MEMORANDUM

To: Benjamin R. Arnold, Esquire
From: David J. Shuffler
Subject: Work Product Memorandum re: Albert S. Crown, D.M.D., P.C.
Valuation Report Rendered by I.W. Expert, LLC
Date: December 10, 2010X

In accordance with your request on January 16, 200X, I have reviewed the Albert S. Crown, D.M.D., P.C., Valuation of Practice rendered by I.W. Expert, LLC (Adversary Expert), West Beltway, Anytown, USA, as well as the appraisal methods and techniques that Adversary Expert used to determine the fair market value of the tangible assets and patient records of Albert S. Crown, D.M.D., P.C. (Subject Practice) The effective date is December 31, 200Y. The date of the report is September 19, 200X.

My review of the Adversary Expert has been conducted in conformity with Standard 3 of the Uniform Standards of Professional Appraisal Practice of The Appraisal Foundation (USPAP), Rule 3-1 and Rule 3-2.

Standard 3 states that:

> "In reviewing an appraisal and reporting the results of that review, a review appraiser must form an opinion regarding the adequacy and appropriateness of the report that is being reviewed and comment on the content and conclusions of the report."

Standards Rule 3-1 states that a review appraiser must:

> "Form an opinion regarding the completeness of the report under review in light of the requirements contained in these standards; form an opinion regarding the adequacy and relevance of the data and the propriety of any adjustments to the data; form an opinion regarding the appropriateness of the appraisal methods and techniques that were used; form an opinion as to whether the analysis, opinions and conclusions contained in the report are appropriate and reasonable."

I have given careful consideration to USPAP Standard 3, Rule 3-1 and Rule 3-2, as well as USPAP Competency Provision, which requires an appraiser to have the knowledge and experience to define and execute the valuation assignment competently; USPAP Ethics Provision, which requires an appraiser to perform assignments with impartiality, objectivity and independence; USPAP Standard 9, which is the requirement for developing a business or intangible asset appraisal, and Rule 9-1, Rule 9-4, Rule 9-5; USPAP Standard 10, which is the requirement for reporting the results of a business or intangible asset appraisal, and Rule 10-1, Rule 10-2, Rule 10-3 and, it is my opinion, that the SM Report does not conform to the USPAP Competency Provision, USPAP Ethics Provision, USPAP Standard 9 or Standard 10.

EFFECTIVE DATE

There are two significant dates in an appraisal report: the effective date or date of valuation and the date of the report. The effective date is the cut-off date for data gathering and establishes the context of the valuation conclusion. The date of the report is the date the report was written and indicates the appraiser's perspective of dentistry as well as the Practice.

Although there is no absolute rule for determining the effective date for the purpose of equitable distribution of marital assets, unless there are compelling equitable considerations, the effective date is the filing date of the divorce complaint.

Appraiser acknowledges the effective date is the filing date of the divorce complaint, "When valuing an asset for a divorce, it is customary to use the date of the marital complaint as the appraisal date. The marital complaint date in this action was May 24, 200X."

Although Adversary Expert recognizes that "it is customary to use the date of the marital complaint as the appraisal date," they did not use the date of complaint because it is not in the best interest of their client. Rather, Appraiser used an effective date of December 31, 200Y, which is the fiscal date preceding the date of complaint.

Adversary Expert state:

> "…We were informed…that Doctor Crown was hospitalized for a good portion of the early months of 2009 and sub-contracted other dentists to see his patients.
>
> "…Since Doctor Crown was an absentee owner during most of the early months of 2009, using financial data for that period would not be indicative of the value of the practice with Doctor Crown there full time."

Adversary Expert deliberately chose the December 31, 200Y effective date because it enabled them to artificially inflate the value of Practice.

Adversary Expert perspective of the Practice was framed four months and twenty six days prior to the date of complaint. This enabled them to ignore the hospitalization of Doctor Crown and the adverse impact his illness would have on production, total income collected, adjusted net cash flow, and the value of Practice. The effective date was convenient. It was not correct.

In his book, *Valuing Small Businesses and Professional Practices*, Shannon P. Pratt, D.B.A., F.A.S.A., C.F.A., discusses the impact of changing circumstances on the effective date and the valuation conclusion:

> "…the date…the business or practice is being valued is critically important, because changing circumstances can cause values to vary dramatically from one date to another, and the valuation date directly influences data available for valuation."

Appraiser is not a matrimonial attorney. It is audacious of him to presume that the hospitalization of Doctor Crown is a compelling equitable consideration or change in circumstance which calls for an effective date of December 31, 200Y. There are no compelling equitable considerations in this case; the effective date is May 24, 200X.

Appraiser did not render appraisal services in a prudent manner. The context of the SM Report as well as the perspective of Appraiser is wrong and, as a result, the analysis, opinions and conclusions of Adversary Expert are meaningless.

STANDARD OF VALUE

In their book, *Valuing a Business: The Analysis and Appraisal of Closely Held Companies*, Shannon P. Pratt, D.B.A., C.F.A., F.A.S.A., Robert F. Reilly, C.P.A., C.F.A., A.S.A., and Robert P. Schweihs, A.S.A., state:

> "…The word value means different things in different contexts…without carefully defining the term value, the conclusion reached in the valuation report has no meaning.
>
> One of the professional appraiser's most important tasks is to…arrive at a definition of value that is appropriate to the specific purpose of the valuation engagement.
>
> In many situations, the standard of value is legally mandated…The standard of value. . addresses what valuation methods are appropriate and what factors should or should not be considered."

In the case of equitable distribution, the parameters of the valuation problem are defined according to statutes, regulations and administrative rulings as well as case precedent and court directives and preferences.

Lavene v. Lavene, 162 N.J. Super 187, 192 (Ch. Div. 1978), on remand from 148 N.J. Super 267 (App. Div. 1977), established fair market value as the standard of value for the equitable distribution of marital assets.

The Levene Court held that:

> "…approach, methods and factors set forth in the revenue ruling for the valuation of closely held corporate stocks for estate and gift tax purposes were applicable in instant case to determine valuation of stock owned by husband.
>
> …Valuation of stock of a closely held corporation calls for an attempt to fix a "fair market value" for stock, that is, price at which property would change hands between a willing buyer and a willing seller…"

Other courts affirmed Lavene. Fair market value has become the standard of value for the equitable distribution of marital assets.

Although Adversary Expert state that "the purpose of this appraisal is to establish a fair market value for the practice to be used for the equitable distribution assets in the dissolution of the marriage of Doctor and Mrs. Crown," they did not use the fair market standard. They used a standard which Lewis A. Barney, Esquire, calls value to holder or equitable distribution value.

Adversary Expert state:

> "…this practice is being valued for a divorce. Therefore, there is no sale being contemplated, Doctor Crown will not be leaving the practice and the financial information should reflect Doctor Crown's presence…"

It is the responsibility of Adversary Expert to implement the standard of value that was established in Levene and render a credible valuation conclusion. It is not their responsibility to interpret the law and issue an opinion regarding which standard of value is appropriate in this matter.

The purpose of this appraisal is to determine the value of Practice for the purpose of equitable distribution. Case precedent indicates that the standard of value is fair market value not investment value or fair value or value to the holder or equitable distribution value.

Since the concept of fair market value presumes a transfer of ownership and a change of doctors, the value of Practice indicates the likelihood patients of record will continue to purchase dental services from the practice once it is sold and, therefore, it reflects the amount of professional goodwill that can be transferred from Doctor Crown to another dentist as of the effective date.

Doctor Crown is a sole practitioner. His illness and hospitalization compromise patient service capacity and adversely impacts the likelihood of retaining business from existing patients. This increases the transfer risk and diminishes the value of professional goodwill.

Adversary Expert did not use the fair market standard because it is not in the best interest of their client. They used the value to holder standard in order to nullify the transfer risk and eliminate the potential erosion in professional goodwill.

APPROACH TO VALUATION

USPAP Standards Rule 9-4 and Revenue Ruling 59-60, I.R.B. 1959-9 as well as the Internal Revenue Service *Exempt Organizations Continuing Professional Education Technical Instruction Program*, direct an appraiser to analyze the nature of the business of the subject practice and its financial history as well as the economic climate for the health-care industry and the dental profession in particular.

Industry-specific factors, such as health-care reform, managed care, health-care regulation, and Medicare and Medicaid reform impact doctor-productivity. Practice-specific factors, such as the clinical focus, service mix, payer profile, referral patterns, length of stay, accounts receivable, expense management, et cetera, impact patient-service charges, total income collected, professional compensation, and the adjusted net cash flow of the subject practice.

An analysis of the inter-relationship of these external and internal factors will enable an appraiser to stipulate the forecast assumptions of the valuation model and select the gross revenue multiplier, discount rate or capitalization rate that he/she will use to determine the fair market value of the tangible assets and professional goodwill of the subject practice.

Adversary Expert did not take a case history of Practice or give it a physical examination. They did not track the aforementioned practice-specific factors or conduct a comparative analysis of doctor productivity, practice overhead expenses, and accounts receivable management and, as a result, discovery is weak.

Appraiser did not gather the requisite data that would enable him to stipulate the forecast assumptions of the valuation model or opine on the gross revenue multiplier that he would use to determine the value of Practice.

The SM Report does not conform to USPAP Standards Rule 9-4 or Revenue Ruling 59-60, I.R.B. 1959-9 or the Internal Revenue Service *Exempt Organizations Continuing Professional Education Technical Instruction Program* or the American Society of Appraisers BVS-VI that requires that an appraiser collect and analyze all the data that is required to reach a fitting valuation conclusion, or ASA BVS-V, which requires an appraiser to document all information that he relied on in order to reach a valuation conclusion.

The SM Report is not fact specific and, as a result, it is misleading.

METHOD OF APPRAISAL

USPAP Standards Rule 9-4 (a) direct an appraiser to "consider all appropriate valuation methods and procedures" in order to render a credible business or intangible asset appraisal. Although Rule 9-4 (a) requires that an appraiser consider each relevant valuation approach, Rule 9-5 (a) compels an appraiser to use a valuation approach that is applicable to the specific valuation assignment.

Adversary Expert used four methods of appraisal to determine the fair market value of the tangible assets and professional goodwill of Practice: Cost Approach (Net Worth Method), Market Approach--Sales Price to Gross (Gross Revenue Multiplier Method), Market Approach--Sales Price to Earnings (Gross Revenue Multiplier Method), and Owner's Discretionary Cash Flow (Multiple of Discretionary Earnings Method).

Cost Approach

The focus of the cost approach is the value of the assets of a professional practice not it's earning capacity and, as a result, it disregards professional goodwill. The net worth method assumes that the value of Practice is the adjusted fair market value of its tangible assets including accounts receivable minus the adjusted fair market value of its liabilities.

According to Adversary Expert:

> "This approach is generally not applicable to service businesses and going concerns. Additionally, it does not value intangibles such as goodwill. Applicability of this approach is for businesses being appraised…in a liquidation situation."

Jay E. Fishman, M.B.A., A.S.A., C.B.A., Shannon P. Pratt, D.B.A., F.A.S.A., C.F.A., J. Clifford Griffith, M.P.A., C.P.A., and D. Keith Wilson, C.P.A., concur. In their book, *Guide to Business Valuations,* Volume 1, Messrs. Fishman, Pratt, Griffith and Wilson state:

> "…asset methods focus on the value of a company's assets…instead of its earnings potential."

Thus, the NAV method is generally used in one of the following situations:

A. The company's value depends on the value of its tangible assets and there is little or no value added to its. . .services from labor or intangible assets.

B. The company has no established earnings history. . .or a questionable ability to continue as a going concern.

The cost approach or net asset method is not applicable in this case. Appraiser should not have used it.

<u>Market Approach - Sales Price to Gross</u>

The market approach--sales price to gross method, which is a gross revenue multiplier, assumes that the fair market value of the subject practice can be determined by the ratio of the sale price to gross revenue of a guideline practice. However, since few, if any, dental practices are comparable, the gross revenue multiplier method is simplistic and has severe limitations.

Shannon P. Pratt, D.B.A., C.F.A., C.F.P., A.S.A., C.R.A., in his book *Valuing Small Businesses and Professional Practices,* states:

> "…One of the most widely used and abused approaches to the valuation of small business and professional practices is the gross revenue multiplier method. It can be useful, but its usefulness has severe limitations. When gross revenue multipliers are used for valuation the result can be an extremely misleading estimate of value."

The gross revenue multiplier method is a rule of thumb and according to Pratt:

> "…a rule of thumb is a homemade recipe for making a guess. It is an easy-to-remember guide that falls somewhere between a mathematical formula and a shot in the dark. Rules of thumb are dumb. . .greatly oversimplified. . .highly unreliable. They are dangerous and full of pitfalls. Simplicity is often achieved at the considerable loss of realism."

In *The Guide to Business Valuations*, Volume 2: sixth edition (March 1996), Shannon P. Pratt, et.

al., state:

> "…The biggest challenges in using comparative company methods is to identify comparative companies for which sufficient information is available, to adequately analyze the similarities and differences between the comparative companies and the company being valued, and to reflect these similarities and differences in the resulting value multiples. The business valuation consultant will rarely find a comparative company that is exactly the same as the company being valued."

Adversary Expert obtained information regarding guideline practices bought and sold from a study titled *Business Appraising in the Real World-Evidence from the IBA Market Data Base* published by The Institute of Business Appraisers, Inc.

According to Adversary Expert:

> "…We examined the sales of the practices with reported gross income in the same range as Doctor Crown's practice that is with gross income between $500,000 and $695,000. The ratio of average sales price to average annual sales is .63 and the average sales price to earnings ratio is 2.76."

It is not likely that the subject practice is comparable with the guideline practices in the IBA data base and, since the *Market Comparison Data* published by The Institute of Business Appraisers, Inc., is not practice specific, it is also not likely that the IBA study contains enough information to enable Adversary Expert to analyze the similarities and differences between Practice and the guideline practices and to reflect these similarities and differences in the resulting value multiple.

The Institute of Business Appraisers, Inc., states:

> "…The information below is supplied in response to your request for data to be used in applying the "Market Data Approach" to business appraisal…we are not able to guarantee its accuracy. Neither do we make any representation as to the applicability of the information to any specific appraisal situation.
>
> The Practice is a general practice with practice-specific risk factors that other dental practices in the IBA data base may not possess. The doctor established the practice in 1983 and he has practiced at the current location for 20 years. Preventive and diagnostics account for 60% of services rendered; operative 20%; periodontal 15%; endodontic 3%; and general services 2%. Eighty percent of the dentistry the doctor performs is well care. Doctor Crown is not a member of any managed-care panels.
>
> The Institute of Business Appraisers, Inc., *Market Comparison Data* includes twenty three general dental practices with annual gross revenue between $500,000 and $695,000; twenty three practices reported the ratio of average sales price to gross; thirteen practices reported average sales price to earnings.
>
> New York accounted for 4% of the general dentists in the data base; California and

Pennsylvania 30% each; Southwest 13%; Northeast 9%; Mid-west, Texas, and Northwest accounted for the balance, 14%. Thirteen practice sales occurred prior to the effective date; three occurring during 2002; one sale occurred after the effective date.

Adversary Expert failed the guideline test and, as a result, their valuation conclusion is speculative and without merit.

Appraiser used a weighted average to determine the reported annual sales volume of Practice and stated that “gross receipts include non-deposited cash receipts.”

The use of a weighted average neutralizes the historical trend in operations and negates the impact of industry-specific and practice-specific factors on the selection of a gross revenue multiplier.

A weighted average does not conform to Section 4.02 (d) or Section 7 of Revenue Ruling 59-60, I.R.B. and is misleading.”

Section 4.02 (d) states that:

> “…Potential future income is a major factor in many valuations of closely-held stocks and all information concerning past income which will be helpful in predicting the future should be secured. Prior earnings records usually are the most reliable guide to future expectancy, but resort to arbitrary five- or ten-year averages without regard to current trends or future prospects will not produce a realistic valuation.”

Section 7 states that:

> “. . .there is no means whereby the various applicable factors in a particular case can be assigned mathematical weights in deriving the fair market value. For this reason, no useful purpose is served by taking an average of several factors . . .and basing the valuation on the result. Such a process excludes active consideration of other pertinent factors, and the end result cannot be supported by a realistic application of the significant facts in the case except by mere chance.”

The allegation of unreported income raises two points: relevance and propriety. If the allegation is true, the impact of $35,000 of non-reported deposits on the valuation conclusion is minimal. If the allegation is not true, it is inflammatory and not appropriate.

The market approach - sales price to gross method may appear to be simple, but it is difficult to apply to a complex business such as a dental practice. It is very mechanical and, as a result, does not produce a credible valuation conclusion. Adversary Expert used this method to nullify the excessive practice overhead expenses and inflate the value of Practice.

<u>Market Approach - Sales Price to Earnings</u>

The market approach - sales price to earnings method assumes that the fair market value of the subject practice can be determined by the ratio of the sales price to earnings of a guideline practice. The market approach - sales price to earnings method is also a gross revenue multiplier.

Adversary Expert state:

> "…Before applying the Sales Price to Earnings ratio of 2.76, income as reported must be normalized…adjustments are made to the reported…operations reflecting the true profit of the practice. Any deducted expenses that were personal and/or not ordinary or necessary to the operations of a dental practice are added back."

The Internal Revenue Service *Exempt Organizations Continuing Professional Education Technical Instruction Program* sets forth valuation guidelines for tax-exempt institutions such as hospitals who want to acquire private medical practices:

> "…The first step is to develop financial statements for the estimation period…the historical information should be adjusted or "normalized" for any extraordinary occurrences...or for known changes in revenues or expenses which will be sustained into the future."

The IRS requires that an appraiser use reasonable forecast assumptions:

> "…After the normalized financial statements are developed, <u>reasonable assumptions</u> are made regarding rates of…expense increase based upon current market conditions, growth, and best estimates of inflation trends…in all cases, reasonable assumptions…should be employed."

The SM Report adjustments to normalize net income are neither correct nor complete.

Appraiser made adjustments to the following revenue and expense centers for the twelve months ended December 31, 200Y: Non-deposited Receipts, Officers Compensation, Corporate Perquisites, Salaries, and Interest.

Appraiser did not account for likely adjustments to the following expense centers: Rent, Telephone, General Expense, Gifts, Office Supplies, Postage, Uniform Expense, Repairs and Maintenance, Outside Services, and Education.

Appraiser failed the Internal Revenue Service *Exempt Organizations Continuing Professional Education Technical Instruction Program* reasonable assumption test.

<u>Owner's Discretionary Cash Flow</u>

The multiple of discretionary earnings method is a valuation approach that is commonly used by the business brokerage community.

According to the American Society of Appraisers *Principles of Valuation Student Manual*:

> "…It is designed to render a "quick and dirty" indication of the amount a buyer, who would make the ownership and operation of the business his/her means of livelihood, might be able to afford to pay for the business.
>
> It involves the use of "discretionary cash" multiples that may or may not adequately reflect how the market would perceive an investment in the business being subjected to appraisal."

In *The Guide to Business Valuations*, Volume 2: sixth edition (March 1996), Shannon P. Pratt, et. al., state:

> "…The multiple of discretionary earnings method is often used to value very small businesses (normally with…values of less than $250,000).
>
> …this method has been misnamed, misused, and misunderstood by appraisers and brokers more so than any other valuation method. Many valuation consultants do not use this method because of the difficulty involved in supporting the required multiples."

Because the rate of return required by owner/managers co-mingles return on labor (managers' compensation) and return on capital (distributions and appreciation), application of this method may not produce an indication of fair market value.

According to Adversary Expert, when an appraiser "chooses a multiple to apply to owner's discretionary cash flow, consideration of the risks associated with owning this dental practice must be considered."

Adversary Expert depiction of the aforementioned industry-specific and practice-specific factors is nebulous.

Adversary Expert did not take a case history of Practice or give it a physical examination. Appraiser did not analyze how health-care reform together with practice-specific factors such as the clinical focus, service mix, payer profile, and referral patterns impact doctor-productivity or conduct a comparative analysis of practice overhead expenses and accounts receivable management to determine the reliability and continuity of future earnings.

Adversary Expert used the multiple of discretionary earnings model to corroborate the price-to-gross value and the price-to-net value, but, since they failed the seller's discretionary cash flow multiplier test, they are unable to stipulate the risk assumptions in the owner's discretionary cash flow model and opine on the discretionary cash flow multiplier.

The seller's discretionary cash flow method is simplistic and unreliable. Although it is commonly used by the brokerage community, it should never be used to determine the value of a professional practice for the purpose of equitable distribution of marital assets.

ACCOUNTS RECEIVABLE

The accounts receivable of a dental practice are fees for patient-service activities that have been billed but not collected. In order to ascribe a value to said receivables, an appraiser must first verify the amount of accounts receivable that are eligible for collection and, then, age the outstanding balance and determine its present value.

Adversary Expertr did not follow the aforementioned method of appraisal; they simply recorded the unadjusted fees for patient-service activities as of November 9, 2008, and incorporated said amount into their valuation conclusion.

Adversary Expert state:

> "A 'Practice Analysis' sheet was completed on November 9, 200Y. This data included a value for accounts receivable of $73,000. Doctor Crown did not know who completed the sheet, however, other data on the sheet was consistent with the practice records and we have therefore utilized the information in our report."

The technique of Appraiser is arbitrary and improper as well as negligent.

The SM Report does not conform to USPAP Standard Rule 9-1 (b) which requires an appraiser use diligence and care.

> "…In performing appraisal services, an appraiser must be certain that the gathering of factual information is conducted in a manner that is sufficiently diligent ...further, an appraiser must use sufficient care in analyzing such data to avoid errors that would significantly affect his/her opinion and conclusion."

CONCLUSION

USPAP Competency Provision requires "an appraiser to have both the knowledge and experience required to perform a specific appraisal service competently."

USPAP Standards Rule 9-1 (a) requires that an appraiser must "be aware of, understand, and correctly employ those recognized methods and procedures that are necessary to produce a credible appraisal." Rule 9-1 (b) states that an appraiser must "not commit a substantial error of omission or commission that would significantly affect an appraisal." Rule 9-1 (c), which requires an appraiser be diligent and not render appraisal services in a careless or negligent manner, states:

> "…The fact that the carelessness or negligence of an appraiser has not caused an error that significantly affects his or her opinions or conclusions and thereby seriously harms a client does not excuse such carelessness or negligence."

USPAP Standard 10 requires that "an appraiser communicate each analysis, opinion, and conclusion in a manner that is not misleading."

Adversary Expert did commit a series of errors of omission and commission and, although each individual error may not have a material impact on the valuation conclusion, the sum of all the errors does have a material impact.

The SM Report is misleading: the effective date is not correct; the standard of value does not conform to case precedent; the approach to valuation does not conform to Revenue Ruling 59-60, I.R.B. 1959-9, ASA BVS-VI, BVS-V, USPAP Standards Rule 9-4, and the IRS *Exempt Organizations Continuing Professional Education Technical Instruction Program*; the appraisal methods and techniques are not relevant; the adjustments to the financial statements are not accurate or complete; the appraisal criteria are erroneous; and the analysis and opinions contained in the report are vacuous.

Adversary Expert did not render appraisal services in a prudent manner. The SM Report does conform to the USPAP Competency Provision, USPAP Standard 9, Rule 9-1 (a) (b) (c), USPAP Standard 10 or the USPAP Ethics Provision which states:

> "…An appraiser who could reasonably be perceived to act as a disinterested third party in rendering an unbiased appraisal, review, or consulting service must perform assignments with impartiality, objectivity and independence without accommodation of personal interests."

Appraiser distorted the value of tangible assets and professional goodwill of Practice; his valuation conclusion is meaningless.

I hereby certify, to the best of my knowledge and belief, that the statements of fact contained in this memorandum are true and correct, and this memorandum has been prepared in conformity with the Uniform Standards of Professional Appraisal Practice of The Appraisal Foundation and the Principles of Appraisal Practice and Code of Ethics of the American Society of Appraisers.