



**JTH TAX, INC. AND SUBSIDIARIES**  
(d/b/a Liberty Tax Service)

Consolidated Financial Statements

April 30, 2007, 2006 and 2005

(With Independent Auditors' Report Thereon)



## Independent Auditors' Report

The Board of Directors and Stockholders  
JTH Tax, Inc.:

We have audited the accompanying consolidated balance sheets of JTH Tax, Inc. and subsidiaries (d/b/a Liberty Tax Service) (the Company) as of April 30, 2007 and 2006, and the related consolidated statements of income, stockholders' equity and comprehensive income, and cash flows for each of the years in the three-year period ended April 30, 2007. These consolidated financial statements are the responsibility of the Company's management. Our responsibility is to express an opinion on these consolidated financial statements based on our audits.

We conducted our audits in accordance with auditing standards generally accepted in the United States of America. Those standards require that we plan and perform the audit to obtain reasonable assurance about whether the financial statements are free of material misstatement. An audit includes consideration of internal control over financial reporting as a basis for designing audit procedures that are appropriate in the circumstances, but not for the purpose of expressing an opinion on the effectiveness of the Company's internal control over financial reporting. Accordingly, we express no such opinion. An audit also includes examining, on a test basis, evidence supporting the amounts and disclosures in the financial statements, assessing the accounting principles used and significant estimates made by management, as well as evaluating the overall financial statement presentation. We believe that our audits provide a reasonable basis for our opinion.

In our opinion, the consolidated financial statements referred to above present fairly, in all material respects, the financial position of JTH Tax, Inc. and subsidiaries as of April 30, 2007 and 2006, and the results of their operations and their cash flows for each of the years in the three-year period ended April 30, 2007 in conformity with U.S. generally accepted accounting principles.

Effective December 31, 2003, the Company implemented the provisions of Financial Accounting Standards Board (FASB) Interpretation No. 46(R), *Consolidation of Variable Interest Entities, an Interpretation of Accounting Research Bulletin No. 51*, as described in note 16.

Effective May 1, 2006, the Company implemented the provisions of FASB Interpretation No. 48, *Accounting for Uncertainty in Income Taxes, an interpretation of FASB Statement No. 109*, as described in note 1(l) and note 9.

Effective May 1, 2006, the Company implemented the provisions of FASB Statement No. 123(R), *Share-Based Payment*, as described in note 1(o).

**KPMG LLP**

June 26, 2007

**JTH TAX, INC. AND SUBSIDIARIES**  
(d/b/a Liberty Tax Service)  
Consolidated Balance Sheets  
April 30, 2007 and 2006

<b>Assets (Notes 5, 7 and 8)</b>	<b>2007</b>	<b>2006</b>
Current assets:		
Cash and cash equivalents	\$ 20,913,811	13,422,348
Short-term investments	—	68,775
Receivables (notes 2 and 13):		
Trade accounts	18,916,287	15,905,246
Notes	27,351,243	26,100,362
Refund anticipation loan fees, net	4,539,793	3,302,751
Interest	2,211,052	1,673,545
Allowance for uncollectible amounts	(3,228,524)	(2,022,887)
Total receivables, net	<u>49,789,851</u>	<u>44,959,017</u>
Inventory	120,431	711,819
Prepaid expenses and other current assets	329,721	898,328
Deferred income taxes (note 9)	2,622,000	2,274,496
Total current assets	<u>73,775,814</u>	<u>62,334,783</u>
Property, equipment and software, net (note 3)	20,417,401	9,037,699
Notes receivable, excluding current portion, net of allowance for uncollectible amounts of \$1,948,476 and \$1,060,534 for 2007 and 2006, respectively (notes 2 and 13)	26,503,837	21,545,731
Goodwill	1,913,028	1,913,028
Other intangible assets, net (note 4)	3,429,990	3,780,794
Restricted cash	195,665	189,561
Other assets	229,320	902,620
Total assets	<u>\$ 126,465,055</u>	<u>99,704,216</u>
<b>Liabilities, Minority Interest and Stockholders' Equity</b>		
Current liabilities:		
Current installments of long-term debt (notes 7)	\$ 6,013,676	846,894
Accounts payable and accrued expenses (notes 13 and 15)	20,313,043	17,639,674
Income taxes payable (note 9)	6,794,000	12,150,090
Deferred franchise fees	8,045,617	7,679,708
Franchise deposits	64,464	72,035
Total current liabilities	<u>41,230,800</u>	<u>38,388,401</u>
Long-term debt, excluding current installments (note 7)	16,579,959	1,104,308
Other long-term liabilities (note 15)	75,027	75,027
Subordinated debt (note 8)	—	15,853,079
Deferred income taxes (note 9)	10,857,047	1,676,880
Total liabilities	<u>68,742,833</u>	<u>57,097,695</u>
Minority interest	—	20,452
Stockholders' equity (notes 10, 11 and 17):		
Preferred stock	2,872,742	2,872,742
Special voting preferred stock	10	10
Common stock	13,101,276	12,458,526
Exchangeable shares	100,000	100,000
Common stock committed to be issued	—	16,000
Additional paid-in capital	6,507,444	6,232,518
Treasury stock, at cost	(2,958,659)	(1,428,000)
Accumulated other comprehensive income	374,283	338,824
Retained earnings	37,725,126	21,995,449
Total stockholders' equity	<u>57,722,222</u>	<u>42,586,069</u>
Commitments, contingencies and subsequent events (notes 2, 5, 6, 15 and 17)		
Total liabilities, minority interest and stockholders' equity	<u>\$ 126,465,055</u>	<u>99,704,216</u>

See accompanying notes to consolidated financial statements.

**JTH TAX, INC. AND SUBSIDIARIES**  
(d/b/a Liberty Tax Service)

Consolidated Statements of Income  
Years ended April 30, 2007, 2006 and 2005

	<b>2007</b>	<b>2006</b>	<b>2005</b>
Revenues (note 13):			
Franchise fees, net of provision for franchise fee refunds of \$1,874,392 in 2007, \$1,330,004 in 2006, and \$1,730,029 in 2005	\$ 22,319,393	23,561,430	19,491,810
Royalties and advertising fees	20,798,072	16,761,528	12,634,833
Bank product and tax discounting income	17,991,566	14,919,392	11,428,239
Interest income (note 2)	6,436,543	4,860,912	4,747,360
Tax preparation fees, net of discounts	5,044,641	4,828,569	1,498,041
Gain on sale of intangibles and property and equipment, net	196,279	106,723	227,941
Other revenue	2,361,176	1,113,992	982,584
Total revenue	75,147,670	66,152,546	51,010,808
Operating expenses:			
Employee compensation and benefits	17,800,706	14,823,206	11,770,454
General and administrative expenses (note 6)	20,944,201	20,585,896	16,067,387
Advertising expense	8,643,636	8,019,131	6,809,370
Interest expense (notes 5, 7 and 8)	2,729,249	3,067,898	2,009,230
Loss on extinguishment of debt (note 8)	885,611	—	311,302
Depreciation, amortization and impairment charges (notes 3 and 4)	3,163,334	2,213,306	1,564,927
Total operating expenses	54,166,737	48,709,437	38,532,670
Other, net	17,500	(404,741)	288,229
Gain on deconsolidation of variable interest entities (note 16)	3,055,042	—	—
Income before income taxes and cumulative effect of accounting change	24,053,475	17,038,368	12,766,367
Income tax expense (note 9)	8,323,798	7,110,966	5,240,140
Income before cumulative effect of accounting change	15,729,677	9,927,402	7,526,227
Cumulative effect of accounting change (note 16)	—	(1,655,702)	—
Net income	15,729,677	8,271,700	7,526,227
Accretion on put warrants (note 10)	—	—	(360,050)
Net income available to common stockholders	\$ 15,729,677	8,271,700	7,166,177

See accompanying notes to consolidated financial statements.

**JTH TAX, INC. AND SUBSIDIARIES**

(d/b/a Liberty Tax Service)

Consolidated Statement of Stockholders' Equity and Comprehensive Income

Year ended April 30, 2007

	Common stock, Class A		Common stock, Class B		Preferred stock, Class A		Preferred stock, Class B		Special voting preferred stock	
	Shares	Amount	Shares	Amount	Shares	Amount	Shares	Amount	Shares	Amount
Balance at May 1, 2006	11,558,526	\$ 11,558,526	900,000	\$ 900,000	190,000	\$ 2,375,000	25,000	\$ 497,742	10	\$ 10
Issuance of common stock in connection with purchase of customer lists	14,000	14,000	—	—	—	—	—	—	—	—
Exercise of warrants (note 10)	463,400	463,400	—	—	—	—	—	—	—	—
Exercise of stock options (note 11)	165,350	165,350	—	—	—	—	—	—	—	—
Balance at April 30, 2007	12,201,276	\$ 12,201,276	900,000	\$ 900,000	190,000	\$ 2,375,000	25,000	\$ 497,742	10	\$ 10

	Exchangeable shares		Common stock committed to be issued		Additional paid-in capital	Treasury stock		Accumulated other comprehensive income	Retained earnings	Total
	Shares	Amount	Shares	Amount		Shares	Amount			
Balance at May 1, 2006	100,000	\$ 100,000	4,000	\$ 16,000	6,232,518	681,000	\$ (1,428,000)	338,824	21,995,449	42,586,069
Issuance of common stock and common stock committed to be issued in connection with purchase of customer lists	—	—	(4,000)	(16,000)	102,000	—	—	—	—	100,000
Exercise of warrants (note 10)	—	—	—	—	(463,395)	—	—	—	—	5
Exercise of stock options (note 11)	—	—	—	—	143,521	—	—	—	—	308,871
Stock-based compensation expense (note 11)	—	—	—	—	251,000	—	—	—	—	251,000
Stock option income tax benefit (note 9)	—	—	—	—	241,800	—	—	—	—	241,800
Repurchase of outstanding stock	—	—	—	—	—	158,828	(1,530,659)	—	—	(1,530,659)
Net income	—	—	—	—	—	—	—	—	15,729,677	15,729,677
Foreign currency translation adjustment	—	—	—	—	—	—	—	35,459	—	35,459
Comprehensive income	—	—	—	—	—	—	—	—	—	15,765,136
Balance at April 30, 2007	100,000	\$ 100,000	—	\$ —	6,507,444	839,828	\$ (2,958,659)	374,283	37,725,126	57,722,222

See accompanying notes to consolidated financial statements.

**JTH TAX, INC. AND SUBSIDIARIES**  
(d/b/a Liberty Tax Service)  
Consolidated Statement of Stockholders' Equity and Comprehensive Income  
Year ended April 30, 2006

	<b>Common stock, Class A</b>		<b>Common stock, Class B</b>		<b>Preferred stock, Class A</b>		<b>Preferred stock, Class B</b>		<b>Special voting preferred stock</b>	
	<b>Shares</b>	<b>Amount</b>	<b>Shares</b>	<b>Amount</b>	<b>Shares</b>	<b>Amount</b>	<b>Shares</b>	<b>Amount</b>	<b>Shares</b>	<b>Amount</b>
Balance at May 1, 2005	11,001,706	\$ 11,001,706	900,000	\$ 900,000	190,000	\$ 2,375,000	25,000	\$ 497,742	10	\$ 10
Issuance of common stock in connection with purchase of customer lists	4,000	4,000	—	—	—	—	—	—	—	—
Exercise of warrants (note 10)	242,640	242,640	—	—	—	—	—	—	—	—
Exercise of stock options (note 11)	310,180	310,180	—	—	—	—	—	—	—	—
Balance at April 30, 2006	<u>11,558,526</u>	<u>\$ 11,558,526</u>	<u>900,000</u>	<u>\$ 900,000</u>	<u>190,000</u>	<u>\$ 2,375,000</u>	<u>25,000</u>	<u>\$ 497,742</u>	<u>10</u>	<u>\$ 10</u>

	<b>Exchangeable shares</b>		<b>Common stock committed to be issued</b>		<b>Put warrants</b>	<b>Additional paid-in capital</b>	<b>Treasury stock</b>		<b>Accumulated other comprehensive income</b>	<b>Retained earnings</b>	<b>Total</b>
	<b>Shares</b>	<b>Amount</b>	<b>Shares</b>	<b>Amount</b>			<b>Shares</b>	<b>Amount</b>			
Balance at May 1, 2005	100,000	\$ 100,000	8,000	\$ 32,000	1,679,578	3,644,230	646,000	\$ (1,288,000)	205,144	13,723,749	32,871,159
Issuance of common stock and common stock committed to be issued in connection with purchase of customer lists	—	—	(4,000)	(16,000)	—	76,342	—	—	—	—	64,342
Adoption of FASB statement No. 150 (note 10)	—	—	—	—	(1,679,578)	1,679,578	—	—	—	—	—
Exercise of warrants (note 10)	—	—	—	—	—	60,660	—	—	—	—	303,300
Exercise of stock options (note 11)	—	—	—	—	—	302,288	—	—	—	—	612,468
Stock option income tax benefit (note 9)	—	—	—	—	—	469,420	—	—	—	—	469,420
Repurchase of outstanding stock	—	—	—	—	—	—	35,000	(140,000)	—	—	(140,000)
Net income	—	—	—	—	—	—	—	—	—	8,271,700	8,271,700
Foreign currency translation adjustment	—	—	—	—	—	—	—	—	133,680	—	133,680
Comprehensive income	—	—	—	—	—	—	—	—	—	—	8,405,380
Balance at April 30, 2006	<u>100,000</u>	<u>\$ 100,000</u>	<u>4,000</u>	<u>\$ 16,000</u>	<u>—</u>	<u>6,232,518</u>	<u>681,000</u>	<u>\$ (1,428,000)</u>	<u>338,824</u>	<u>21,995,449</u>	<u>42,586,069</u>

See accompanying notes to consolidated financial statements.

**JTH TAX, INC. AND SUBSIDIARIES**  
(d/b/a Liberty Tax Service)  
Consolidated Statement of Stockholders' Equity and Comprehensive Income  
Year ended April 30, 2005

	Common stock, Class A		Common stock, Class B		Preferred stock, Class A		Preferred stock, Class B		Special voting preferred stock	
	Shares	Amount	Shares	Amount	Shares	Amount	Shares	Amount	Shares	Amount
Balance at May 1, 2004	10,556,954	\$ 10,556,954	900,000	\$ 900,000	190,000	\$ 2,375,000	25,000	\$ 497,742	10	\$ 10
Issuance of common stock and common stock committed to be issued in connection with purchase of customer lists	30,762	30,762	—	—	—	—	—	—	—	—
Exercise of stock options (note 11)	413,990	413,990	—	—	—	—	—	—	—	—
Balance at April 30, 2005	<u>11,001,706</u>	<u>\$ 11,001,706</u>	<u>900,000</u>	<u>\$ 900,000</u>	<u>190,000</u>	<u>\$ 2,375,000</u>	<u>25,000</u>	<u>\$ 497,742</u>	<u>10</u>	<u>\$ 10</u>

	Exchangeable shares		Common stock committed to be issued		Put warrants	Additional paid-in capital	Treasury stock		Accumulated other comprehensive income	Retained earnings	Total
	Shares	Amount	Shares	Amount			Shares	Amount			
Balance at May 1, 2004	100,000	\$ 100,000	12,000	\$ 48,000	1,319,528	2,907,104	540,000	\$ (864,000)	136,968	6,557,572	24,534,878
Issuance of common stock and common stock committed to be issued in connection with purchase of customer lists	—	—	(4,000)	(16,000)	—	208,638	—	—	—	—	223,400
Accretion of put warrants (note 10)	—	—	—	—	360,050	—	—	—	—	(360,050)	—
Exercise of stock options (note 11)	—	—	—	—	—	528,488	—	—	—	—	942,478
Repurchase of outstanding stock	—	—	—	—	—	—	106,000	(424,000)	—	—	(424,000)
Net income	—	—	—	—	—	—	—	—	—	7,526,227	7,526,227
Foreign currency translation adjustment	—	—	—	—	—	—	—	—	68,176	—	68,176
Comprehensive income	—	—	—	—	—	—	—	—	—	—	7,594,403
Balance at April 30, 2005	<u>100,000</u>	<u>\$ 100,000</u>	<u>8,000</u>	<u>\$ 32,000</u>	<u>1,679,578</u>	<u>3,644,230</u>	<u>646,000</u>	<u>\$ (1,288,000)</u>	<u>205,144</u>	<u>13,723,749</u>	<u>32,871,159</u>

See accompanying notes to consolidated financial statements.

**JTH TAX, INC. AND SUBSIDIARIES**  
(d/b/a Liberty Tax Service)

Consolidated Statements of Cash Flows  
Years ended April 30, 2007, 2006 and 2005

	<u>2007</u>	<u>2006</u>	<u>2005</u>
Cash flows from operating activities:			
Net income	\$ 15,729,677	8,271,700	7,526,227
Adjustments to reconcile net income to net cash provided by operating activities:			
Cumulative effect of accounting change	—	1,655,702	—
Depreciation and amortization	2,945,599	1,868,950	1,236,990
Write-down of impaired assets	217,735	344,356	327,937
Amortization of deferred financing costs and original issue discount	113,514	207,156	190,807
Tax benefit of stock option exercises	—	469,420	—
Provision for doubtful accounts and franchise fee refunds	6,345,528	5,478,444	4,022,416
Gain on sale of intangible assets and property and equipment, net	(196,279)	(106,723)	(227,941)
Loss on early extinguishment of debt	623,131	—	311,302
Accrued interest on subordinated debt	320,724	626,958	226,121
Deferred tax expense (benefit)	372,666	(617,950)	37,143
Changes in assets and liabilities increasing (decreasing) cash flows from operating activities:			
Trade accounts receivable	(9,870,092)	(12,177,515)	(7,638,985)
Notes receivable	(2,369,661)	(8,518,191)	(8,613,297)
Refund anticipation loan fees	(1,235,704)	(298,542)	1,553,712
Interest receivable	(1,202,842)	(548,878)	(1,573,784)
Inventory	591,388	614,418	(849,950)
Prepaid expenses and other current assets	413,558	940,128	(825,559)
Other assets	142,718	(17,968)	68,536
Accounts payable and accrued expenses	3,482,427	6,865,793	(421,004)
Income taxes payable	3,399,673	3,408,740	3,848,867
Deferred franchise fees and franchise deposits	896,680	3,609,725	1,822,470
Net cash provided by operating activities	<u>20,720,440</u>	<u>12,075,723</u>	<u>1,022,008</u>
Cash flows from investing activities:			
Issuance of operating loans to franchisees	(12,457,491)	(8,411,883)	(7,341,161)
Payments received on operating loans from franchisees	9,789,448	6,530,657	5,602,533
Purchases of customer lists and other assets	(1,373,961)	(748,532)	(797,216)
Payments issued in conjunction with exchanges of territories	—	(193,470)	—
Proceeds from sale of customer lists and other assets	546,455	293,770	298,005
Proceeds from sale of short-term investments	68,775	3,214	4,734
Purchases of long-term investments	—	(40,000)	—
Purchases of property and equipment	(6,195,879)	(2,491,214)	(1,592,988)
Increase (decrease) in cash from consolidation (deconsolidation) of VIEs	(174,044)	174,044	—
Net cash used in investing activities	<u>(9,796,697)</u>	<u>(4,883,414)</u>	<u>(3,826,093)</u>
Cash flows from financing activities:			
Proceeds from the exercise of stock options and warrants	308,871	915,768	942,478
Proceeds from issuance of long-term debt	17,600,000	—	13,000,000
Repayment of long-term debt	(20,051,154)	(985,247)	(1,494,057)
Payment for debt issuance costs	—	—	(1,036,358)
Purchase of treasury stock	(1,530,659)	(140,000)	(424,000)
Net repayments under lines of credit	—	—	(1,039,800)
Tax benefit of stock option exercises	241,800	—	—
Net cash provided by (used in) financing activities	<u>(3,431,142)</u>	<u>(209,479)</u>	<u>9,948,263</u>
Effect of exchange rate changes on cash	<u>(1,138)</u>	<u>(595,630)</u>	<u>(367,224)</u>
Net increase in cash and cash equivalents	7,491,463	6,387,200	6,776,954
Cash and cash equivalents at beginning of year	<u>13,422,348</u>	<u>7,035,148</u>	<u>258,194</u>
Cash and cash equivalents at end of year	\$ <u>20,913,811</u>	<u>13,422,348</u>	<u>7,035,148</u>

**JTH TAX, INC. AND SUBSIDIARIES**  
(d/b/a Liberty Tax Service)

Consolidated Statements of Cash Flows  
Years ended April 30, 2007, 2006 and 2005

	<b>2007</b>	<b>2006</b>	<b>2005</b>
Supplemental disclosure of cash flow information -			
Cash paid for interest	\$ 3,868,717	2,457,976	1,446,225
Supplemental disclosure of noncash investing and financing activities:			
During the years ended April 30, 2007, 2006 and 2005, the Company acquired certain assets from franchisees as follows:			
Fair value of assets purchased	\$ 6,908,817	4,352,207	4,454,268
Receivables forgiven	(9,620,292)	(6,275,704)	(3,775,863)
Accounts payable cancelled	775,373	276,924	125,461
Liabilities assumed	(65,769)	(196,573)	(163,357)
Notes payable issued	(120,000)	(246,049)	(191,164)
Deferred revenue recognized	3,373,036	2,670,086	788,295
Common stock issued	(100,000)	—	(171,432)
Applied from (to) sales of franchise territories	222,796	167,641	(268,992)
Cash paid to seller	\$ 1,373,961	748,532	797,216
During the year ended April 30, 2007, 2006 and 2005, the Company sold certain assets to franchisees as follows:			
Book value of assets sold	\$ 5,618,165	2,882,993	3,477,703
Gain (loss) on sale	(152,148)	105,770	231,942
Deferred gain on sale	2,145,434	217,476	733,499
Applied from acquisitions of franchise territories	97,796	—	(249,206)
Notes issued	(7,162,792)	(2,912,469)	(3,895,933)
Cash received	\$ 546,455	293,770	298,005

In 2007, the Company purchased an online tax preparation software application for \$9,405,663, including direct costs of the acquisition. The purchase price was paid as follows: \$2,748,000 in cash and \$6,597,000 through the issuance of a term note payable.

In 2006, certain franchisees exchanged their existing territories for others. In conjunction with these transactions, the Company recorded intangible assets of \$493,053, receivables of \$1,364,739, recorded deferred revenue of \$578,672 and recognized franchise fees of \$1,085,650. Cash of \$193,470 was paid by the Company in conjunction with these exchanges.

In 2005, \$2,000,000 of subordinated debt issued in 2001 was refinanced under a new subordinated debt agreement (note 8).

See accompanying notes to consolidated financial statements.

**JTH TAX, INC. AND SUBSIDIARIES**  
(d/b/a Liberty Tax Service)

Notes to Consolidated Financial Statements

April 30, 2007, 2006 and 2005

**(1) Organization and Significant Accounting Policies**

**(a) Organization**

JTH Tax, Inc. and subsidiaries (d/b/a Liberty Tax Service) (the Company) is a franchisor and operator of a system of offices in the United States and Canada engaged in the preparation of personal income tax returns. Through this system of offices, the Company also facilitates to its customers refund-based financial products such as refund anticipation loans, electronic refund checks and personal income tax refund discounting. The Company operates under the trade name "Liberty Tax Service." The Company also offers online tax preparation services. The Company was formed in October 1996 as a Delaware corporation.

**(b) Principles of Consolidation**

The consolidated financial statements include the accounts of JTH Tax, Inc. and its wholly owned subsidiaries. Assets and liabilities of the Canadian Subsidiary have been translated into U.S. Dollars using the exchange rate in effect at the end of the year. The revenues and expenses have been translated using the average exchange rates in effect each month of the year. Transaction gains and losses are recognized in income when incurred. In accordance with the Financial Accounting Standards Board (FASB) Interpretation No. 46(R), *Consolidation of Variable Interest Entities, an Interpretation of Accounting Research Bulletin No. 51* (FIN 46R), the Company also consolidates any variable interest entities (VIEs) of which it is the primary beneficiary, as defined. All significant intercompany balances and transactions have been eliminated in consolidation.

**(c) Cash and Cash Equivalents**

For purposes of the consolidated statements of cash flows, the Company considers all highly liquid debt instruments with original maturities of three months or less to be cash equivalents.

**(d) Trade Accounts Receivable**

Trade accounts receivable are recorded at the invoiced amount and bear interest at 18% annually once they have aged greater than 30 days. Finance charges are fully reserved and are only recognized in income when they have been paid. The allowance for doubtful accounts includes the Company's best estimate of the amount of probable credit losses in the Company's existing accounts receivable. Because the repayment of accounts receivable is dependent on the performance of the underlying franchisees, management estimates the amount of the allowance for doubtful accounts based on a comparison of amounts due to the estimated fair value of the underlying franchise. Account balances are charged off against the allowance after all means of collection have been exhausted and the potential for recovery is considered remote. The Company does not have any off-balance-sheet credit exposure related to its accounts receivable.

**(e) Notes Receivable**

Notes receivable are recorded at cost, less the related allowance for doubtful accounts. Because the repayment of the notes receivable is dependent on the performance of the underlying franchise which collateralizes the note, management estimates the amount of the allowance for doubtful accounts based on a comparison of amounts due to the estimated fair value of the underlying franchise. The

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Company provides an allowance against accrued interest on a delinquent note when a scheduled payment becomes 90 days past due or the recorded value of the note receivable exceeds the value of the underlying franchise. Loans are written off against the allowance when all possible means of collection have been exhausted and the potential for recovery is considered remote.

**(f) *Property, Equipment and Software***

Property, equipment and software are stated at cost less accumulated depreciation and amortization. Depreciation and amortization is calculated using the straight-line method over the estimated useful lives of the depreciable assets, generally three to five years for computer equipment, three to seven years for software, seven years for furniture and fixtures and twenty to thirty years for buildings. Leasehold improvements are amortized over the lesser of the lease term or the estimated useful lives of the assets.

**(g) *Goodwill and Other Intangible Assets***

Goodwill represents the excess of costs over fair value of assets of businesses acquired. Goodwill is not amortized, but instead tested for impairment at least annually in accordance with the provisions of FASB Statement No. 142, *Goodwill and Other Intangible Assets*. Intangible assets with estimable useful lives are amortized over their respective estimated useful lives to their estimated residual values, and reviewed for impairment in accordance with FASB Statement No. 144, *Accounting for Impairment or Disposal of Long-Lived Assets*.

**(h) *Deferred Franchise Fees***

The Company may receive all or part of the initial franchise fee prior to the execution of the franchise agreement or completion of the earnings process. These amounts are classified as deferred franchise fees until the franchise fee qualifies to be recognized as revenue or is refunded.

**(i) *Treasury Stock***

Treasury stock is accounted for under the cost method.

**(j) *Revenue Recognition***

Franchise fee revenue, net of a provision for franchise fee refunds, is recognized when obligations of the Company to prepare the franchisee for operation have been substantially completed. Franchise fees are also recognized from area developer sales wherein the Company sells a cluster of territories to an individual. Franchise fees that are financed by the Company are recorded as deferred franchise fees until such time as the unit franchisee or area developer has made a significant financial commitment (20% of the franchise fee).

Royalties and advertising fees are recognized currently as the franchised territory generates sales. Tax return preparation fees, bank product and tax discounting fees are recognized as revenue in the period the related tax return is filed or prepared for the customer. Discounts for promotional programs are recorded at the time the return is prepared.

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Gains on sales of Company-owned stores, which are financed by the Company, are deferred until the franchisee has made a significant financial commitment (20%). Losses on sales of Company-owned stores are recognized immediately.

**(k) Other, Net**

Other, net primarily consists of net gains and losses incurred on the settlement of various litigation.

**(l) Income Taxes**

Income taxes are accounted for under the asset and liability method. Deferred tax assets and liabilities are recognized for the future tax consequences attributable to the differences between the financial statement carrying amounts of existing assets and liabilities and their respective tax bases. Deferred tax assets and liabilities are measured using enacted rates expected to apply to taxable income in the years in which those temporary differences are expected to be recovered or settled. The effect on deferred tax assets and liabilities of a change in tax rates is recognized in income in the period that includes the enactment date.

In July 2006, the FASB issued FASB Interpretation No. 48, *Accounting for Uncertainty in Income Taxes, an interpretation of FASB Statement No. 109* (FIN 48). FIN 48 clarifies the accounting for uncertainty in income taxes recognized in an enterprise's financial statements and prescribes a threshold of more-likely-than-not for recognition of tax benefits of uncertain tax positions taken or expected to be taken in a tax return. FIN 48 also provides related guidance on measurement, derecognition, classification, interest and penalties, and disclosure. The Company adopted the provisions of FIN 48 effective May 1, 2006.

**(m) Impairment of Long-Lived Assets**

In accordance with Statement 144, long-lived assets, such as property, plant and equipment, and purchased intangibles subject to amortization, are reviewed for impairment whenever events or changes in circumstances indicate that the carrying amount of an asset may not be recoverable. Recoverability of assets to be held and used is measured by a comparison of the carrying amount of an asset to estimated undiscounted future cash flows expected to be generated by the asset. If the carrying amount of an asset exceeds its estimated future cash flows, an impairment charge is recognized by the amount by which the carrying amount of the asset exceeds the fair value of the asset. Assets to be disposed of would be separately presented in the balance sheet and reported at the lower of the carrying amount or fair value less costs to sell, and are no longer depreciated. The assets and liabilities of a disposed group classified as held for sale would be presented separately in the appropriate asset and liability sections of the balance sheet.

Goodwill is tested annually for impairment, and is tested for impairment more frequently if events and circumstance indicate that the asset might be impaired. An impairment loss is recognized to the extent that the carrying amount exceeds the asset's fair value. This determination is made at the reporting unit level and consists of two steps. First, the Company determines the fair value of a reporting unit and compares it to its carrying amount. Second, if the carrying amount of a reporting unit exceeds its fair value, an impairment loss is recognized for any excess of the carrying amount of

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the reporting unit's goodwill over the implied fair value of that goodwill. The implied fair value of goodwill is determined by allocating the fair value of the reporting unit in a manner similar to a purchase price allocation, in accordance with FASB Statement No. 141, *Business Combinations*. The residual fair value after this allocation is the implied fair value of the reporting unit goodwill.

For the years ended April 30, 2007, 2006 and 2005, the Company recognized an impairment loss of \$218,066, \$344,356 and \$327,937, respectively, related to Company-owned stores which has been included in depreciation, amortization and impairment charges in the accompanying consolidated statements of income.

**(n) Comprehensive Income**

Comprehensive income consists of net income and the foreign currency translation adjustment and is presented in the accompanying consolidated statements of stockholders' equity.

**(o) Stock-Based Compensation**

Prior to 2007, the Company applied the intrinsic value-based method of accounting prescribed by Accounting Principles Board (APB) Opinion No. 25, *Accounting for Stock Issued to Employees*, and related interpretations in accounting for stock options granted under its stock option plan. As such, compensation expense would have been recorded on the date of grant only if the current market price of the underlying stock exceeded the exercise price. Accordingly, no compensation costs were recognized in the accompanying consolidated statements of income prior to 2007 on stock options granted, since all options granted under the Company's stock option plan had an exercise price equal to the market value of the underlying common stock on the date of grant.

Effective May 1, 2006, the Company adopted FASB Statement No. 123(R), *Share-Based Payment* (Statement 123(R)). This statement replaces FASB Statement No. 123, *Accounting for Stock-Based Compensation* (Statement 123) and supersedes APB No. 25. Statement 123(R) requires that all stock-based compensation be recognized as an expense in the financial statements and that such cost be measured at the fair value of the award. This statement was adopted using the modified prospective method of application, which requires the Company to recognize compensation cost on a prospective basis. Therefore, prior years' financial statements have not been restated. Under this method, the Company records stock-based compensation expense for awards granted prior to, but not yet vested as of May 1, 2006, using the fair value amounts determined for pro forma disclosures under Statement 123. For stock-based awards granted after May 1, 2006, the Company recognizes compensation expense based on estimated grant date fair value using the Black-Scholes option-pricing model. Share-based compensation cost that has been included in income from continuing operations amounted to \$251,000 for the year ended April 30, 2007.

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The following table illustrates the effect on net income for the years ended April 30, 2006 and 2005 as if the Company had applied the fair value recognition provisions of Statement 123(R) to options granted under the Company's stock plans prior to adoption of Statement 123(R) on May 1, 2006. No pro forma disclosure has been made for periods subsequent to April 30, 2006 as all stock-based compensation has been recognized in net income. For purposes of this pro forma disclosure, the value of the options is estimated using a Black-Scholes option-pricing model and amortized to expense over the options' service periods with forfeitures recognized as they occurred.

	<b>2006</b>	<b>2005</b>
Net income available to common stockholder – as reported	\$ 8,271,700	7,166,177
Less pro forma stock compensation cost, net of tax benefit	1,037,305	510,936
Pro forma net income available to common stockholders	\$ 7,234,395	6,655,241

In a change from previous standards, Statement 123(R) also requires that excess tax benefits related to stock option exercises be reflected as financing cash inflows. Therefore, excess tax benefits related to stock option exercises in 2006 are reflected in operating activities.

**(p) Use of Estimates**

Management of the Company has made a number of estimates and assumptions relating to the reporting of assets and liabilities and the disclosure of contingent assets and liabilities at the date of the financial statements and the reported amounts of revenues and expenses during the reporting period to prepare these consolidated financial statements in conformity with accounting principles generally accepted in the United States of America. Actual results could differ from those estimates.

**(q) Reclassification**

Certain 2006 and 2005 amounts have been reclassified to conform to the 2007 financial statement presentation.

**(2) Notes and Accounts Receivable**

The Company provides financing to franchisees for the purchase of franchises and/or for working capital and equipment needs. The notes generally are payable annually over five years and bear interest at various rates ranging from 6% to 12%. Transactions for 2007 and 2006 are as follows:

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	<u>2007</u>	<u>2006</u>
Balance at beginning of year	\$ 48,706,627	41,091,153
Impact of consolidating and deconsolidated VIEs	3,284,127	(2,705,174)
Notes issued:		
Sales of franchise territories	17,310,548	20,988,667
Sales of Company-owned stores	7,162,792	2,662,469
Franchisee to franchisee note assumptions	2,675,087	2,212,515
Operating loans to franchisees	12,457,491	8,411,883
Refinancing of notes and accounts receivable	4,582,790	4,219,362
Repayment of notes	(26,140,625)	(19,082,541)
Notes canceled	(14,237,243)	(9,390,954)
Foreign currency adjustment related to notes	1,962	299,247
Balance at end of year	<u>\$ 55,803,556</u>	<u>48,706,627</u>

Notes receivable reflected on the accompanying consolidated balance sheets include notes related to the sale of Company-owned stores, as well as loans to franchisees for franchise fees, working capital and equipment. Most of the notes receivable reflected on the accompanying consolidated balance sheets are due from the Company's franchisees. The notes are collateralized by the underlying franchise and are guaranteed by the respective franchisee and franchise owner(s). The franchisees' ability to repay the notes is dependent upon the performance of the tax preparation industry as a whole and the Company in particular. Management believes that the recorded allowance is adequate based upon its consideration of the estimated value of the franchises supporting the receivables. Any adverse change in the tax preparation industry could affect the Company's estimate of the allowance.

At April 30, 2007 and 2006, the Company had an investment in impaired notes and related interest receivable of approximately \$8,434,000 and \$6,429,000, respectively, which had recorded values that exceeded the fair value of the underlying collateral by approximately \$1,014,000 and \$737,000, respectively. In addition, the Company had trade accounts receivable due from these franchisees of approximately \$2,570,000 and \$1,406,000 at April 30, 2007 and 2006, respectively. The Company has reflected an allowance of approximately \$3,584,000 and \$2,143,000, respectively, for this impairment in the accompanying consolidated balance sheets. Activity in the allowance for doubtful accounts for the years ended April 30, 2007 and 2006 is summarized as follows:

	<u>2007</u>	<u>2006</u>	<u>2005</u>
Beginning balance	\$ 3,083,421	2,743,822	3,547,205
Impact of consolidating and deconsolidating VIEs	431,120	(70,970)	—
Additions charged to expense	4,471,136	4,145,440	2,292,387
Provision for franchise fee refunds	1,874,392	1,333,004	1,730,029
Write-offs	(4,683,232)	(5,111,636)	(4,879,132)
Foreign currency adjustment related to allowance	163	43,761	53,333
Ending balance	<u>\$ 5,177,000</u>	<u>3,083,421</u>	<u>2,743,822</u>

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The Company's average investment in impaired notes receivable during the years ended April 30, 2007 and 2006 was approximately \$7,433,000 and \$6,456,000, respectively. Interest income related to impaired notes was approximately \$1,406,000, \$746,000 and \$210,000 for the years ended April 30, 2007, 2006 and 2005, respectively. The Company's investment in notes receivable on nonaccrual status as of April 30, 2007 and 2006 was approximately \$11,573,000 and \$5,555,000, respectively.

**(3) Property, Equipment and Software, Net**

Property, equipment and software, net consists of the following at April 30, 2007 and 2006:

	<b>2007</b>	<b>2006</b>
Land	\$ 798,629	330,229
Buildings	3,419,648	890,403
Leasehold improvements	124,280	820,582
Furniture, fixtures and equipment	3,380,193	3,145,376
Software	17,879,741	7,130,564
	25,602,491	12,317,154
Less accumulated depreciation and amortization	5,185,090	3,279,455
Property, equipment and software, net	\$ 20,417,401	9,037,699

The software included above includes both internally developed software and purchased software. During 2002, the Company acquired a perpetual license for proprietary tax preparation software to be used by its Company-owned stores and franchisees. Capitalized costs related to this software totaled \$6,993,783 and \$5,753,323 at April 30, 2007 and 2006, respectively, and have been included in property, equipment and software in the accompanying consolidated balance sheets. The Company placed this software in service and began amortizing in 2007. In December 2006, the Company purchased and placed in service an online tax preparation software application for approximately \$9,400,000.

In August 2006, the Company purchased its corporate office building for \$2,650,000. Prior to the purchase, the Company had leased the facility since July 2004.

**(4) Other Intangible Assets, Net**

Other intangible assets, net consist of the following at April 30, 2007 and 2006:

	<b>Amortization period</b>	<b>2007</b>	<b>2006</b>
Customer lists	5 years	\$ 3,359,464	4,404,587
Area franchise rights	10 years	841,160	874,312
		4,200,624	5,278,899
Less accumulated amortization		770,634	1,498,105
Intangible assets, net		\$ 3,429,990	3,780,794

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Amortization and impairment charges for the years ended April 30, 2007, 2006 and 2005 were \$1,104,476, \$1,126,815 and \$730,508, respectively. Estimated amortization expense for the next five years is \$756,421 in 2008, \$719,943 in 2009, \$690,329 in 2010, \$584,589 in 2011, and \$358,408 in 2012.

**(5) Lines of Credit**

The Company has a line of credit with a financial institution, which allows for borrowings up to \$25,000,000 and accrues interest at LIBOR plus 1.45%. The line is collateralized by all the assets of the Company and expires on July 31, 2008. There were no borrowings against the line at April 30, 2007 and 2006. In June 2007, the line of credit was renegotiated with the bank to allow borrowings up to \$60,000,000 at LIBOR plus 1.45% with an expiration date of August 31, 2009. The line of credit contains certain financial covenants, which the Company must meet, including a minimum debt service coverage ratio and a maximum debt to net worth ratio.

In 2006, the Company had two lines of credit with a financial institution that it utilizes to fund the Canadian Subsidiary (one for discounting and one for a guidance facility). The discounting and guidance lines allow for borrowings up to \$20,000,000 and \$5,000,000, respectively, and accrue interest at Canadian LIBOR plus 3%. There were no borrowings against either line at April 30, 2007 or 2006. Both lines expired May 31, 2007 and are collateralized by all the assets of the Company. In June 2007, the discounting line and the guidance facility were renegotiated to be included in the \$60,000,000 line of credit discussed above.

**(6) Leases**

The Company is obligated under various operating leases for office space that expire at various dates. Future minimum lease payments under noncancelable operating leases (with initial or remaining lease terms in excess of one year) as of April 30, 2007 are:

Year ending April 30:	
2008	\$ 1,761,390
2009	1,050,625
2010	624,334
2011	385,128
2012	174,916
Thereafter	<u>59,000</u>
Total minimum lease payments	<u>\$ 4,055,393</u>

The Company has subleases under certain of these commitments as of April 30, 2007 amounting to \$1,324,730 in 2008, \$771,754 in 2009, \$507,160 in 2010, \$342,827 in 2011, \$131,866 in 2012 and \$29,500 thereafter.

Total rent expense for operating leases was approximately \$1,238,000, \$1,707,000 and \$1,490,000 for the years ended April 30, 2007, 2006 and 2005, respectively.

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**(7) Long-Term Debt**

Long-term debt at April 30, 2007 and 2006 consists of the following:

	<b>2007</b>	<b>2006</b>
Mortgage note payable to a bank in monthly installments of \$1,236 including interest at 8.50% through December 2019; collateralized by land and building	\$ 112,415	117,450
Mortgage note payable to a bank in monthly installments of \$1,389 including interest at 9.25% through August 2010; collateralized by land and building	94,598	102,138
Mortgage note payable to a bank in monthly installments of \$15,689 including interest at 6.06% through September 2016; collateralized by land and building	2,582,706	—
Notes payable for acquired practices, interest rates ranging from 8% to 12%; due May 2007 through January 2011	504,132	731,614
Term note payable in four annual installments of \$500,000 principal plus interest at LIBOR plus 2.5% beginning February 2005; collateralized by all assets of the Company	500,000	1,000,000
Term note payable in quarterly installments of \$750,000 principal plus interest at LIBOR plus 2.25% beginning January 2007; collateralized by all assets of the Company (see note 8)	13,500,000	—
Term note payable for software purchase payable in three annual installments of \$2,000,000 at 0% interest beginning December 2007; interest has been imputed at 8%	5,299,784	—
Total long-term debt	22,593,635	1,951,202
Less current installments	6,013,676	846,894
Total long-term debt, less current installments	\$ 16,579,959	1,104,308

Aggregate maturities of long-term debt as of April 30, 2007 are as follows:

2008	\$ 6,013,676
2009	4,787,421
2010	4,636,069
2011	3,063,048
2012	1,558,038
Thereafter	2,535,383
	\$ 22,593,635

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The term note contains certain financial covenants, which the Company must meet, including a minimum debt service coverage ratio and a maximum funded debt to tangible net worth ratio.

**(8) Subordinated Debt**

In November 2004, the Company entered an agreement to borrow \$15,000,000 from a group of lenders. The loan bore interest at 16%, with 12% payable quarterly and 4% added to the principal balance of the debt and payable at maturity. The compounded portion related to the 4% additional interest on the subordinated debt was \$626,958 for the year ended April 30, 2006 and was recorded as an increase to subordinated debt. Deferred financing costs incurred in securing the loan were amortized over its life using the effective interest method. The loan was refinanced in November 2006 as a part of the term loan agreement described in note 7. Because the refinancing constituted a debt extinguishment for accounting purposes, the remaining related financing costs were expensed in 2007 and reflected as a loss on extinguishment of debt.

Interest expense totaling \$113,830, \$207,156 and \$190,807 was recorded in 2007, 2006 and 2005, respectively, related to the amortization of deferred financing costs and the original issue discount.

**(9) Income Taxes**

Total income taxes were allocated as follows:

	<u>2007</u>	<u>2006</u>	<u>2005</u>
Income from continuing operations	\$ 8,323,798	7,110,966	5,240,140
Stockholders' equity, tax benefit on exercise of stock options	(241,800)	(469,420)	—
	<u>\$ 8,081,998</u>	<u>6,641,546</u>	<u>5,240,140</u>

Components of income tax expense for the years ended April 30, 2007, 2006 and 2005 were as follows:

	<u>2007</u>	<u>2006</u>	<u>2005</u>
Federal – current	\$ 6,633,545	6,292,958	4,183,210
Federal – deferred	310,911	(549,075)	29,863
State – current	1,317,587	1,497,767	1,019,787
State – deferred	61,755	(130,684)	7,280
	<u>\$ 8,323,798</u>	<u>7,110,966</u>	<u>5,240,140</u>

The Company's effective tax expense (computed by multiplying income before income taxes and cumulative effect of accounting change by the U.S. Federal statutory rate of 35% in 2007, 2006 and 2005) differs from tax expense for the years ended April 30, 2007, 2006, and 2005 as follows:

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	<b>2007</b>	<b>2006</b>	<b>2005</b>
Computed "expected" income tax expense	\$ 8,418,716	5,963,429	4,468,228
Increase (decrease) in income taxes resulting from:			
State income taxes, net of federal benefit	896,572	888,604	667,594
Change in taxes resulting from permanent differences, net	255,791	75,600	106,097
Impact of nontaxable VIEs	(917,570)	356,544	—
Other	(329,711)	(173,211)	(1,779)
	\$ 8,323,798	7,110,966	5,240,140

The tax effect of temporary differences between the financial statement carrying amounts and tax bases of assets and liabilities that give rise to significant portions of deferred tax assets and liabilities at April 30, 2007 and 2006 are as follows:

	<b>2007</b>	<b>2006</b>
Deferred tax assets:		
Net operating loss carryforwards	\$ —	287,923
Accounts payable and accrued liabilities	173,946	276,405
Allowance for doubtful accounts	2,566,316	2,747,006
Total deferred tax assets	2,740,262	3,311,334
Deferred tax liability:		
Property, equipment and software	1,838,148	2,440,903
Deferred revenue	9,019,871	—
Prepaid expenses	117,290	272,815
Total deferred tax liabilities	10,975,309	2,713,718
Net deferred tax asset (liability)	\$ (8,235,047)	597,616

As a result of adopting FIN 48 on May 1, 2006, the Company reclassified approximately \$8,456,000 between income taxes payable and deferred income taxes.

In assessing the realizability of the gross deferred tax assets, management considers whether it is more likely than not that some portion or all the deferred tax assets will not be realized. The ultimate realization of deferred tax assets is dependent upon the generation of future taxable income during the periods in which those temporary differences become deductible. Management considers the scheduled reversal of deferred tax liabilities, projected future taxable income, and tax planning strategies in making this assessment. Based upon the level of historical taxable income and projections for future taxable income over the periods in which the deferred tax assets are deductible, management believes it is more likely than not that the Company will realize the benefits of these deductible differences.

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**(10) Stockholders' Equity**

**(a) Preferred Stock and Exchangeable Shares**

The Company has three authorized classes of preferred stock: Class A has 190,000 authorized shares, Class B has 33,334 authorized shares, and the special voting preferred stock has 10 authorized shares. All classes have a par value of \$1.

The holders of the Class A preferred stock are entitled to a dividend if a dividend is declared for common stock and shall receive a dividend as if each share of preferred stock had been converted to Class A common stock in accordance with the conversion ratio, and a liquidation preference upon the liquidation, dissolution or consolidation of the Company. In the event of liquidation, dissolution or consolidation, the holders of Class A preferred stock will be entitled to receive out of the assets of the Company, after payment or provision for payment of the debts or other liabilities of the Company, the original issue price per share for each share of preferred stock then outstanding, plus an amount equal to the original issue price per share multiplied by 10% per annum from the original issue date, compounded annually to the date of such distribution. The liquidation value of the Class A preferred stock was \$5,091,023 and \$4,628,205 as of April 30, 2007 and 2006, respectively. Its carrying amount was \$2,375,000 at April 30, 2007 and 2006.

A holder of the Class A preferred stock may, at the holder's option, elect to convert each share of the Class A preferred stock into 10 shares of fully paid and nonassessable shares of Class A common stock.

The holders of Class B preferred stock are entitled to the same rights and privileges as holders of Class A preferred stock except that in the event of liquidation, dissolution or consolidation, the holders of the Class B preferred stock are not entitled to a payment until the provision for payment to holders of Class A preferred stock has been satisfied. The liquidation value of the Class B preferred stock was \$858,938 and \$780,853 as of April 30, 2007 and 2006, respectively. Its carrying amount was \$497,742 at April 30, 2007 and 2006.

In October 2001, the Company acquired the remaining 40% of the outstanding common stock of the Canadian Subsidiary in a transaction which was accounted for as a purchase. The Company issued consideration to the minority shareholder consisting of 1,600,000 shares of Class A common stock, 10 shares of special voting preferred stock and 100,000 shares of exchangeable shares in exchange for \$2,000,000 in cash and the 40% minority interest in the Canadian Subsidiary. The 100,000 exchangeable shares are exchangeable at any time at a 10:1 ratio into the Class A common stock of the Company. The special voting preferred shares issued have a \$1.00 par value and no liquidation value and entitle the holder to vote each share as if it represented 100,000 shares of Class A common stock. These shares will be cancelled as the holder exchanges the exchangeable shares.

**(b) Common Stock**

The Company is authorized to issue 21,200,000 shares of Class A common stock, par value \$1.00 per share and 1,000,000 shares of Class B common stock, par value \$1.00 per share. Class A common stock and Class B common stock entitle the holders thereof to the same rights and privileges and are identical in all respects as to all matters, except the holders of Class B common stock are entitled to elect one more director than the number of directors elected by holders of all

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other classes of stock combined. Also, a holder of Class B common stock may, at the holder's option, elect to convert the Class B common stock into an equal number of fully paid and nonassessable shares of Class A common stock.

During 2007 and 2005, in connection with the acquisition of franchises from existing franchisees, the Company issued a total of 10,000 and 26,762 shares of Class A common stock, respectively. The Company did not issue shares of Class A common stock in the connection with the acquisition of franchises during 2006. In conjunction with a transaction that occurred in 2003, the Company agreed to issue 16,000 additional shares over the next five years at \$4.00 per share. This obligation was previously reflected in the accompanying consolidated balance sheets as shares committed to be issued, but was fully satisfied during 2007.

(c) ***Warrants and put option***

In July 2001, the Company issued 463,400 warrants to purchase Class A common stock to a venture capital group. These warrants were exercisable immediately upon issuance at an exercise price of \$0.00001 per share and were exercised in 2007. The warrants were issued in conjunction with a freestanding put option which allows the holder, at its discretion, to put the warrants or underlying shares of stock obtained upon exercise back to the Company at a formula based on the Company's cash flow after the third anniversary date of the warrant agreement, which was July 30, 2004, or a nonqualified public offering, as defined. The put option expires in July 2011. The warrants and the put option were valued at \$970,000 as of the date of issuance, and were accreted to the estimated redemption price over the period from issuance through July 30, 2004, and were carried at their estimated redemption price of \$1,679,578 as of April 30, 2005. Accretion of \$360,050 was recorded in 2005.

Effective May 1, 2005, the Company adopted FASB Statement No. 150, *Accounting for Certain Financial Instruments with Characteristics of both Liabilities and Equity*. This statement establishes standards for the classification and measurement of certain financial instruments with characteristics of both liabilities and equity. The put option associated with these warrants is within the scope of this statement. The fair value of the put option has been estimated to have an insignificant value.

Changes in the fair value of the Company's common stock do not affect the redemption price of the put option. If settlement of the put option were to occur at April 30, 2007, the amount that would be paid under the formula specified in the agreement is \$3,142,000. The agreement does not limit the amount the Company would be required to pay.

(d) ***Other Warrants***

The Company issued 260,590 warrants to officers and directors in June 2001 in conjunction with short-term loans to the Company totaling \$1,302,967. All of the loans were repaid in fiscal year 2002. All of these warrants had been exercised as of April 30, 2006.

**(11) Stock Compensation Plan**

In May 1998, the board of directors approved the JTH Tax, Inc. Stock Option Plan (the Plan). Employees and outside directors are eligible to receive awards under the Plan and 4,000,000 shares of Class A common stock have been authorized for grant under the Plan. At April 30, 2007, approximately

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664,000 shares of Class A common stock are available for grant under the Plan. Stock options vests from immediately to five years and generally expire five years from the vesting date.

There were no options granted in 2007. The weighted average fair value of option grants in 2006 was \$1.70 estimated on the dates of grant using an option pricing model with the following assumptions: dividend yield of 0%, expected volatility of 0%, risk-free interest rates of 3.83% – 5.12% and expected life of five years. The weighted average fair value of option grants in 2005 was \$1.15 estimated on the dates of grant using an option pricing model with the following assumptions: dividend yield of 0%, expected volatility of 0%, risk-free interest rates of 3.61% – 3.96% and expected life of five years.

The following table summarizes all stock option activity during the periods indicated:

	<b>Number of options</b>	<b>Weighted average exercise price</b>
Outstanding at April 30, 2004	1,761,920	\$ 2.82
Granted	739,800	6.71
Exercised	(413,990)	2.28
Cancelled	(107,450)	2.48
Outstanding at April 30, 2005	1,980,280	4.39
Granted	754,700	8.74
Exercised	(310,180)	1.98
Cancelled	(31,700)	7.28
Outstanding at April 30, 2006	2,393,100	6.04
Granted	—	—
Exercised	(165,350)	1.82
Cancelled	(163,500)	6.59
Outstanding at April 30, 2007	2,064,250	6.34

All stock options were granted to employees of the Company except for options issued to non-employee directors. Non-employee directors were granted 130,000 and 120,000 stock options during the years ending April 30, 2006 and 2005, respectively. No stock options were issued to non-employee directors in 2007.

The following table summarizes all nonvested share transactions during the periods indicated:

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	<b>Nonvested shares outstanding</b>	<b>Weighted average exercise price</b>
Outstanding at April 30, 2004	160,000	\$ 5.50
Granted	360,000	7.11
Vested	(146,668)	6.52
Cancelled	—	—
	373,332	6.65
Outstanding at April 30, 2005	373,332	6.65
Granted	145,000	8.69
Vested	(156,668)	7.15
Cancelled	—	—
	361,664	7.26
Outstanding at April 30, 2006	361,664	7.26
Granted	—	—
Vested	(135,000)	7.05
Cancelled	(120,000)	7.50
	106,664	7.25
Outstanding at April 30, 2007	106,664	7.25

At April 30, 2007, there was \$90,000 of total unrecognized compensation costs related to nonvested share-based compensation arrangements granted under the Plan. That cost is expected to be recognized during 2008.

The following tables summarize information about stock options outstanding and exercisable at April 30, 2007:

Number of shares outstanding at April 30, 2007	Range of exercise prices	Weighted average exercise price	Weighted average remaining contractual life	Number of shares exercisable at April 30, 2007	Weighted average exercise price
281,750	\$ 2.50 - 2.75	2.54	31 days	281,750	\$ 2.54
285,000	4.00 - 4.40	4.06	1.1 years	285,000	4.06
618,800	5.50 - 6.88	6.06	2.8 years	578,800	6.10
160,000	7.00 - 7.50	7.25	3.7 years	160,000	7.25
425,200	8.50 - 9.00	8.59	3.7 years	358,536	8.55
293,500	9.00 - 9.90	9.03	4 years	293,500	9.03

**(12) Fair Value of Financial Instruments**

The following methods and assumptions were used to estimate the fair values of the Company's financial instruments at April 30, 2007. The fair value of a financial instrument is the amount at which the instrument could be exchanged in a current transaction between willing parties.

*Cash and cash equivalents, trade accounts receivable, refund anticipation loan fees, other current assets, accounts payable and accrued expenses, deferred franchise fees and franchise deposits:* The carrying amounts approximate fair value because of the short maturity of these instruments.

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*Notes receivable:* The carrying amount of the Company's notes receivable approximates fair value based upon the present value of expected future cash flows discounted at the interest rate currently offered by the Company, which approximates rates currently offered by local lending institutions for loans of similar terms to companies with comparable credit risk.

*Long-term debt:* The carrying amount of the Company's long-term debt approximates fair value based on the present value of expected future cash flows discounted at the interest rates offered by the lenders, which approximates rates currently offered by local lending institutions for loans of similar terms to companies with comparable credit risk.

Financial instruments that could potentially subject the Company to concentrations of credit risks consist of accounts and notes receivable with its franchisees. The Company manages such risk by evaluating the financial position, value of the franchises as well as the personal guarantee of the individual franchisees. As of April 30, 2007, there were no significant concentrations of credit risk associated with any individual franchisee or group of franchisees. The Company maintains an allowance for potential losses based on its expected collectibility of the receivables, which the Company believes is adequate for its credit loss exposure.

#### **(13) Related-Party Transactions**

The following summarizes the Company's related-party transactions:

*Purchases and Sales of Franchises and Customer Lists and Other Assets* – During 2007, 2006 and 2005, franchises were sold to related parties for \$642,501, \$1,550,430 and \$105,000, respectively. In 2007, payment for these sales consisted of notes receivable of \$642,501. In 2006, payment for these sales consisted of cash of \$227,130 and notes receivable of \$1,323,300. In 2005, payment for these sales consisted of cash of \$105,000.

Under area franchise arrangements held by related parties, \$666,365, \$415,481 and \$627,092 was paid to related parties in 2007, 2006 and 2005, respectively, for franchise fees and royalties collected by the Company on their behalf. As of April 30, 2007 and 2006, \$329,676 and \$240,498, respectively, was recorded as a liability to related area franchisees, and is reflected as a component of accounts payable and accrued expenses in the accompanying consolidated balance sheets.

During 2007, area franchises were purchased from related parties for \$454,195. Payment for these purchases consisted of \$454,195 applied to related parties notes receivable balances.

*Notes Receivable* – At April 30, 2007 and 2006, related parties owed the Company \$1,783,107 and \$1,879,472, respectively, under notes receivable. Repayments of notes receivable from these parties during 2007 and 2006 were \$520,064 and \$393,380, respectively. Notes receivable from related parties relate to sales of franchise territories and are subject to the same terms and conditions as notes with unrelated parties, which are described in note 2.

*Other* – During 2007 and 2006, the Company assisted in the sale of 112,680 and 51,340 shares of common stock for related parties, respectively. Proceeds to related parties under these sales were \$1,113,594 and \$455,272 in 2007 and 2006, respectively.

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**(14) Employee 401(k) Plan**

The Company sponsors a defined contribution 401(k) profit sharing plan. Under the plan, employees who are 18 years of age and have completed 90 days of service are eligible to make voluntary contributions to the plan. The Company makes matching contributions of 50% of the employees' contribution up to 6% of the employee's salary. Total compensation expense related to these contributions was \$96,754 for the year ended April 30, 2007. The Company did not make contributions to the plan during the years ended April 30, 2006 and 2005.

**(15) Commitments and Contingencies**

The Company has guaranteed borrowings of certain franchisees with two third-parties that provide financing to franchisees for operations. Under the arrangements, the Company would be required to perform in the event of nonpayment by the franchisees to the third parties. Total guaranteed borrowings were \$560,360 as of April 30, 2007. Pursuant to the requirements of FASB Interpretation No. 45, *Guarantor's Accounting and Disclosure Requirements for Guarantees, Including Indirect Guarantees of Indebtedness of Others*, the Company recorded a liability of \$74,227 related to its stand ready obligation under the guaranty arrangements at both April 30, 2007 and 2006, which is included in other long-term liabilities in the accompanying consolidated balance sheets. In addition, the Company recorded a liability of \$244,632 and \$445,420 as of April 30, 2007 and 2006, respectively, included in accounts payable and accrued expenses in the accompanying consolidated balance sheets, related to borrowings for which performance by the Company under the guarantees is probable.

The Company is a defendant in certain lawsuits and is aware of other threatened claims generally incidental to its business as a franchisor. Management is of the opinion that the accompanying consolidated financial statements will not be materially affected by the ultimate resolution of litigation pending or threatened as of April 30, 2007.

**(16) Variable Interest Entities**

FIN 46R requires the consolidation of a VIE if the Company is deemed to be the primary beneficiary of the VIE. FIN 46R requires an entity to assess its equity investments and certain other contractual interests to determine if they are variable interest entities. As defined in FIN 46R, variable interests are contractual, ownership or other interests in an entity that change with changes in the entity's net asset value. Variable interests in an entity may arise from financial instruments, service contracts, guarantees, leases or other arrangements with the VIE. The Company may, in certain cases, provide financing or guarantee financing to unit franchisees or area developers. The Company does not possess any ownership interest in any franchise or area developer entities nor does it typically provide ongoing financial support to these entities. Unit franchisees or area developers generally qualify as VIEs due to the existence of financing provided to purchase the franchise and/or for working capital and equipment needs. The Company adopted FIN 46R on December 31, 2003. FIN 46R provided certain implementation provisions whereas through the year ended April 30, 2005, the Company only applied FIN 46R to VIEs established after December 31, 2003. Full adoption to all VIEs occurred in 2006.

An entity that will absorb a majority of the VIE's expected losses or expected residual returns, as defined in FIN 46R, is considered the primary beneficiary of the VIE. The primary beneficiary should include the

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VIE's assets, liabilities and results of operations in its consolidated financial statements until a reconsideration event, as defined in FIN 46R, occurs to require deconsolidation of the VIE. At the deconsolidation date, the assets and liabilities of the VIE are removed from the consolidated financial statements and any assets and liabilities of the Company that were eliminated in consolidation are restored. The gain recognized from deconsolidating VIEs was recorded in the consolidated statements of income as gain on deconsolidation of variable interest entities.

During 2006, the Company was deemed to be the primary beneficiary of 16 of its franchise entities due to the relatively significant financial support provided to these entities. The Company does not hold an ownership interest in any of these entities. The summarized effect of these entities in the accompanying consolidated balance sheet at April 30, 2006, and the accompanying consolidated statement of income for the year then ended, is as follows:

	<u>JTH Tax, Inc. and subsidiaries</u>	<u>VIEs</u>	<u>Consolidating adjustments and eliminations</u>	<u>Consolidated</u>
<b>Assets</b>				
Current assets	\$ 64,703,149	343,513	(2,711,879)	62,334,783
Non-current assets	37,069,590	1,577,970	(1,278,127)	37,369,433
Total assets	<u>\$ 101,772,739</u>	<u>1,921,483</u>	<u>(3,990,006)</u>	<u>99,704,216</u>
<b>Liabilities, Minority Interest and Stockholders' Equity</b>				
Current liabilities	\$ 38,138,128	3,258,759	(3,008,486)	38,388,401
Non-current liabilities	18,709,294	1,140,140	(1,140,140)	18,709,294
Total liabilities	56,847,422	4,398,899	(4,148,626)	57,097,695
Minority interest	—	—	20,452	20,452
Stockholders' equity (deficit)	<u>44,925,317</u>	<u>(2,477,416)</u>	<u>138,168</u>	<u>42,586,069</u>
Total liabilities, minority interest and stockholders' equity	<u>\$ 101,772,739</u>	<u>1,921,483</u>	<u>(3,990,006)</u>	<u>99,704,216</u>
Revenue	\$ 64,281,546	2,773,060	(902,060)	66,152,546
Operating expenses	46,101,962	3,844,685	(1,237,210)	48,709,437
Other, net	<u>(457,670)</u>	<u>—</u>	<u>52,929</u>	<u>(404,741)</u>
Income (loss) before income taxes and cumulative effect of accounting change	17,721,914	(1,071,625)	388,079	17,038,368
Income tax expense	<u>7,110,966</u>	<u>—</u>	<u>—</u>	<u>7,110,966</u>
Income (loss) before cumulative effect of accounting change	10,610,948	(1,071,625)	388,079	9,927,402
Cumulative effect of accounting change	<u>—</u>	<u>—</u>	<u>(1,655,702)</u>	<u>(1,655,702)</u>
Net income (loss)	<u>\$ 10,610,948</u>	<u>(1,071,625)</u>	<u>(1,267,623)</u>	<u>8,271,700</u>

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During 2007, a reconsideration event occurred for each of the 16 VIEs consolidated at April 30, 2006. The operating results of each VIE, through its deconsolidation date, are consolidated in the accompanying consolidated statement of income for the year ended April 30, 2007. The Company was not deemed to be the primary beneficiary of any additional VIEs during 2007 and there are no VIEs consolidated at April 30, 2007. The summarized effect of these entities in the accompanying consolidated statement of income for the year ended April 30, 2007, is as follows:

	<b>JTH Tax, Inc. and subsidiaries</b>	<b>VIEs</b>	<b>Consolidating and deconsolidating adjustments and eliminations</b>	<b>Consolidated</b>
Revenue	\$ 74,990,025	577,996	(420,351)	75,147,670
Operating expenses	53,293,298	1,293,790	(420,351)	54,166,737
Other, net	17,500	—	—	17,500
Gain on deconsolidation of VIEs	—	—	3,055,042	3,055,042
Income (loss) before income taxes	21,714,227	(715,794)	3,055,042	24,053,475
Income tax expense	8,323,798	—	—	8,323,798
Net income (loss)	<u>\$ 13,390,429</u>	<u>(715,794)</u>	<u>3,055,042</u>	<u>15,729,677</u>

**(17) Subsequent Events**

On June 1, 2007, the Company authorized a 2-for-1 stock split where all shareholders will receive an additional share of stock of the same class for each share they hold. The effective date of this stock split was June 1, 2007. All share and per share amounts have been adjusted to give effect to the stock split on a retroactive basis.

On June 1, 2007, the Company authorized the grant of 435,120 post-split stock options to certain employees and 50,000 post-split stock options to the directors of the Company. The post-split exercise price of these options will be \$10.50 per share which management believes was the fair value at the date of the grant. Most of the options will vest after six months and may be exercised over a five-year period.