, FL, Florida Institute of Certified Public Accountants, 1999, 2003.
- *Discount and Capitalization Rates.* San Antonio, TX, The Institute of Business Appraise, Inc., 1998; Asheville, NC, North Carolina Association of Certified Public Accountants, 1998; Ohio, Ohio Society of Certified Public Accountants, 1998.
- *Developing a Niche in Business Valuation.* Las Vegas, NV, American Institute of Certified Public Accountants, 1998.
- *Digesting Business Valuation for Legal Transactions.* New Brunswick, NJ, Institute of Continuing Legal Education, 1997.
- *The Market Approach to Business Valuation.* Baltimore, MD, CPA Associates International, 1997.
- *Valuing Accounting Practices for Sale or Merger.* New Orleans, LA, American Institute of Certified Public Accountants Practitioners Symposium, 1997.
- *The Value of a Deal.* New York, NY, Practicing Law Institute, 1997.
- *Revenue Ruling 59-60 Revisited .* San Diego, CA, The Institute of Business Appraisers, Inc., 1997.
- *Capitalization Rates.* Greensboro, NC, National Association of Certified Valuation Analysts, 1996.
- *Valuation Discounts and Premiums.* Greensboro, NC, National Association of Certified Valuation Analysts, 1996; New York, NY, New York State Society of Certified Public Accountants, 1999; San Francisco, CA, Accounting Firms Associated, Inc., 1999.
- *Equitable Distribution Value of Small Closely-Held Businesses and Professional Practices.* Greensboro, NC, North Carolina Association of Certified Public Accountants, 1996.
- *Does the Market Transaction Method Really Work?* Phoenix, AZ, National Business Valuation Conference, American Institute of Certified Public Accountants, 1996.
- *Valuation Issues Affecting Transfers of Family Businesses.* Princeton, NJ, New Jersey Society of Certified Public Accountants Financial Planning Conference, 1996.

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PROFESSIONAL QUALIFICATIONS

Lecturer

- *Crossfire: Why You Should Not Use the Excess Earnings Method.* New Orleans, LA, American Institute of Certified Public Accountants Business Valuation Conference, 1995.
- *Practice Aid 93-3, What Did We Do?* Tampa, FL, Florida Institute of Certified Public Accountants, 1995.
- *Revenue Ruling 59-60: What Does It Really Say?* East Brunswick, NJ, New Jersey Society of Certified Public Accountants, 1995.
- *Preparing and Defending a Business Valuation Report in Litigation.* Holmdel, NJ, New Jersey Society of Certified Public Accountants, 1995.
- *Using the Market Approach to Value Small and Medium Sized Businesses.* San Diego, CA; Orlando, FL, American Institute of Certified Public Accountants, Institute of Business Appraisers, Inc., Joint Conference, 1995 - 1996.
- *CPA's Role in Divorce Litigation.* Holmdel, NJ, New Jersey Society of Certified Public Accountants, 1995.
- *Business Valuation and Litigation.* Reno and Las Vegas, NV, Nevada Society of Certified Public Accountants, 1994.
- *Business Valuation with an Emphasis on Employee Stock Ownership Plans, Mergers and Acquisitions, and Initial Public Offerings.* Phoenix, AZ, National Industry Conference, American Institute of Certified Public Accountants, 1994.
- *Business Valuation-There's a Right Way and a Wrong Way to Do It.* Dallas, TX, Dallas Estate Planning Council, 1993, Chattanooga, TN, Chattanooga Estate Planning Council, 1998.
- *The CPA's Role in Divorce Litigation.* Louisville, KY, Kentucky Society of Certified Public Accountants, 1993.
- *Valuation of Accounting and Other Professional Practices.* West Orange, NJ, Small and Medium Firm Conference, NJ Society of Certified Public Accountants, 1993.
- *Information Gathering Strategies for Business Appraisal.* San Diego, CA, National Conference on Appraising Closely-Held Businesses, The Institute of Business Appraisers, Inc., 1993.
- *Capitalization Rates.* Edison, NJ, Matrimonial Conference, NJ Society of Certified Public Accountants, 1993.
- *Measure of Value in Theory and Reality for Marital Dissolutions.* Orlando, FL, National Conference on Appraising Closely-Held Businesses, The Institute of Business Appraisers, Inc., 1992.

**GARY R. TRUGMAN, C.P.A.*/A.B.V., M.C.B.A., A.S.A., M.V.S.
PROFESSIONAL QUALIFICATIONS**

Lecturer

- *Equitable Distribution Value of Closely-Held Companies and Professional Practices.* San Diego, CA, National Conference on Appraising Closely-Held Businesses, The Institute of Business Appraisers, Inc., 1991.
- *Tax Aspects of Divorce.* NJ, Institute of Continuing Legal Education, 1989-1990, 1992.
- *Appraising Closely-Held Businesses: Expert Testimony.* Orlando, FL, National Conference on Appraising Closely-Held Businesses, The Institute of Business Appraisers, Inc., 1990.
- *Business Valuation for Accountants.* NJ, The Institute of Business Appraisers, Inc., 1988, 1989, 1990.
- *Using Forecasts and Projections in Business Valuation.* Orlando, FL, Valuation Study Group, 1989.
- *What You Need to Know About Valuation and Litigation Support Services.* East Hanover, NJ, CPA Club, 1989.
- *Valuing Professional Practices.* San Diego, CA, National Conference on Appraising Closely-Held Businesses, The Institute of Business Appraisers, Inc., 1989.
- *What is Your Business Worth?* Wayne, NJ, Dean Witter Reynolds, 1988.
- *Understanding Business Valuation for the Practice of Law.* NJ, Institute of Continuing Legal Education, 1987.

Instructor

- *Standards and Ethics: An Appraiser's Obligation.* The Institute of Business Appraisers, Denver, CO, 2007.
- *Principles of Valuation - Part 2.* American Society of Appraisers, Austin, TX, 2005; Chicago, IL, 2006; Brooklyn, NY 2006; Herndon, VA 2007; Chicago, IL 2007; Deloitte & Touche, NY 2007.
- *Small Business Valuation: A Real Life Case Study.* American Institute of Certified Public Accountants, Rocky Hill, CT, 2005; Richmond, VA, 2005; Columbia, MD, 2005, Providence, RI, 2007.
- *Valuation Discount and Capitalization Rates, Valuations Premiums and Discounts.* Rhode Island Society of CPAs, Providence, RI, 2004.
- *Mergers and Acquisitions.* Rhode Island Society of CPAs, Providence, RI, 2004.

GARY R. TRUGMAN, C.P.A.*/A.B.V., M.C.B.A., A.S.A., M.V.S. PROFESSIONAL QUALIFICATIONS

Instructor

- *Valuing a Small Business: Case Study.* Rhode Island Society of CPAs, Providence, RI, 2004.
- *Discounts & Premiums in a Business Valuation Environment.* American Institute of Certified Public Accountants, Roseland, NJ; 2004, Rocky Hill, CT, 2005.
- *Advanced Cost of Capital Computations.* American Society of Certified Public Accountants, Rhode Island, NJ 2004.
- *Fundamentals of Business Valuation - Part 2.* American Institute of Certified Public Accountants, Atlanta, GA, 2004.
- *Splitting Up is Hard to Do: Advanced Valuation Issues in Divorce and Other Litigation Disputes.* American Institute of Certified Public Accountants, Providence, RI, 2002.
- *Fundamentals of Business Valuation - Part 1.* American Institute of Certified Public Accountants, Dallas, TX, 2001.
- *Advanced Topics.* The Institute of Business Appraisers, Orlando, FL, 2001.
- *Business Valuation.* Federal Judicial Center, Washington, DC, 2001.
- *Business Issues: Business Valuation-State Issues; Marital Dissolution; Shareholder Issues and Economic Damages.* National Judicial College, Charleston, SC, 2000.
- *Business Valuation for Marital Dissolutions.* National Judicial College, San Francisco, CA, 2000.
- *Business Valuation Workshop.* 2000 Spring Industry Conference, American Institute of Certified Public Accountants, Seattle, WA, 2000.
- *Developing Discount & Capitalization Rates.* The Institute of Business Appraisers, Phoenix, AZ, 2000.
- *Mergers & Acquisitions.* National Association of Certified Valuation Analysts, Nevada, 1998; Ohio, 1998.
- *Valuation Issues in Divorce Settings.* American Institute of Certified Public Accountants, New Jersey, 1998.
- *Financial Statements in the Courtroom (Business Valuation Component).* American Institute of Certified Public Accountants for the National Judicial College, Texas, 1997; Florida, 1997, 1998, 2001; Louisiana, 1998, 1999; Nevada, 1999, 2001; South Carolina, 2000, 2006; Georgia, 2000; Arizona, 2001; New York, 2002; Colorado, 2003; Ohio, 2003; Florida, 2003; New Jersey 2005

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PROFESSIONAL QUALIFICATIONS

Instructor

- *Preparing for AICPA's ABV Examination Review Course.* American Institute of Certified Public Accountants, New York, 1997, 2000, 2001; Pennsylvania, 1998; Kansas, 1998; Maryland, 2000, 2001; Massachusetts, 2000; Virginia, 2002.
- *How to Value Mid-Size and Smaller Businesses/Using Transaction Data to Value Closely-Held Businesses.* Atlanta, GA, Chicago, IL, 1996.
- *Conducting a Valuation of a Closely-Held Business.* The Institute of Business Appraisers, Inc., 1996.
- *How To Value Mid-Size and Smaller Businesses.* The Institute of Business Appraisers, Inc., 1995.
- *Valuation of Small Businesses and Professional Practices.* American Society of Appraisers, 1995.
- *Uniform Standards of Professional Appraisal Practice.* American Society of Appraisers, 1995.
- *Advanced Topics in Business Valuation.* New Jersey Society of Certified Public Accountants, 1995, 1996, 1997.
- *Business Valuation Theory.* New Jersey, 1994, 1995, 1996, 1997, 1999, 2000, 2002; Rhode Island, 2004.
- *Business Valuation Approaches and Methods.* New Jersey, 1994, 1995, 1996, 1997, 1998, 1999, 2000, 2002; North Carolina, 1997, 1999, 2000; Louisiana, 1997, 1998; Massachusetts, 1997, 1998, 1999; Pennsylvania, 1997; New York, 1997, 2000; Indiana, 1997; Connecticut, 1997, 2000; Ohio, 1998; Rhode Island, 1999, 2003.
- *Business Valuation Discount Rates, Capitalization Rates, Valuation Premiums and Discounts.* New Jersey, 1998, 2000, 2002; North Carolina, 1997, 1999, 2000; Louisiana, 1997; Massachusetts, 1997, 1998; Rhode Island, 1997, 1999; Indiana, 1997; Connecticut, 1997, 2000.
- *Business Valuation.* Champaign, IL, American Institute of Certified Public Accountants National Tax School, 1994, 1995, 1996.
- *Principles of Valuation: Introduction to Business Valuation.* American Society of Appraisers, 1998, 1999, 2001, 2002.
- *Principles of Valuation: Business Valuation Methodology.* American Society of Appraisers, 1992, 1993, 1995, 1996, 1997, 1998, 1999, 2001.
- *Principles of Valuation: Case Study.* American Society of Appraisers, 1993, 1999, 2000, 2001, 2002, 2003.

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PROFESSIONAL QUALIFICATIONS**

Instructor

- *Principles of Valuation: Selected Advanced Topics.* American Society of Appraisers, 1992, 1994, 1995, 1996, 1998, 2002.
- *Developing Your Business Valuation Skills: An Engagement Approach.* NJ Society of Certified Public Accountants, 1992, 1993.
- *Advanced Business Valuation Seminar.* The Institute of Business Appraisers, Inc., 1991, 1992.
- *10 Day Workshop on Appraising Closely-Held Businesses.* The Institute of Business Appraisers, Inc., 1991, 1998.
- *Financial Statement Analysis.* St. Charles, MO, Lindenwood College Valuation Sciences Program, 1989, 1990.
- *Former Adjunct Instructor of Federal Income Taxation and Intermediate Accounting.* Centenary College, Hackettstown, NJ, 1982-1987.

Organizations

- The Institute of Business Appraisers, Inc.
- American Society of Appraisers.
- American Institute of Certified Public Accountants.
- New Jersey Society of Certified Public Accountants.
- New York State Society of Certified Public Accountants.
- Florida Institute of Certified Public Accountants.
- Collaborative Family Lawyers of South Florida

Awards

- Presented with the “Hall of Fame Award” by the American Institute of Certified Public Accountants in December 1999 for dedication towards the advancement of the business valuation profession.
- Presented with the “Fellow Award” by The Institute of Business Appraisers Inc., in January 1996 for contributions made to the profession.

GARY R. TRUGMAN, C.P.A.*/A.B.V., M.C.B.A., A.S.A., M.V.S.
PROFESSIONAL QUALIFICATIONS

Professional Appointments

- *The Institute of Business Appraisers, Inc.* Former Regional Governor for the Mid-Atlantic Region consisting of Delaware, Kentucky, Maryland, New Jersey, Pennsylvania, Ohio, Virginia, and West Virginia.
- *The American Society of Appraisers Chapter 73.* Treasurer, 1996 - 1997.

Current Committee Service

- Chairman of Valuation, Forensic Accounting and Litigation Services Section - Florida Institute of CPAs.
- Chairman of Disciplinary and Ethics Committee -The Institute of Business Appraisers, Inc. (committee established 1989).
- AICPA ABV Examination Committee.

Past Committee Service

- AICPA Committee with the Judiciary.
- AICPA ABV Credential Committee.
- AICPA Management Consulting Services Division - Executive Committee.
- Chairman of the Valuation Standards Subcommittee - NJ Society of Certified Public Accountants Litigation Services Committee.
- Matrimonial Subcommittee - NJ Society of Certified Public Accountants Litigation Services Committee.
- Co-Chair of Courses and Seminars for Certified Public Accountants Subcommittee - NJ Society of Certified Public Accountants.
- Education Committee - The Institute of Business Appraisers, Inc.
- Chairman of Education Committee - North Jersey Chapter of American Society of Appraisers.
- AICPA Subcommittee on Business Valuation & Appraisal.
- International Board of Examiners - American Society of Appraisers.
- Qualifications Review Committee - The Institute of Business Appraisers, Inc.

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PROFESSIONAL QUALIFICATIONS

Editor

- Editorial Advisor for *Financial Valuation and Litigation Expert*, Valuation Products and Services.
- Editorial Advisor for *CPA Expert*, American Institute of Certified Public Accountants.
- Editorial Advisor for *The Journal of Accountancy*, American Institute of Certified Public Accountants.
- Former Editorial Advisor of *BV Q&A*, Business Valuation Resources.
- Former Editorial Board of *CPA Litigation Service Counselor*, Harcourt Brace, San Diego, CA.
- Former Editorial Board of *Business Valuation Review*, American Society of Appraisers, Herndon, VA.

Author

- Course entitled *Small Business Valuation: A Real Life Case Study*, American Institute of Certified Public Accountants (2005).
- *Guideline Public Company Method - Control or Minority Value?*, Shannon Pratt's Business Valuation Update (2003).
- *Signed, Sealed, Delivered*, Journal of Accountancy (2002).
- *A CPA's Guide to Valuing a Closely Held Business*, American Institute of Certified Public Accountants (2001).
- Course entitled *Business Issues - State Courts*, National Judicial College, Reno, NV (2000).
- *Understanding Business Valuation: A Practical Guide to Valuing Small to Medium-Sized Businesses*, American Institute of Certified Public Accountants, First Edition (1998) Second Edition (2002).
- Contributing author to *The Handbook of Advanced Business Valuation*, McGraw-Hill (1999).
- Course entitled *Valuation Issues in Divorce Settings* for the American Institute of Certified Public Accountants (1997).
- Co-author of course entitled *Accredited Business Valuer Review Course* (Market Approach Chapter) for the American Institute of Certified Public Accountants (1997).

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PROFESSIONAL QUALIFICATIONS**

Author

- *Understanding Business Valuations* for The Institute of Continuing Legal Education (1997).
- Six Day Business Valuation Series consisting of *Business Valuation Theory, Valuation Approaches & Methods* and *Advanced Topics in Business Valuation* (1994, 1995.)
- *Advocacy vs. Objectivity, CPA Litigation Service Counselor*, Harcourt Brace, San Diego, CA (1993).
- *Valuation of a Closely-Held Business*, Practice Aid for the American Institute of Certified Public Accountants (1993).
- Co-author of *Guide to Divorce Engagements*, Practitioners Publishing Company, Fort Worth, TX (1992).
- *A Threat to Business Valuation Practices, Journal of Accountancy* (December 1991).
- Course entitled *Advanced One Day Seminar* for The Institute of Business Appraisers, Inc. (1991).
- Course entitled *Understanding Business Valuation for the Practice of Law* for the Institute of Continuing Legal Education in NJ.
- *An Appraiser's Approach to Business Valuation, Fair\$hare*, Prentice Hall Law & Business (July & August, 1991).
- *What is Fair Market Value? Back to Basics, Fair\$hare*, Prentice Hall Law & Business (June 1990).