

Capital Financial Holdings, Inc  
Form 10-K  
March 23, 2011

**UNITED STATES  
SECURITIES AND EXCHANGE COMMISSION  
Washington, DC 20549**

**Form 10-K**

[X] ANNUAL REPORT UNDER SECTION 13 OR 15(d) OF THE SECURITIES  
EXCHANGE ACT OF 1934

For the fiscal year ended December 31, 2010

Commission file number: 000-25958

**CAPITAL FINANCIAL HOLDINGS, INC.**

*(Exact name of registrant as specified in its charter)*

**North Dakota**

**45-0404061**

*(State or other jurisdiction of incorporation or organization)*

*(IRS Employer Identification No.)*

**1 Main Street North  
Minot, North Dakota 58703**

*(Address of principal executive offices)*

Registrant's telephone number, including area code:

(701) 837-9600

Securities registered pursuant to Section 12(b) of the Act:

None

Securities registered pursuant to Section 12(g) of the Act:

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Common Stock; \$.0001 par value

Indicate by check mark if the registrant is a well-known seasoned issuer, as defined in Rule 405 of the Securities Act.

Yes

X

No

Indicate by check mark if the registrant is not required to file reports pursuant to Section 13 or Section 15(d) of the Act.

Yes

X

No

Indicate by check mark whether the registrant (1) has filed all reports required to be filed by Section 13 or 15(d) of the Exchange Act of 1934 during the preceding 12 months (or for such shorter period that the registrant was required to file such reports), and (2) has been subject to such filing requirements for the past 90 days.

X

Yes

No

Indicate by check mark if disclosure of delinquent filers pursuant to Item 405 of Regulation S-K is not contained herein, and will not be contained, to the best of registrant's knowledge, in definitive proxy or information statements incorporated by reference in Part III of this Form 10-K or any amendment to this Form 10-K.

X

Indicate by check mark whether the registrant is a large accelerated filer, an accelerated filer, a non-accelerated filer, or a smaller reporting company. See definition of "large accelerated filer," "accelerated filer," and "smaller reporting company" in Rule 12b-2 of the Exchange Act. (Check one):

Large accelerated filer

Accelerated filer

Non-accelerated filer

Smaller Reporting Company

X

Indicate by check mark whether the registrant is a shell company (as defined in Rule 12b-2 of the Act)

Yes

X

No

Aggregate market value of voting and non-voting common equity held by non-affiliates of the registrant as of February 28, 2011: \$1,077,468.

On February 28, 2011, there were 14,455,943 shares of the issuer's common equity outstanding.

DOCUMENTS INCORPORATED BY REFERENCE:

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Portions of the Company's definitive Proxy Statement for the Annual Meeting of Shareholders to be held on June 9, 2011, are incorporated by reference in certain sections of Part III.

**10-K**

**CAPITAL FINANCIAL HOLDINGS, INC.**

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### **Special Note Regarding Forward Looking Statements**

When used herein, in future filings by the Company with the Securities and Exchange Commission ("SEC"), in the Company's press releases, and in other Company-authorized written or oral statements, the words and phrases "can be," "expects," "anticipates," "may affect," "may depend," "believes," "estimate," or similar expressions are intended to identify "forward-looking statements" within the meaning of the Private Securities Litigation Reform Act of 1995. The Company cautions readers not to place undue reliance on any such forward-looking statements, which speak only as of the date made. Such statements are subject to certain risks and uncertainties, including those set forth in this "Forward-Looking Statements" section, which could cause actual results for future periods to differ materially from those presently anticipated or projected. The Company does not undertake and specifically disclaims any obligation to update any forward-looking statement to reflect events or circumstances after the date of such statements.

Until July 31, 2009 the Company derived substantially all of its revenues from two sources; commission revenue earned in connection with sales of shares of mutual funds, insurance products, and various other securities and fees relating to management of, and provision of services to mutual funds. Following the disposition of the Mutual Fund Services Segment, the Company has two operating subsidiaries, Capital Financial Services, Inc. ("CFS" or the "broker-dealer subsidiary") a FINRA member broker-dealer and Capital Energy Resources, Inc. ("CER" or the "oil and gas subsidiary").

The Company is a financial services holding company that, through its broker dealer subsidiary, provides brokerage, investment advisory, insurance and related services. The Company operates in a highly regulated and competitive industry that is influenced by numerous external factors such as economic conditions, marketplace liquidity and volatility, monetary policy, global and national political events, regulatory developments, competition, and investor preferences. The Company's revenues and net earnings may be either enhanced or diminished from period to period by such external factors. The Company remains focused on continuing to reduce redundant operating costs, upgrade operating efficiency, recruit quality representatives and grow our revenue base. The Company provides broker-dealer services in support of trading and investment by its representatives' customers in corporate equity and debt securities, U.S. Government securities, municipal securities, mutual funds, private placement alternative investments, variable annuities and variable life insurance. The Company also provides investment advisory services for its representative's customers. In the past, investment advisory services were performed by both Capital Financial Services, Inc. on an individual client basis and Integrity Money Management, Inc. on behalf of the mutual fund segment; services through Integrity Money Management, Inc. were discontinued as a result of the disposition of the Mutual Funds Service Segment effective July 31, 2009.

A key component of the broker-dealer subsidiary's business strategy is to recruit well-established, productive representatives who generate substantial revenues from an array of investment products and services. Additionally, the broker-dealer subsidiary assists its representatives in developing and expanding their business by providing a variety of support services and a diversified range of investment products for their clients.

Forward-looking statements include, but are not limited to, statements about the Company's:

- 

Business strategies and investment policies,

- 

Possible or assumed future results of operations and operating cash flows,

- 

Financing plans and the availability of short-term borrowing,

- 

Competitive position,

- 

Potential growth opportunities,

- 

Recruitment and retention of the Company's key employees,

- 

Potential operating performance, achievements, productivity improvements, efficiency and cost reduction efforts,

- 

Likelihood of success and impact of litigation,

- 

Expected tax rates,

- 

Expectations with respect to the economy, securities markets, the market for merger and acquisition activity, the market for asset management activity, and other industry trends,

- 

Competition, and

- 

Effect from the impact of future legislation and regulation on the Company.

The following factors, among others, could cause actual results to differ materially from forward-looking statements, and future results could differ materially from historical performance:

- 

General political and economic conditions which may be less favorable than expected;

- 

The effect of changes in interest rates, inflation rates, the stock markets, or other financial markets;

- 

Unfavorable legislative, regulatory, or judicial developments;

- 

Adverse findings or rulings in arbitrations, litigation or regulatory proceedings;

- 

Incidence and severity of catastrophes, both natural and man-made;

- Changes in accounting rules, policies, practices, and procedures which may adversely affect the business;

- Terrorist activities or other hostilities which may adversely affect the general economy.

## **PART I**

### **Item 1. Business**

#### **OVERVIEW**

Capital Financial Holdings, Inc. derives the majority of its revenues and net income from sales of mutual funds, insurance products, and various other securities through Capital Financial Services, Inc. ("CFS"), the Company's broker-dealer subsidiary.

The Company organizes its current business units into two reportable segments: broker-dealer services and oil and gas activities. The broker-dealer services segment distributes securities and insurance products to retail investors through a network of registered representatives. The oil and gas activities segment will seek opportunities in petroleum and natural gas exploration and production.

The Company has been engaged in the financial services business since 1987. The Company was incorporated September 22, 1987, as a North Dakota corporation by Robert E. Walstad, founder and Chairman Emeritus of the Company. The Company's principal offices are located at 1 Main Street North, Minot, North Dakota 58703. As of December 31, 2010, the Company had 22 full-time employees consisting of officers, securities distribution, data processing, compliance, accounting, and clerical support staff.

#### **BUSINESS DEVELOPMENT**

On April 22, 2005, the Company acquired the management rights to the IPS Millennium Fund and the IPS New Frontier Fund from IPS Advisory, Inc. ("IPS Advisory"), and merged them into a new Integrity Fund called the Integrity Growth & Income Fund. The two funds had combined assets of approximately \$57 million at the time of acquisition. The purchase agreement called for total consideration of approximately 656,000 common shares of the Company. The Company provided IPS Advisory with 250,000 common shares upon closing. The remaining consideration of approximately 406,000 common shares, which was subject to adjustment based on retention of assets in the fund, was to be issued as follows: 203,000 common shares at the one-year anniversary of the closing date, and 203,000 common shares at the two-year anniversary of the closing date. The shares are subject to a put option, which allows the holders of the shares to put them back to the Company at a price equal to the market price of the Company's shares as of the closing date, which was \$.36 per share. The put option is exercisable with respect to one-third of the shares per year starting on the third anniversary of the closing date. The Company will also provide IPS Advisory with a stock option incentive bonus based on growth in assets in the Fund based on the following schedule: 150,000



options on the Company's common shares if assets of the Fund reach \$100 million and 150,000 options on the Company's common shares if the assets of the Fund reach \$200 million. The options will have a strike price of \$.65 per share and mature 10 years from the closing date. The securities issued in connection with this transaction were issued on a private placement basis. In April of 2006, the one-year anniversary payment of 158,603 common shares was made, which reflected the assets of the acquired funds at the one-year anniversary. In June of 2007, the two-year anniversary payment of 138,797 common shares was made, which reflected the assets of the acquired funds at the two-year anniversary. In April 2010 the put option mentioned above expired, which resulted in the liability of this acquisition to be reduced to \$0.

On March 7, 2007, the Company acquired certain assets of United Heritage Financial Services, Inc. (UHFS), a wholly owned subsidiary of United Heritage Financial Group, Inc., of Meridian, Idaho. UHFS had approximately 120 independent registered representatives who became part of Capital Financial Services, Inc. (CFS), the retail brokerage division of the Company. Pursuant to the agreement, in exchange for receipt of the assets of UHFS set forth above, the Company agreed to issue 500,000 restricted CFH shares and pay a deferred cash earn out payment totaling a maximum of \$900,000, to be paid in 21 quarterly installments. On March 7, 2007, the Company issued 500,000 restricted common shares to UHFS. As a result of this issuance of shares, \$175,000 was recorded by the Company as goodwill relating to the purchase of the assets. As of December 31, 2010, the Company had made fifteen quarterly installment payments totaling \$330,736. The liability relating to this acquisition is valued at approximately \$244,615 as of December 31, 2010, and has also been recorded by the Company as goodwill. Due to the goodwill impairment charge that was recorded (see "Recent Developments" note), as of December 31, 2010, the total goodwill recorded relating to this acquisition was \$656,906.

## **THE COMPANY'S SUBSIDIARIES**

Capital Financial Holdings, Inc. derives the majority of its revenues and net income from sales of mutual funds, insurance products, and various other securities through Capital Financial Services, Inc. ("CFS"), the Company's broker-dealer subsidiary.

The Company organizes its current business units into two reportable segments: broker-dealer services and oil and gas activities. The broker-dealer services segment distributes securities and insurance products to retail investors through a network of registered representatives. The oil and gas activities segment will seek opportunities in petroleum and natural gas exploration and production.

### ***Capital Financial Services, Inc.***

CFS is a full-service brokerage firm. CFS is registered with the SEC as an investment advisor and broker-dealer and also with FINRA as a broker-dealer. CFS specializes in providing investment products and services to independent investment representatives, financial planners, and investment advisors and currently supports over 280 investment representatives and investment advisors.

### ***Capital Energy Resources, Inc.***

CER is an oil and gas operating company that will seek opportunities in petroleum and natural gas exploration and production.

## **DESCRIPTION OF BUSINESS**

### ***Brokerage Commissions***

CFS's primary source of revenue is commission revenue in connection with sales of shares of mutual funds, insurance products, and various other securities. CFS receives commission and Rule 12b-1 servicing revenue generated from the

sale of investment products originated by its registered representatives. CFS also receives investment advisory revenue as a registered investment advisor. CFS pays a portion of the revenue generated to its registered representatives and retains the balance.

## **REGULATION**

Virtually all aspects of the Company's businesses are subject to various complex and extensive federal and state laws and regulations. Regulated areas include, but are not limited to, the effecting of securities transactions, the financial condition of the Company's subsidiaries, record-keeping and reporting procedures, relationships with clients, and experience and training requirements for certain employees. The Company's subsidiary is registered with various federal and state government agencies, including the SEC, as well as FINRA, a self-regulatory industry organization, as described below.

CFS is a registered broker-dealer, subject to extensive regulation and periodic examinations by the SEC, FINRA, and state agencies in those states in which CFS conducts business. As a broker-dealer, CFS is subject to the Net Capital Rule promulgated by the SEC under the Exchange Act. This rule requires that a broker-dealer must maintain certain minimum net capital and that its aggregate indebtedness may not exceed specified limitations.

Federal and state laws and regulations, and the rules of FINRA, grant broad powers to such regulatory agencies and organizations. These include the power to limit, restrict, or prevent the Company from carrying on its business if it fails to comply with such laws, regulations and rules. Other possible sanctions that may be imposed include the suspension of individual employees, restrictions on the Company expanding its business or paying cash dividends, the revocation of the investment advisor or broker dealer expulsions, censures, and/or fines.

Since 1993, FINRA rules have limited the amount of aggregate sales charges which may be paid in connection with the purchase and holding of investment company shares sold through broker-dealers. Congress and the SEC presently are considering amendments to Rule 12b-1 and other statutory provisions and rules that regulate the distribution of mutual fund shares. The effect of the rule amendments and other legislative or regulatory actions might be to limit the amount of fees that could be paid pursuant to a fund's 12b-1 Plan in a situation where a fund has no, or limited, new sales for a prolonged period of time, as well as the imposition of other limits on the use of fund assets to pay for distribution.

## **COMPETITION**

The Company derives substantially all of its revenues from commission revenue earned in connection with sales of shares of mutual funds, insurance products and various other securities, and also receives investment advisory revenue.

The Company participates in retail brokerage, a highly competitive related sector of the financial services industry. The Company competes directly with full-service stock brokerage firms, insurance companies, banks, regional broker-dealers, other independent broker-dealers, and other financial institutions, as well as investment advisory firms. Each of these competitors offer to the public many of the same investment products and services offered by the Company. Further, other broker-dealers providing the same services heavily recruit the representatives and advisors transacting business through the Company. This competition forces the Company to maintain high levels of support services and commission payouts for these representatives and advisors. These high levels of services and payouts could have a materially adverse effect on the Company's earnings.

## **RECENT DEVELOPMENTS**

The Company tests goodwill for impairment annually during the second quarter of each fiscal year. If an event occurs or circumstances change that would more likely than not reduce fair value of a reporting unit below its carrying value,

goodwill is evaluated for impairment between annual tests. As a result of ongoing volatility in the financial industry and a reduction in the calculated fair market value of its wholly owned subsidiary Capital Financial Services, Inc., the Company performed an interim goodwill impairment test for the quarter ended December 31, 2010. On February 25, 2011, the Company determined that it will incur a goodwill impairment charge for the fourth quarter of the fiscal year ended December 31, 2010 of \$753,518 related to the Broker-Dealer segment. This charge resulted from an interim test for impairment under the FASB accounting and reporting standards for goodwill and other intangible assets, prompted by the ongoing volatility in the financial industry and an opinion of fair market value provided by a third party. The Company will not be required to make any current or future cash expenditures as a result of the impairment. The impairment charge will be reflected in the Company's financial statements as of and for the fourth quarter and fiscal year ended December 31, 2010.

In the Company's third quarter filing it reported capitalized costs of \$154,865, in the Oil & Gas segment. These costs have been fully expensed, by the Company, as of December 31, 2010. A termination request has been received by CER, requesting termination of the Joint Participation Agreement between CER and Nakota Energy LLC. If this agreement is terminated CER would no longer have rights to the leases, in which CER had paid acquisition costs. It was determined by the Company that until the outcome of this termination is finalized these capitalized costs would be expensed.

On September 24, 2010 the Company announced the resignation of Bradley P. Wells, the Company's Chief Executive Officer and Chief Financial Officer and Treasurer. On October 13, 2010 the Company then announced, effective October 6, 2010, that Jacqueline L. Case had been appointed as the Company's interim President and acting Executive Officer, and Valarie A. Hoskin had been appointed as the Company's interim Chief Financial Officer and Treasurer to replace Bradley P. Wells.

On March 25, 2010 the Board of Directors approved pursuant to the Bylaws of the Company, a reduction in the number of directors from five to four. In accordance with the Bylaws of the Company when the number of directors is reduced, the current directors continue to serve until the expiration of their terms and therefore the number of directors will remain at five until the Annual Meeting of Shareholders of the Company.

On March 25, 2010 Mr. Vance Castleman announced his retirement from the Board of Directors effective upon the Annual Meeting of Shareholders of the Company. As a result, Mr. Castleman will not be a director nominee at the Annual Meeting of Shareholders.

In March of 2009 the Company entered into a Definitive Agreement (the "Agreement") with Corridor Investors, LLC ("Buyer"), pursuant to which Buyer agreed to purchase from Seller, and Seller agreed to sell to Buyer: (i) all of the issued and outstanding shares of each of three subsidiaries of the Company, Integrity Fund Services, Inc., a share transfer agency, Integrity Funds Distributor, Inc., a FINRA member broker dealer and Integrity Mutual Funds, Inc. of Nevada, a non-operating entity (the "Companies"); (ii) all of Seller's right, title and interest in and to certain tangible assets and (iii) the sale of certain assets of Integrity Money Management, Inc. related to its mutual fund advisory business. The purpose of the Agreement was to facilitate a change in advisor as well as to transfer, together with the operating subsidiaries, the combined mutual fund service business of the Seller currently provided to The Integrity Funds, Integrity Managed Portfolios, ND Tax-Free Fund, Inc., Montana Tax-Free Fund, Inc. and Integrity Fund of Funds, Inc. ("the Funds"), which are investment companies registered with the Securities and Exchange Commission ("SEC") under the Investment Company Act of 1940. As per the Agreement, closing occurred; the Buyer paid \$1,525,480 (60 BPS of the aggregate net assets, totaling \$254,246,596 as of July 30, 2009) to the Company. On August 5, 2010 the Company received \$227,200 (10 BPS of the aggregate net assets, totaling \$227,199,779 as of July 30, 2010), the first of the three additional payments consisting of 10 BPS of the aggregate net assets as of July 30, 2010, 2011 and 2012. With the closing and transfer of entities, the Company is no longer involved in the mutual fund service business. The Company continues to operate as a Broker-Dealer through its wholly owned subsidiary Capital Financial Services, Inc. As a result of the transfer, post closing of the transaction, Integrity Fund Services, Inc., Integrity Funds Distributor, Inc. and Integrity Money Management, Inc., which constitute the mutual fund division of

the Company, will be reflected in the Company's future consolidated financial statements as a discontinued operation.

The Company tests goodwill for impairment annually during the second quarter of each fiscal year. If an event occurs or circumstances change that would more likely than not reduce fair value of a reporting unit below its carrying value, goodwill is evaluated for impairment between annual tests. As a result of ongoing volatility in the financial industry and a significant reduction in assets under management in the Company's sponsored mutual funds at the time, the Company performed an interim goodwill impairment test for the quarter ended December 31, 2008. On February 24, 2009, the Company determined that it would incur a goodwill impairment charge for the fourth quarter of the fiscal year ended December 31, 2008 of \$5,312,606 in the Mutual Fund Services segment. This charge resulted from an interim test for impairment under the FASB accounting and reporting standards for goodwill and other intangible assets, prompted by a significant reduction in assets under management and ongoing volatility in the financial service industry during the fourth quarter of 2008. The Company was not required to make any current or future cash expenditures as a result of the impairment. The impairment charge was reflected in the Company's financial statements as of and for the fourth quarter and fiscal year ended December 31, 2008.

### **AVAILABILITY OF SEC REPORTS**

All SEC reports may be viewed and copied at the SEC's Public Reference Room at 100 F Street NE, Washington, DC 20549, on official business days during the hours of 10 a.m. to 3 p.m. local time. Information on the operation of the Public Reference Room may be obtained by calling the Commission at 1-800-SEC-0330. The Commission maintains an Internet site (<http://www.sec.gov>) that contains reports, proxy and information statements, and other information regarding issuers that file electronically with the Commission.

All SEC reports are also made available on the Company's website at <http://capitalfinancialholdings.com>. These reports, including annual reports on Form 10-K and 10-KSB, quarterly reports of Form 10-Q and 10-QSB, and current reports on Form 8-K, are available on the same day they are filed with the SEC.

### **Item 1A. Risk Factors**

Not Applicable as a Smaller Reporting Company.

### **Item 1B. Unresolved Staff Comments**

None

### **Item 2. Properties**

The Company operates the majority of its business out of its location at 1 Main Street North, Minot, North Dakota, which the Company owns. As of December 31, 2010, the building has a \$277,772 mortgage.

### **Item 3. Legal Proceedings**

The Company operates in a legal and regulatory environment that exposes it to potentially significant litigation risks. As a result, the Company is involved in various disputes and legal proceedings, including litigation, arbitration and regulatory investigations, including a number of investigatory matters and legal proceedings arising out of customer allegations related to past commissioned sales of alternative investment products. In 2007 through the first quarter of 2009 a substantial amount (approximately 10% to 20%) of the Company's sales of commissioned products were in private placements of alternative products, two of which as of December 31, 2009 (Medical Capital Corporation and related issuer entities and Provident Royalties, LLC and related issuer entities) were placed in receivership by action of the United States Securities and Exchange Commission and issuers of certain other alternative products sold by the Company are in Chapter 11 Bankruptcy or may have financial difficulties. Additionally, difficult economic conditions

in general and the stock market decline have contributed to decline in broker-dealer subsidiary client portfolio values. As a result of such alleged failings of alternative products and the uncertainty of client recovery from the various product issuers, the Company is subject to regulatory scrutiny and a number of recently instituted legal or arbitration proceedings, including two recently instituted proceedings seeking certification as class actions which name the Company as one of a number of defendants and allege various securities or conduct violations, one with respect to private placements of Medical Capital Corporation and related issuer entities for which the broker-dealer subsidiary placed approximately \$100 million of debt securities and the other with regard to private placements of Provident Royalties, LLC and related issuer entities for which the broker-dealer subsidiary placed approximately \$60 million of debt securities. The Company intends to vigorously contest the allegations of the various proceedings and believes that there are multiple meritorious legal and fact based defenses in these matters. Such cases are subject to many uncertainties, and their outcome is often difficult to predict, including the impact on operations or on the financial statements, particularly in the earlier stages of a case. The Company makes provisions for cases brought against it when, in the opinion of management after seeking legal advice, it is probable that a liability exists, and the amount can be reasonably estimated. The current proceedings are subject to uncertainties and as such, the Company is unable to estimate the possible loss or a range of loss that may result from each individual matter. There is a contemplated settlement regarding both Medical Capital Corporation and Provident Royalties, LLC, by which the Company would contribute monies to a settlement fund. The contemplated settlement, in the amount of \$200,000, was recorded in the books of the company as a liability, though the settlement is subject to approval by a number of entities, and there is no assurance that the settlement will be completed.

## **PART II**

### **Item 4. Market for Registrant's Common Equity, Related Stockholder Matters and Issuer Purchases of Equity Securities**

#### *Information about the Company's Common Stock*

The Company's Common Shares are traded on the OTC Bulletin Board under the symbol CPFH. The Company's common shares began trading on the OTC Bulletin Board on November 7, 1997. On May 31, 2002, the shareholders of the Company approved a two for one (2:1) share split of the issued and outstanding common shares of the Company, which took effect on July 1, 2002. On December 31, 2010, the closing price of the Company's Common Shares on the OTC Bulletin Board was \$.07 per share. At February 28, 2010, there were approximately 733 shareholders of record.

The following table sets forth the high and low closing prices for the Company's common stock. The quotations reflect inter-dealer prices, without retail mark-up, mark-down, or commission, and may not represent actual transactions.

**2010**

**2009**

**Fiscal Year**

**Fiscal Year**

**Quarter**

**High**

**Low**

**High**

**Low**

First Quarter

.190

.130

.280

.150

Second Quarter

.190

.110

.240

.140

Third Quarter

.200

.090

.230

.150

Fourth Quarter

.130

..050

.240

.120

The Company has not paid a dividend with respect to its common stock, nor does the Company anticipate paying dividends in the foreseeable future.

*The Company has issued the following securities in the past quarter without registering the securities under the Securities Act:*

None

*Smaller Reporting Company Repurchases of Equity Securities:*

**Period**

**Total Number of Shares Purchased**

**Average Price Per Share**

**Total Number of Shares Purchased as Part of Publicly Announced Plans or Programs**

**Approximate Dollar Value of Shares that May Yet Be Purchased Under the Plans or Programs**

October 2010

-

-

-

\$597,754

November 2010

-

-

-  
\$597,754

December 2010

-  
-  
-  
\$597,754

Total

-  
-  
-  
\$597,754

**Item 5. Selected Financial Data**

Not Applicable as a Smaller Reporting Company.

**Item 6. Management's Discussion and Analysis of Financial Condition and Results of Operations**

The following information is provided in connection with, and should be read in conjunction with, the consolidated financial statements and notes included in this Annual Report on Form 10-K.

**GENERAL**

Capital Financial Holdings, Inc. derives the majority of its revenues and net income from sales of mutual funds, insurance products, and various other securities through Capital Financial Services, Inc. ("CFS"), the Company's broker-dealer subsidiary.

The Company organizes its current business units into two reportable segments: broker-dealer services and oil and gas activities. The broker-dealer services segment distributes securities and insurance products to retail investors through a network of registered representatives. The oil and gas activities segment will seek opportunities in petroleum and natural gas exploration and production.

**RESULTS OF OPERATIONS**

The following table sets forth, for the periods indicated, amounts included in the Company's Consolidated Statements of Operations and the percentage change in those amounts from period to period.



**Variance 2010 to  
2009**

**Variance 2009 to  
2008**

**2010**

**2009**

**2008**

**OPERATING REVENUES**

Fee income

\$

975,010

\$

1,062,492

\$

1,551,245

(8)%

(32)%

Commission income

17,746,472

16,096,513

25,869,214

10%

(37)%

Other income

670,325

743,769

975,877

(10)%

(46)%

Total revenue

\$

19,391,807

\$

17,902,774

\$

28,396,336

8%

(37)%

**OPERATING EXPENSES**

Compensation and benefits

\$

1,350,094

\$

1,786,179

\$

2,089,297

(24)%

(15)%

Commission expense

16,566,033

15,223,613

24,390,850

9%

(38)%

Goodwill impairment expense

753,518

-

-

100%

-

General and administrative expenses

1,423,353

1,036,490

1,125,767

37%

(8%)

Geological & geophysical costs

66,310

-

-

100%

-

Depreciation and amortization

75,381

100,369

115,487

(25)%

(13)%

Total operating expenses

\$

20,234,689

\$

18,146,651

\$

27,721,401

12%

(35)%

**OPERATING INCOME (LOSS)**

\$

(842,882)

\$

(243,877)

\$

674,935

246%

(136)%

**OTHER EXPENSES**

Loss on investment

\$

-

\$

(31,876)

\$

-

(100)%

100%

Interest expense

(80,880)

(212,552)

(302,369)

(62)%



(30)%

Net other expenses

\$

(80,880)

\$

(244,428)

\$

(302,369)

(67)%

(19)%

**INCOME (LOSS) OF CONTINUING OPERATIONS BEFORE INCOME TAX BENEFIT (EXPENSE)**

\$

(923,762)

\$

(488,305)

\$

372,566

89%

(231)%

**INCOME TAX BENEFIT (EXPENSE)**

\$

40,581

\$

191,416

\$

(146,046)

(79)%

231%

**NET INCOME (LOSS) BEFORE DISCONTINUED OPERATIONS**

\$

(883,181)

\$

(296,889)

\$

226,520

197%

(231)%

**DISCONTINUED OPERATIONS**

Income (Loss) from operations of discontinued operations (net of tax)

\$

-

\$

(125,211)

\$

1,576,389

100%

(107)%

Goodwill impairment expense

-

-

(5,312,606)

-

(100)%

Gain (Loss) on disposal of discontinued operations

(111,601)

228,402

-

(149)%

100%

Net discontinued operations

\$

(111,601)

\$

103,191

\$

(3,736,217)

(208)%

103%

**NET LOSS**

\$

(994,782)

\$

(193,698)

\$

(3,509,697)

(414)%

94%

**NET INCOME (LOSS) OF CONTINUING OPERATIONS PER COMMON SHARE:**

(.07)

(.03)

.01

**NET LOSS PER COMMON SHARE:**

(.07)

(.02)

(.25)

**Year Ended December 31, 2010, compared with Year Ended December 31, 2009:**

**Operating Revenues**—Total operating revenues for 2010 were \$19,391,807, an increase of 8% from \$17,902,774 in 2009. The increase resulted from increased commission income relating to CFS, the Company's broker-dealer division.

**Fee Income**—Fee income for 2010 was \$975,010, an 8% decrease from \$1,062,492 in 2009. The decrease was due to a reduction in fees received by CFS due to a reduction in assets under management in CFS' registered investment advisor.

The Company earns investment advisory fees in connection with CFS' registered investment advisor. The Company pays the registered representatives a portion of this fee income as commission expense and retains the balance. These fees constituted 5% of the Company's consolidated revenues in 2010.

**Commission Income**—Commission income includes CFS. The Company pays the registered representatives a percentage of this income as commission expense and retains the balance. Commission income for 2010 was \$17,746,472, a 10% increase from \$16,096,513 in 2009. The increase was due primarily to an increase in

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commissions received by CFS due to market conditions. Future market conditions will continue to impact commission levels. Commission revenues constituted 92% of the Company's consolidated revenues in 2010.

**Other Income**—Other income for 2010 was \$670,325 a 10% decrease from \$743,769 in 2009. Other income is comprised primarily of due diligence and marketing allowances received by CFS. Other income constituted 4% of the Company's consolidated revenues in 2010.

**Operating Expenses**—Total operating expenses for 2010 were \$20,234,689 a 12% increase from \$18,146,651 in 2009. The increase resulted from the net increases in the expense categories described in the paragraphs below.

The table below displays the expenses relating to the Oil & Gas activities for the years ending December 31, 2010, 2009 and 2008:

2010

2009

2008

Geological & geophysical expenses

\$

66,310

\$

-

\$

-

Depreciation expense

\$

261

\$

-



\$

-

General & administrative expenses

\$

63,143

\$

-

\$

-

Compensation & benefit expenses

\$

59,608

\$

-

\$

-

Total oil & gas expenses

\$

189,322

\$

-

\$

-

***Compensation and Benefits***—Compensation and benefits expense for 2010 was \$1,350,094, a 24% decrease from \$1,786,179 in 2009. The decrease resulted primarily from a reduction in incentive overrides paid to certain employees for the recruitment of new registered representatives in CFS, as well as a reduction in the number of employees over the past twelve months.

**Commission Expense**—Commission expense for 2010 was \$16,566,033, an 8% increase from \$15,223,613 in 2009. The increase corresponds with the increase in commission income.

**Goodwill Impairment Expense**—Goodwill impairment expense for 2010 was \$753,518, a 100% increase from \$0 in 2009. The Company tests goodwill for impairment annually during the second quarter of each fiscal year. If an event occurs or circumstances change that would more likely than not reduce fair value of a reporting unit below its carrying value, goodwill is evaluated for impairment between annual tests. As a result of ongoing volatility in the financial industry and a reduction in the calculated fair market value of its wholly owned subsidiary Capital Financial Services, Inc., the Company performed an interim goodwill impairment test for the quarter ended December 31, 2010. On February 25, 2011, the Company determined that it will incur a goodwill impairment charge for the fourth quarter of the fiscal year ended December 31, 2010 of \$753,518 related to the Broker-Dealer segment. This charge resulted from an interim test for impairment under the FASB accounting and reporting standards for goodwill and other intangible assets, prompted by the ongoing volatility in the financial industry and an opinion of fair market value provided by a third party. The Company will not be required to make any current or future cash expenditures as a result of the impairment. The impairment charge will be reflected in the Company's financial statements as of and for the fourth quarter and fiscal year ended December 31, 2010.

**General and Administrative Expenses**—Total general and administrative expenses for 2010 were \$1,423,353, an increase of 37% from \$1,036,490 in 2009. The increase was due primarily to an increase in licensing fees and legal expenses paid by CFS.

**Geological & Geophysical Costs**—Total Geological & Geophysical costs for 2010 were \$66,310, an increase of 100% from \$0 in 2009. The increase was due to the oil and gas division being opened in February of 2010.

**Depreciation and Amortization**—Depreciation and amortization for 2010 was \$75,381, a 25% decrease from \$100,369 in 2009. The decrease was due to the disposal of assets associated with the mutual fund division sale.

**Interest Expense**—Interest expense was \$80,880 for 2010, a 62% decrease from \$212,552 in 2009. The decrease was due primarily to a reduction in outstanding debt due to redemptions of the company's subordinated corporate notes processed on June 23rd and July 31st, totaling \$500,000, and also the company's decision to call the remaining notes, totaling \$1,500,000, processed on September 30, 2009.

#### **Year Ended December 31, 2009, compared with Year Ended December 31, 2008:**

**Operating Revenues**—Total operating revenues for 2009 were \$17,902,774, a decrease of 37% from \$28,396,337 in 2008. The decrease resulted primarily from decreased commission and fee income relating to CFS, the Company's broker-dealer division.

**Fee Income**—Fee income for 2009 was \$1,062,492, a 32% decrease from \$1,551,245 in 2008. The decrease was due to a reduction in fees received by CFS due to a reduction in assets under management in CFS' registered investment advisor.

The Company earns investment advisory fees in connection with CFS' registered investment advisor. The Company pays the registered representatives a portion of this fee income as commission expense and retains the balance. These fees constituted 6% of the Company's consolidated revenues in 2009.

**Commission Income**—Commission income includes CFS. The Company pays the registered representatives a percentage of this income as commission expense and retains the balance. Commission income for 2009 was \$16,096,513, a 37% decrease from \$25,869,214 in 2008. The decrease was due primarily to a decrease in commissions received by CFS due to market conditions. Future market conditions will continue to impact commission levels. Commission revenues constituted 90% of the Company's consolidated revenues in 2009.

**Other Income**—Other income for 2009 was \$743,769, a 24% decrease from \$975,877 in 2008. Other income is comprised primarily of due diligence and marketing allowances received by CFS. Other income constituted 4% of the Company's consolidated revenues in 2009.

**Operating Expenses**—Total operating expenses for 2009 were \$18,146,651 a 35% decrease from \$27,721,401 in 2008. The decrease resulted from the net decreases in the expense categories described in the paragraphs below.

**Compensation and Benefits**—Compensation and benefits expense for 2009 was \$1,786,179, a 15% decrease from \$2,089,297 in 2008. The decrease resulted primarily from a reduction in incentive overrides paid to certain employees for the recruitment of new registered representatives in CFS, as well as a reduction in the number of employees over the past twelve months.

**Commission Expense**—Commission expense for 2009 was \$15,223,613, a 38% decrease from \$24,390,850 in 2008. The decrease corresponds with the decreases in fee and commission income.

**Goodwill Impairment Expense**—Goodwill impairment expense for 2009 was \$0, a 100% decrease from \$5,312,606 in 2008. The Company tests goodwill for impairment annually during the second quarter of each fiscal year. If an event occurs or circumstances change that would more likely than not reduce fair value of a reporting unit below its carrying value, goodwill is evaluated for impairment between annual tests. As a result of ongoing volatility in the financial industry and a significant reduction in assets under management in the Company's sponsored mutual funds, the Company performed an interim goodwill impairment test for the quarter ended December 31, 2008. On February 24, 2009, the Company determined that it would incur a goodwill impairment charge for the fourth quarter of the fiscal year ended December 31, 2008 of \$5,312,606 in the Mutual Fund Services segment. This charge resulted from an interim test for impairment under the FASB accounting and reporting standards for goodwill and other intangible assets, prompted by a significant reduction in assets under management and ongoing volatility in the financial service industry during the fourth quarter of 2008. The Company was not required to make any current or future cash expenditures as a result of the impairment. The impairment charge was reflected in the Company's financial statements as of and for the fourth quarter and fiscal year ended December 31, 2008.

**General and Administrative Expenses**—Total general and administrative expenses for 2009 were \$1,036,490, a decrease of 8% from \$1,125,767 in 2008. The decrease was due primarily to a reduction in the distributions being paid to outside wholesalers during the time that Capital Financial Holdings, Inc. owned the mutual fund division.

**Depreciation and Amortization**—Depreciation and amortization for 2009 was \$100,369, a 13% decrease from \$115,487 in 2008. The decrease was due to the disposal of assets associated with the mutual fund division sale.

**Interest Expense**—Interest expense was \$212,552 for 2009, a 30% decrease from \$302,369 in 2008. The decrease was due primarily to a reduction in outstanding debt due to redemptions of the company's subordinated corporate notes processed on June 23rd and July 31st, totaling \$500,000, and also the company's decision to call the remaining notes, totaling \$1,500,000, processed on September 30, 2009.

## FINANCIAL CONDITION

On December 31, 2010, the Company's assets aggregated \$8,707,621, a decrease of 8% from \$9,500,728 in 2009, due to increases in cash and cash equivalents, accounts receivable, prepaids, deferred tax asset and other assets, offset by decreases in income tax receivables, long-term assets, goodwill, and net property and equipment. Stockholder's equity was \$5,457,729 on December 31, 2010, compared to \$6,494,044 on December 31, 2009.

On December 31, 2009, the Company's assets aggregated \$9,500,728, a decrease of 24% from \$12,532,431 in 2008, due to increases in income taxes receivable and long-term assets, offset by decreases in cash and cash equivalents, accounts receivable, goodwill, prepaids, net property and equipment, and other assets. Stockholders equity was

\$6,494,044 on December 31, 2009, compared to \$6,708,250 on December 31, 2008.

Cash provided by operating activities was \$204,833 for the year ended December 31, 2010, as compared to net cash used by operating activities of \$162,907 for the year ended December 31, 2009 and net cash provided by operating activities of \$739,023 for the year ended December 31, 2008.

Net cash provided by investing activities was \$211,125 for the year ended December 31, 2010, as compared to net cash provided by investing activities of \$1,424,096 for the year ended December 31, 2009 and net cash used by investing activities of \$131,326 for the year ended December 31, 2008. During the twelve months ended December 31, 2010, the cash provided by investing activities were the proceeds from the first of three installment payments received from Corridor Investors, LLC (See Note 18-Discontinued Operations), minus office and computer equipment purchased during this time frame.

Net cash used by financing activities was \$198,495 for the year ended December 31, 2010, as compared to net cash used by financing activities of \$2,132,559 for the year ended December 31, 2009, and net cash used by financing activities of \$910,839 for the year ended December 31, 2008. During the year ended December 31, 2010, the Company paid out \$91,500 in preferred stock dividends, repaid \$30,130 of bank debt and paid \$76,865 relating to the acquisition of certain assets of United Heritage Financial Services in 2007.

## **LIQUIDITY AND CAPITAL RESOURCES**

On December 31, 2010, the Company held \$2,186,201 in cash and cash equivalents, as compared to \$1,968,738 on December 31, 2009, and \$2,840,108 on December 31, 2008. Liquid assets, which consist of cash and cash equivalents, totaled \$2,186,201 at December 31, 2010, as compared to \$1,968,738 on December 31, 2009, and \$2,840,108 on December 31, 2008. The Company is required to maintain certain levels of cash and liquid securities in its broker-dealer subsidiary to meet regulatory net capital requirements.

The Company currently has no lines of credit available.

The Company has historically relied upon sales of its equity securities and debt instruments, as well as bank loans, for liquidity and growth. Management believes that the Company's existing liquid assets, along with cash flow from operations, will provide the Company with sufficient resources to meet its ordinary operating expenses during the next twelve months. Significant, unforeseen or extraordinary expenses may require the Company to seek alternative financing sources, including common or preferred share issuance or additional debt financing.

In addition to the liabilities coming due in the next twelve months, management expects that the principal needs for cash may be to acquire additional financial services firms, broker recruitment, asset acquisition opportunities for the Company's new oil and gas operations subsidiary, repurchase shares of the Company's common stock, and service debt. Management also expects to realize increases in consultant expenses as well as increased compliance and legal costs with respect to its broker dealer subsidiary related to regulatory and litigation matters.

### **Item 6. Quantitative and Qualitative Disclosures About Market Risk**

Not Applicable as a Smaller Reporting Company.

### **Item 7. Financial Statements and Supplementary Data**

The financial statements required by this item, the accompanying notes thereto, and the reports of independent registered public accounting firm are included as part of this Form 10-K immediately following the signatures page, beginning on page F-1.

**Item 8. Changes In and Disagreements with Accountants on Accounting and Financial Disclosure**

None.

**Item 8A. Controls and Procedures**

The Company's management, including the Company's Interim Chief Executive Officer and Chief Financial Officer, evaluated the effectiveness of the design and operation of the Company's disclosure controls and procedures (as defined in Rule 13a-14(c) and Rule 15c-14(c) under the Exchange Act) as of the end of the period covered by this report, pursuant to Rule 13a-15(b) of the Exchange Act. Based upon that evaluation, the Interim Chief Executive Officer and Chief Financial Officer have concluded that the Company's disclosure controls and procedures are effective as of December 31, 2010, and that information required to be disclosed by the Company in reports that it files or submits under the Exchange Act is recorded, processed and summarized, and reported within the time periods specified by the SEC's rules and forms.

Disclosure controls and procedures are the controls and other procedures that are designed to ensure that information required to be disclosed in the reports that the Company files or submits under the Exchange Act is recorded, processed, summarized and reported within the time periods specified in the SEC's rules and forms. Disclosure controls and procedures include, without limitation, controls and procedures designed to ensure that information required to be disclosed in the reports that the Company files or submits under the Exchange Act is accumulated and communicated to management, including the Interim Chief Executive Officer and Interim Chief Financial Officer, as appropriate, to allow timely decisions regarding required disclosure.

There were no significant changes in the Company's internal controls or in other factors that could significantly affect these controls subsequent to the date of their evaluation, including any corrective actions with regard to significant deficiencies or material weaknesses.

## **MANAGEMENT'S REPORT ON INTERNAL CONTROL OVER FINANCIAL REPORTING**

Management of Capital Financial Holdings, Inc. (together with its consolidated subsidiaries, the "Company"), is responsible for establishing and maintaining adequate internal control over financial reporting. The Company's internal control over financial reporting is a process designed under the supervision of the Company's principal executive and principal financial officers to provide reasonable assurance regarding the reliability of financial reporting and the preparation of the Company's financial statements for external reporting purposes in accordance with United States generally accepted accounting principles.

As of December 31, 2010, management conducted an assessment of the effectiveness of the Company's internal control over financial reporting, based on the framework established in Internal Control - Integrated Framework issued by the Committee of Sponsoring Organizations of the Treadway Commission (COSO). Based on this assessment, management has determined that the Company's internal control over financial reporting as of December 31, 2010, is effective.

The Company's internal control over financial reporting includes policies and procedures that pertain to the maintenance of records that, in reasonable detail, accurately and fairly reflect transactions and acquisitions and dispositions of assets; provide reasonable assurance that transactions are recorded as necessary to permit preparation of financial statements in accordance with United States generally accepted accounting principles, and that receipts and expenditures are being made only in accordance with authorizations of management and the directors of the Company; and provide reasonable assurance regarding prevention or timely detection of unauthorized acquisition, use or disposition of Company assets that could have a material effect on the Company's financial statements.

This annual report does not include an attestation report of the Company's registered public accounting firm regarding internal control over financial reporting. Management's report was not subject to attestation by the Company's registered public accounting firm pursuant to final rules of the Securities and Exchange Commission that permit the Company to provide only management's report in this annual report.

### **Item 8B. Other Information**

None.

## **PART III**

### **Item 9. Directors, Executive Officers and Corporate Governance**

The information required by this Item will be contained in our definitive Proxy Statement for our 2011 Annual Meeting of Shareholders and such information is incorporated herein by reference.

### **Item 10. Executive Compensation**

The information required by this Item will be contained in our definitive Proxy Statement for our 2011 Annual Meeting of Shareholders and such information is incorporated herein by reference.

### **Item 11. Security Ownership of Certain Beneficial Owners and Management and Related Stockholder Matters**

The information required by this Item will be contained in our definitive Proxy Statement for our 2011 Annual Meeting of Shareholders and such information is incorporated herein by reference.

**Item 12. Certain Relationships and Related Transactions, and Director Independence**

The information required by this Item will be contained in our definitive Proxy Statement for our 2011 Annual Meeting of Shareholders and such information is incorporated herein by reference.

**Item 13. Principal Accounting Fees and Services**

The information required by this Item will be contained in our definitive Proxy Statement for our 2011 Annual Meeting of Shareholders and such information is incorporated herein by reference.

**PART IV**

**Item 14. Exhibits**

The following exhibits are filed herewith or incorporated herein by reference as set forth below:

3.1

Restated Articles of Incorporation of the Company (incorporated by reference to Exhibit 3.1 contained in the Company's Quarterly Report on Form 10-QSB, (File No. 0-25958), filed with the Commission on November 10, 2004 and amended on June 5, 2009).

3.2

Amended Bylaws of the Company (incorporated by reference to Exhibit 3.2 contained in the Company's Quarterly Report on Form 10-QSB, as amended (File No. 0-25958), filed with the Commission on August 11, 2006).

4.1

Specimen form of Common Stock Certificate (incorporated by reference to Exhibit 4.1 contained in the Company's Registration Statement on Form S-1, as amended (File No.33-96824), filed with the Commission on September 12, 1995).

4.2

Certificate of designation of Series A Convertible Preferred Shares (incorporated by reference to Exhibit 4.1 contained in the Company's Quarterly Report on Form 10-QSB, (File No. 0-25958), filed with the Commission on November 10, 2004).

4.3

Instruments defining rights of holders of securities: (See Exhibit 3.1 & 3.2)

14.1

Code of Ethics (incorporated by reference to Exhibit 14.1 contained in the Company's Annual Report on Form 10-KSB, filed with the Commission on March 28, 2006).



21.1

Subsidiaries of the Company (incorporated by reference to Exhibit 21.1 contained in the Company's Annual Report on Form 10-KSB, filed with the Commission on March 28, 2005).

31.1

CEO Certification Pursuant to Section 302 of the Sarbanes-Oxley Act and Rules 13a-14(a) and 15d-14(a) of the Exchange Act.

31.2

CFO Certification Pursuant to Section 302 of the Sarbanes-Oxley Act and Rules 13a-14(a) and 15d-14(a) of the Exchange Act.

32.1

CEO Certification Pursuant to Section 906 of the Sarbanes-Oxley Act and 18 U.S.C. Section 1350.

32.2

CFO Certification Pursuant to Section 906 of the Sarbanes-Oxley Act and 18 U.S.C. Section 1350.

\* Indicates Management Contract or Compensatory Plan.

**SIGNATURES**

In accordance with Section 13 or 15(d) of the Exchange Act, the Registrant has caused this report to be signed on its behalf by the undersigned, thereunto duly authorized.

CAPITAL FINANCIAL HOLDINGS, INC.

Date: March 23, 2011

By /s/ Jacqueline L. Case

Jacqueline L. Case

Interim President & Executive Officer

(Principal Executive Officer)

In accordance with the Exchange Act, this report has been signed below by the following persons on behalf of the registrant and in the capacities and on the dates indicated.

Date: March 23, 2011

By /s/ Valarie A. Hoskin

Valarie A. Hoskin

Chief Financial Officer

(Principal Financial Officer)

Date: March 23, 2011

By /s/ Jeffrey A. Cummer

Jeffrey A. Cummer

Chairman

Date: March 23, 2011

By /s/ Myron D. Thompson

Myron D. Thompson

Director

Date: March 23, 2011

By /s/ Gregory G. Philipps

Gregory G. Philipps

Director

Date: March 23, 2011

By /s/ Vaune M. Cripe

Vaune M. Cripe

Director

**CAPITAL FINANCIAL HOLDINGS, INC., AND SUBSIDIARIES**

MINOT, NORTH DAKOTA

CONSOLIDATED FINANCIAL STATEMENTS

AS OF

DECEMBER 31, 2010, 2009 AND 2008

AND

REPORT OF INDEPENDENT REGISTERED PUBLIC ACCOUNTING FIRM

**CAPITAL FINANCIAL HOLDINGS, INC., AND SUBSIDIARIES**  
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**REPORT OF INDEPENDENT REGISTERED PUBLIC ACCOUNTING FIRM**

To the Stockholders and Directors of  
Capital Financial Holdings, Inc. and Subsidiaries  
Minot, North Dakota

We have audited the accompanying consolidated balance sheets of Capital Financial Holdings, Inc. and Subsidiaries as of December 31, 2010 and 2009 and the related consolidated statements of operations, stockholders' equity and cash flows for the years ended December 31, 2010, 2009 and 2008. 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 standards of the Public Company Accounting Oversight Board (United States). Those standards require that we plan and perform the audit to obtain reasonable assurance about whether the consolidated financial statements are free of material misstatement. An audit includes examining, on a test basis, evidence supporting the amounts and disclosures in the consolidated financial statements. An audit also includes assessing the accounting principles used and significant estimates made by management, as well as evaluating the overall consolidated 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 consolidated financial position of Capital Financial Holdings, Inc. and Subsidiaries as of December 31, 2010 and 2009, and the results of their consolidated operations and their consolidated cash flows for the years ended December 31, 2010, 2009 and 2008 in conformity with accounting principles generally accepted in the United States of America.

BRADY, MARTZ & ASSOCIATES, P.C.  
Minot, North Dakota USA

March 23, 2011

**CAPITAL FINANCIAL HOLDINGS, INC., AND SUBSIDIARIES**  
**CONSOLIDATED BALANCE SHEETS**  
**DECEMBER 31, 2010 AND 2009**

**ASSETS**

2010

2009

**CURRENT ASSETS**

Cash and cash equivalents

\$

1,973,938

\$

1,968,738

Accounts receivable (net of allowance for doubtful  
accounts of \$24,000 for 2010 and 2009)

1,432,575

1,242,630

Income taxes receivable

57,900

173,502

Deferred tax asset - current

68,683

45,032

Current portion of long-term receivable

211,969

254,247

Prepays

38,809

27,849

Total current assets

\$

3,783,874

\$

3,711,998

**LONG-TERM ASSETS**

LT receivable-MF Division Sale

\$

423,938

\$

762,740

Less: current portion shown above

(211,969)

(254,247)

Total long-term assets

\$

211,969

\$

508,493

**PROPERTY AND EQUIPMENT**

\$

1,727,320

\$

1,711,245

Less accumulated depreciation

(606,753)

(536,395)

Net property and equipment

\$

1,120,567

\$

1,174,850

**OTHER ASSETS**

Goodwill

\$

2,574,413

\$

3,431,641

Severance escrow

212,263

-

Deferred tax asset - non-current

579,084

474,755

Other assets (net of accumulated amortization

225,451

198,991

of \$214,444 for 2010 and \$209,422 for 2009)

Total other assets

\$

3,591,211

\$

4,105,387



**TOTAL ASSETS**

\$

8,707,621

\$

9,500,728

SEE NOTES TO THE CONSOLIDATED FINANCIAL STATEMENTS

CONSOLIDATED BALANCE SHEETS (CONTINUED)

**LIABILITIES AND STOCKHOLDERS' EQUITY**

2010

2009

**CURRENT LIABILITIES**

Accounts payable

\$

331,895

\$

103,726

Commissions payable

1,298,078

1,115,134

Other current liabilities

147,532

54,765

Current portion of long-term debt

229,522

278,117

Total current liabilities

\$

2,007,027

\$

1,551,742

**LONG-TERM LIABILITIES**

Note payable

\$

277,772

\$

307,902

Convertible promissory note

950,000

950,000

Other long-term liabilities

244,615

475,157

Less current portion of long-term debt

(229,522)

(278,117)

Total long-term liabilities

\$

1,242,865

\$

1,454,942

**TOTAL LIABILITIES**

\$

3,249,892

\$

3,006,684

**STOCKHOLDERS' EQUITY**

Series A Preferred stock - 5,000,000 shares authorized, \$.0001 par value;

\$

305

\$

305

3,050,000 and 3,050,000 shares issued and outstanding, respectively

Additional paid in capital - series A preferred stock

1,524,695

1,524,695

Common stock - 1,000,000,000 shares authorized, \$.0001 par value;

1,446

1,446

14,455,943 and 14,455,943 shares issued and outstanding, respectively

Additional paid in capital - common stock

10,446,302

10,396,335

Accumulated deficit

(6,515,019)

(5,428,737)

**TOTAL STOCKHOLDERS' EQUITY**

\$

5,457,729

\$

6,494,044

**TOTAL LIABILITIES AND STOCKHOLDERS' EQUITY**

\$

8,707,621

\$

9,500,728

SEE NOTES TO THE CONSOLIDATED FINANCIAL STATEMENTS



**CAPITAL FINANCIAL HOLDINGS, INC., AND SUBSIDIARIES**  
**CONSOLIDATED STATEMENTS OF OPERATIONS**  
**FOR THE YEARS ENDED DECEMBER 31, 2010, 2009 AND 2008**

2010

2009

2008

**OPERATING REVENUES**

Fee income

\$

975,010

\$

1,062,492

\$

1,551,245

Commission income

17,746,472

16,096,513

25,869,214

Other income

670,325

743,769

975,877

Total revenue

\$

19,391,807

\$

17,902,774

\$

28,396,336

**OPERATING EXPENSES**

Compensation and benefits

\$

1,350,094

\$

1,786,179

\$

2,089,297

Commission expense

16,566,033

15,223,613

24,390,850

Goodwill impairment expense

753,518

-

-

General and administrative expenses

1,423,353

1,036,490

1,125,767

Geophysical & geological costs

66,310

-

-

Depreciation and amortization

75,381

100,369

115,487

Total operating expenses

\$

20,234,689

\$

18,146,651

\$

27,721,401

**OPERATING INCOME (LOSS)**

\$

(842,882)

\$

(243,877)

\$

674,935

**OTHER EXPENSES**

Loss on investment

\$

-

\$

(31,876)

\$

-

Interest expense

(80,880)

(212,552)

(302,369)

Net other expenses

\$

(80,880)

\$

(244,428)

\$

(302,369)

**INCOME (LOSS) OF CONTINUING OPERATIONS BEFORE INCOME TAX BENEFIT (EXPENSE)**

\$

(923,762)

\$

(488,305)

\$

372,566

**INCOME TAX BENEFIT (EXPENSE)**

40,581

191,416

(146,046)

**NET INCOME (LOSS) BEFORE DISCONTINUED OPERATIONS**

\$

(883,181)

\$

(296,889)



\$

226,520

**DISCONTINUED OPERATIONS**

Income (Loss) from operation of discontinued mutual fund segment (net of tax)

\$

-

\$

(125,211)

\$

1,576,389

Goodwill impairment expense

-

-

(5,312,606)

Gain (Loss) on disposal of mutual fund segment

(111,601)

228,402

-

Total discontinued operations (net of tax)

\$

(111,601)

\$

103,191

\$

(3,736,217)

**NET LOSS**

\$

(994,782)

\$

(193,698)

\$

(3,509,697)

SEE NOTES TO THE CONSOLIDATED FINANCIAL STATEMENTS

CONSOLIDATED STATEMENTS OF OPERATIONS (CONTINUED)

**NET INCOME (LOSS) OF CONTINUING OPERATIONS PER COMMON SHARE:**

Basic

\$

(.07)

\$

(.03)

\$

.01

Diluted

\$

(.07)

\$

(.03)

\$

.01

**SHARES USED IN COMPUTING NET INCOME (LOSS) OF CONTINUING OPERATIONS PER COMMON SHARE:**

Basic

14,638,937

14,541,585

14,519,372

Diluted

14,638,937

14,541,585

17,587,107

**NET INCOME (LOSS) OF DISCONTINUED OPERATIONS PER COMMON SHARE:**

Basic

\$

(.01)

\$

.00

\$

(.26)

Diluted

\$

(.01)

\$

.01

\$

(.26)

**SHARES USED IN COMPUTING NET INCOME (LOSS) OF DISCONTINUED OPERATIONS PER  
COMMON SHARE:**

Basic

14,638,937

14,541,585

14,519,372

Diluted

14,638,937

17,591,585

14,519,372

**NET LOSS PER COMMON SHARE:**



Basic

\$

(.07)

\$

(.02)

\$

(.25)

Diluted

\$

(.07)

\$

(.02)

\$

(.25)

**SHARES USED IN COMPUTING NET LOSS PER COMMON SHARE:**

Basic

14,638,937

14,541,585

14,519,372

Diluted

14,638,937

14,541,585

14,519,372

SEE NOTES TO THE CONSOLIDATED FINANCIAL STATEMENTS

**CAPITAL FINANCIAL HOLDINGS, INC., AND SUBSIDIARIES**  
CONSOLIDATED STATEMENTS OF STOCKHOLDERS' EQUITY  
FOR THE YEARS ENDED DECEMBER 31, 2010, 2009 AND 2008

Amounts

Shares

2010

2009

2008

2010

2009

2008

**Preferred stock and additional paid-in capital**

Balance, beginning of year

\$

1,525,000

\$

1,525,000

\$

1,525,000

3,050,000

3,050,000

3,050,000

Preferred stock issued

-

-

-

-  
-  
-

Balance, end of year

\$

1,525,000

\$

1,525,000

\$

1,525,000

3,050,000

3,050,000

3,050,000

**Common stock and additional paid-in capital**

Balance, beginning of year

\$

10,397,780

\$

10,375,474

\$

10,286,346

14,455,943

14,455,943

14,455,943

Common stock issued

49,968

57,097

90,000

-

-

-

Purchase of common stock

-

(34,791)

(872)

-

-

-

Balance, end of year

\$

10,447,748

\$

10,397,780

\$

10,375,474

14,455,943

14,455,943

14,455,943



**Accumulated deficit**

Balance, beginning of year

\$

(5,428,737)

\$

(5,143,539)

\$

(1,542,342)

Net loss

(994,782)

(193,698)

(3,509,697)

Preferred dividends

(91,500)

(91,500)

(91,500)

Balance, end of year

\$

(6,515,019)

\$

(5,428,737)

\$

(5,143,539)

**ESOP activity**

Balance, beginning of year

\$

-

\$

(48,685)

\$

(55,379)

Repayments from ESOP

-

48,685

6,694

Balance, end of year

\$

-

\$

-

\$

(48,685)

**Total stockholders' equity**

\$

5,457,729

\$

6,494,044

\$

6,708,250

SEE NOTES TO THE CONSOLIDATED FINANCIAL STATEMENTS

**CAPITAL FINANCIAL HOLDINGS, INC., AND SUBSIDIARIES**  
**CONSOLIDATED STATEMENTS OF CASH FLOWS**  
**FOR THE YEARS ENDED DECEMBER 31, 2010, 2009 AND 2008**

2010

2009

2008

**CASH FLOWS FROM OPERATING ACTIVITIES**

Net loss

\$

(994,782)

\$

(193,698)



\$

(3,509,697)

Adjustments to reconcile net loss to net cash provided (used) by operating activities:

Depreciation

70,357

85,302

115,488

Amortization

5,022

15,067

-

Goodwill impairment expense

753,518

-

5,312,606

Loss on investment

-

31,876

-

Sales commissions amortized

-

-

151,693

Gain on allocation of ESOP shares

-

(34,791)

-

(Gain) Loss on disposal of discontinued operations

111,601

(228,402)

-

Loss on disposal of assets

-

67,860

-

Effects on operating cash flows due to changes in:

Accounts receivable

(189,945)

316,543

632,453

Income taxes receivable

115,602

(145,321)

(28,181)

Prepays

(10,960)

46,975

(5,057)

Deferred sales commissions capitalized, net of CDSC collected

-

-

13,433

Deferred tax asset

(127,979)

405,541

(840,426)

Other assets

(31,482)

31,657

(587)

Commissions Payable

182,944

(98,056)

(695,308)

Accounts payable

228,169

(266,772)

(340,747)

Income taxes payable

-

-

(20,512)

Other liabilities

92,768

(196,688)

(46,135)

Net cash provided (used) by operating activities

\$

204,833

\$

(162,907)

\$

739,023

**CASH FLOWS FROM INVESTING ACTIVITIES**

Purchase of investment

\$

-

\$

(76,876)

\$



-

Purchase of property and equipment

(16,075)

(24,508)

(131,326)

Proceeds on sale of mutual fund division

-

1,525,480

-

Long-term receivable

227,200

-

-

Net cash provided (used) by investing activities

\$

211,125

\$

1,424,096

\$

(131,326)

SEE NOTES TO THE CONSOLIDATED FINANCIAL STATEMENTS

CONSOLIDATED STATEMENTS OF CASH FLOWS (CONTINUED)

2010

2009

2008

**CASH FLOWS FROM FINANCING ACTIVITIES**

Repayments from ESOP

\$

-

\$

48,685

\$

6,694

Redemption of common stock

-

-

(872)

Reduction of long-term liability

(76,865)

(63,450)

(129,872)

Reduction of short-term borrowing

-

-

(110,085)

Dividends paid

(91,500)

(91,500)

(91,500)

Reduction of notes payable

(30,130)

(26,294)

(24,204)

Redemption of commercial notes

-

-

(561,000)

Reduction of subordinate corporate notes

-

(2,000,000)

-

Net cash used by financing activities

\$

(198,495)

\$

(2,132,559)

\$

(910,839)

**NET INCREASE (DECREASE) IN CASH AND CASH EQUIVALENTS**

\$

217,463

\$

(871,370)

\$

(303,142)

**CASH AND CASH EQUIVALENTS AT BEGINNING OF YEAR**

1,968,738

2,840,108

3,143,250

**CASH AND CASH EQUIVALENTS AT END OF YEAR**

\$

2,186,201

\$

1,968,738

\$

2,840,108

**SUPPLEMENTARY DISCLOSURE OF CASH FLOW INFORMATION**

Cash paid during the year for:

Interest

\$

80,880

\$

382,135

\$

327,951

Income taxes

\$

31,929

\$

276,768

\$

510,349



**RECONCILIATION OF CASH AND CASH EQUIVALENTS**

Cash

\$

1,973,938

\$

1,986,738

\$

2,840,108

Severance escrow

212,263

-

-

Net Cash

\$

2,186,201

\$

1,986,738

\$

2,840,108

**SUPPLEMENTAL SCHEDULE OF NONCASH INVESTING AND FINANCING ACTIVITIES**

Increase in long-term receivable

\$

-

\$

762,740

\$

-

Decrease in goodwill

\$

103,710

\$

109,140

\$

59,161

Decrease in other long-term liabilities

\$

153,677

\$

166,237

\$

149,161

Increase in common stock

\$

49,967

\$

57,097

\$

90,000

Preferred stock dividends declared

\$

22,875

\$

22,875

\$

22,875

Goodwill impairment expense

\$

753,518

\$

-

\$

5,312,606

SEE NOTES TO THE CONSOLIDATED FINANCIAL STATEMENTS

**CAPITAL FINANCIAL HOLDINGS, INC., AND SUBSIDIARIES**

NOTES TO CONSOLIDATED FINANCIAL STATEMENTS

DECEMBER 31, 2010, 2009 AND 2008

**NOTE 1—NATURE OF OPERATIONS AND SIGNIFICANT ACCOUNTING POLICIES**

The nature of operations and significant accounting policies of Capital Financial Holdings, Inc., (formerly known as Integrity Mutual Funds, Inc.) and its Subsidiaries are presented to assist in understanding the Company's consolidated financial statements.

**Nature of operations**—Capital Financial Holdings, Inc., and its Subsidiaries (the "Company") was established in September 1987 as a North Dakota corporation. The Company derives its revenue from investment advisory fees as well as commissions earned from sales of mutual funds, insurance products, and various other securities through its Subsidiary Capital Financial Services, Inc. Headquartered in Minot, North Dakota, the Company is marketing its services throughout the United States.

**Principles of consolidation**—The consolidated financial statements include the accounts of Capital Financial Holdings, Inc., and its wholly owned subsidiaries Capital Financial Services, Inc. ("CFS") and Capital Energy Resources, Inc. ("CER"). All significant inter-company transactions and balances have been eliminated in the accompanying consolidated financial statements.

**Concentrations**—Capital Financial Holdings, Inc. derives the majority of its revenues and net income from sales of mutual funds, insurance products, and various other securities through CFS, the Company's broker-dealer subsidiary. The company's revenues are largely dependent on the sales activity of registered representatives operating as independent contractors. Accordingly, fluctuations in financial markets and the composition of assets under management impact revenues and results of operations.

**Accounting Principles**—The company has elected to use the Successful Efforts accounting method for the oil & gas division. Under this method, all expenses related to Geological & Geophysical operations are fully expensed on the income statement of the company, and all Acquisition costs, i.e. lease costs, are capitalized on the company's balance sheet.

**Use of estimates**—The preparation of consolidated financial statements in conformity with accounting principles generally accepted in the United States of America requires management to make estimates and assumptions that affect the reported amounts of assets and liabilities and disclosure of contingent assets and liabilities at the date of the consolidated financial statements and the reported amounts of revenues and expenses during the reporting period. Actual results could differ from those estimates.

**Revenue recognition**—Commission income and the related clearing expenses are recorded on a trade-date basis as securities transactions occur. The revenue earned from 12b-1 and advisory fees is recognized in the period earned.

**Stock-based compensation**—In December of 2005, the Company adopted the Financial Accounting Standards Board ("FASB") accounting and reporting standards for share-based payment which requires the measurement and recognition of compensation expense for all share-based payment awards made to employees and directors, including employee stock options, based on estimated fair values.

**Cash and cash equivalents**—The Company's policy is to record all liquid investments with original maturities of three months or less as cash equivalents. Liquid investments with maturities greater than three months are recorded as investments.

**Clearing Deposits**—The Company has "Deposit Accounts" with each of its Clearing Firms, as set forth in each of the Clearing Agreements. Upon termination or expiration of these agreements, the Clearing Firms would deliver the balance of these accounts to the Company.

**Accounts receivable**—The Company's receivables consist primarily of concessions related to registered representative activity. Management evaluates the need for an allowance for doubtful accounts by identifying troubled accounts and using historical experience. Accounts receivable are written off when management deems them uncollectible. Recoveries of accounts receivable previously written off are recorded when received. The Company does not charge interest on its receivables.

**Goodwill**—The Company accounts for goodwill under the FASB accounting and reporting standards for goodwill and other intangible assets, which requires that goodwill and indefinite-lived other intangible assets deemed to have an indefinite useful life be assessed annually for impairment using fair value measurement techniques.

**Property and equipment**—Property and equipment is stated at cost less accumulated depreciation computed on straight-line and accelerated methods over estimated useful lives as follows:

Equipment

5-7 years

Building

40 years

**Other assets**—Other assets include debt issue costs and other miscellaneous assets. Debt issue costs are amortized over the life of the corresponding debt.

**Advertising**—Costs of advertising and promotion are expensed as incurred. Advertising and promotion costs aggregated \$11,252 in 2010, \$27,903 in 2009 and \$116,303 in 2008.

**Earnings per common share**—Basic earnings per common share was computed using the weighted average number of shares outstanding of 14,638,937 in 2010, in 14,541,585 2009 and 14,519,372 in 2008. Diluted earnings per common share is computed using the weighted average number of shares outstanding adjusted for share equivalents arising from unexercised stock warrants, stock options, and written put options. The weighted average shares outstanding used in computing diluted earnings per common share were 14,638,937 in 2010, in 14,541,585 2009 and 14,519,372 in 2008.

**Income taxes**—The Company files a consolidated income tax return with its wholly owned subsidiaries. The amount of deferred tax benefit or expense is recognized as of the date of the consolidated financial statements, utilizing currently enacted tax laws and rates. Deferred tax benefits or expenses are recognized in the financial statements for the changes in deferred tax assets between years. The Company's policy is to evaluate the likelihood that its uncertain tax positions will prevail upon examination based on the extent to which those positions have substantial support within the Internal Revenue Code and Regulations, Revenue Rulings, court decisions, and other evidence. It is the opinion of management that the Company has no significant uncertain tax positions that would be subject to change upon examination. The federal income tax returns of the Company are subject to examination by the IRS, generally for three years after they were filed.

**Severance Escrow**—The Company has put into place a contingent Severance Benefit Package for its employees. The package has an expiration date of August 1, 2011. The funds for this package have been placed into an account specifically designated for these funds.

**Reclassification**—Certain amounts from 2009 and 2008 have been reclassified to conform to the 2010 presentation. These reclassifications had no effect on the Company's net income.

**Recent Accounting Developments**—In July 2009, the FASB launched the FASB Accounting Standards Codification (the Codification) as the single source of Generally Accepted Accounting Principals ("GAAP"). While the Codification did not change GAAP, it introduced a new structure to the accounting literature and changed references to accounting standards and other authoritative accounting guidance. The Codification was effective for the firm for the third quarter of fiscal 2009 and did not have an effect on the Company's financial condition, results of operations or cash flows.

In December 2007, the FASB issued amended accounting principles related to business combinations, which changed the accounting for transaction costs, certain contingent assets and liabilities, and other balances in a business combination. In addition, in partial acquisitions, when control is obtained, the amended principles require that the acquiring company measure and record all of the target's assets and liabilities, including goodwill, at fair value as if the entire target company had been acquired. These amended accounting principles applied to the Company's business combinations beginning in the first quarter of fiscal 2009. Adoption did not affect the Company's financial condition, results of operations or cash flows, but may have an effect on accounting for future business combinations.

In December 2007, the FASB issued amended accounting principles related to noncontrolling interests in consolidated financial statements, which require that ownership interests in consolidated subsidiaries held by parties other than the parent (i.e., noncontrolling interests) be accounted for and presented as equity, rather than as a liability or mezzanine equity. These amended accounting principles were effective for the Company's financials beginning in the first quarter of the 2009 fiscal year. Adoption did not have a material effect on the Company's financial condition, results of operations or cash flows.

In June 2008, the FASB issued amended accounting principles related to determining whether an instrument (or embedded feature) is indexed to an entity's own stock. These amended accounting principles provide guidance about whether an instrument (such as the Company's outstanding common stock warrants) should be classified as equity and not subsequently recorded at fair value. The Company adopted these amended accounting principles in the first quarter of the 2009 fiscal year. Adoption did not affect the Company's financial condition, results of operations or cash flows.

In April 2009, the FASB issued amended accounting principles related to recognition and presentation of other-than-temporary impairments. These amended principles prescribe that only the portion of an other-than-temporary impairment on a debt security related to credit loss is recognized in current period earnings, with the remainder recognized in other comprehensive income, if the holder does not intend to sell the security and it is more likely than not that the holder will not be required to sell the security prior to recovery. Previously, the entire other-than-temporary impairment was recognized in current period earnings. The Company adopted these amended accounting principles in the second quarter of the 2009 fiscal year. Adoption did not have a material effect on the Company's financial condition, results of operations or cash flows.

In January 2010, the FASB issued ASU No. 2010-06, "Fair Value Measurements and Disclosures (Topic 820) — Improving Disclosures about Fair Value Measurements." ASU No. 2010-06 provides amended disclosure requirements related to fair value measurements. ASU No. 2010-06 is effective for financial statements issued for reporting periods beginning after December 15, 2009 for certain disclosures and for reporting periods beginning after December 15, 2010 for other disclosures. Since these amended principles require only additional disclosures concerning fair value measurements, adoption did not affect the Company's financial condition, results of operations or cash flows.

In December 2008, the SEC issued a final rule, "Modernization of Oil and Gas Reporting." This rule revised some of the oil and gas reporting disclosures in Regulation S-K and Regulation S-X under the Securities Act and the Securities

Exchange Act of 1934, as amended (the "Exchange Act"), as well as Industry Guide 2. Effective December 31, 2009, the Financial Accounting Standards Board ("FASB") issued revised guidance that substantially aligned the oil and gas accounting disclosures with the SEC's final rule. The amendments were designed to modernize and update oil and gas disclosure requirements to align them with current practices and changes in technology. Additionally, this new accounting standard requires that entities use 12-month average natural gas and oil prices when calculating the quantities of proved reserves and performing the full-cost ceiling test calculation. The new standard also clarified that an entity's equity-method investments must be considered in determining whether it has significant oil and gas activities. The disclosure requirements were effective for registration statements filed on or after January 1, 2010 and for annual financial statements filed on or after December 31, 2009; however, the FASB provided a one-year deferral of the disclosure requirements if an entity became subject to the requirements because of a change to the definition of significant oil and gas activities. We have incurred acquisition costs and geological and geophysical costs during the twelve month period ended December 31, 2010, under our wholly owned subsidiary, CER.

**NOTE 2—CASH AND CASH EQUIVALENTS**

Cash and cash equivalents at December 31, 2010 and 2009 consist of the following:

Current Maturity

Current Interest Rate

Amount

2010

2009

Cash in checking

Demand

-

\$



1,006,858

\$

852,483

Cash in escrow

Demand

0.21%

212,263

-

Cash in savings

Demand

0.70%

967,080

1,116,255

\$

2,186,201

\$

1,968,738

**NOTE 3—PROPERTY AND EQUIPMENT**

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Property and equipment at December 31, 2010 and 2009, consists of the following:

2010

2009

Office furniture and equipment

\$

314,615

\$

301,631

Building and land

1,412,705

1,409,614

\$

1,727,320

\$

1,711,245

Accumulated depreciation and amortization

(606,753)

(536,395)

\$

1,120,567

\$

1,174,850

Depreciation expense totaled \$75,381, \$85,302 and \$98,667 in 2010, 2009 and 2008, respectively.

#### NOTE 4—BUSINESS ACQUISITIONS

##### **Purchase Combinations—**

On April 22, 2005, the Company acquired the management rights to the IPS Millennium Fund and the IPS New Frontier Fund from IPS Advisory, Inc. ("IPS Advisory"), and merged them into a new Integrity Fund called the Integrity Growth & Income Fund. The two funds had combined assets of approximately \$57 million at the time of acquisition. The purchase agreement called for total consideration of approximately 656,000 common shares of the Company. The Company provided IPS Advisory with 250,000 common shares upon closing. The remaining consideration of approximately 406,000 common shares, which was subject to adjustment based on retention of assets in the fund, was to be issued as follows: 203,000 common shares at the one-year anniversary of the closing date, and 203,000 common shares at the two-year anniversary of the closing date. The shares are subject to a put option, which allows the holders of the shares to put them back to the Company at a price equal to the market price of the Company's shares as of the closing date, which was \$.36 per share. The put option is exercisable with respect to one-third of the shares per year starting on the third anniversary of the closing date. The Company will also provide IPS Advisory with a stock option incentive bonus based on growth in assets in the Fund based on the following schedule: 150,000 options on the Company's common shares if assets of the Fund reach \$100 million and 150,000 options on the Company's common shares if the assets of the Fund reach \$200 million. The options will have a strike price of \$.65 per share and mature 10 years from the closing date. The securities issued in connection with this transaction were issued on a private placement basis. In April of 2006, the one-year anniversary payment of 158,603 common shares was made, which reflected the assets of the acquired funds at the one-year anniversary. In June of 2007, the two-year anniversary payment of 138,797 common shares was made, which reflected the assets of the acquired funds at the two-year anniversary. In April 2010 the put option mentioned above expired, which resulted in the liability of this acquisition to be reduced to \$0.

On March 7, 2007, the Company acquired certain assets of United Heritage Financial Services, Inc. (UHFS), a wholly owned subsidiary of United Heritage Financial Group, Inc., of Meridian, Idaho. UHFS had approximately 120 independent registered representatives who became part of Capital Financial Services, Inc. (CFS), the retail brokerage division of the Company. Pursuant to the agreement, in exchange for receipt of the assets of UHFS set forth above, the Company agreed to issue 500,000 restricted CFH shares and pay a deferred cash earn out payment totaling a maximum of \$900,000, to be paid in 21 quarterly installments. On March 7, 2007, the Company issued 500,000 restricted common shares to UHFS. As a result of this issuance of shares, \$175,000 was recorded by the Company as goodwill relating to the purchase of the assets. As of December 31, 2010, the Company had made fifteen quarterly

installment payments totaling \$330,736. The liability relating to this acquisition is valued at approximately \$244,615 as of December 31, 2010, and has also been recorded by the Company as goodwill. Due to the goodwill impairment charge that was recorded (see Note 12-Goodwill), as of December 31, 2010, the total goodwill recorded relating to this acquisition was \$656,906.

**NOTE 5—LONG-TERM DEBT**

Long-term debt at December 31, 2010 and 2009 was as follows:

Current Portion

Rate

2010

2009

Long-term debt:

First Western Bank

6.50%

\$

32,032

\$

277,772

\$

307,902

Convertible promissory note

6.50%

-

950,000

950,000

Future payments on acquisitions

197,490

244,615

475,157

Totals

\$

229,522

\$

1,472,387

\$

1,733,059

Summaries of the terms of the current long-term debt agreements follow:

**First Western Bank**—In June of 1999, the Company converted its outstanding balance of \$500,000 borrowed on its bank line-of-credit to long-term debt. The debt was refinanced in September of 2009 and currently carries an interest rate of 6.50%, with monthly payments of \$4,105. On October 1, 2014, the remaining balance will be due in full.

**Subordinate Commercial Notes**—The Company approved a \$1 million intra-state subordinate commercial note offering limiting the sale in North Dakota, to North Dakota residents only. The subordinate commercial notes did not represent ownership in the Company. The subordinate commercial notes carried an interest rate of 9% per annum, payable semi-annually. On June 30, 2008, the subordinate commercial notes matured and the liability was paid in full.

**Subordinate Corporate Notes**—The Company approved a \$2 million intra-state subordinate corporate note offering limiting the sale in North Dakota, to North Dakota residents only. The subordinate corporate notes did not represent ownership in the Company. On June 23, 2009 and July 30, 2009 redemptions were processed, totaling \$200,000 and \$300,000 respectively. On September 30, 2009 the Company elected pursuant to the terms of its Corporate Note

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obligations to call and prepay its remaining \$1,500,000 Corporate Note obligation. This amount consists of all of outstanding Corporate Notes originally due January 1, 2011. By prepaying the Corporate Notes from available cash, the current asset position of the Company was reduced by \$1,591,613 and the Corporate Note liability of the same amount was eliminated. There was no prepayment charge or other cost to the Company associated with the prepayment.

**Convertible Promissory Note**—In October of 2006, the Company issued a \$950,000 convertible promissory note to PawnMart, Inc., in a private placement. The unsecured note carries an interest rate of 6.5% per annum, payable semi-annually, and matures on October 15, 2016. The holder of the note has the right, at any time after October 15, 2009, to convert the note in whole or in part, into \$0.0001 par value common shares of the Company. The conversion price shall be equal to \$0.50 per share. The entire principal amount of this note shall be automatically converted into common shares at the conversion price on October 15, 2016.

The aggregate amount of required future payments on the above long-term debt at December 31, 2010, is as follows:

Year ending December 31,

2011

\$

229,522

2012

139,865

2013

153,000

Thereafter

950,000

Total due

\$

**NOTE 6—INCOME TAXES**

The provision for income taxes is based on earnings before income taxes reported for financial statement purposes and consisted of the following:

2010

2009

2008

Current income tax benefit (expense):

Federal

\$

-

\$

-

\$

(329,803)

State



(17,358)

(13,096)

(86,812)

Total current tax benefit (expense)

\$

(17,358)

\$

(13,096)

\$

(416,615)

Deferred tax benefit (expense):

Federal

\$

51,334

\$

181,198

\$

239,724

State

6,605

23,314

30,845

Total deferred tax benefit (expense)

\$

57,939

\$

204,512

\$

270,569

Total provision for income tax

benefit (expense)

\$

40,581

\$

191,416

\$

(146,046)

Deferred taxes arise because of different tax treatment between financial statement accounting and tax accounting, known as "temporary differences." The Company records the tax effect of these temporary differences as "deferred tax assets" (generally items that can be used as a tax deduction or credit in future periods) and "deferred tax liabilities" (generally items for which the Company has received a tax deduction and has not yet been recorded in the consolidated statement of operations).

Deferred tax assets (liabilities) were comprised of the following:

2010

2009

2008

Deferred tax asset:

Net operating and capital loss carry forwards

\$

68,687

\$

52,139

\$

20,767

Goodwill impairment adjustment

75,371

-

995,920

Stock option compensation

583,374

583,374

583,374

Total deferred tax assets

\$

727,432

\$

635,513

\$

1,600,061

Deferred tax liabilities:

Accumulated depreciation

\$

25,723

\$

37,502

\$

74,545

Accumulated amortization

53,942

78,224

540,371

Total deferred tax liabilities

\$

79,665

\$

115,726

\$

614,916

Net deferred tax asset

\$

647,767

\$

519,787

\$

985,145

Net deferred tax asset - current

\$

68,683

\$

45,032

\$

-

Net deferred tax asset - non-current

579,084

474,755

985,145

Net deferred tax asset

\$

647,767

\$

519,787

\$

985,145

A reconciliation of the difference between the expected income tax benefit (expense) computed at the U.S. statutory income tax rate of 35% and the Company's income tax expense is shown in the following table:

2010

2009

2008

Federal tax benefit (expense) at statutory rates

\$

323,317

35%

\$

(105,000)

(35%)

\$

1,360,000

35%



State tax benefit (expense), net of federal tax effect

46,188

5%

(15,000)

(5%)

194,000

5%

Tax impact of goodwill impairment expense

(293,872)

(32%)

-

-

(1,086,621)

(28%)

Net tax impact of discontinued operations

-

-

311,416

104%

(522,816)

(14%)

Other

(35,052)

(4%)

-

-

(90,609)

(2%)

Actual tax benefit (expense)

\$

40,581

4%

\$

191,416

64%

\$

(146,046)

(4%)

Included in "other" are amounts separately allocated to stockholder's equity to recognize the related tax effect of the change in net unrealized gain or loss on securities available for sale, ESOP plan activity, and effects of stock-based employee compensation and other adjustments for the years ended December 31, 2010, 2009 and 2008.

The Company has an estimated net operating loss carryover of approximately \$200,000 that will expire, if unused, in 2030.

#### **NOTE 7—STOCK WARRANTS, STOCK SPLITS, AND STOCK OPTIONS**

The Company has authorized 2,100,000 perpetual warrants to certain organizers, directors, officers, employees and shareholders of the Company. All of these warrants were issued between 1987 and 1990 and were accounted for in accordance with the provisions of Accounting Principles Board ("APB") Opinion No. 25, Accounting for Stock Issued to Employees. No compensation expense was recorded for these warrants as the exercise price exceeded the market price of the stock at the date of issue. The Company plans to continue to apply APB Opinion No. 25 in accounting for these warrants. These warrants, at the date of issue, allowed for the purchase of shares of stock at \$2.00 per share. The exercise prices of these warrants were adjusted to reflect stock splits of 2 for 1 in 2002, and 11 for 10 in 1990 and 1989. 2,000 warrants (adjusted for the 2 for 1 stock split in 2002) were exercised in 1997, leaving an outstanding balance of 2,098,000 warrants as of December 31, 2010.

In addition to the warrants discussed above, the Company has also issued warrants to purchase 600,000 common shares in March of 2004 at an exercise price of \$.60 per share. These options are considered to be fully vested and have a contractual expiration date of September 1, 2010. 100,000 warrants were exercised in 2007, leaving an outstanding balance of 500,000 warrants as of December 31, 2010.

The Company had entered into employment agreements with past employees of the Company. Upon execution of these employment agreements, a one-time granting of stock options took effect. These options are fully vested and have a perpetual life. Each employment contract stated the strike price for which options were granted. In addition, the contracts granted options when the employees reach specified performance goals.

The Company has also issued options to directors as well as various other employees and past employees. The options granted to employees were granted in connection with reaching certain performance goals. These options are considered to be fully vested and have a contractual life of ten years.

As part of the acquisition of Capital Financial Services, Inc., 500,000 options were granted in January of 2002 at a strike price of \$.50. These options are fully vested and expire ten years from the acquisition date.

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The Company plans to issue additional common shares if any of its outstanding options are exercised. There have been no options exercised to date.

In December of 2005, the Company adopted the FASB accounting and standards for fair value recognition provisions for stock-based employee compensation. There were no compensation costs or deferred tax benefits recognized for stock-based compensation awards for the twelve months ended December 31, 2010.

Option activity for the last three years was as follows:

Number of Options

Weighted Average Exercise Price per Share

Weighted Average Grant Date Fair Value

Aggregate Intrinsic Value

Outstanding on January 1, 2008

5,888,113

\$

.54

\$

.28

\$

1,081,950

Granted

-

-

-

Exercised

-

-

-

Canceled

-

-

-

Outstanding on December 31, 2008

5,888,113

\$

.54

\$

.28

\$

-

Granted

-

-

-

Exercised

-

-

-

Canceled

-

-

-

Outstanding on December 31, 2009

5,888,113

\$

.54

\$

.28

\$

-

Granted

-

-

-

Exercised

-

-

-

Canceled

-

-

-

Outstanding on December 31, 2010

5,888,113

\$

.54

\$

.28

\$

-

Exercisable options at the end of 2010, 2009, and 2008 were 5,888,113, respectively. The following table summarizes information concerning options outstanding and exercisable as of December 31, 2010:

Range of Exercise Prices

Number Outstanding

Weighted Average Remaining Contractual Life (Years)

Weighted Average Exercise Price



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Number Exercisable

Weighted Average Exercise Price

\$ .00 to \$ .49

1,380,000

Perpetual

\$

.42

1,380,000

\$

.42

\$ .50 to \$ .99

3,935,000

6\*

\$

.52

3,935,000

\$

.52

\$1.00 to \$1.50

573,113

3\*

\$

1.01

573,113

\$

1.01

\$ .00 to \$ 1.50

5,888,113

4.5\*

\$

.54

5,888,113

\$

.54

\* Excludes options with a perpetual life

#### **NOTE 8—EMPLOYEE BENEFIT PLANS**

The Company sponsors a 401(K) plan for all its employees. Effective January 1, 2005, the Company implemented a match of up to 4% of employee deferrals. Plan expenses paid for by the Company were \$4,937, \$10,639, and \$11,807 for the years ended December 31, 2010, 2009, and 2008, respectively. The matching contributions paid by the Company were \$40,629, \$77,820 and \$105,669 for the years ended December 31, 2010, 2009 and 2008, respectively.

The Company established an employee stock ownership plan ("ESOP") effective January 1, 1999. Pursuant to the ESOP, each year the Company would determine the amount to contribute to the plan. Contributions were made at the discretion of the Board of Directors. To be eligible to participate in the plan, an employee must have had completed one year of service and have attained age 21. The ESOP plan was closed by the company, effective December 31, 2009, and the shares have been issued to each plan member.

During 2001, the ESOP purchased 208,000 shares of the Company's common stock, at a weighted average price of \$.48 per share. The purchase was funded with a loan of \$100,000 from the Company, which was collateralized by the unallocated Company shares owned by the ESOP. As of December 31, 2009 this loan had been paid in full and all shares purchased by this loan had been allocated to employees.

Total ESOP contribution expense recognized was \$0, \$18,231 and \$8,813 for the years ended December 31, 2010, 2009, and 2008, respectively.

#### **NOTE 9—NET CAPITAL REQUIREMENTS**

The Company's broker-dealer subsidiary Capital Financial Services, Inc. is a member firm of the Financial Industry Regulatory Authority (FINRA) and is registered with the Securities and Exchange Commission (SEC) as a broker-dealer. Under the Uniform Net Capital Rule (Rule 15c3-1 under the Securities Exchange Act of 1934), the subsidiary is required to maintain a minimum net capital and a ratio of aggregate indebtedness to net capital, as defined, of not more than 15 to 1. At December 31, 2010, this subsidiary had net capital of \$518,183; a minimum net capital requirement of \$112,454; excess net capital of \$405,730 and a ratio of aggregate indebtedness to net capital of 3.26 to 1. This subsidiary is exempt from the reserve requirements of Rule 15c3-3.

#### **NOTE 10—OPERATING SEGMENTS**

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Capital Financial Holdings, Inc. derives the majority of its revenues and net income from sales of mutual funds, insurance products, and various other securities through Capital Financial Services, Inc. ("CFS"), the Company's broker-dealer subsidiary.

The Company organizes its current business units into two reportable segments: broker-dealer services and oil and gas activities. The broker-dealer services segment distributes securities and insurance products to retail investors through a network of registered representatives. The oil and gas activities segment will seek opportunities in petroleum and natural gas exploration and production.

The Company's reportable segments are strategic business units that offer different products and services. They are managed separately because each business requires different technology and marketing strategies. The accounting policies of each of these segments are the same as those described in Note 1.

As of, and for the year ended, December 31, 2010:

Holding

Oil & Gas

Broker-Dealer

Company

Activities

Services

Total

Revenues from external customers

\$

182,069

\$

3,209

\$

19,206,529

\$

19,391,807

Inter-segment revenues

-

-

1081

1,081

Interest expense

80,880

-

-

80,880

Depreciation and amortization

47,983

262

27,136

75,381

Income (loss) before income tax benefit (expense)

(1,303,886)

(186,114)

566,238

(923,762)

Income tax benefit (expense)

189,581

73,000

(222,000)

40,581

Net income (loss) before discontinued operations

(1,114,306)

(113,113)

344,238

(883,181)

Discontinued operations

(111,601)

-

-

(111,601)

Net income (loss) after discontinued operations

(1,225,907)

(113,113)

344,238

(994,782)

Segment assets

5,081,755

813,886

2,811,980

8,707,621

Expenditure for segment assets

3,090

2,612

10,373

16,075

As of, and for the year ended, December 31, 2009:

Holding

Oil & Gas

Broker-Dealer

Company

Activities

Services



Total

Revenues from external customers

\$

54,420

\$

-

\$

17,848,354

\$

17,902,774

Inter-segment revenues

-

-

26,726

26,726

Interest Expense

212,552

-

-

212,552

Depreciation and amortization

75,386

-

24,983

100,369

Income (loss) before income tax benefit (expense)

(1,056,186)

-

567,881

(488,305)

Income tax benefit (expense)

414,016

-

(222,600)

191,416

Net income (loss) before discontinued operations

(642,170)

-

345,281

(296,889)

Discontinued operations

103,191

-

-

103,191

Net income (loss) after discontinued operations

(538,979)

-

345,281

(193,698)

Segment assets

7,172,931

-

2,327,797

9,500,728

Expenditure for segment assets

13,882

-

10,626

24,508

As of, and for the year ended, December 31, 2008:

Holding

Oil & Gas

Broker-Dealer

Company

Activities

Services

Total

Revenues from external customers

\$

12,520

\$

-

\$

28,383,816

\$

28,396,336

Inter-segment revenues

-

-

29,588

29,588

Interest expense

302,369

-

-

302,369

Depreciation and amortization

95,730

-

19,757

115,487

Income (loss) before income tax benefit (expense)

(1,304,207)

-

1,676,773

372,566

Income tax benefit (expense)

511,254

-

(657,300)

(146,046)

Net income (loss) before discontinued operations

(792,953)

-

1,019,473

226,520

Discontinued operations

(3,736,217)

-



-

(3,736,217)

Net income (loss) after discontinued operations

(4,529,170)

-

1,019,473

(3,509,697)

Segment assets

8,619,220

-

3,913,211

12,532,431

Expenditure for segment assets

80,956

-

50,370

131,326

**Reconciliation of Segment Information**

2010

2009

2008

Revenues

Total revenues for reportable segments

\$

19,392,888

\$

17,929,500

\$

28,425,924

Elimination of inter-company revenues

(1,081)

(26,726)

(29,588)

Consolidated total revenue

\$

19,391,807

\$

17,902,774

\$

28,396,336

Profit

Total reportable segment profit (loss)

\$

(994,782)

\$

(193,698)

\$

(3,509,697)

Assets

Total assets for reportable segments

\$

8,891,013

\$

9,579,120

\$

12,610,823

Elimination of inter-company receivables

(183,392)

(78,392)

(78,392)

Consolidated assets

\$

8,707,621

\$

9,500,728

\$

12,532,431

The Mutual Fund segment has been reported in Note 18-Discontinued Operations, for the years ended December 31, 2009 and 2008.

In the Company's third quarter filing it reported capitalized costs of \$154,865, in the Oil & Gas segment. These costs have been fully expensed, by the Company, as of December 31, 2010. A termination request has been received by CER, requesting termination of the Joint Participation Agreement between CER and Nakota Energy LLC. If this agreement is terminated CER would no longer have rights to the leases, in which CER had paid acquisition costs. It was determined by the Company that until the outcome of this termination is finalized these capitalized costs would be expensed.

#### NOTE 11—OPERATING LEASES

The Company had various leases for office equipment that were to expire over the next several years through 2012. The total rent expense for these leases was \$20,545, \$42,700, and \$44,000 for December 31, 2010, 2009 and 2008 respectively.

In October of 2010 the Company signed new lease agreements for office equipment, which were meant to replace the existing lease agreements. These new lease agreements are set to expire in April of 2014.

The following is a schedule by years of future minimum rental payments on operating leases as of December 31, 2010.

Years ending December 31,

2011

\$

17,442

2012

17,442

2013

17,442

2014

8,721

Total minimum future rental payments

\$

61,047

**NOTE 12—GOODWILL**

The changes in the carrying amount of goodwill for the years ended December 31, 2010, 2009, and 2008, are as follows:

Capital Financial Holdings, Inc.

Broker-Dealer Services

Total

Balance as of January 1, 2008

\$

7,312,606

\$

3,599,942

\$

10,912,548

Goodwill acquired during the period

-

-

-

Goodwill acquisition price adjustment during the period (see Note 4)

-

(59,161)

(59,161)

Impairment losses

(5,312,606)

-



(5,312,606)

Balance as of December 31, 2008

\$

2,000,000

\$

3,540,781

\$

5,540,781

Goodwill acquired during the period

-

-

-

Goodwill acquisition price adjustment during the period (see Note 4)

-

(109,140)

(109,140)

Reduction in Goodwill as a result of mutual fund segment sale

(2,000,000)

-

(2,000,000)

Balance as of December 31, 2009

\$

-

\$

3,431,641

\$

3,431,641

Goodwill acquired during the period

-

-

-

Goodwill acquisition price adjustment during the period (see Note 4)

-

(103,710)

(103,710)

Impairment losses

-

(753,518)

(753,518)

Balance as of December 31, 2010

\$

-

\$

2,574,413

\$

2,574,413

The Company tests goodwill for impairment annually during the second quarter of each fiscal year. If an event occurs or circumstances change that would more likely than not reduce the fair value of a reporting unit below its carrying value, goodwill will be evaluated for impairment between annual tests.

In December of 2010, as a result of ongoing volatility in the financial industry and a reduction in the estimated fair market value of the Company's wholly owned subsidiary Capital Financial Services, Inc., the Company determined it was necessary to perform an interim goodwill impairment test. At that time the Company recorded a non-cash goodwill impairment loss of \$753,518 in the Broker-Dealer Services segment. The fair value of that reporting unit was estimated by using an independent third-party appraisal.

In December of 2008, as a result of ongoing volatility in the financial industry and a significant reduction in assets under management in the Company's sponsored mutual funds, the Company determined it was necessary to perform an interim goodwill impairment test. At that time the Company recorded a non-cash goodwill impairment loss of \$5,312,606 in the Mutual Fund Services segment. The fair value of that reporting unit was estimated by using an independent third-party appraisal.

**NOTE 13—FAIR VALUE DISCLOSURES**

FASB ASC 820 defines fair value, establishes a framework for measuring fair value, and establishes a fair value hierarchy which prioritizes the inputs to valuation techniques. Fair value is the price that would be received to sell an asset or paid to transfer a liability in an orderly transaction between market participants at the measurement date. A fair value measurement assumes that the transaction to sell the asset or transfer the liability occurs in the principal market for the asset or liability or, in the absence of a principal market, the most advantageous market. Valuation techniques that are consistent with the market, income or cost approach, as specified by FASB ASC 820, are used to measure fair value.

The fair value hierarchy prioritizes the inputs to valuation techniques used to measure fair value in three broad levels:

•

Level 1 inputs are quoted prices (unadjusted) in active markets for identical assets or liabilities the Company has the ability to access.

•

Level 2 inputs are inputs (other than quoted prices included within level 1) that are observable for the asset or liability, either directly or indirectly.

Level 3 are unobservable inputs for the asset or liability and rely on management's own assumptions about the assumptions that market participants would use in pricing the asset or liability. (The unobservable inputs should be developed based on the best information available in the circumstances and may include the Company's own data.)

The application of valuation techniques applied to similar assets and liabilities has been consistently applied. The following is a description of the valuation methodologies used for instruments measured at fair value:

Certain assets and liabilities are measured at fair value on a nonrecurring basis; that is, the instruments are not measured at fair value on an ongoing basis but are subject to fair value adjustments in certain circumstances (for example, when there is evidence of impairment).

On February 12, 2009, CFS entered into a settlement agreement with a client, which resulted in CFS purchasing the client's investment in the Omega 2007 Drilling Program 1, LP. This limited partnership carries a "presentment" feature which will allow CFS to sell the investment to the General Managing Partner of the limited partnership; and this feature will become available three years from the date of the first income distribution, which was December of 2007. The fair market value of this \$76,876 investment is estimated to be \$45,000; however this amount could fluctuate with the prices of oil and natural gas. CFS will continue to carry the investment on its books at the \$45,000 value until the "presentment" feature can be utilized.

Carrying Value at December 31, 2010

Year ended December 31, 2010

Total

Level 1

Level 2

Level 3 Other Investment

Total Losses

Other Investment

\$

45,000

\$

-

\$

-  
\$  
45,000  
\$  
-

Carrying Value at December 31, 2009

Year ended December 31, 2009

Total  
Level 1  
Level 2  
Level 3 Other Investment

Total Losses

Beginning Balance

\$  
-  
\$  
-  
\$  
-  
\$  
-

\$

-

Purchases: Other Investment

76,876

-

-

76,876

Loss impairment included in net earnings

(31,876)

-

-

(31,876)

Other Investment

\$

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45,000

\$

-

\$

-

\$

45,000

\$

31,876

The loss of \$31,876 represents the original purchase price of the investment minus its current fair market value.

Reconciliation of Level 3 Balances:

Balance 1-1-09

\$

-

Purchase of other investment

76,876

Impairment loss on other investment

(31,876)

Balance 12-31-09

45,000



Impairment loss on other investment

-

Balance 12-31-10

\$

45,000

The following table presents the assets and liabilities carried on the balance sheet by caption and by level within the codification hierarchy (as described above) as of December 31, 2010 and 2008, for which a nonrecurring change in fair value has been recorded during the year ended December 31, 2010 and 2008.

Carrying Value at December 31, 2008

Year ended December 31, 2008

Total

Level 1

Level 2

Level 3

Total Losses

Goodwill

\$

2,000,000

\$

-

\$

-

\$

2,000,000

\$

5,312,606

Losses of \$5,312,606 represent an impairment charge related to the goodwill of the Mutual Fund Services segment. The fair value of the goodwill was estimated by utilizing an independent third-party appraisal (See Note 12 - Goodwill).

Carrying Value at December 31, 2010

Year ended December 31, 2010

Total

Level 1

Level 2

Level 3

Total Losses

Goodwill  
\$  
2,574,413  
\$  
-  
\$  
-  
\$  
2,574,413  
\$  
753,518

Losses of \$753,518 represent an impairment charge related to the goodwill of the Broker-Dealer segment. The fair value of the goodwill was estimated by utilizing an independent third-party appraisal (See Note 12—Goodwill).

Reconciliation of Level 3 Balances:

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Balance 1-1-08

\$

10,912,547

Impairment loss on goodwill

(5,312,606)

Reduction in goodwill related to UHFS acquisition (See Note 4-Business Acquisitions)

(59,160)

Balance 12-31-08

5,540,781

Reduction in goodwill caused by mutual fund division sale

(2,000,000)

Reduction in goodwill related to UHFS acquisition (See Note 4-Business Acquisitions)

(109,140)

Balance 12-31-09

3,431,641

Impairment loss on goodwill

(753,518)

Reduction in goodwill related to UHFS acquisition (See Note 4-Business Acquisitions)

(103,710)

Balance 12-31-10

\$

2,574,413

See Note 12—Goodwill for a reconciliation of goodwill balances.

**NOTE 14—EARNINGS PER SHARE**

Basic earnings per share are computed by dividing earnings available to common stockholders by the weighted average number of common shares outstanding during the period. Diluted earnings per share reflect per share amounts that would have resulted if dilutive potential common stock had been converted to common stock. The following reconciles amounts reported in the financial statements:

For the Year Ended December 31, 2010

Income (Numerator)

Shares (Denominator)

Per Share Amount

Loss from continuing operations

\$

(883,181)

Less: preferred stock dividends

(91,500)

Loss available to common stockholders -  
Basic earnings per share

(974,681)

14,638,937

(.07)

Effect of dilutive securities:

Options and warrants

-

-

Loss available to common stockholders -  
Diluted earnings per share

\$

(974,681)

14,638,937

(.07)

For the Year Ended December 31, 2009

Income (Numerator)

Shares (Denominator)

Per Share Amount

Loss from continuing operations

\$

(296,889)

Less: preferred stock dividends

(91,500)

Loss available to common stockholders - Basic earnings per share

(388,389)

14,541,585

(.03)

Effect of dilutive securities:

Options and warrants

-

-

Diluted earnings per share

\$

(388,389)

14,541,585

(.03)

For the Year Ended December 31, 2008



Income (Numerator)

Shares (Denominator)

Per Share Amount

Income from continuing operations

\$

226,520

Less: preferred stock dividends

(91,500)

Income available to common stockholders - Basic earnings per share

135,020

14,519,372

\$

.01

Effect of dilutive securities:

Options and warrants

-

17,735

Preferred stock dividends

91,500

3,050,000

Income available to common stockholders - Diluted earnings per share

\$

226,520

17,587,107

\$

.01

Options and warrants to purchase 8,486,113 common shares at exercise prices between \$0.35 and \$1.43 were outstanding at December 31, 2010, but were not included in the computation of earnings per share for the year ended December 31, 2010. The options and warrants were not included in the calculation because their exercise prices were greater than the average market price of the common shares during the period.

In December of 2003, the Company issued 3,050,000 Series A preferred shares for total proceeds of \$1,525,000. The holders of the Series A preferred shares are entitled to receive cumulative dividends at a rate of 6% per year, payable quarterly. These dividends are in preference and priority to any payment of any dividend on the Company's common shares. The holders of the Series A preferred shares are also entitled to a liquidation preference of \$.50 per share. The Series A preferred shares are convertible to the Company's common shares at the rate of one share of common shares for one share of Series A preferred shares at any time after issuance. At any time after five years from issuance, the

Company has the right to redeem any or all of the Series A preferred shares after a sixty day notice upon payment of the liquidation preference of \$.50 per share to the holders, for a total of \$1,525,000.

The Series A preferred shares were not included in the computation of diluted earnings per share for the year ended December 31, 2010, because their effect was anti-dilutive.

Additionally, the Company had outstanding at December 31, 2010, a \$950,000 convertible promissory note. The unsecured note carries an interest rate of 6.5% per year, payable semi-annually, and matures on October 15, 2016. The holder of the note has the right, at any time after October 15, 2009, to convert the note in whole or in part, into common shares of the Company at a conversion price of \$0.50 per share. The entire principal amount of this note shall be automatically converted into common shares at the conversion price on October 15, 2016.

The convertible promissory note was not included in the computation of diluted earnings per share for the year ended December 31, 2010, because the conversion price was greater than the average market price of the common shares during those periods.

**NOTE 15—COMPREHENSIVE INCOME (LOSS)**

Comprehensive loss is reported on the accompanying consolidated statement of shareholders' equity as a component of retained earnings (accumulated deficit) and consists of net loss and other gains and losses affecting shareholders' equity that, under accounting principles generally accepted in the United States of America, are excluded from net loss. For the Company, such items consist primarily of unrealized gains and losses on available-for-sale equity investments.

The following summary sets forth the components of other comprehensive loss, net of tax, accumulated in shareholders' equity:

For the Year Ended December 31, 2010

Net Loss

\$

(994,782)

Other Comprehensive Income (Loss), net of tax:

Unrealized gain (loss) on securities

-

Total Comprehensive Loss

\$

(994,782)

For the Year Ended December 31, 2009

Net Loss

\$

(193,698)

Other Comprehensive Income (Loss), net of tax:

Unrealized gain (loss) on securities

-

Total Comprehensive Loss

\$

(193,698)

For the Year Ended December 31, 2008

Net Loss

\$

(3,509,697)

Other Comprehensive Income (Loss), net of tax:

Unrealized gain on securities

-

Total Comprehensive Loss

\$

(3,509,697)

#### NOTE 16—**RISKS AND UNCERTAINTIES**

The Company has a concentration of credit risk for cash deposits at various financial institutions. These deposits may at times exceed amounts covered by insurance provided by the U.S. Federal Deposit Insurance Corporation (FDIC). The Company has not experienced any losses in such accounts.

#### NOTE 17—**RELATED PARTY TRANSACTIONS**

Mr. Jeffrey A. Cummer was elected a director of Capital Financial Holdings, Inc. on June 1, 2006. Mr. Cummer is president and senior portfolio manager of SMH Capital Advisors, Inc. During 2008, Capital Financial Holdings, Inc. paid monthly sub-advisory fees to SMH Capital Advisors, Inc. for advisory services provided to some of the Funds. On March 4, 2008, SMH Capital Advisors was notified that the Board of Trustees of The Integrity Funds had approved the termination of the sub-advisory agreements between Integrity Money Management, Inc., and SMH Capital Advisors. Sub-advisory payments made to SMH Capital Advisors, Inc. totaled \$0 in 2010, \$0 in 2009 and \$246,248 in 2008.

In May of 2006, Xponential, Inc. issued a tender offer to purchase up to 3,000,000 shares of Capital Financial Holdings, Inc. common shares at a purchase price of \$0.40 per share. At the close of the tender offer, Xponential, Inc. had obtained 1,323,642 shares, representing approximately 9.76% of the outstanding Capital Financial Holdings Inc. common shares. Mr. Cummer is Chief Executive Officer and Chairman of the Board of Xponential, Inc.

In October of 2006, Capital Financial Holdings Inc. issued a \$950,000 convertible promissory note to PawnMart, Inc., in a private placement. The unsecured note carries an interest rate of 6.5% per annum, payable semi-annually, and matures on October 15, 2016. The holder of the note has the right, at any time after October 15, 2009, to convert the note in whole or in part, into \$0.0001 par value common shares of the Company. The conversion price shall be equal to \$0.50 per share. The entire principal amount of this note shall be automatically converted into common shares at the conversion price on October 15, 2016. PawnMart, Inc. is a wholly owned subsidiary of Xponential, Inc. Mr. Cummer is Chairman of the Board and Executive Vice President of PawnMart, Inc. Interest payments made to PawnMart, Inc. relating to this note totaled \$61,750 in 2010, 2009 and 2008, respectively.

Mr. Steven D. Lysne was elected a director of Capital Financial Holdings, Inc. on May 27, 2005. On February 11, 2008, Steven D. Lysne announced his resignation from the Board of Directors effective upon the Annual Meeting of Shareholders of the Company. Mr. Lysne is CEO and general manager of SRT Communications, Inc. Capital Financial Holdings, Inc. pays SRT Communications, Inc. for telephone and internet services. Payments made to SRT Communications, Inc. totaled \$45,156 in 2010, \$63,702 in 2009, and \$79,563 in 2008.

#### NOTE 18—**DISCONTINUED OPERATIONS**

On March 6, 2009, Capital Financial Holdings, Inc. (the "Company") entered into a Definitive Agreement (the "Agreement") with Corridor Investors, LLC ("Buyer"), pursuant to which Buyer agreed to purchase from Seller, and Seller agreed to sell to Buyer: (i) all of the issued and outstanding shares of each of three subsidiaries of the Company, Integrity Fund Services, Inc., a share transfer agency, Integrity Funds Distributor, Inc., a FINRA member broker dealer and Integrity Mutual Funds, Inc. of Nevada, a non-operating entity (the "Companies"); (ii) all of Seller's right, title and interest in and to certain tangible assets and (iii) the sale of certain assets of Integrity Money Management, Inc. related to its mutual fund advisory business. The purpose of the Agreement was to facilitate a change in advisor as well as to transfer, together with the operating subsidiaries, the combined mutual fund service business of the Seller currently provided to The Integrity Funds, Integrity Managed Portfolios, ND Tax-Free Fund, Inc., Montana Tax-Free Fund, Inc. and Integrity Fund of Funds, Inc. ("the Funds"), which are investment companies registered with the Securities and Exchange Commission ("SEC") under the Investment Company Act of 1940. As of July 31, 2009, the required Fund shareholder approval from the various Funds had been received to consummate the change in advisor along with the transfer of the mutual fund service to the Buyer. As per the Agreement, at closing on July 31, 2009, the Buyer paid \$1,525,480 (60 BPS of the aggregate net assets, totaling \$254,246,596 as of July 30, 2009) to the Company. The Company received \$227,200 for the first of the three installments consisting of 10 BPS of the aggregate net assets as of July 30, 2010. The Company had originally estimated this receivable at \$762,740 based on the aggregate net assets as of July 30, 2009. Due to a reduction in the net aggregate assets of the funds, this estimate was reduced to \$651,138. The difference of \$111,601 has been reflected as a revision of this estimate and recorded as a loss on discontinued operations in the current year statement of operations. The Company will receive two additional payments over the next two years, consisting of 10 BPS of the aggregate net assets as of July 30, 2011 and 2012. With the closing and transfer of entities, the Company is no longer involved in the mutual fund service business. The Company continues to operate as a Broker-Dealer through its wholly owned subsidiary Capital Financial Services, Inc. As a result of the transfer, post closing of the transaction, Integrity Fund Services, Inc., Integrity Funds Distributor, Inc. and Integrity Money Management, Inc., which constitutes the mutual fund division of the Company, will be reflected in the Company's future consolidated financial statements as a discontinued operation.

The results of the mutual fund segment are reported in the Company's Consolidated Statements of Operations separately as discontinued operations. In accordance with GAAP, the Consolidated Balance Sheets have not been restated.

Summarized financial information for discontinued operations is as follows:

#### Mutual Fund Segment

December 31, 2010

December 31, 2009

December 31, 2008

Revenues

\$

-

\$

2,058,425

\$

4,152,890

Income from operation of discontinued mutual fund segment

-

560,864

1,053,573

Goodwill impairment expense

-

-

(5,312,606)

Gain (Loss) on disposal of discontinued operations

(111,601)

228,402

-

Discontinued operations before taxes

(111,601)

789,266

(4,259,033)

Tax benefit (expense) of discontinued operations

-

(686,075)

522,816

Total gain (loss) on discontinued operations, net of tax

\$

(111,601)

\$

103,191



\$

(3,736,217)

**NOTE 19—LITIGATION**

The Company operates in a legal and regulatory environment that exposes it to potentially significant litigation risks. As a result, the Company is involved in various disputes and legal proceedings, including litigation, arbitration and regulatory investigations, including a number of investigatory matters and legal proceedings arising out of customer allegations related to past commissioned sales of alternative investment products. In 2007 through the first quarter of 2009 a substantial amount (approximately 10% to 20%) of the Company's sales of commissioned products were in private placements of alternative products, two of which as of December 31, 2009 (Medical Capital Corporation and related issuer entities and Provident Royalties, LLC and related issuer entities) were placed in receivership by action of the United States Securities and Exchange Commission and issuers of certain other alternative products sold by the Company are in Chapter 11 Bankruptcy or may have financial difficulties. Additionally, difficult economic conditions in general and the stock market decline have contributed to decline in broker-dealer subsidiary client portfolio values. As a result of such alleged failings of alternative products and the uncertainty of client recovery from the various product issuers, the Company is subject to regulatory scrutiny and a number of recently instituted legal or arbitration proceedings, including two recently instituted proceedings seeking certification as class actions which name the Company as one of a number of defendants and allege various securities or conduct violations, one with respect to private placements of Medical Capital Corporation and related issuer entities for which the broker-dealer subsidiary placed approximately \$100 million of debt securities and the other with regard to private placements of Provident Royalties, LLC and related issuer entities for which the broker-dealer subsidiary placed approximately \$60 million of debt securities. The Company intends to vigorously contest the allegations of the various proceedings and believes that there are multiple meritorious legal and fact based defenses in these matters. Such cases are subject to many uncertainties, and their outcome is often difficult to predict, including the impact on operations or on the financial statements, particularly in the earlier stages of a case. The Company makes provisions for cases brought against it when, in the opinion of management after seeking legal advice, it is probable that a liability exists, and the amount can be reasonably estimated. The current proceedings are subject to uncertainties and as such, the Company is unable to estimate the possible loss or a range of loss that may result from each individual matter. There is a contemplated settlement regarding both Medical Capital Corporation and Provident Royalties, LLC, by which the Company would contribute monies to a settlement fund. The contemplated settlement, in the amount of \$200,000, was recorded in the books of the company as a liability, though the settlement is subject to approval by a number of entities.

**NOTE 20—SUBSEQUENT EVENTS**

There have not been any significant events that have occurred subsequent to the Company's year end. Subsequent events have been evaluated through the date these financial statements were subject to be issued.

ADDITIONAL INFORMATION

**REPORT OF INDEPENDENT REGISTERED PUBLIC ACCOUNTING FIRM  
ON ADDITIONAL INFORMATION**

To the Stockholders and Directors  
Capital Financial Holdings, Inc. and Subsidiaries  
Minot, North Dakota

Our report on our audit of the basic consolidated financial statements of Capital Financial Holdings, Inc. and Subsidiaries for the years ended December 31, 2010, 2009 and 2008, appears on page F-1. Those audits were made for the purpose of forming an opinion on such consolidated financial statements taken as a whole. The information on page F-28, related to the 2010, 2009 and 2008 consolidated financial statements, is presented for purposes of additional analysis and is not a required part of the basic consolidated financial statements. Such information has been subjected to the auditing procedures applied in the audits of the basic consolidated financial statements, and, in our opinion, the information is fairly stated in all material respects in relation to the basic consolidated financial statements for the years ended December 31, 2010, 2009 and 2008, taken as a whole.

We also have previously audited, in accordance with standards of the Public Company Accounting Oversight Board (United States), the consolidated balance sheets of Capital Financial Holdings, Inc. and Subsidiaries as of December 31, 2008, 2007 and 2006, and the related consolidated statements of operations, stockholders' equity, and cash flows for each of the two years in the periods ended December 31, 2007 and 2006, none of which is presented herein, and we expressed unqualified opinions on those consolidated financial statements. In our opinion, the information on page F-28 relating to the 2008, 2007, and 2006 consolidated balance sheets and statements of operations is fairly stated in all material respects in relation to the basic consolidated financial statements from which it has been derived.

BRADY, MARTZ & ASSOCIATES, P.C.  
Minot, North Dakota USA

March 23, 2011

**CAPITAL FINANCIAL HOLDINGS, INC., AND SUBSIDIARIES**  
SELECTED FINANCIAL DATA \*  
FOR THE YEARS ENDED DECEMBER 31, AS INDICATED

2010

2009

2008

2007

2006

Operating revenue

\$

19,391,807

\$

17,902,774

\$

32,549,226

\$

38,842,231

\$

27,020,574

Operating income (loss)

\$

(842,882)

\$

(243,877)

\$

(3,584,098)

\$

1,349,602

\$

298,310

Income tax benefit (expense)

\$

40,581

\$

(274,759)

\$

376,770

\$

(434,702)

\$

(11,091)

Basic earnings (loss) per share

\$

(.07)

\$

(.02)

\$

(.25)

\$

.03

\$

(.01)

Diluted earnings (loss) per share

\$

(.07)

\$

(.02)

\$

(.25)

\$

.03

\$

(.01)

Total assets

\$

8,707,621

\$

9,500,728



\$

12,532,431

\$

18,114,830

\$

15,466,130

Long-term obligations

\$

1,363,522

\$

1,733,059

\$

3,989,040

\$

4,853,277

\$

4,090,158

Shareholders' equity

\$

5,457,729

\$

6,494,044

\$

6,708,250

\$

10,213,625

\$

9,398,208

Dividends paid

\$

0

\$

0

\$

0

\$

0

\$

0

\*Excludes discontinued operations of the mutual fund division.

**CAPITAL FINANCIAL HOLDINGS, INC., AND SUBSIDIARIES**  
**QUARTERLY RESULTS OF CONSOLIDATED OPERATIONS (UNAUDITED)\***

**Quarter Ended**

**3-31-10**

**6-30-10**

**9-30-10**

**12-31-10**

Revenues

\$

4,535,563

\$

5,155,622

\$

4,714,262

\$

4,986,360

Operating income (loss)

(35,148)

165,226

(63,080)

(909,882)

Other expense

(20,391)

(20,268)

(20,198)

(20,023)

Income tax benefit (expense)

(44,772)

(105,695)

9,476

181,573

Net income (loss)

(100,311)

39,263

(154,942)

(778,792)

Per Share

Operating income (loss)

(.00)

.01

.00

(.06)

Other expense

(.00)

(.00)

(.00)

(.00)

Income tax benefit (expense)

(.00)

(.01)

(.00)

(.01)

**Quarter Ended**

**3-31-09**

**6-30-09**

**9-30-09**

**12-31-09**

Revenues

\$

5,114,009

\$

5,389,687

\$

4,588,517

\$

4,584,615

Operating income (loss)

(42,296)

366,741

2,926

(31,259)

Other expense



(67,688)

(66,035)

(58,151)

(52,554)

Income tax benefit (expense)

(37,157)

(92,206)

(378,147)

21,153

Net income (loss)

(147,141)

208,499

(192,496)

(62,560)

Per Share

Operating income (loss)

(.00)

.02

(.00)

(.00)

Other expense

(.01)

(.01)

(.01)

(.01)

Income tax benefit (expense)

(.00)

(.01)

(.03)

(.00)

**Quarter Ended**

**3-31-08**

**6-30-08**

**9-30-08**

**12-31-08**

Revenues

\$

9,487,056

\$

9,260,788

\$

7,660,078

\$

6,141,304

Operating income (loss)

568,758

678,592

305,406

(5,136,853)

Other expense

(82,824)

(82,074)

(69,255)

(68,216)

Income tax benefit (expense)

(201,647)

(259,997)

(107,001)

945,415

Net income (loss)

284,287

336,521

129,149

(4,259,654)

Per Share, Basic

Operating income (loss)

.04

.05

.02

(.36)

Other expense

(.01)

(.01)

(.01)

(.01)

Income tax benefit (expense)

(.01)

(.02)

(.01)

.07

(1) For calculating per share amounts, basic and diluted common share are not materially different.

The above financial information is unaudited. In the opinion of management, all adjustments (which are of a normal recurring nature) have been included for a fair presentation.

\*Excludes discontinued operations of the mutual fund division.