HELPING JUDGE AND JURY UNDERSTAND VALUATION TESTIMONY

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I. INTRODUCTION

Most lawyers possess little more than a basic understanding of valuation approaches and techniques. If you have tried a complex valuation case, you may have found that some "experts" do not know a whole lot more. If professionals who regularly deal with complicated valuation problems have difficulty understanding how to value a business or other entity, one can imagine how challenging it is for a layperson to grapple with such a difficult subject.

The purpose of this paper is to provide attorneys and expert witnesses with the information and knowledge necessary to help a judge or jury understand valuation testimony. The paper consists of three parts. The first part provides the practitioner with practical tips to use in preparing and presenting valuation testimony to a judge or jury. The second part is an analysis of the strengths and weaknesses of a fictitious valuation report. The third part is the actual valuation report itself. The authors of this paper hope that it will be a valuable resource to aid practitioners in understanding valuation reports, preparing and presenting valuation testimony, and attacking and defending expert valuation opinions.

II. PRACTICAL TIPS

A. Know Your Audience

1. Judge

If your case is tried to a judge, a great deal of information is available to guide you in presenting your valuation case. Remember that all judges are not created equal. Learning about a judge can provide valuable insight into how valuation testimony should be presented. In order to better understand your judge, consider the following questions:

Does the judge have experience in business valuation cases? Has the judge dealt with cases with this level of complexity? If so, how often? Does the judge have a track record that would suggest what you should focus on or avoid? Have any of the experts in your case testified in front of the judge? If so, what were the results of the case.

2. Jury

If your case is tried to a jury, it is equally helpful to understand the individuals who will decide the case. The following are examples of questions you should consider asking the members of your jury.

Are they from an urban area? Are they from a more rural area? What is the general socio-economic background of your jury pool? Do they have a business or accounting background?

Answers to these questions can be helpful in determining how to connect with the jury. Specifically, they may provide valuable insight into what examples to use in conveying your message. For example, using the illustration of buying a house to explain the Market Approach may not be appropriate in an urban area where everyone rents. As discussed below, the more relevant and identifiable your examples are, the more likely you will be to get your point across to the jury.

B. Keep It Simple

1. Use "everyday" language if at all possible

This is not business school and the judge and/or jury members are not working toward becoming accountants. While it is important to tailor your presentation to the level of sophistication of your audience, you should always strive to make valuation testimony as easy to understand as possible. This is important to keep in mind when preparing your valuation report as well. Always speak and write in language that can be understood by a mass audience, not in jargon that only fellow practitioners will comprehend.

2. Do not get too caught up in the details

The audience does not need to fully understand all the intricacies and nuances of business valuation. Give them something they can sink their teeth into. If you overwhelm them, your message will get lost, even if it is technically sound.

This is not to say that the details are not important. In fact, they can be critical, especially

This can be a very fine line to walk. Often, the difference is not so much in the content of the valuation testimony as it is in the presentation. This is something to consider when selecting your expert. A valuation expert might have impeccable qualifications yet that expert might not be the best choice for your particular case. For example, an expert from New York might not "play" well in a rural Southern town. On the other hand, the same expert might be a perfect fit for a case on the East Coast.

4. Always be respectful, never arrogant

It is important to focus on an expert's qualifications, especially if he or she is imminently more qualified than the opposing expert. However, this should not be done in a "showy" or pretentious way. If they don't like you, they may not listen to you, or worse, they may punish the client because of how you present yourself.

D. Use "Real World" Examples

When explaining a complex and relatively unknown subject like valuation, one of the best ways to connect with the audience is through the use of examples that the audience members can easily understand and identify. If you can compare your valuation approach to an experience with which they are familiar, the odds that they will understand and, more importantly, accept your valuation opinion increase significantly.

One example that many people can identify with is the purchase of a home. This common experience can be used to demonstrate all three of the traditional valuation approaches.

in attacking or defending a valuation opinion on cross examination. However, the presentation of your expert's opinion through direct examination should done in an organized and straightforward manner.

3. Assume the listener has no background in the area

Even if all your jurors have business degrees, you need to start with the basics. If you lose them at the beginning, you may never be able to recover.

C. Do Not Speak In A Condescending Tone

3. Keep it simple, but don't talk down to them

While they are obviously oversimplifications of each approach, these examples can be a valuable tool in forming a basic understanding of each approach in the minds of you audience.

1. <u>Income Approach</u>: If in individual is purchasing a rental home, he or she would value the property based on the income that can be derived from future rentals. In other words, how much would a buyer pay today for the right to receive rental payments in the future?

2. <u>Cost/Asset Approach</u>: Another approach to valuing a home is to determine what it would cost to replace the house. In other words, the house is worth whatever it would cost to purchase the various materials necessary to build it.

3. <u>Market Approach</u>: Finally, one could determine the value of a home by looking at the prices of comparable homes. While adjustments must be made for certain factors (i.e. the house is the biggest in the neighborhood), the value of the house will probably not vary significantly from the relevant market.

E. Give Your Audience Something They Can Look At

1. People are visual learners

While the statistics vary from study to study, there is no question that learning is significantly aided by visual aids. If the visual component of your presentation is ignored, you run the risk of not fully conveying your message to the audience. Furthermore, you may fail to connect at all with those members of the audience whose primary learning style is visual.

2. Include charts and graphs whenever possible

If it all possible, use charts, graphs, or other visual aids to support your argument. These aids will be particularly helpful if they are admitted into evidence so that the jury can review them during deliberation. Even if they are not admissible, visual aids can be a powerful and effective demonstrative tool.

III. ANALYSIS OF VALUATION REPORT

A. Introduction

Set forth hereinbelow is an analysis of the strengths and weaknesses of the subject fictitious valuation report, attached hereto as Appendix A. This report is based upon a real case, but the facts and analyses have been altered for illustrative purposes. Our presentation has been structured from the standpoint of both direct and cross examination of a valuation expert. It is designed to assist you in (i) identifying the strengths and weaknesses in a valuation report; (ii) developing appropriate questions for direct examination; and (iii) developing appropriate questions for cross examination. In addition, it is our hope that this handout can be put to work in your everyday practice.

B. Strengths

2. The identity of the business to be valued is identified.

3. The percentage ownership interest in the business to be valued is identified. This should be stated at the very beginning of the report. It should **always** be checked to make certain that the appraiser has valued the appropriate business ownership interest.

4. The **Effective Date** of the valuation is clearly stated. This is critical because it serves as a demarcation point. An appraiser is charged with knowledge of all facts and circumstances existing as of the valuation date. Additionally, an appraiser is expected to consider subsequent events that provide evidence of facts and circumstances existing as of the effective date of the valuation.

5. A table of contents is provided.

6. The applicable standard of value, along with its definition, is stated.

7. The 8 factors to be considered in all valuations as set forth in Revenue Ruling 59-60 are stated.

8. The company's legal form of organization, including state of organization, is set forth.

9. The Company Description and Business Model section is succinct and addresses key points such as the legal form of organization of the subject company (single member LLC organized under California law), the litigant's ownership and role in the subject company, the subject company's specialties, number of employees, geographical location, major lines of business (temporary and permanent placements), major revenue sources, major customers, etc.

10. The history and capital structure of the subject company are described in detail.

11. The national and regional economy as of the effective date of the valuation are reviewed.

12. There is a strong discussion of the different approaches to valuation (Cost, Income and Market).

13. The financial analysis of the subject company is both detailed and substantive in nature which demonstrates that the appraiser has a

thorough understanding of the company's finances.

14. A preferable measure of cash flow, called free cash flow (sometimes referred to as net cash flow), is employed in valuing the subject company using a single period capitalization of economic benefits valuation model.

15. The appraiser gave consideration to the potential financial effects of using financial data for the calendar year-end versus annualized financial data for 12-month periods ended February 28.

16. Normalization adjustments are described in sufficient detail for the reader of the report to discern their derivation and calculation.

17. Notwithstanding that the normalization adjustment related to accounts receivable is complex and not free from challenge from a number of perspectives, it represented a reasonable approach to estimating the cash flow effects associated with the *change* in accounts receivable. Failure to adjust for the *change* in accounts receivable when starting from a zero balance would have been a major mistake resulting in an understatement of free cash flow.

18. Notwithstanding that the normalization adjustment related to an implied 40% income tax liability is not free from challenge, its underlying theory is consistent with current practices within the business valuation community. Although this practice is currently being strenuously debated within the business valuation community, there is more support <u>for</u> deducting a hypothetical corporate-level tax than <u>against</u> doing so.

19. The appraisal report provides a detailed analysis of the derivation of the capitalization rate to be applied to free cash flow. The specific company risk factor is separately supported, although it could be argued that some of the cited factors could support other normalization adjustments and/or valuation adjustments. This creates some risk of double-counting.

20. Although not free from challenge, the appraiser provides support for a 2% long-term perpetual growth rate in free cash flow.

21. The appraiser develops an estimate of value based upon *Done Deals Data* which is a generally accepted source of actual sales transactions. More weight is placed upon the most recent transactions which intuitively makes sense notwithstanding whether or not such a weighting has any empirical research foundation.

22. The appraiser provides limited analysis and support for a modest 10% discount for lack of marketability (DLOM). Additionally, the appraiser correctly only applies that valuation adjustment to the indication of value produced by the single period capitalization of free cash flow.

23. Although not free from challenge, the appraiser clearly described how he developed his final conclusion of value based upon consideration of the indications of value based upon application of the single period capitalization of cash flow and comparable transactions valuation methods.

24. The valuation report is organized and is free from typographical, spelling and grammatical errors.

C. Weaknesses

3. A close reading of the Company Description and Business Model section reveals a number of inconsistencies:

d. The report states that between April and December 2000, the Company paid out "less than $500,000 in total base salaries and $1.03 million in commissions." It is unclear how those figures reconcile to Exhibit H because that exhibit does not break out commissions separately from "salary."

e. The average salary for a permanent position placement in Chicago is approximately five (5) times that of Los Angeles or Houston. L.A. is one of the most expensive cities in the U.S. in which to live; therefore, one would expect salaries to be commensurate with the cost of living as they are elsewhere. This contradiction is never addressed by the appraiser. Could this represent a mistake?

f. The majority of the firm's revenue (approximately 75% from April 2000 - February 2001) is generated through the LA office despite the fact that the average salary per permanent placement – according to the report – in Chicago is approximately five (5) times that in L.A. Assuming that the percentage of salary that P.R. charges for commissions is approximately equal in both cities and both offices have approximately the same percentage of permanent versus temporary placements, this purported fact only makes sense if the sales volume in the L.A. office is approximately *fifteen (15) times* that of Chicago. Does that make sense? For example, if L.A. makes $1 for every $5 made in Chicago, the volume in L.A. would have to be *five (5) times* that of Chicago in order to reach an approximate breakeven between the two offices on an absolute dollar of revenue basis. In order for the L.A. office to generate approximate 75% of P.R.'s overall revenue, L.A. would have to generate approximately $3 in revenue for every $1 generated in Chicago; so 5 x 3 = 15x meaning that L.A. would have to generate approximately fifteen (15) times the sales volume in Chicago. Does this make much sense?

d. The appraiser gives short shrift to the mix of permanent versus temporary placement volume; however, that has an impact upon a personnel firm's cash flow. Permanent placement revenue is generally higher, but much more sporadic than revenue from temporary placements, unless the search firm works on a substantial retainer basis in connection with their permanent placements. Temporary placements, however, produce weekly cash flow which is, in general, more steady than that which is associated with permanent placements. Moreover, temporary employment may rise in a slower economic environment as employers lay off full-time employees and replace them with temporary employees, thus increasing employer payroll flexibility.

2. The History of the Company and its Capital Structure section provides an incomplete financial analysis of the transaction between Professional Recruiters, LLC, PR, Inc., John Smith and Randall Klein. It is impossible to impute a value for 100% of the value of PR, Inc. as of the closing date of the transaction given the incomplete information contained in the appraisal report. This is an issue that should be explored on cross-examination. Another related issue that should be explored on redirect would be the financial effect of the difference between investment value (actual transaction price and terms) and fair market value or in comparison to the

stated standard of value in your particular state if it is not fair market value.

3. The Company was capitalized with $475,000, all or a portion of which was deposited into a bank account with Republic National Bank of New York. Why does a company with locations in Chicago, Houston and L.A. use a New York bank? Is it cash management of disbursements (in order to maximize payment float time) or is there an undisclosed reason why the subject company is using a New York-based bank? What business might the subject company have in New York? Does the owner-spouse have a paramour in New York? Does s/he travel to New York on a regular basis and does this relate to a need to maintain a New York bank account?

4. The report does not describe the rent undertaking in each of the subject company's offices.

5. The valuation report describes the national economic forecast as of the valuation date. The appraiser does not adequately relate it to the valuation.

b. For example, the appraiser does not indicate if the economic forecast supports valuation indications at the lower, mid-point or average, or high end of a possible range of values. Moreover, the appraiser makes no reference to any post-DOC national economic data that may have been foreseeable as of the effective date of the valuation, and whether such information may have impacted the appraiser's conclusions.

c. If the national economic forecast is that economic growth will moderate, the appraiser should explain that those conditions could result in a somewhat lesser demand for employees and a moderation in salaries. Moderating salaries generally translate into lower commissions. In addition, the moderating economic environment should be related to its effect upon the subject company's expected commission revenue stream based upon the subject company's expected mix of permanent versus temporary employee placements.

6. As part of the financial analysis of the Company, it is stated that PR's executive salaries at 15.8% of sales for the 8-months ended December 31, 2000 was approximately three (3) times higher than its peer group average of 5.1%. The valuation analyst posits that this factor would tend to *increase* the perceived value of the subject company because a hypothetical buyer could decrease executive compensation to the peer group average. The appraiser appears to fail to relate the above-average compensation to the fact that the company is performing way above its peers when measured by pretax profit margins (four (4) times: 12% versus 3% pretax profit margins). That would tend to support the reasonableness of the higher compensation levels. Therefore, a hypothetical buyer would unlikely count upon reducing executive compensation if such a buyer expects to enjoy the fruits of the labor of current management!

7. The statement of the appraiser's assessment of the investment attractiveness of the subject company is ambiguous. It is unclear if – on balance – the appraiser concluded that an ownership interest in the subject company was less favorable, the same as or more favorable than an investment in its competitors! Please refer to the report paragraph located just above the section entitled *Valuation Conclusions*.

8. Referring to Exhibit K, the appraiser appears to have made an error in calculating adjusted free cash flow which is used in the single period capitalization method. In calculating adjusted free cash flow, the appraiser deducts $330,103 for an increase in accounts receivable (an increase in accounts receivable is normally a "use" of cash flow) from PR, LLC's inception until 12/31/00. Recognizing that using zero as the starting point for calculating the change in accounts receivable would be a distortion, the appraiser then decreases accounts receivable by $461,316 in an attempt to estimate the change in accounts receivable from 12/31/99 to 12/31/00. The net effect of these two items is to decrease accounts receivable (therefore, increase cash flow related to working capital) by $131,213. Thus, the appraiser implicitly posited a perpetual $131,213 increase in free cash flow from a decrease in working capital. This assumption is unsustainable. Moreover, if one assumes at least $100,000 **less** free cash flow and one were to capitalize that change in cash flow at the appraiser's 21.24% capitalization rate (23.24% discount rate less 2% estimated long-term growth rate), that change alone would decrease the calculated value by $470,810, or 14.28%, which is material by anyone's standards.

9. The next error appears in Exhibit K with respect to the calculation of the tax provision of 40%. Footnote 1 appears to be incorrect. It starts out with operating income from Exhibit H for the period 4/17/00 - 12/31/00 and annualizes it by dividing by a fraction equal to 0.7715 (represents 185 working days/260 working days in a year). The appraiser should have started with the annualized operating income from Exhibit H of $388,018. In addition, the appraiser adds in $910,778 of normalization adjustments, but the accounts receivable adjustment of $461,316 should not have been added to the $388,018. Although the $461,316 has a cash flow impact, it is not an element of operating income for income tax purposes; therefore, it should not have been added in. The correct calculation should have been $388,018 + $910,778 - $461,778 = $837,018 x 0.40 = $334,807. Even though the valuation effect of the error ($338,303 - $334,807 = $3,496/.2124 = $16,460) is immaterial, it could easily be used to impugn the valuation work performed by the expert!

10. The appraiser's reasonable compensation adjustment is subject to challenge because it does not explicitly address the issue of whether it includes an element of compensation for Mr. Smith's sales efforts. Mr. Smith is PR's most successful sales person. For every $100,000 that reasonable compensation is understated, the appraiser's estimate of value is overstated by $470,810, or 14.28% based upon the appraiser's stated opinion of value.

11. The appraiser uses a comparable transactions methodology, in addition to an income approach, to estimate the subject company's value. *Done Deals Data* is used. While it is a fact that the appropriate ratio to be used to value a personnel agency is Price/EBITDA, the appraiser never supports choosing any particular type of ratio by employing statistical analysis including computing a coefficient of variation and R^2 which would show the relative dispersion of data around a particular multiple in support of choosing one type of multiple over another. That fact notwithstanding, the

appraiser's calculation of value is set forth in Exhibit Q. The appraiser uses an economic benefit stream labeled as "cash flow from operations." Unfortunately, one can't find the $659,968 figure anywhere in this report! In addition, in discussing comparable transactions in the Valuation Conclusion section of the subject report, the appraiser states that the price to operating cash flow ratios were weighted 3-2-1 for 2000, 1999 and 1998, respectively. Unfortunately, a reader of this report – based solely upon this report – could not possibly determine how the appraiser, in fact, applied that weighting as set forth in Exhibit Q. Moreover, the appraiser's choice to weight by year may be subject to challenge. The appraiser could have provided the reader with all of the figures to reproduce the multiples in 1998 - 2000. The appraiser may also have considered summing the numerators over the 3 years and dividing by the sum of the denominators over that same period of time. This methodology would also have produced a weighted average, but this weighted average would be weighted by the actual values, rather than weighted by time. The appraiser may have, in fact, undertaken this type of weighting and simply concluded that it was inappropriate to use for this valuation for one or more other unknown reasons. Since the underlying data is not included in the report, the reader can not determine the effect of undertaking this type of procedure. This is an area for cross-examination!

12. The support for the 10% discount for lack of marketability (DLOM) is insufficient. No reference to specific Pre-IPO or restricted stock studies is offered. Developing a DLOM for a control ownership interest using the Pre-IPO and restricted stock studies is controversial. There are appraisers who believe that it is inappropriate to infer an appropriate DLOM using these empirical market studies because these studies are based upon transactions involving minority stock ownership interests. It is also worth noting that new academic empirical research is in the process of being published which challenges the basic premise of using the Pre-IPO and restricted stock studies to develop a DLOM to be applied to the valuation of closely-held stock.

13. Some other issues for consideration.

a. The appraiser notes the existence of off-balance-sheet financing in the form of factoring of receivables with recourse. Query. The appraiser uses a debt-free methodology to calculate the fair market value of total invested capital (interest-bearing debt plus stockholder's equity). In the final analysis, the appraiser does **not** deduct the contingent debt from the calculated value of total invested capital. Should the appraiser have done so? Answer: It would be incorrect to deduct the debt since the receivables would also have to be added back and, with the exception of the implicit interest cost associated with the factoring facility, the two amounts should otherwise offset one another.

b. While the appraiser weights the valuation indication based upon the application of the market method twice as much as the valuation indication based upon the application of the income approach, such an overt weighting is always subject to challenge. To the appraiser's credit, a reasonable explanation is offered for the weighting. That having been said, in cross examination, the expert should be challenged on how their conclusion would change using different weights.

D. Summary

In summary, **the devil is in the details**. In order to challenge an appraisal report, you have to scrutinize all the details in the expert's report. Here are some **"Do's"** and **"Don't's."** This is **not** meant to be an all-inclusive list.

6. Verify all mathematical calculations.

7. Trace all numbers between schedules/exhibits/text.

8. Evaluate the care with which the report was prepared.

9. Challenge the appropriateness of cited research sources.

10. Challenge whether all available research data was utilized.

11. Challenge the appraiser's choice of valuation approaches and methods.

12. Verify that the appraiser considered all three valuation approaches (cost, market and income).

13. Challenge the use of a single period capitalization of economic benefits income method versus employing a discounted cash flow (DCF) methodology. Make certain that the appraiser can articulate the justification for using one methodology versus another.

14. Challenge the source and calculation of the components of the discount and/or capitalization rates used by the appraiser in employing the income approach, and, in particular, the specific company risk and perpetual growth elements thereof.

15. Challenge the appraiser's choice of valuation multiples when the market approach to valuation is employed. Make certain that the appraiser can articulate the basis for their choice of employing one or more multiples versus employing one or more other multiples.

16. Challenge all material assumptions and ascertain how the valuation opinion would change if one or more assumptions were changed.

17. Don't impugn the personal integrity of the appraiser.

18. Challenge all valuation adjustments (discounts and premiums). Make certain that the expert is completely familiar with all the pertinent empirical studies that s/he cites in their report or upon which they have relied as stated in their testimony. Make certain that they have kept up-to-date on all the changes occurring in this dynamic area of valuation.

19. Keep in mind that appraisal reports contain hundreds and possibly thousands of numbers. Mistakes can and do occur. Many appraisers work in medium and large firms and not every piece of work receives the same level of review. Those who work as sole practitioners may have no review other than themselves. As a general rule, it is probably better not to crucify the appraiser for making a mistake. It happens to everyone. It may be more effective to bring the error to the appraiser's attention and provide the appraiser with an opportunity to gracefully acknowledge the error and its effect on the ultimate valuation conclusion. This is a very controversial issue for trial lawyers because there are those lawyers who believe that the most effective trial strategy is to try and totally discredit the appraiser, but the effectiveness of this approach is not free from doubt. A lawyer may want to totally discredit an expert in front of a jury, but take a more reserved tact – as suggested hereinabove – in front of a

judge. **Know your audience!**

20. Accept the fact that experts can and do intellectually disagree. Do explore controversial positions; don't dismiss positions that are controversial simply because they may be controversial. Do your own research long before you get to Court so you're prepared to challenge the controversial points. **Remember Daubert!**

Appendix A

Valuation of John Smith's 100% Ownership Interest in Professional Recruiters, LLC As of February 28, 2001

Business Valuation L.L.C.
Certified Public Accountants & Consultants
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Applicable Standard of Value

We used the fair market value standard to value the ownership interest of John Smith in Professional Recruiters, LLC (PR). This standard of value is conventionally described as follows:

> *The value of the property is the price at which such property would change hands between a willing buyer and a willing seller, neither being under any compulsion to buy or to sell, and both having reasonable knowledge of the relevant facts. The value of a particular kind of property is not the price that a forced sale of the property would produce. Nor is the fair market value of an item of property the sale price in a market other than that in which such item is most commonly sold to the public taking into account the location of the item wherever appropriate.*[1]

We also derived our valuation opinion in a manner that is consistent with Internal Revenue Service Revenue Ruling 59-60.[2] The Ruling directs business appraisers to consider the following factors in valuing the stock of closely-held corporations:

1. The nature of the business and the history of the enterprise from its inception;
2. The economic outlook in general and the condition and outlook of the specific industry in particular;
3. The book value of the stock and the financial condition of the business;
4. The earning capacity of the company;
5. The dividend-paying capacity of the company;
6. Whether or not the enterprise has goodwill or other intangible value;
7. Sales of the stock and the size and the block of the stock to be valued; and
8. The market price of stocks of corporations engaged in the same or similar line of business having their stocks actively traded in a free and open market, either on an exchange or over-the-counter.

In addition, various federal and U.S. Tax Court decisions frequently state that the hypothetical buyer and seller are assumed to be able and willing to consummate the transaction and that both are assumed to be informed about the property and the market for such property. Also implied in this definition is that the value represents a cash or cash equivalent amount. It also assumes that the property would have been exposed on the open market for a long enough period of time to allow market forces to interact to establish value.

[1] *U.S. Treasury regulation 25.2512-1.*

[2] Rev. Rul. 59-60, 1959-1 C.B. 237.

Company Description and Business Model

Professional Recruiters, LLC (PR) is a single-member limited liability company (LLC) organized under the laws of the State of California. John Smith is the sole member and manager of the company. PR is a staffing concern that places temporary and permanent personnel within the financial services industry. PR specializes in the placement of back office clearing and processing clerks and managers and similar securities trading support personal with banks and securities brokerage firms. PR operates out of three office locations: Los Angeles, CA; Chicago, IL; and Houston, TX.

John Smith is the President and Chief Executive Officer of PR. As of August 2001, the company employed approximately 24 employees; 16 of whom were recruiters and salespeople. The Los Angeles office is the largest location, employing 8 recruiters and salespeople, 4 administrative personnel and 1 temporary position. The balance of the employees is divided evenly between the Chicago and Houston locations. Compensation for salespeople and recruiters is heavily dependent on commissions. Commissions are typically earned as a percentage of the annual salary (or hourly wage) paid by PR's customers to the temporary or permanent personnel placed by PR. For the period April through December 2000, PR paid less than $500,000 in total base salaries and $1.03 million in commissions.

In 2000, PR listed approximately 50 customers. Specific customers included Bank of California, Bank of Texas, Bank of Chicago and Bank of Los Angeles. The average salary for a permanent position filled by PR in Los Angeles is $52,000; the averages for Chicago and Houston are $250,000 and $45,000, respectively.

The majority of PR's annual revenue is generated through its Los Angeles office. For the period April 2000 through February 2001, approximately 75% of the company's revenue was generated by the Los Angeles office. During this same period, permanent placements accounted for a slightly higher percentage of the Los Angeles revenue than temporary placements. The Chicago office only provided permanent placements during this period. A large majority of the revenue generated by the Texas office during this period was also due to permanent placements.

History of the Company and its Capital Structure

PR commenced operations on April 17, 2000 as a limited liability company.[3] PR was formed as a result of an asset and stock sale involving a predecessor company, PR, **Inc**. PR, Inc. was engaged in substantially the same business as PR. PR, Inc. placed temporary and permanent personnel in back-office positions for financial services companies; it operated out of the same three office locations; and John Smith was the President and Chief Operating Officer and was responsible for the day-to-day management of PR, Inc. At the time of the asset sale, Mr. Smith owned 50% of PR, Inc. Randall Klein, Mr. Smith's business partner and PR, Inc.'s Chief Executive Officer, owned the remaining 50% of the company. As per the terms of PR, Inc.'s shareholder agreement, Mr. Smith was responsible to "recruit, solicit and provide services to employer-clients" and to "recruit, solicit, interview and refer to employer-clients" personnel for placement. Mr. Smith was directed to "devote his full business time and attention" to PR, Inc. Mr. Klein, in contrast, was a passive investment partner. The shareholder agreement specified that Mr. Klein "need not devote any time and attention to the business " except "such time that he alone, in his sole discretion, deems necessary."[4]

On April 25, 2000 PR and John Smith purchased certain of the assets of PR, Inc. in exchange for consideration of $2,663. PR had previously been established by John Smith for the specific purpose of receiving the assets of PR, Inc. The purchased assets consisted of "contracts, files, orders, lists, personal property, telephone numbers, the names Professional Recruiters and URL www.professionalrecruiters.com and the goodwill of the business."[5] The personal property consisted of all office furniture and trade fixtures from all three office locations. PR also assumed from PR, Inc. the property leases for the office locations in Houston, Texas and Chicago, Illinois.[6] Recruiting Services, Inc., a business entity owned, at least in part, by Randall Klein, licensed to PR the right to occupy the Los Angeles office space. Certain assets were excluded from the purchase agreement, including pre-closing accounts receivable and any cash, cash equivalents and investments held in the name of PR, Inc.[7] Contemporaneous with the asset sale, Mr. Smith sold his 50% ownership interest in PR, Inc. to Randall Klein for total consideration of $1.

[3] In the Notes to Financial Statements that accompany PR's financial statements for the year-ended December 31, 2000, it is stated that the business began operation on April 19, 2000. However a review of the company's books and records indicates receipt of revenue beginning April 17, 2000.

[4] See: Shareholder's Agreement, Professional Recruiters, Inc. Dated April 28, 1993.

[5] See: Asset Purchase Agreement By and Among Professional Recruiters LLC, as Buyer, John Smith and Professional Recruiters, Inc. as Seller, Article 2.1.

[6] We reviewed Assignment and Assumption of Lease agreements for the Houston and Chicago properties. The parties to this agreement were PR, Inc. and PR, LLC. We were not provided with any written documentation, to which the property landlords were a party, evidencing the formal conveyance of PR, Inc.'s lease obligations to PR, LLC.

[7] See: Asset Purchase Agreement By and Among Professional Recruiters LLC, as Buyer, John Smith and Professional Recruiters, Inc. as Seller, Article 1 ("Excluded Assets").

According to PR's financial statements for the period ending December 31, 2000 the company was capitalized with $475,000. PR's electronic books and records indicate that a capital contribution of $250,000 was received on April 24, 2000 and a second contribution of $225,000 was received on May 23, 2000. We were told by Mr. Smith that the source of funds for both contributions was his personal SG Cowen Securities Corporation investment account (account no. XXXXXX). We reviewed an April 2000 statement for this account and confirmed a wire transfer from this account in the amount of $250,000 dated April 26, 2000. Mr. Smith was unable to locate the account statement evidencing the second wire transfer of $225,000. However, Mr. Smith did inform us that the contribution of $225,000 was deposited in an account at the Republic National Bank of New York (RNBNY). The deposit was pledged as security against two irrevocable standby letters of credit issued by RNBNY on behalf of PR. The letters of credit were issued to provide lease deposits for PR's three office locations. We reviewed two letters of credit issued by RNBNY on behalf of PR and totaling $225,000. The first letter, in the amount of $125,000, listed Real Estate Syndicate (of Los Angeles, CA) as the beneficiary. The second letter of credit, in the amount of $100,000, listed Professional Recruiters, Inc. as the beneficiary. Notwithstanding the lease assumption agreements between PR, Inc. and PR, it is our understanding that PR, Inc. remained legally responsible for the Chicago and Houston properties.[8] As such, PR, Inc. required from PR a security deposit for these properties in the amount of $100,000.

As a single member limited liability company, PR pays no income taxes. Rather, PR's income is reported on Schedule C of Mr. Smith's personal federal tax return, form 1040. However, the company does maintain separate books and records.

Economic Outlook

The value of any business interest is influenced by the general economic outlook as of the valuation date. The outlook of the economy at any given point in time influences how investors perceive alternative investment opportunities.

National Outlook

The economy of the late 1990s was clearly in an expansionary phase, which arguably peaked in early 2000 and began the transition to contraction. The economy performed exceptionally well during the mid-to-late 1990's with rapid growth, low unemployment and declining inflation. Since 1996, real gross domestic product (GDP) growth averaged over four percent versus a three-percent average since 1973. Unemployment fell to 4.1 percent, its lowest level since January 1970. Core CPI inflation, which excludes food and energy prices, was roughly two percent in 1999 versus an average of three percent earlier in the decade.

Much of the economic success was attributable to a surge in productivity growth, allowing the economy to grow at a faster rate (as compared to historical growth rates), without a corresponding rise in inflation. Low import and oil prices through most of 1999 also helped to suppress inflation. Domestic demand grew faster than productivity, which boosted employment and real disposable income. This supported a consumer-spending boom that was also fueled by rising stock prices and resulted in an unprecedented increase

8 See footnote #6, above.

in household wealth.[9]

[9] *The Budget and Economic Outlook: Fiscal Years 2000 - 2010*, Congressional Budget Office, January 2000.

"The growth during the early 1990s has exceeded that which can be accounted for by most estimates of sustainable productivity growth and by the rise in the working-age population. Consequently, the unemployment rate has fallen, and the pool of workers available to meet continued growth in demand has dwindled to a bare minimum."[10] A tight labor market puts pressure on employers to increase wages and benefits in order to attract and retain employees. Such rising labor costs could result in increased inflation if passed on to consumers or the reduction of corporate profits if firms are unable to pass the increases along.

The economic forecast set forth by the Congressional Budget Office in January 2000 saw the economic growth remaining strong, but slowing at least moderately from the 4.3 percent pace of the prior three years. The report foretold of growth averaging about 3 percent through 2002 and a slight increase in inflation. From 2002 through 2010, the growth of real GDP is expected to average 2.7 percent per year, while inflation, as measured by the consumer price index (CPI) averages 2.5 percent annually and the unemployment rate averages 5.0 percent. After 2001, short- and long-term interest rates are assumed to average 4.8 and 5.7 percent respectively.

However, the U.S. Congressional Budget Office report also recognized that the near-term outlook could be worse than expected if tight labor markets triggered higher inflation and interest rates, or if the stock market declines significantly.[11]

Regional Outlook

PR operates in three locations: Los Angeles, CA; Chicago, IL; and Houston, TX. Thus, in addition to analyzing national economic conditions in the late 1990's we also undertook a study of regional employment trends. We focused on employment trends given the nature of PR's business.

Los Angeles

As of December 2000, the Los Angeles metropolitan area was experiencing a 12-year low in the level of unemployment. According to the U.S. Bureau of Labor Statistics (BLS), the average unemployment rate for the area for the calendar year 2000 was 5.7%. Not since 1988 had the level of unemployment in the Los Angeles area dipped below 6%. However, on the heels of the low unemployment levels in the late 1980's, an economic recession in the early 1990's caused the metropolitan unemployment rate to peak at 11% in 1992. Unemployment remained high, relative to historical figures, in 1993, when the unemployment rate averaged 10.4%. Although unemployment began to recede between 1994 and 1998, it was not until 1999 that the rate decreased significantly to 6.7%. By the end of 2000, the rate had decreased by nearly one-half from its peak in 1992.[12]

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10 *The Budget and Economic Outlook: Fiscal Years 2000 - 2010*, Congressional Budget Office, January 2000.

11 *Ibid.*

12 Regional unemployment data downloaded from Bureau of Labor Statistics' Local Area Unemployment Statistics website [REDACTED] on September 4, 2001.

The Los Angeles metropolitan area is significantly dependent on employment in finance, insurance and real estate. According to the Federal Deposit Insurance Corporation (FDIC), the metropolitan area is 110% more reliant on employment in these sectors than is the nation as a whole.[13] At the end of 2000, the BLS reported that nearly one-half million people, in Los Angeles alone, were employed in the finance, insurance or real estate sectors.[14] As of the first calendar quarter in 2001, the FDIC reports 12.3% of all employment in the Los Angeles area was concentrated in these sectors. However, employment growth in these sectors has recently slowed. After a 1% year-over-year increase in 1997 and a 2% increase in 1998, employment in these sectors grew by 0.5% percent in 1999 and 0.9% in 2000. As of the first quarter in 2001, year-over-year growth in these sectors was 0.8% for the Los Angeles area. Of the seven industry groupings tracked by the FDIC, the grouping represented by finance, insurance and real estate had the third-lowest year-over-year growth, ahead of manufacturing and government and government enterprises.[15]

Chicago

As of December 2000, the unemployment rate in the Chicago, Illinois metropolitan area was at its lowest point in more than 10 years. According to the U.S. Bureau of Labor Statistics (BLS), the average unemployment rate (for the area) for the calendar year 2000 was 4.0%. This is consistent with the national level of unemployment as of December 2000. As in the Los Angeles metro area, unemployment in the Chicago metro area peaked most recently in 1992, when the rate averaged 7.9%. Also similar to the Los Angeles area, the Chicago unemployment rate decreased by nearly one-half from 1992 to 2000. However, in comparison to Los Angeles, the rate in Chicago decreased more rapidly from 1992 to 2000.

The Chicago metropolitan area is slightly more reliant on employment in finance, insurance and real estate than is the nation as a whole. According to the FDIC, the metropolitan area is 20% more reliant on employment in these sectors.[16] At the end of 2000, the BLS reported that 169,200 people were employed in these sectors in the Chicago metro area. The FDIC reported that 7.1% of all metro area employment was concentrated in one of these three sectors as of the first quarter of 2001. Chicago has experienced stronger employment growth in these sectors than Los Angeles. In 1997 the year-over-year growth in employment in these sectors was 2.1%, in 1998 employment growth was 2.8%. Although employment growth in these sectors slowed in 1999 (1.67%), growth continued above 2% in 2000 (2.5%). Of the seven industry groupings tracked by the FDIC, the employment growth rate for the grouping comprised of finance, insurance and real estate was fourth, based on year-over-year growth in the first quarter of 2001.

Houston

[13] All FDIC data downloaded from the agency's RECON website [REDACTED].

[14] All BLS data downloaded from the Bureau's State and Area Employment Statistics website [REDACTED].

[15] Other industry groupings are: services, trade, transportation and public utilities, and construction and mining.

[16] All FDIC data downloaded from the agency's RECON website [REDACTED].

Throughout the 1990's the level of unemployment in the Houston metropolitan area was below the national average. As of December 2000, the average unemployment level for the year (for the Houston metro area) was 3.3%. Following the trend of Los Angeles and Chicago, unemployment peaked most recently for Houston in 1992. However, even at its peak, the unemployment rate for the area was only 5.6%, well below the national unemployment level in 1992. By 1993, the area unemployment rate had fallen to 4.6%. On an annual average basis, the rate has remained below 4% since 1993.

Houston is more reliant on employment in finance, insurance and real estate than is the nation as a whole. According to the FDIC, the Houston metropolitan area is 37% more dependent on employment in these sectors. As of December 2000, the BLS reported 67,500 people employed in one of these three sectors in the Houston area. Houston has experienced stronger employment growth in these sectors as compared to Los Angeles and Chicago. In 1997, employment in these sectors increased by 7.4%. Strong growth continued in 1998 and 1999 as employment in these sectors increased by 12.4% and 7.4%, respectively. Although employment growth in these sectors slowed in 2000 to 3.2%, this still represented stronger growth than either Chicago or Los Angeles.

Approaches to Value

An entity's value is derived from its potential future benefits. Those benefits, however, cannot be measured with certainty. Also, entities have different risks and earnings characteristics; no single formula can be used to determine the value of an entity in every situation. There are three basic approaches to valuing a business that an appraiser should consider: the **Cost Approach**, the **Income Approach** and the **Market Approach**.[17]

The **Cost (or Asset-Based) Approach** is used to separately value all of an enterprise's assets and liabilities. The total value of the assets less the total value of the liabilities equals the total value of the enterprise. This approach is commonly used for assets that are not sold on an active market, such as land improvements and special purpose equipment. For business valuations, the approach generally applies to companies with little value beyond that derived from their tangible assets (e.g., as holding companies).[18] This approach is also frequently used in business valuation when the enterprise to be valued is expected to liquidate and cease operations. This approach is extremely difficult to use for an on-going service business, such as PR, because many of the firm's assets are not recorded, or are not fully recorded, on historical cost balance sheets. Tangible assets, such as contact lists and computer systems, and intangible assets, such as reputation, branding and an assembled work force, are extremely valuable to a service business but are generally not recorded on the company's financial statements.[19]

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17 Fishman, Jay E., ASA, CBA, MBA, Pratt, Shannon P., DBA, FASA, CFA, CBA, Griffith, J. Clifford, MPA, CPA and Wilson, D. Keith, CPA, *Guide To Business Valuations* (Fort Worth, TX: Practitioners Publishing Company, Tenth Edition, January 2000), page 203.2.

18 *Ibid,* page 203.5.

19 In general, such assets are only recorded at true value when acquired from a third-party in an arms-length transaction.

The **Income Approach** is used to convert anticipated future economic benefits of an enterprise to their present value; the present value of all of an enterprise's future economic benefits is equal to the value of the enterprise. The exact measure of future economic benefits varies. Business valuators often use measures such as net income, dividends, gross cash flows, net cash flows, etc. However, free cash flow is the most accurate measure of economic benefit for the purposes of enterprise valuation. Free cash flow is generally defined to mean the "net cash flow to shareholders after paying for future investments."[20] There are two principal methods used to apply this approach to valuation: the Capitalized Returns Method and the Discounted Future Returns Method.

The <u>Capitalized Returns Method</u> may be used when a company's future operations are not expected to change significantly from its current normalized operations or where future operating results are expected to grow at a somewhat predictable rate. To apply this method, an estimate of a company's operating results (gross cash flow, net cash flow, EBIT[21], EBITDA[22], pretax income, net income, etc.) is divided by a capitalization rate to estimate the value for the business as a whole. The capitalization rate equals the discount rate (defined below) less the estimated long-term sustainable growth rate for the measure of operating results being capitalized.[23]

The <u>Discounted Future Returns</u> method may be used when the company's future returns (a) can be reasonably estimated, and (b) are expected to differ significantly from its current operations because of factors such as changes in business structure or expected changes in economic conditions. To apply this method, the business appraiser forecasts the subject company's future operating results until they reach a stabilized level. Then the appraiser determines a terminal value for the company based on its stabilized operating results.[24] Operating results are considered "stabilized" at a point when the company's future operations are not expected to change significantly from that point forward or at the point at which future operations are expected to grow at a reasonably predictable rate.[25] Finally, the company's estimated future returns, including the terminal value, are then discounted to present value using a discount rate.

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20 Myers, Stewart and Brealey, Richard. *Principles of Corporate Finance, Sixth Edition.,* p. 77.

21 EBIT = Earnings before Interest and Taxes.

22 EBITDA = Earnings before Interest, Taxes, Depreciation and Amortization.

23 The capitalization method derives from the method of valuing an annuity. An annuity is a financial instrument that pays its holder either a (i) fixed stream of payments into the future or (ii) a stream of future payments that is expected to grow at a constant rate in the future. Under this method, a company's future operating results are treated in a manner consistent with the cash flow stream expected from an annuity.

24 Fishman, Jay E., ASA, CBA, MBA, Pratt, Shannon P., DBA, FASA, CFA, CBA, Griffith, J. Clifford, MPA, CPA and Wilson, D. Keith, CPA, *Guide To Business Valuations* (Fort Worth, TX: Practitioners Publishing Company, Tenth Edition, January 2000), paraphrased from pages 203.9 - 203.11.

25 The terminal value calculated using the Discounted Future Returns method is identical, in concept, to the Capitalization method. The difference between the two methods is that under the Discount Future Returns method, the appraiser must first develop a multi-period forecast for the enterprise until the stabilized operating results can be capitalized.

The discount rate (also commonly referred to as the cost of capital) can be viewed from three perspectives. On the asset side of a company's balance sheet, it is the rate that should be used to discount to present value the expected future cash flows from all of the company's assets. On the liability side of the balance sheet, it is the economic cost to a company of attracting and retaining shareholder capital and loans in a competitive environment. From an investor's perspective, it is the return one expects and requires from an investment in the company.[26]

The third approach by which to value a business enterprise or asset is the **Market Approach**. The Internal Revenue Service provides the following description of the Market Approach:

> *The market approach, also known as the market comparison approach, values property on the basis of the prices of actual sales of similar (comparable) properties. An arms-length sale of the property at issue on the valuation date would normally be determinative of its fair market value, and would also, with few exceptions, eliminate the need to arrive at value by other means. . . . The market approach is based upon the assumption that a reasonably prudent person will not pay more to acquire a property than it would cost to acquire a comparable substitute property. Conversely, a prudent seller will not ordinarily sell a property for less than other sellers have been able to get for their similar properties. It is extremely unlikely, if not actually impossible, that an exact comparable can be found. It is sufficient to consider sales of similar property, making adjustments for differences that exist between the comparables and the property to be valued. When using the market approach, as many comparables as possible should be used.*[27]

"One of the most fundamentally sound methods of estimating the value of closely-held company stock is to look to the public markets for evidence of the prices investors are willing to pay for the stock of companies in the same (or similar) lines of business."[28] Revenue Ruling 59-60 directs business appraisers to consider: "The market price of stocks of corporations engaged in the same or a similar line of business having their stocks actively traded in a free and open market either on an exchange or over the counter."[29]

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26 Ibbotson Associates, *Stocks, Bonds, Bills, and Inflation 2001 Yearbook Valuation Edition* (Chicago, IL: Ibbotson Associates, 2001), p. 9.

27 IRS Valuation Training for Appeals Officers *(Chicago, IL: 1998), pages 1-10.*

28 Pratt, Shannon P., DBA, CFA, FASA, CBA, Robert F. Reilly, CFA, ASA, CPA and Robert P. Schweihs, ASA, *Valuing Small Business & Professional Practices*, 3rd edition (New York, New York, McGraw-Hill, 1998), page 548.

29 Revenue Ruling 59-60, 1959-1 C.B. 237, Section 4.01(h).

The Market Approach is typically applied to business entities by deriving valuation multiples from the historical transactions involving the sale of comparable companies. The valuation multiples are calculated by expressing the price paid for the company *as a multiple* of an annual operating result of the company. For example, the purchase price may represent *two (2) times annual revenue* or *three (3) times annual operating earnings*. The average (mean or median) valuation multiple for the group of comparable transactions can then be applied, as appropriate, to the operating results of the subject interest. In this way, the appraiser is able to estimate a value (i.e., an implied purchase price) for the subject interest. In calculating valuation multiples for the comparable transactions, the appraiser should take care to note components of a transaction that may make the multiple less indicative of the true value of the seller.[30] If such components exist, the appraiser may need to adjust the calculated multiples.

Discussion of Valuation Approach and Methods Chosen

We used the **Income Approach** and the **Market Approach** to value John Smith's ownership interest in PR. The future economic benefits of ownership of the company could reasonably be predicted and the present value of such future economic benefits could be mathematically calculated. In addition, we were able to identify a sufficient number of transactions involving the sale of comparable businesses. From these transactions we were able to derive a reliable valuation multiple which we ultimately applied to the subject interest.

In performing a valuation, it is common to use more than one valuation approach and/or methodology. The conclusions reached by different valuation methodologies are then reconciled to reach a final valuation conclusion. The process of reconciling potentially different conclusions produces a final result that is superior to a valuation based upon a single methodology. The reconciliation requires the valuator to analyze and assess *all* of the relevant valuation factors. Otherwise pertinent factors may inadvertently be overlooked if the valuator limits his analysis to a single valuation methodology.

As discussed above, the **Cost Approach** is extremely difficult to use for a service business such as PR. We do not believe that this approach would sufficiently value PR's intangible assets. This would substantially understate the value of PR as it is significantly derived from such assets. For this reason, we concluded that it would be inappropriate to use this approach.

[30] For example, the upfront cash price paid for a company may significantly depend on an earn-out provision. Under such a provision, the total consideration received by the seller typically depends on the future performance of the company. Thus the seller may receive a relatively smaller payment up-front and a subsequent payment based on future performance. Therefore, the up-front cash payment, if considered in isolation, would understate the true value to the seller.

Financial Statement Analysis

An important step in the valuation of any company is an analysis of its financial performance over time. Past sales and earnings growth may provide an indication of future growth, and financial analysis can be used to identify a company's financial strengths and weaknesses. They, in turn, would affect a potential investor's assessment of the potential reward and risks associated with an investment in the company. Other things being equal, a company with greater growth potential will be worth more than one with lesser growth potential, given the same level of risk.

PR commenced operations in April 2000. Therefore we reviewed and analyzed the financial results of PR from inception (April 17, 2000) through December 31, 2000. However given that the business of PR, Inc. was nearly identical to PR, including business operations, active management and geographic location, we also analyzed the historical performance of PR, Inc. from January 1996 through December 1999. We believe that a hypothetical investor would also look to the history of PR, Inc. to determine the attractiveness of an investment opportunity in PR. Therefore, the history of PR, Inc. is a relevant factor for the purposes of estimating the value of PR.

In analyzing the PR and PR, Inc. comparative balance sheets for 1996-2000, as set forth in Exhibit E in dollars, Exhibit F in percentages (called common size statements), and Exhibit G, as compared to Robert Morris Associates data,[31] we noted the following:

1. The ratio of sales to total assets decreased between 1998 and 2000. For the 8-months ending December 31, 2000, PR recorded a ratio of 3.8, down from 5.4 in 1998 and 4.5 in 1999. This indicates that $1 of assets produced fewer sales in 2000 as compared to 1998 and 1999. When compared to the RMA data, PR (and PR, Inc.) required more assets than the peer group to generate a given level of sales. The average ratio for the peer group was 5.4 in 1999-2000 and 6.1 in 1997-1998. This factor would tend to decrease the value of PR.
2. However, during the period 1996 through 2000, the ratio of pre-tax operating profit to total assets was substantially higher for PR and PR, Inc. as compared to the peer group. From 1996 through 2000 this ratio averaged 45.5% for PR and PR, Inc. The comparable ratio of the peer group averaged 31.3% during this period. For the 8-month period ended December 31, 2000, PR recorded a ratio of pre-tax operating profit to total assets equal to 35.1%. Although lower than the historical ratio for PR, Inc., this is still considerably higher than the comparable ratio of 23.9% for the peer group during the period 1999-2000. Thus even though PR was producing fewer sales per $1 of assets (as compared to the peer group), PR was generating greater pre-tax profit per $1 of assets. The higher level of profitability, for a given level of assets, would tend to increase the value of PR. Additionally, this would tend to at least partially, if not completely, offset the decrease in value attributable to fewer sales for a given level of assets.
3. Current assets as a percent of total assets were much higher for PR and PR, Inc. as compared to the peer group represented by the RMA data. Between 1996 and 2000 current assets, on average, represented 96% of the companies' total assets. As of December 2000, current assets represented 97% of PR's total assets. In

[31] *Annual Statement Studies 1996-1997, 1997-1998 and 1999-2000* (Philadelphia, PA: Robert Morris Associates), SIC code 7361 (Employment Agencies). Companies with between $3 to $5 million in annual sales.

comparison, current assets, on average, represented 74.6% of total assets for the peer group between 1996 and 2000. For the period 1999-2000, current assets represented 71.5% of total assets for the peer group. We also analyzed PR, Inc.'s current assets excluding amounts due from affiliated organizations.[32] Excluding these amounts, current assets, on average, represented 87% of total assets for PR and PR, Inc. The higher ratio of current assets to total assets indicates that PR (and PR, Inc.) had a higher percentage of assets that could be more readily converted to cash. This factor would tend to increase the value of PR by reducing the risk to a hypothetical investor should PR face financial difficulty in the near future.

[32] PR, Inc. maintained various fee arrangements with business entities that were, at least, partially owned by Mr. Smith's business partner, Randall Klein. PR, Inc. recorded a current asset described as "Due from affiliates" on its balance sheet as of December 31 for the years 1996 through 1999: 1996 - $475,908; 1997 – $169,958; 1998 - $137,058 and 1999 - $57,280.

4. PR had no short-term or long-term debt on its balance sheet at December 31, 2000. By comparison, the RMA peer group reported that short-term debt equaled 20% of the sum of total liabilities and net worth for the period 1999 – 2000. The peer group reported that long-term debt accounted for an additional 8.7% during the same time period. As of December 31, 1999, PR, Inc. recorded a current liability of $300,000 on its balance sheet as "Advances under Credit Facility."[33] This current liability accounted for 25% of total liabilities and net worth. However, this liability was *not* assumed by PR as a part of the asset purchase. Typically, low leverage would tend to increase the value of a company. However, in the case of PR, the lack of debt reported on the company's balance sheet is not a true indication of low leverage. In fact, as of December 31, 2000, PR reported an off-balance sheet contingent liability of $262,013 associated with the company's factored receivables.[34] If carried as debt on the company's balance sheet, it would represent approximately 25% of the sum of total liabilities and net worth.
5. For the years 1996 and 1997, PR, Inc.'s sales-to-working capital ratio lagged behind that of the peer group. That is, PR, Inc. produced fewer sales per $1 of working capital than did the peer group (on average). For 1996 and 1997 PR, Inc. produced, on average, $6.40 in sales for every $1 in working capital. In contrast, the peer group produced, on average, $13.80 in sales for every $1 in working capital during 1996 and 1997. However, in 1998 and 1999, PR, Inc.'s results were in line with, or slightly above, that of the peer group. PR, Inc. produced approximately $11.70 in sales for every $1 of working capital. Given that the sales-to-total assets ratio for PR, Inc. was lower than the average of the comparable ratio for the peer group (see #1, above), the comparison of the sales-to-working capital ratios for PR, Inc. and the peer group indicates that PR, Inc. incurred fewer current liabilities (as compared to the peer group) for a given level of sales during 1998 and 1999.
6. However, for the 8-months ending December 31, 2000, PR, on average, produced only $4.40 in sales for every $1 of working capital. This was significantly below the $9.90 in sales produced by the peer group for every $1 of working capital. This discrepancy between PR and the peer group is partially due to the lack of short-term debt reported on PR's balance sheet. The lack of short-term debt increased reported working capital and, therefore, decreased the reported sales-to-working capital ratio. However, even taking into consideration PR's off-balance sheet debt, the excess of working capital relative to sales would tend to decrease the value of the company.

In analyzing the PR and PR, Inc. comparative income statements for 1996-2000, as set forth in Exhibit H in dollars, Exhibit I in percentages (called common size statements), and Exhibit J, as compared to Robert Morris Associates data,[35] we noted the following:

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[33] PR, Inc. did not record any long-term debt on its balance sheet as of December 31, 1999.

[34] As of December 31, 2000, PR had an arrangement with Temporary Help Industry Servicing Company, Inc. (THISCO) in which THISCO purchased accounts receivable associated with PR's temporary placement business. PR was contingently liable to THISCO for certain accounts receivable.

[35] *Annual Statement Studies 1996-1997, 1997-1998 and 1999-2000* (Philadelphia, PA: Robert Morris Associates), SIC code 7361 (Employment Agencies). Companies with between $3 to $5 million in annual sales.

1. PR, Inc. revenue growth was strong from 1996 through 1998. Year-over-year, revenue increased 48.9% in 1997 and 16.7% in 1998. However, revenue declined in both 1999 and 2000. On an annualized basis, revenue decreased by 20.8% from1999 to 2000. We believe that the decrease in revenue may have been attributable to two factors. The first factor was the declining employment growth in the financial services sectors, particularly in the Los Angeles metropolitan area. Approximately 75% of PR's revenue is derived from its operations in Los Angeles. A second reason for the decline in revenue might have been management distraction due to the assets sale transaction and a subsequent move of the Los Angeles office location that occurred during July 2000. A declining revenue trend would tend to decrease the value of PR.
2. PR, Inc.'s operating expenses as a percent of sales increased each year from 1996 to 1999. Operating expenses equaled 7.1% of revenue in 1996 but had increased to 20.2% by 1999. However, operating expenses as a percent of revenue decreased for the 8-months ended December 31, 2000. Although the presentation of the financial information changed from year-end 1999 to year-end 2000, we estimated that operating expenses in 2000 (as categorized prior to 2000) equaled approximately 13% of sales.[36] If sustainable, this recent decrease in operating expense, relative to sales, would tend to increase the value of PR.
3. In comparison to the peer group represented by RMA data, both PR, Inc. and PR recorded lower total expenses, relative to sales, for the period 1996 to 2000.[37] Between 1996 and 2000 total expenses averaged 88% of sales for PR, Inc. and PR. In comparison, total expenses averaged 96% of sales for the peer group during this period. As a result, pre-tax profit averaged 12% of sales for PR, Inc. and PR during 1996 through 2000 versus 3% for the peer group. These results are consistent with PR's operating results for the 8-months ended December 31, 2000. The higher level of profitability, relative to the peer group, would tend to increase the value of PR.
4. PR executive salary[38] as a percent of sales equaled 15.8% for the 8-months ending December 31, 2000. This is significantly higher than the level of compensation reported by the peer group. For the period 1999-2000, the peer group reported that the average compensation for officers, directors and owners equaled 5.1% of sales. This discrepancy would tend to increase the value of PR because it indicates that a hypothetical investor could decrease the amount of executive compensation thereby increasing PR's free cash flow.

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[36] From 1996 through 1999, PR, Inc. reported an "Operating Expense" item on its income statements. Beginning in May 2000, PR reported only selling, general and administrative (SG&A) expenses. We estimated operating expenses for 2000 by subtracting from SG&A expenses salary, payroll and financing expenses.

[37] Total expenses = operating expense, SG&A and financing charges.

[38] Consists of John Smith's salary only. Executive salary reported on financial statements agrees to John Smith's salary as reported on his federal W-2 tax form.

Our conclusion based on the analysis of the financial statements for PR, Inc. and PR is that PR compares favorably to its peer group. In fact, following the asset purchase agreement, PR may have emerged as a more competitive company. If a hypothetical investor were looking to invest in this sector, PR might represent an attractive opportunity. However, by specializing in financial services – particularly banks and securities brokerage companies – PR operates in a niche market where demand for labor had begun to decline as of February 2000. PR's financial services business is directly tied to activity in the capital markets. Bull markets, in which equity prices are rising, increase trading (and other transaction) volume and thereby increase demand for back-office personnel. This has a direct and positive impact on PR's revenues. However, bear markets, in which equity prices are falling, have exactly the opposite effect on PR's revenue. Therefore the steep declines in U.S. equity prices as of February 28, 2000 would tend to decrease the attractiveness of an investment opportunity in PR.

Valuation Conclusions

As discussed above, we utilized two approaches to estimate the value of John Smith's ownership interest in PR: the Income Approach and the Market Approach.

<u>Single-Period Capitalization</u>

The single-period capitalization of economic benefits method is an application of the income approach to business valuation. The goal of the income approach is to value a business based on the present value of the business's expected future benefits. We used normalized free cash flow as the measure of PR's expected future benefits. To conduct a free cash flow analysis for the purposes of business valuation, it is necessary to determine annualized free cash flow for several years prior to the date of valuation. Typically, the analysis encompasses a five-year historical period. Free cash flow is estimated for prior years even when a single-period capitalization model is used to value the business. Because the single-period used in the model is intended to reasonably represent the company's long-term annualized free cash flow, it is important to evaluate the single-period relative to historical annual free cash flows.[39] Large deviations between the single-period used in the valuation model and the historical periods should be fully explained.
To value PR, we used annualized cash flows for periods ending December 31st. This corresponds to the end of the fiscal quarter preceding the valuation date. We chose to use 12-month periods ending in December because historical financial statements, reviewed by outside accounting firms, were readily available for both PR and PR, Inc. Given the sale of PR, Inc. stock and John Smith severing his prior business relationship with Randall Klein, it was simply not possible to obtain annualized financial data for the historical 12-month periods ending February 28, 1997-2001. Such an analysis would only be necessary if it were reasonable to assume that a valuation conclusion based on February-ended data would differ materially from a valuation conclusion based on December-ended data. The valuation conclusion would differ only if the February-ended annual cash flows were inconsistent with the estimate of long-term cash flow derived from the December-ended data and embodied in the single period capitalization model.

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[39] If appropriate, the annualized cash flow can be assumed to grow at a constant rate by subtracting the assumed growth rate from the appropriate discount rate.

To determine whether the valuation conclusion would differ based on February-ended data, we conducted an analysis of PR's financial results for the period April 2000 (inception) to February 2001. Based on PR's unaudited electronic books and records, we compiled an income statement for the period April 14, 2000 through February 28, 2001 and balance sheet as of February 28, 2001. We have displayed these results in Exhibits E and H. We then annualized these results and compared them to the annualized results based on December 31, 2000. As shown in Exhibits E and H, the February-ended results do not differ significantly from the December-ended results. In particular, the February-ended results are fully consistent with the estimate of annualized free cash flow derived from the December-ended periods.

1. Exhibit K displays our calculation of free cash flow for the period 1996 through 2000. Financial results for the 8-months ending December 31, 2000 have been annualized to estimated results for a 12-month period. We only used the free cash flow for the annualized period ending December 31, 2000 to derive the value of PR (this is the single period employed in the capitalization method). The free cash flow calculation for 1996 through 1999 is displayed to show the historical trend in free cash flow.
2. For the annualized December 31, 2000 free cash flow, we made the following normalization adjustments. Normalization adjustments are frequently required when valuing a small private company. Such adjustments are made to estimate the normalized level of economic income the business is expected to produce in the future. We made the following normalization adjustments to the 2000 free cash flow:
   a) <u>Executive Compensation</u>: A normalization adjustment for compensation is necessary when a company is paying compensation that is significantly above or below market compensation rates. An adjustment is made because it is assumed that a hypothetical buyer of the business would, in fact, pay market compensation rates. On an annualized basis, John Smith earned $668,827 in compensation as of December 31, 2000. This amount does not include capital distributions. Our analysis of Mr. Smith's annual compensation indicated that his compensation, as of December 2000, was above market compensation rates. We used three methodologies to estimate a reasonable compensation level for a CEO and/or president of a staffing company similar in size to PR.
      i. Our first estimate was determined by obtaining market compensation industry data from the National Institute of Business Management, *Executive Compensation,* 2001 Survey (see Exhibit L). Compensation data was selected for companies within PR's SIC code (73). Compensation data was also selected for all companies with annual revenues between $2.5 - $9.99 million. We then selected both the median and the 75th percentile total compensation levels for CEOs and/or presidents within each group. Considering that PR is profitable and that the CEO, Mr. Smith, is experienced, we selected the higher compensation level for each group (75th percentile). Finally, we computed the average of the 75^{th} percentile compensation levels from each group. This produced a reasonable compensation estimate for Mr. Smith of $222,059.
      ii. Our second estimate of reasonable compensation for John Smith was obtained from the Robert Morris Associates (RMA) Annual Statement

Studies (2000- 2001). RMA reports that in the 1999-2000 period, compensation for officers and directors for companies with SIC code 7361 (employment agencies) ranged from 2.6% to 13.9% of annual sales. The median compensation level was reported to be 5.17% of sales. The median compensation level of 5.17% would imply a compensation estimate of approximately $219,000 for John Smith, based on PR's annualized sales as of December 31, 2000. Our first estimate of $222,059 represents 5.2% of annualized PR sales (see Exhibit M).

iii. Our final estimate of reasonable compensation for John Smith was obtained by consulting the *Staffing Industry Sourcebook, 2000-2001 Edition*. The sourcebook reports total compensation for publicly-traded companies, grouped by industry. We relied on data for the staffing industry. The smallest staffing company, in terms of annual revenues, included in this guide had annual revenues of $6.3 million. In total, the guide reported compensation levels for CEO/Presidents in six companies with annual revenues ranging between $6.3 and $59.7 million. The compensation data is summarized in Exhibit N. Overall, with the exception of one company, an Internet company, salaries ranged from $175,000 to approximately $405,000 for the executives of these companies. The smallest company, which has revenues more than double that of PR, LLC, provided the Chairman of the Board/CEO a $300,000 salary plus stock options. Given that PR is not publicly traded and its annual revenues are approximately one-half that of the smallest company in the survey, a total compensation package of $222,059 (as calculated above) appears reasonable. This would indicate that Mr. Smith's annualized salary ($668,827) exceeds an estimate of reasonable compensation ($222,059) by $446,768. Therefore, as a normalization adjustment, we added $446,768 to December 2000 annualized free cash flow.

b) <u>Moving, Storage and Relocation</u>: For the 8-months ending December 31, 2000, PR recorded a moving, storage and relocation expense of $14,244. Based on our conversations with John Smith, we believe that approximately 75% of this amount represents a non-recurring business expense. This expense was incurred in 2000 as a result of the relocation of the Los Angeles office in July of that year. As a normalization adjustment, we added $10,683 (75% * $14,244) back to free cash flow.

c) <u>Interest Income</u>: For the 8-month period ending December 31, 2000, PR recorded interest income of $12,417. Based on our conversations with John Smith and our review of PR, Inc.'s historical financial results, we do not believe that this income represents recurring business income. As a normalization adjustment, we subtracted $12,417 from free cash flow.

d) <u>Personal Expenses</u>: Following a comprehensive forensic examination of PR's business expenses from May through December 2000, we noted only $289 in non-business (i.e., personal) expenses for the 8-months ending December 31, 2000.[40] As a normalization adjustment, we added $289 to free cash flow.

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40 Our forensic accounting investigation was limited to PR. It did not include PR, Inc.

e) Accounts Receivable: As specified in the asset purchase agreement between PR, Inc. and PR, PR, Inc. retained the accounts receivable on the closing date of the transaction. As a result, PR had a zero accounts receivable balance at the inception of operations in April 2000. As of December 31, 2000, PR's balance sheet reflected accounts receivable of $330,103. In a typical free cash flow calculation, an increase in accounts receivable would represent a decrease in free cash.[41] However, when calculating free cash flow for PR, the increase in the accounts receivable balance (from zero to $330,103) is slightly misleading. Although the increase in PR's accounts receivable balance did represent a use of cash totaling $330,103 for the 8-months ending December 31, 2000, this amount is not typical of the use of cash that would normally result from PR's accounts receivable. The increase in accounts_receivable (or the amount of cash used) is artificially inflated due to the zero accounts receivable balance as of April 2000 (the date of the company's inception). To estimate a normalized use of cash represented by a change in the accounts receivable balance we performed the following calculation:

i. Calculated the average accounts receivable days outstanding for PR, Inc. for the period 1996 through 1998. This was determined to be 42 days.[42]

ii. Multiplied account receivable days outstanding by *annualized* 2000 sales for PR and then divided this number by 365. The result of the calculation is an estimate of the accounts receivable balance on December 31, 2000 based on 12 months of sales ($478,553).[43]

iii. Subtracted the estimate of the accounts receivable balance at December 31, 2000 ($478,553) from the accounts receivable balance as of December 31, 1999 ($609,766) to derive $131,213. This is the normalized *decrease* in accounts receivable. Alternatively it can be thought of as a *source* of cash for PR equal to $131,213. Therefore, the $131,213 amount is reflected as a *positive* number in the normalized cash flow calculation.

iv. Lastly, we subtracted $131,213 from the actual change in the accounts receivable balance for PR as of December 31, 2000. The actual change was an increase in account receivable of $330,103. An increase in accounts receivable can be thought of as a *use* of cash. Therefore, the $330,103 amount is reflected as a *negative* number in the normalized free cash flow calculation. Thus we subtracted *positive* $131,213 from *negative* $330,103 to derive negative $461,316. Therefore, the actual change in the accounts receivable balance from May to December 2000, *underestimated* free cash flow by $461,316.

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41 A company would need to use cash to finance business operations while awaiting payment from customers.

42 Accounts receivable days outstanding is a measure of the average number of days it takes a company to collect its accounts receivable. It is calculated as follows: (days outstanding) = (accounts receivable)/(sales/365). The peer group represented by the RMA data also reported an average of 42 days.

43 Calculation: (accounts receivable) = (days outstanding) x (annualized sales)/365

As a normalization adjustment, we added $461,316 to free cash flow.

v. Effectively, what we did was to normalize the impact of PR's accounts receivable on free cash flow. The unadjusted free cash flow calculation was essentially understated due to the distortion in accounts receivable. This adjustment corrects for that distortion.

f) Tax Liability: As a single member LLC, PR does not incur an entity-level federal or state income tax liability. Any tax obligation is "passed-through" to John Smith (the sole member of the LLC). In estimating the value of PR, it is necessary to impute the tax obligation that would be faced by a hypothetical buyer of the business. To estimate this tax liability, we applied a 40% tax rate to PR's annualized and normalized operating income. The tax rate represents federal, state and local tax liability. As a normalization adjustment we subtracted $338,303 (40% * $845,758) from 2000 free cash flow.

g) Total Normalization Adjustments: In total we increased PR's annualized 2000 free cash flow by $572,475.

3. Normalized free cash flow for PR as of December 31, 2000 equals $727,619.

To apply the single-period capitalization model it was necessary to determine an appropriate discount rate and perpetual growth rate for PR's normalized free cash flow.

4. Exhibit O details our discount rate calculation. We used a typical "build-up" rate calculation. Of note is the following:

a. We relied upon data from Ibbotson Associates as of December 31, 2000 to estimate the risk-free rate and the equity risk premium. The risk-free rate (5.6%) is based on the 20-year U.S. Treasury coupon bond yield. The equity risk premium (7.8%) is the long-horizon premium using the S&P 500 as the market benchmark.[44]

b. We also relied upon Ibbotson Associates data to determine an appropriate industry risk premium and company size premium as of December 31, 2000. The industry risk premium (-3.58%) was calculated by Ibbotson using stock return data for 50 companies with SIC code 736 (personnel supply services). The beta-adjusted size premium (8.42%) is based on the smallest companies listed on the NYSE, AMEX and NASDAQ.[45] The size premium uses the S&P 500 as the market benchmark.

c. Finally, we added a company specific risk premium of 5%. The specific risk premium is based on the following risk factors.

i. PR is a niche company with a high concentration of its business derived from personnel placements in brokerage companies. The company faces a significant potential loss of revenue if the U.S. equity markets continue to be bearish. We considered this to be a risk factor that was not fully reflected in Ibbotson's general industry risk premium for staffing companies;

ii. PR is critically dependent on John Smith. He is the company's CEO and President. He also has responsibilities as a salesperson and recruiter. Mr. Smith provides the continuity between PR, Inc. and

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[44] Ibbotson Associates, *Stocks, Bonds, Bills, and Inflation 2001 Yearbook Valuation Edition* (Chicago, IL: Ibbotson Associates, 2001).

[45] Ibbotson refers to the smallest group of companies as those belonging to the "10b-Smallest" decile.

PR. In an identical asset purchase transaction in which Mr. Smith had not continued with PR, the value of PR would be less; and

iii. as of December 2000, PR was a newly-organized entity with a limited operating history even though it is an outgrowth of PR, Inc. A potential investor would likely demand some additional return to compensate for this fact.

d. By aggregating these build-up components we derived a 23.24% discount rate for PR.

2. We estimated a 2% perpetual growth rate for PR. This growth rate is based on the following factors:

a. PR's year-over-year revenue declined 24.7% in 1999 and 15.4% 2000 (on an annualized basis). However, the decline in 2000 could reasonably be partially attributed to management distraction as a result of the asset purchase and the relocation of the Los Angeles office.

b. Although the U.S. equity markets experienced a decrease in trading volume as of December 31, 2000, the level of trading volume was still significantly ahead of historical levels.

c. Labor demand within the financial services industry was slowing in Los Angeles as of December 31, 2000. However, labor demand within this industry seemed poised to increase in Chicago and Houston.

d. The financial services industry is transitioning from a labor-intensive industry to a more technology-enabled industry. In the short-term this could decrease the demand for labor in this industry. However, in the longer-term labor demand is more uncertain.

Based upon the normalized free cash flow, a discount rate of 23.24% and perpetual growth rate estimate of 2% we derived a value of $3,425,702 for John Smith's ownership interest in PR based on the Income Approach.

<u>Comparable Transactions (Market Approach)</u>

We also derived a value for PR based on a market approach. To implement the market approach we search a commercial database for transactions involving the sale of companies comparable to PR.

We conducted a search using *Done Deals Data*.[46] We requested all transactions involving the sale of companies with SIC codes 7361 – 7363. This search identified 73 such transactions. We immediately discarded all transactions with closing dates before 1998. We believe these transactions were too old to produce reliable estimates of value as of February 2001. This reduced the number of transactions to 30. For the 30 transactions, we reviewed the business, size and geographic location of the selling companies. We eliminated transactions involving non-U.S. companies, companies with annual revenues greater than $19 million and companies involved in businesses significantly dissimilar to PR. In this way, we identified 12 transactions that we believe

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[46] We also conducted a search for comparable transactions using *BizComp Business Sale Statistics*. However, this database returned an insufficient number of comparable transactions.

represent the sales of companies reasonably comparable to PR. Exhibit P displays relevant information pertaining to these 12 transactions.

Based on the information supplied by *Done Deals Data*, we calculated price-to-revenue and price-to-operating cash flow multiples for each of the selling companies. However, given that staffing companies are typically valued based on earnings before interest, taxes, depreciation and amortization (EBITDA), we believed that the price-to-operating cash flow multiple would provide a more reliable estimate of value for PR. The average price-to-operating cash flow multiple for the 12 transactions equaled 6.39. However, we also calculated the average multiple by year. The results indicate that valuation multiples have decreased from 1998 through 2000. Given this pattern, we calculated four average multiples, applying different weights to each year. To derive a value for PR, we applied these multiples to PR's 2000 cash flow from operations. Exhibit Q displays the implied valuation for PR based upon these multiples. The implied values range from $3.7 million to $3.1 million. To derive our point estimate for the value of PR based on the market approach, we applied a multiple that averaged across all transactions, but applied greater weight to the more recent transactions. We relied on a 3-2-1 weighting scheme applied to the multiples for 2000, 1999 and 1998, respectively. Thus, the estimated value of PR based on the market approach is $3,405,223.

Consideration of Discount for Lack of Marketability

A discount for lack of marketability (DLOM) is often applied to compensate an investor for holding an illiquid investment, such as an ownership stake in a private company. We considered whether either of the valuation estimates contained in this should be reduced by a DLOM. We concluded that a DLOM would not be appropriate for the valuation estimate derived as a result of the market approach. All 12 of the comparable transactions referenced in the market approach involved the sale of private companies. Therefore, the selling prices already reflected an appropriate DLOM. To apply a DLOM to the valuation estimate of PR derived from the comparable transactions would "double-count" any appropriate DLOM.

It is more arguable that a DLOM might be appropriate for the valuation estimate based on the Income Approach. Several empirical market studies have been conducted to isolate and measure the effect on an asset's value due to a lack of marketability.[47] These studies typically analyze the sales of securities and assets with limited marketability and compare the data to sales of similar, but more marketable, securities and assets. We reviewed 12 such studies that, in total, represented approximately 1,100 private transactions over a period ranging from 1966 through 1998. There was a consistent pattern of findings contained among the various studies, as follows:

1. The DLOM was based on perceived risk. Risk was inversely correlated with earnings and revenues (with a greater emphasis on earnings), and directly correlated with size of block sold and other factors, in lesser or greater detail, in each study. We believe, based on the findings of the studies, that stability of earnings was the greatest indicator of size of discount.
2. The average and median discounts for lack of marketability have been declining since 1990 with the easing of restrictions under SEC Rule 144A and

[47] These empirical studies are generally referred to as Restricted Stock Studies.

Rule 144 creating a larger and more liquid market for unregistered securities of public companies.

3. There is a wide range of discounts for lack of marketability noted in each study.

4. The determination of a DLOM in any particular circumstance should not be based on averages noted in a study, but rather the facts and circumstances of each transaction.

Factors relevant for determining the size of the DLOM for the valuation of PR include:
Percentage of Control Being Sold: In the case of PR, a 100% ownership interest is being valued. This would tend to decrease the size of the DLOM discount. For transactions involving minority ownership interests, the DLOM is typically higher to compensate investors for the significantly greater risk assumed by minority owners.
Size and Pattern of the Company's Earnings: Although PR is a relatively new business entity, it has an operating history (in the form of PR, Inc.) that indicates increasing earnings from 1996 to 1998 and decreasing earnings thereafter. The company is also relatively small, with annual revenue between $4 - $5 million, most recently. This would tend to increase the DLOM for PR.
Resale Agreement Provisions: Due to the 100% ownership interest, our valuation conclusion assumes no restrictions on resale. This would tend to decrease the size of the DLOM.
Based on the empirical data presented in the DLOM studies and based on the specific factors relevant for determining the appropriate DLOM for PR (as discussed above), we have chosen to apply a 10% DLOM to our estimate of value based on the Income Approach. The DLOM discount, thus, reduces this estimate of value to $3,083,132.

Overall Conclusion

In determining the value of PR we placed greater weight on the estimate derived by the market approach. Actual market transactions are the best indication of what a hypothetical buyer would be willing to pay to purchase PR. We assigned this estimate a weight of 2/3. However, the estimate derived from the income approach is indicative of the competitive nature of PR relative to its peer group. Given PR's higher level of profitability, we thought it would be appropriate to consider the valuation estimate derived from the income approach; we assigned this estimate a weight of 1/3. Based upon all the research, analysis and other work that we performed as documented in this report, and subject to the assumptions and limiting conditions set forth in Exhibit A as well as elsewhere throughout this report, it is our opinion that the fair market value of John Smith's 100% ownership interest in PR, LLC as of February 28, 2001 is $3,297,859, or $3,298,000 (rounded):

Market:	$3,405,223	x	2/3	=	$2,270,149
Income:	$3,083,132	x	1/3	=	$1,027,711
					$3,297,859
					$3,298,000 (rounded)

Exhibit A

ASSUMPTIONS AND LIMITING CONDITIONS

1. We did not audit, review or compile the financial statements of Professional Recruiters, Inc. or Professional Recruiters, LLC (PR, Inc. or PR, LLC) for any year in accordance with generally accepted auditing standards and/or any other professional standards as promulgated by the American Institute of Certified Public Accountants; accordingly, we express no opinion or any other form of assurance with respect to any financial statements of those businesses. Our engagement was not designed, nor may it be relied upon, to detect errors and/or irregularities, including fraud, which individually and/or in the aggregate may have a material adverse effect upon the financial statements of these entities. While our investigation did encompass a forensic examination, it was limited in scope to PR, LLC, for the period April 2000 through February 2001, and it was solely for the purpose of detecting personal expenses for the determination of normalization adjustments.

2. All of the facts and data set forth in this report are true and materially accurate to the best of our knowledge and belief. We have not knowingly withheld or omitted anything from our report affecting our conclusions.

3. Possession of this report, or a copy thereof, does not carry with it the right of publication and/or distribution to anyone other than Jane Smith, the law firm(s) and other experts representing her, and any court of competent jurisdiction that has before it a complaint seeking the dissolution of the marriage of Jane and John Smith. Reproduction of this report, in whole or in part, by any and all means whatsoever without our express prior written permission is specifically prohibited.

4. The conclusions and/or opinions presented in this report apply to this case only and shall not be used out of the context presented herein. The conclusions and/or opinions expressed in this report are valid only for the purpose or purposes specified herein. Any other use of this report may lead the user to an incorrect conclusion for which Business Valuation L.L.C., its members, employees, agents, and representatives shall not assume any responsibility.

5. Unless specifically referred to within the body of our written report, no investigation of titles to properties, and/or any claims to ownership thereof, by any individuals and/or entities has been undertaken.

6. Unless otherwise provided for in writing and agreed to by both parties in advance, the extent of the liability for the completeness or accuracy of the data, opinions, comments, recommendations and/or conclusions contained in this report shall not exceed the amount paid to the appraisers for professional fees, and then only to the party for whom this report was originally prepared.

7. We are not attorneys or legal experts. Nothing contained in this report shall be construed to constitute legal advice or a legal opinion.

8. This report reflects facts and conditions existing as of February 28, 2001. Subsequent events and circumstances, other than those which may have been foreseeable as of that date or which, while not foreseeable, nevertheless relate back to, and are indicative of, conditions existing as of February 28, 2001, were not considered, and we have no obligation to update our report for such events and conditions.

9. Our report assumes that there are no hidden or unexpected conditions and/or special circumstances affecting PR, Inc. or PR, LLC that would adversely affect our conclusions and/or opinions unless you or your attorney advised us, in writing, of the existence of such conditions and/or special circumstances.

10. Our report assumes that we have been provided with all pertinent agreements and amendments thereto which might affect our conclusions as stated herein.

Exhibit B

APPRAISER'S CERTIFICATION

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

1. The statements of fact in this report are true and materially accurate.

2. The reported analyses, opinions and conclusions are limited only by the reported assumptions and limiting conditions, and represent our personal, impartial, unbiased professional analyses, opinions and conclusions.

3. The accounting and consulting firm of Business Valuation L.L.C., and George Warwick, CPA/ABV, do not have any present or contemplated future interest in the Professional Recruiters, LLC or any affiliated entity, or any other personal interest with respect to the parties involved, that might prevent us from preparing an unbiased valuation.

4. Our compensation is not contingent on an action or event resulting from the analyses, opinions, or conclusions expressed in, or the use of, this report.

5. [REDACTED], MBA, [REDACTED], CPA, [REDACTED], CPA, MBA [REDACTED], CPA, and [REDACTED], MBA, JD, MS provided professional assistance to George Warwick, CPA/ABV in the work performed leading to the opinions expressed herein.

Exhibit C

STATEMENT OF QUALIFICATIONS

George Warwick, CPA/ABV

Academic and Professional Credentials

[REDACTED]

Positions and Experience

[REDACTED]

Professional Affiliations

[REDACTED]

Former Affiliations

[REDACTED]

Publications and Seminars

[REDACTED]

Exhibit D

SOURCES OF INFORMATION RELIED UPON FOR THIS REPORT

Books

1. Ibbotson Associates, *Stocks, Bonds, Bills, and Inflation 2001 Yearbook* (Chicago, IL: Ibbotson Associates, 2001).
2. Meyers, Stewart C. and Brealey, Richard A., *Principles of Corporate Finance* (New York, New York: Irwin McGraw-Hill, Sixth Edition, 2000).
3. Pratt, Shannon P., DBA, CFA, FASA, CBA, Robert F. Reilly, CFA, ASA, CPA, and Robert P. Schweihs, ASA, *Valuing a Business*, Fourth Edition (New York, New York: McGraw-Hill, 2000).
4. Reilly, Robert F., CFA, ASA, CPA and Schweihs, Robert P., ASA, *The Handbook of Advanced Business Valuation* (New York, New York: McGraw-Hill, 1998).
5. Staffing Industry Analysts, Inc., *Staffing Industry Sourcebook: Facts and Figures for Market Research*, 2000-2001 Edition (Los Altos, CA: Staffing Industry Analysts, 2000).
6. National Institute of Business Management, *Executive Compensation 2001 Survey Analysis* (McLean, VA: National Institute of Business Management, 2001).
7. Robert Morris Association, *Annual Statement Studies* 2000-2001 (Philadelphia, PA: RMA, 2001).

Other Sources of Information

1. Jane and John Smith personal income tax returns.
2. Business tax returns for PR, Inc.
3. Financial statements for PR, Inc. and PR, LLC.
4. Brokerage statements for various accounts held in the names of John Smith, Jane Smith, PR, Inc., PR., LLC and held in trust for the Smith's minor children.
5. Statements relating to personal life insurance held in the name of John Smith.
6. Statements for personal and corporate credit cards held in the names of John Smith, Jane Smith, and PR, LLC.
7. Closing documents pertaining to the asset purchase agreement and stock sale agreement between PR, Inc., PR, LLC and John Smith.
8. Receivables Purchase Agreement between THISCO and PR, LLC.
9. Numerous conversations with John Smith.