

**VALUATION FOR MMN BUILDERS INC. AS OF JUNE 30, 2007**  
**SFAS 142 REVIEW PROGRAM**

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## **Introduction and Purpose**

As part of the audit engagement team's review of MMN Builders, Inc.'s financial statements you have been asked to review the valuation analysis performed by Appraisal Professionals, LLC for purposes of goodwill impairment testing under SFAS 142. The valuation analysis has been organized as follows with each section requiring individual attention and review:

<b>Subject</b>	<b>Report Section</b>	<b>Exhibit Number</b>
Company and Testing Background	Section 1	
Industry Overview	Section 2	
Engagement Overview	Section 3	
Impairment Executive Summary	Section 4	Exhibits I and II
SFAS 142 Step 1 <ul style="list-style-type: none"><li>▪ Discounted Cash Flow</li><li>▪ Publicly Traded Company Multiples</li></ul>	Section 5	Exhibits III-VIII
SFAS 142 Step 2 for the Northeast Reporting Unit	Section 6	Exhibits IX-XIV
Assumptions and Limiting Conditions	Appendix 1	
Accounting Guidance	Appendix 2	
Valuation Methodology	Appendix 3	
Certifications and Qualifications	Appendix 4	

The following review program is intended to assist auditing professionals in reviewing goodwill impairment testing and measurement analyses performed in accordance with SFAS 142. It provides a structured approach and contains suggested technical references. This review program is divided into sections which roughly correspond to those listed in the report structure table above. This program organization is meant to facilitate a structured review of each section of the valuation analysis. These sections can be reviewed all at once or in a piecemeal fashion.

The attached program contains a list of questions and comments designed to guide your review. Effort should be made to answer each question in as much detail as possible, noting all means expended to gain comfort with each aspect of the valuation analysis. Simple "Yes" or "No" answers should be avoided when possible. In the event that the information provided within the subject valuation report and calculation schedules is not sufficient to answer a given question within this program, such deficiencies should be noted along with suggested steps to be undertaken to ensure a resolution of the issue. In making such a suggestion, students should consider the materiality of the issue and its importance to the overall impairment testing and measurement exercise. Materiality may be assessed through the use of sensitivity analyses. For example, if an assumption lacks support, an analysis of how different the impairment conclusion

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would be if that assumption were changed upward or downward could be performed. The methodologies used and conclusions reached through such an analysis should be noted within this program.

Through deliberation of the considerations noted within this review program students should reach an assessment of the 5-8 key value-driving issues for which further clarification, analysis, and diligence is required in order to assess the reasonableness of the impairment conclusions reached. These key issues should be those which will have the largest impact on the impairment conclusion. Students should prepare a presentation including the following items to be discussed for each of the key issues identified:

1. Identification and explanation of the key issue;
2. An explanation of how this matter was determined to be critical to the impairment calculation;
3. A summary of any sensitivity analyses which have been performed to determine the effects of changes to the approach taken by the appraiser to address the subject issue;
4. Suggested methods of verifying the accuracy or inaccuracy of the appraiser's approach or conclusions reached as related to the issue; and
5. Next steps required to further address the issue and reach an ultimate conclusion.

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<p><b>Brief Introduction</b></p> <p>Goodwill and intangible assets not subject to amortization (i.e. indefinite-lived intangible assets) shall be tested for impairment on an annual basis and between annual tests if an event (i.e. a "triggering event") occurs or circumstances change that would more likely than not reduce the fair value of a reporting unit/intangible asset not subject to amortization below its carrying amount.</p>	
<p>1. Note who performed the valuation analysis (i.e., management, third-party valuation firm, etc).</p>	<p>The appraisal has been performed by Appraisal Professionals, LLC.</p>
<p>2. If a third-party appraiser is used, are the preparers of the analysis qualified to perform a valuation exercise of this nature? Consider and document the expertise and experience of those persons preparing the fair value measurements and review and document their respective qualifications to perform the work. Include a discussion that goes beyond discussing the reputation of the independent valuation firm, e.g., is the preparer a Chartered Financial Analyst (CFA) or a member of the American Society of Appraisers (ASA), and does the specialist have relevant industry experience? Is the preparer familiar with the guidance in the relevant accounting pronouncements?</p>	<p>Based on the qualifications section of the report, the appraisers appear to have extensive collective experience both in performing valuations and in the residential construction industry, in particular. The lead principal on the engagement holds both the CFA and ASA designations and appears to be well versed in the relevant financial reporting guidance.</p>
<p>3. Does the valuation report conform to the AICPA's <i>Statement on Standards for Valuation Services</i> by including a statement of representation by the appraiser, a listing of the appraiser's qualifications, and a section for assumptions and limiting conditions?</p>	<p>The transmittal letter at the beginning of the appraisal report indicates that the analysis is compliant with the SSVS. We note that representations, qualifications, and a statement of assumptions and limiting conditions have been included in the</p>

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	appendices.
<p>4. Note what types of assets (e.g. goodwill, indefinite-lived intangible assets, etc.) are being considered for impairment and the order in which these assets are being tested.</p> <p>The order of impairment testing should be as follows and impairment should be recorded before moving to the next category:</p> <ul style="list-style-type: none"> <li>• Indefinite-lived intangible assets (SFAS 142)</li> <li>• Long-lived intangible assets (SFAS 144)</li> <li>• Goodwill (SFAS142)</li> </ul> <p>The order of testing is important to ensure the carrying values of the underlying assets are properly adjusted for applicable impairment in the proper order. For example, testing goodwill for impairment before testing long-lived assets could result in a larger write-down in goodwill and a smaller (or no) write down in long-lived assets than had the testing been performed in the prescribed order. This is a result of the fact that by not impairing long-lived assets first, you increase the carrying value against which you test goodwill for impairment. This results in a larger goodwill impairment charge and a lower carrying value against which you then test the long-lived assets for impairment.</p> <p>Has the above order been followed correctly in the calculation of impairment within the analysis?</p>	<p>The appraisal report is strictly for purposes of testing goodwill for impairment and measuring the impairment to goodwill alone. MMN Builders does not appear to have any indefinite-lived intangibles on their balance sheet and the report indicates that testing under SFAS 144 has resulted in significant impairment charges for the company's home inventories (i.e., homes held for sale by the company). The report indicates that the carrying values used to test and compute the impairment on goodwill have been adjusted for this write-down in inventory.</p>
<p>5. Note the date of test and whether the analysis has been performed as an annual impairment test or as a result of a "triggering event." If as a result of triggering event, note the event.</p>	<p>The impairment test is being performed as a result of a triggering event; specifically, the recent impairment of the</p>

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<b>Area</b>	<b>Auditor's Comments and Observations</b>
	company's home inventories.

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<p><b>Goodwill - Step 1</b>            Step 1 is similar to performing a business valuation. The first step of the goodwill impairment test is to compare the Fair Value of the reporting unit to its Carrying Value, including goodwill.</p>	
<p>6. Note how many reporting units ("RUs") the entity has and whether all or some portion thereof are being tested for impairment (not all reporting units are always tested – could be a triggering event in one reporting unit and not others; could be that some reporting units do not have goodwill to test). An annual test may be at any time during the year but must be performed at same time every year. Different reporting units may be tested for impairment at different times.</p>	<p>The company has two reporting units, each of which is being tested for goodwill impairment.</p>
<p>7. How were the entities being tested identified to be reporting units? Paragraph 30 of SFAS 142 defines a reporting unit as "an operating segment or one level below an operating segment (referred to as a component). A component of an operating segment is a reporting unit if the component constitutes a business for which discrete financial information is available and segment management regularly reviews the operating results of that component."</p>	<p>The two reporting units represent distinct geographical operating segments for which discrete financial information is available and reviewed by management.</p>

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<p>8. Note basis on which Fair Value ("FV") of RUs are determined (i.e. on an asset, invested capital or equity basis). Accounting guidance refers to the notion of net assets, which presumably implies an equity basis. However, depending on facts and circumstances (e.g. debt at corporate level may not be able to allocated to RUs in a reasonable manner), an invested capital (i.e. business enterprise value) basis may be more appropriate. What is key in this assessment is to ensure that the manner in which the FVs of RUs are determined is consistent with Carrying Value ("CV") determination. In other words, if the FV is based on an invested capital basis, the CV against which the FV is tested should be on an invested capital basis as well. If the FV is based on an equity value, the CV should be book equity.</p>	<p>Each RU's business enterprise value is determined and debt is subtracted to arrive at the fair value of equity. This fair value of equity is compared to each RU's book value of equity.</p>
<p><b>Goodwill - Step 1</b>  <b>Valuation of Reporting Units</b>  <i>Note: If reviewing a SFAS 142 goodwill impairment test with multiple RUs, please answer the following questions in light of the valuations performed for all RUs.</i></p>	
<p>9. Note methodologies used to determine the FVs of the RUs (e.g.: DCF, market multiples etc).</p>	<p>The enterprise values are determined by use of both a DCF and the application of market multiples.</p>
<p>10. Were multiple methodologies used? If so, how was the concluded business value arrived at? Is the spread in the various indications of value by methodology significant? If a single methodology was used, note why and whether or not any attempts we made by the appraiser to corroborate conclusions using an alternative methodology.</p>	<p>The concluded values are based on a 75% weighting to the results of the DCF and a 25% weighting for the results of the Market Approach.</p>
<p>11. Were any premiums (e.g. control premium) or discounts applied in valuing the RUs (e.g. lack of control ("LOC")),</p>	<p>No discounts or premiums were</p>

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<p>lack of marketability (“LOM”), etc.)? If so, note their percentage</p> <ul style="list-style-type: none"> <li>• How are premiums/discounts determined?</li> <li>• Are premiums/discounts used reasonable given the facts and circumstances?</li> </ul> <p>NOTE: Premiums/discounts, in the context of impairment testing are heavily scrutinized by the SEC. Control premiums are often applied in the application of market multiples from publicly-traded comparable companies. Because those multiples are derived through prices of publicly-traded shares and because those shares represent minority interests in the company's equity, a premium for the right to control the reporting unit being tested for impairment is often applied. On the other hand, discounts for lack of marketability are often used to adjust for the fact that publicly-traded shares are liquid while business enterprises are not.</p>	<p>applied.</p>
<b>Market Approach – Guideline Public Company Method (“GPC Method”)</b>	
<p>12. Was the GPC Method applied? If not, note reason.</p>	<p>The GPC Method was used.</p>
<p>13. <i>Selection of Guideline Companies</i> - Does the selection of guideline companies appear reasonable? Factors to consider include:</p> <ul style="list-style-type: none"> <li>• Industry and business description;</li> <li>• Size, profitability, expected growth and geographic</li> </ul>	<p>All of the selected guideline companies are large players in the residential design, construction, and marketing industry. In terms of size, all of these companies are significantly larger than each of the RUs being tested for</p>

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<p>location;</p> <ul style="list-style-type: none"> <li>• Confirm that companies are not subject to unique factors (lawsuits, pending acquisition, etc) which would skew multiples; and</li> <li>• Ensure there is sufficient trading volume to provide a reasonable basis for the stock price. In other words, prices for thinly-traded stocks may not be good representations of market values.</li> </ul>	<p>impairment but appear to be effected by similar downturns in the profitability of the industry. We note, however, that the guideline companies appear to be significantly more profitable than the Northeast RU.</p>
<b><i>Calculation of Multiples</i></b>	
<p>14. Calculation of Multiples</p> <p>Are multiples calculated appropriately? Factors to consider include:</p> <ul style="list-style-type: none"> <li>• How is enterprise value (most commonly defined as market value of equity plus book value of preferred stock, if any, plus net interest bearing long term and short term debt) defined (e.g. definitions may vary especially with regard to treatment of cash as excess cash held by one or more of the comparable companies may skew their multiples)?</li> <li>• Share prices used to calculate the market value of equity should be consistent with the impairment testing date;</li> <li>• Book value of preferred stock, cash and interest bearing debt should be pulled from closest filing prior to impairment testing date;</li> <li>• Numerator and denominator should be consistent when calculating multiples. For example, if the</li> </ul>	<ul style="list-style-type: none"> <li>▪ Multiples are on an enterprise basis (as opposed to an equity basis) and enterprise value is defined as market cap + debt + preferred - cash.</li> <li>▪ The prices used to derive the market cap appear to have been taken from the valuation date.</li> <li>▪ Amounts of debt, preferred, and cash appear to be consistent with the financial statements issued closest to the valuation date.</li> <li>▪ The denominators (revenue, EBITDA, and net asset value) are consistent with the enterprise value basis of</li> </ul>

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<p>numerator is enterprise value, the denominator should be an operating metric which does not reflect the impact of capital structure, such as revenues, EBITDA or EBIT. If the numerator is equity value, the denominator should represent a flow to equity holders only, such as net income.</p> <ul style="list-style-type: none"> <li>• Has the appraiser considered differences between the subject company and the guideline companies for factors such as size, risk, growth, and profitability?</li> </ul> <p>If not, please note why.</p> <p>If so, how did they make their adjustments?</p>	<p>the numerator.</p> <ul style="list-style-type: none"> <li>▪ The appraiser utilized multiples that approximate the mean and median of the range exhibited by the comparable companies without adjustment. This approach is deficient in that it does not account for the fact that the subject RUs are significantly smaller than the guideline companies. We would normally expect a downward adjustment to the multiple in such a circumstance. For the Southwest RU, however, the large cushion between the FV and CV would likely make any adjustment immaterial in the impairment conclusion. For the Northeast RU such an adjustment could increase the amount of impairment. However, the fact that only a 30% weighting is applied to the Market Approach may mitigate this effect.</li> </ul>
<p>15. If various multiples were used, how was the concluded indication of value arrived at for this approach?</p> <p>Is the spread in the various indications of value significant?</p>	<p>Rounded median values were selected.</p> <p>The spread between the various value indications were minimal</p>

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	for the Southwest RU. For the Northeast, the revenue multiple was deemed to be the most representative value indication and was equivalent to the median value.

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<b>Income Approach – DCF Analysis</b>	
16. Was an Income Approach applied? If not, note reason.	The DCF form of the Income Approach was applied.
17. Which Income Approach was used: free cash flow to the firm (FCF) discounted at WACC, free cash flow to equity (FCE) discounted at cost of equity, adjusted present value technique, capitalization of earnings, etc.? Note that the FCF using WACC approach is most common in practice. However, depending on what industry the subject company belongs to, other approaches may be more appropriate (e.g. for financial services, a FCE using cost of equity is typically used).	FCF discounted at the WACC was used.
18. Projections  a. Understand and document the basis for projections. How were they derived?  b. How do growth rates and margins compare to historic and industry growth rates? In situations in which information is lacking, request that the appraiser provide substantiation. Gain an understanding for large variances relative to historical trends and industry indications.	Projections were provided by MMN Builders management.  The appraisal report does not include an analysis of historical of industry performance to which we can compare the projections. In order to gain comfort with the projection assumptions we will request that MMN Builders management provide historical financials by RU as well as a schedule reconciling the utilized projections to those of the company's internal budgets and forecasts.

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<p>19. Taxes</p> <p>a. What is the basis for the tax rate (i.e., combined federal and state rates)? Is it correct for the geography?</p> <p>b. Consistent with the concept of cash flow analysis, cash (i.e., effective) tax rates should be used.</p> <p>c. Are there any Net Operating Losses ("NOLs") which have been or should have been considered within the analysis? NOLs have the effect of lowering taxes as a result of historical losses.</p>	<p>The 38% tax rate appears reasonable for a US-based company.</p> <p>The projections do not show any NOLs, which is consistent with the positive operating margins forecast for the business.</p>
<p>20. Capex &amp; Depreciation</p> <p>a. Have capital expenditures and depreciation been properly accounted for? Factors to consider, include:</p> <ul style="list-style-type: none"> <li>• Comparison to historic and industry data (fixed asset turnover ratios, percentage of revenue, etc.);</li> <li>• Consistency with the expected growth in the business (i.e. it's difficult to obtain significant growth without significant capex);</li> <li>• Capex and depreciation should be internally consistent (i.e. you cannot depreciate more assets than you have purchased through capex).</li> </ul> <p>b. At the end of the discrete projection period, do depreciation and capex offset each other? If not, does the gap appear reasonable given the revenue and other expenses in the terminal value calculation? It is unlikely that capex would exceed depreciation into perpetuity or that depreciation would exceed capex for</p>	<p>Capex and depreciation have been accounted for in the valuation. The relatively low levels of capex is consistent with the projected decay in the RU's revenues. Similarly, the fact that capex is slightly lower than depreciation in the early years of the projections appears consistent with the recent drop in capital spending within the housing industry.</p> <p>Capex and depreciation are offsetting in the terminal period.</p>

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an extended number of years.	
<p>21. Working capital ("WC")</p> <p>a. Has an adjustment been made for working capital? Is the level of working capital implied reasonable? Factors to consider, include:</p> <ul style="list-style-type: none"> <li>• Comparison to historic and industry data (i.e., current ratios, days receivable/payable, inventory turns, working capital as percentage of revenue, etc);</li> <li>• Level of expenses.</li> </ul>	<p>Adjustments have been made for incremental working capital in 2010 and 2011, the years in which revenue is projected to increase. Although we would normally expect some levels of working capital inflows in the early years for which revenue is expected to decline, the approach taken is conservative as it reduces the fair value of the enterprise.</p> <p>The appraisal report does not include an analysis of historical or industry performance to which we can compare the projected working capital levels. In order to gain comfort with the projection assumptions we will request that MMN Builders management provide historical financials by RU as well as a schedule reconciling the utilized projections to those of the company's internal budgets and forecasts.</p>
<b><i>Terminal Value</i></b>	
<p>22. What methodology has been used to calculate the terminal value?</p> <ul style="list-style-type: none"> <li>• The Gordon Growth method takes the free cash flow in</li> </ul>	<p>The Gordon Growth method was used to calculate the</p>

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<p>the last year of the forecast period and grows it one more year at the long term growth rate. This free cash flow is then capitalized at a rate equal to the discount rate minus the perpetual long term growth rate (i.e. k-g).</p> <ul style="list-style-type: none"> <li>• The Exit Multiple method assumes that the business is sold at the end of the explicit forecast period.</li> </ul>	terminal value.
<b><i>Gordon Growth Model</i></b>	
<p>23. Does the terminal value calculated using this method appear unreasonable? Consider the following factors:</p> <ul style="list-style-type: none"> <li>• Has a normalized cost of capital been utilized (for early stage companies, the risk-profile at the terminal period should be much lower than at the valuation date)?</li> <li>• Were sales from the last projection period grown by the assumed long term/residual growth rate? Have the operating margins been set at long term sustainable levels?</li> <li>• Is capex adequate to sustain growth?</li> <li>• Does capex have a sustainable relationship with depreciation?</li> <li>• Does long term sustainable growth rate appear reasonable? Typically, this growth rate will range from 2-5%.</li> <li>• Are working capital requirements adequate to support sales growth?</li> </ul>	<ul style="list-style-type: none"> <li>▪ The 10.3% discount rate is already normalized.</li> <li>▪ Sales is grown by a reasonable 4% long-term growth rate and margins are set to normalized levels.</li> <li>▪ Capex and depreciation are offsetting.</li> <li>▪ Working capital is set to a normalized level.</li> <li>▪ The implied exit multiple is 10.2x EBIT for the RUs which is slightly higher than the range of those multiples exhibited by the comparable companies. This multiple appear reasonable especially in light of the fact that current multiples within the industry are likely depressed</li> </ul>

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<ul style="list-style-type: none"><li>• What is the implied Exit Multiple and does it appear reasonable? One approach to test this would be to compare the implied multiple to comparable company multiples or historical industry multiples.</li></ul>	by the recent downturn in the market and may be low compared to multiples that will be present after the final projected year of projection period (2011).

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<b><i>Exit Multiple Approach</i></b>	
<p>24. Does the terminal value calculated using this method appear reasonable? Consider the following factors:</p> <ul style="list-style-type: none"> <li>• M&amp;A and Public Company multiples.</li> <li>• Multiples for mature players in the industry (focus on longer-term averages for industry versus current multiples which might be distorted).</li> <li>• Guideline company multiples or historical industry multiples.</li> </ul> <p>Was a discount applied to the multiple used? Note that usually it is appropriate to take some discount to reflect the fact that all things being equal, the multiple in future years should be less as growth slows over time.</p>	<p>Not applicable - The Exit Multiple Approach was not used.</p>
<b><i>Discount rate</i></b>	
<p>25. Have present value ("PV") factors been calculated properly? Was the PV factor adjusted to account for partial year cash flows in the first year, if applicable?</p>	<p>The PV factors have been calculated correctly. Partial periods as well as the mid-year discounting convention have been used.</p>

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<p>26. Note the discount rate and assess reasonableness. Ensure that the discount rate used is consistent with the projected cash flow stream. In other words, when discounting cash flow to all stakeholders, the cost of capital for the entire firm (WACC) should be used. When discounting cash flow to equity holders only, the cost of equity should be used.</p> <p>Factors to consider, include:</p> <ul style="list-style-type: none"> <li>• Company's stage of development and investor's required rate of return;</li> <li>• Capital structure and leverage;</li> <li>• Has the cost of debt been tax-affected?</li> </ul>	<ul style="list-style-type: none"> <li>▪ The 10.3% discount rate is based on the WACC which is consistent with the approach of discounting the cash flows to the firm to arrive at a business enterprise value.</li> <li>▪ The discount rate appears reasonable given the mature nature of the company and its industry.</li> <li>▪ The capital structure used to calculate the WACC is consistent with the average capital structure of the comparable companies.</li> <li>▪ The cost of debt is tax-effected.</li> </ul>
<p>27. Which approach was used to calculate the cost of equity: capital asset pricing model ("CAPM"), build up approach, arbitrage pricing theory, Fama-French three factor model, dividend discount model, other?</p> <p>In practice CAPM is the most commonly used approach.</p>	<p>The CAPM approach was used.</p>
<p>28. <b>Risk free rate</b> – Does the risk free rate appear reasonable? Note the source used.</p>	<p>The risk free rate is set equal to the rate on 20 yr US Treasury bonds as of the valuation date.</p>
<p>29. <b>Market risk premium ("MRP")</b> - Is the MRP between 4%</p>	<p>The MRP is 5% based on</p>

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and 7%? Note the source used.	studies of historical equity market performance.
<p>30. <b>Beta</b> - Consider the following in assessing the utilized beta:</p> <ul style="list-style-type: none"> <li>• Was the beta determined using a reasonable peer group analysis? Does the selection of guideline companies appear reasonable?</li> <li>• Are betas unlevered and relevered appropriately? The capital structure assumption used to relever the subject company's beta should be the same as that used to weight the debt and equity in the calculation of the subject company's WACC.</li> </ul>	<ul style="list-style-type: none"> <li>▪ The peer group is made up of the same companies as those used in the Market Approach discussed above.</li> <li>▪ Betas are unlevered and relevered at the average industry capital structure.</li> </ul>
<p>31. <b>Capital structure</b> - Consider the following in assessing the assumed capital structure:</p> <p>What capital structure is assumed in the calculation of the WACC? Is the capital structure based on company-specific parameters or is an industry average used? When assessing fair value for tax or financial reporting purposes, the common practice is to use the industry average capital structure.</p>	The average industry capital structure is used in the WACC computation.
<p>32. If applicable, does the discount rate include a size premium? If so, does the magnitude of the premium appear reasonable? A size premium is typically applied to cost of equity as determined by CAPM.</p> <p>NOTE: Company-specific risk premiums are highly judgmental and subject to scrutiny.</p>	A company-specific risk premium from Ibbotson's study of 2% was added for the additional risk inherent in the company's new operating strategy. This does not appear unreasonable.

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<p><b>Goodwill Impairment - Step 2 (i.e. for all RUs where <math>FV &lt; CV</math>)</b>  <i>Note: Step 2 analysis should be performed similar to a SFAS 141 exercise and should make reference to all tangible and intangible assets/liabilities. This includes intangibles that may not be recorded on a reporting unit's balance sheet.</i></p>	
<p>33. List all tangible and intangible assets/liabilities included in the Step 2 analysis. Does this list appear to be complete?</p>	<p>Tangible assets (home inventories and PP&amp;E) have been valued separately by the company and the calculations used have not been shown within the analysis.</p> <p>Two intangible assets (a customer relationship and the company's trade name) have been identified and valued. To ensure that all assets have been identified, MMN Builders management should be walked through the list of potential assets in Paragraph A14 of SFAS 141.</p>
<p>34. Is the appraiser's assumption that CV is equal to FV for any assets or liabilities? Is this a reasonable assumption given the nature of the assets/liabilities?</p>	<p>The post-SFAS 144 carrying values for home inventories and fixed assets were assumed to be fair value. Assuming that the valuations underlying the SFAS 144 impairment are correct, this assumption would be reasonable. However, we have not been presented with the SFAS 144 analysis and will need to gain comfort with its calculations and conclusions before accepting the results of</p>

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	the current SFAS 142 analysis.
35. Has the impairment loss been measured as the difference between book value of goodwill and the implied fair value of goodwill? The implied fair value of goodwill should be calculated as the Step 1 FV of the RU less the FV of all assets/liabilities identified and valued in the Step 2 analysis.	The impairment loss has been measured as the difference between the book value of goodwill and the implied fair value of goodwill.
<p><b>Goodwill Impairment - Step 2 (i.e. for all RUs where FV &lt; CV)</b></p> <p><b>Valuation of Intangible Assets</b></p> <p><b>Assets valued using the Income Approach – Excess Earnings Method.</b> The application of the Excess Earnings Method to value intangible assets is discussed in AICPA Practice Aid on In Process Research &amp; Development. The fundamental premise of the Excess Earnings Method is that the value of an intangible asset is equal to the present value of the net cash flows attributable to the subject intangible asset. Intangible assets valued using the excess earnings method are generally the primary intangible assets acquired in a transaction and often include technology (developed and in-process) and customer relationships. On rare occasions, customer relationship assets may not be identifiable in early-stage companies when the Target has no history of revenues.</p>	
36. Note the assets valued using this approach.	A customer relationship with a real estate developer has been valued using the Excess Earning Method.
37. Is the use of this method to value the given asset reasonable in the overall context of the deal and the manner in which the asset can be marketed (e.g., key value-driving assets, such as customer relationships and enabling technology, are often valued using the Excess Earnings Method)?	Customer relationships are considered a key value-generating asset and are often valued using the Excess Earnings Method.
38. Do the gross margins or COGS % of revenues differ	The margins assumed for the

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significantly from the margins used in Step 1 to determine the business enterprise value? If so, is there a reason why?	customer relationship model do vary considerably from those assumed for the business overall. This assumption may be due to many factors including, but not limited to, the specific types of services performed for this specific developer.
39. If valuing customer relationships, note the probability of attrition and retention. What is the basis for the probabilities applied (e.g., historical attrition rates or probabilities of renewal). Ensure proper support is obtained if appraiser relied solely on management indications of renewal. An analysis of detailed historical customer turnover information may be appropriate to assess attrition estimates.	The model assumes a 25% annual probability of attrition. This assumption is not substantiated and needs to be verified with historical attrition data or other forms of support.
40. If valuing customer relationships, is some level of growth embedded in the revenues attributable to existing customers before the attrition? Some level of growth may be appropriate to reflect the fact that the company may be selling new products and/or services to existing customers before they leave.	A 3% growth is assumed before attrition.
41. If valuing customer relationships, note maintenance Sales and Marketing expense. Typically, these expenses are lower for existing customers than for new customers and an adjustments needs to be made.	5% of revenue is added back to the cash flow of the customer relationship as a result of lower selling and marketing effort required to encourage future patronage.
42. Has a tax amortization benefit been applied?	Yes

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<p><b>Contributory Asset Charges</b></p> <p>Under the Excess Earnings Method, charges for assets that contribute to the generation of cash flows are deducted from operating profits of the intangible asset being valued in order to arrive at only those cash flows attributable to the subject asset. Contributory assets typically include fixed assets, working capital, workforce, and other intangible assets. Typically, returns on assets are applied as a percentage of revenue. Charges are broken down into returns OF and returns ON which are analogous to the principal and interest concepts of a loan. Returns OF represent the payback of the initial capital employed to purchase or develop the asset (i.e. the principal). Returns ON are the returns one expects to generate on his initial investment in the asset (i.e. the interest). Charges for the returns OF should only be taken for assets whose value depreciates over time. Charges for returns ON should be taken for all assets that contribute to value. At times, returns OF are already embedded in the cash flow projections, such as with depreciation for fixed assets. Under such circumstances, only a return ON needs to be taken.</p>	
<p>43. Have all assets which contribute to the generation of cash flows been identified as contributory assets?</p>	<p>Home inventories, fixed assets, the company trade name, and the assembled work force have been assumed to contribute to the cash flow generated from the customer relationship.</p>
<p>44. Is return ON working capital reasonable? Working capital rates of return should be similar to short term lending rates. Only a return ON working capital is appropriate. It is incorrect to ever reflect return OF working capital in the form of working capital investments because the hypothetical return OF working capital is conceptually offset by a borrowing of funds. Thus, working capital is not a wasting asset for which a return OF is required.</p>	<p>The company carries minimal working capital and a charge was, therefore, not applied.</p>
<p>45. Is return ON fixed assets reasonable? Fixed assets rates are those implied by operating leases, capital leases, or both. Returns OF are typically included in the depreciation charged to arrived at operating profit. If depreciation is included in this charge, it should be tax-effected.</p>	<p>The 9.3% return on inventories and the 5.6% return on other fixed assets do not appear unreasonable.</p>

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46. A charge for use of the RU's work force should be included. Is return OF work force included in the calculation of the charge? Only a return ON work force should be considered because use of and replenishment of the work force is already captured in the cash flow assumptions in the form of employee salary and training expenses.	A return ON the work force has been taken.
<b>Assets valued by the Income Approach</b>  <b>Relief from Royalty Method</b>  Intangible assets valued using the Relief from Royalty Method are generally considered secondary to those assets valued using the excess earnings method. Generally trade name and core technology (often in the form of patents) are valued in this way; however, this approach may also serve to validate values of technology derived using the excess earnings method. Consider how the royalty rate was determined and whether the rate itself is reasonable. After-tax royalties greater than 10% are not typical.	
47. Note the assets being valued using this method.	The company trade name has been valued using the Relief from Royalty Method.
48. Is the royalty rate based on market data (e.g., Royalty Source)? The market data should reflect licensing transactions involving similar assets.	Support has not been given for the royalty rate. We will ask the appraiser to provide support in order to assess the reasonableness of the concluded value.
49. Is the royalty based on a proportion of operating profit? A general rule of thumb is that 25% to 33% of normalized operating profit is attributable to intangible assets (e.g., trade names or patents).	The 0.75% royalty rate is about 8.0% (give or take) of the RU's long-term EBIT margins. This appears low in light of the 25% to 33% rule of thumb. However, in the home construction industry, you would not typically expect a

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	large value to be allocated to the trade name (since homes are not truly branded products) and, thus, a lower rate may not be unreasonable.
50. Is the royalty rate applied to applicable revenue stream? Patent royalties should only be applied to the applicable technology (future and existing revenues). Trade name royalties should only be applied to those products sold under that trade name.	The royalty rate is applied to overall RU revenue which appears appropriate since all of the company's activities use the trade name.
51. Has a tax amortization benefit been applied?	Yes
<p><b>Assets valued using the Cost Approach.</b> This approach captures the costs associated with replicating or replacing the acquired asset in its existing state, and is based on the principle of substitution (i.e., an investor would pay no more for an asset than it would cost to replace its functional utility). These costs may or may not include applicable costs to finance the endeavor. Methods under the Cost Approach include:</p> <ul style="list-style-type: none"> <li>• Reproduction cost new – Cost to exactly replace asset</li> <li>• Replacement cost new – Cost to replace asset’s functionality</li> </ul> <p>Both methods adjust for various forms of physical, functional, and economic obsolescence.</p>	
52. Note type of asset valued using this approach.	The assembled work force has been valued using a Cost Approach.
53. Has the Cost Approach only been used for those assets that are not deemed to be the primary cash generating assets?	The work force is not a primary cash generating asset, so it is not unreasonable to use a Cost Approach.
54. Have the costs to recreate the asset been tax-effected? If not, explain why. If costs are after-tax, has a tax amortization benefit been applied?	The costs have been tax-effected and a tax amortization benefit has been added.

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55. Have only soft costs been considered? Investments in capital equipment should not be included.	Only hiring, training, and lost production costs have been included.
56. If any employee salaries have been included, are these indications fully-burdened? Fully-burdened salaries should be used.	Fully-burdened salaries have been used.

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**Key Issues for Further Investigation**

- 1. Projections:** The report does not provide any support for the assumptions used to develop cash flow projections for the RUs. Care must be taken to reconcile these projections to:
  - a. Historical performance
  - b. Industry-wide historical metrics and forecasts
  - c. The company's internal budgets and forecasts
- 2. SFAS 144:** We have only been presented with the SFAS 142 analysis but not the SFAS 144 analysis which preceded it and resulted in a substantial reduction in the carrying value of the company's home inventories. Because these inventories are the largest asset on the Northeast RU's balance sheet, changes to their fair values and carrying values will have a large impact on both the Step 1 and Step 2 analyses. The audit team will need to confirm the accuracy of the SFAS 144 impairment charge before forming an opinion of the SFAS 142 results.
- 3. Trade name royalty rate:** No support (such as data on royalty rates charged for the use of similar assets by third parties) has been given for the 0.75% royalty rate. The following table shows the effects of changes to that rate on the value of the trade name and the amount of goodwill impairment. As you can see, the royalty rate conclusion can have a sizable impact on the level of impairment.

	<b>Royalty Rate</b>	<b>Trade Name Value</b>	<b>Goodwill Impairment</b>
	0.25%	12	(99)
	0.50%	24	(110)
Current Analysis	0.75%	36	(121)
	1.00%	48	(132)
	1.25%	59	(143)
	1.50%	71	(155)
	1.75%	83	(157)
	2.00%	95	(157)

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- 4. Probability of customer attrition:** No support has been presented for the 75% annual probability of retention. The following table shows the effects of changes to that probability on the value of the customer relationship and the amount of goodwill impairment. As you can see, the probability conclusion can have a sizable impact on the level of impairment. Historical customer attrition data or other support should be sought to confirm the accuracy of this input.

	<b>Prob. Of Retention</b>	<b>Customer Value</b>	<b>Goodwill Impairment</b>
	60.00%	17	(111)
	65.00%	20	(114)
	70.00%	23	(118)
<b>Current Analysis</b>	<b>75.00%</b>	<b>27</b>	<b>(121)</b>
	80.00%	31	(125)
	85.00%	36	(130)
	90.00%	41	(135)