Goodwill Valuation Approaches, Methods, and Procedures

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Financial advisers are often asked to value goodwill within a corporate transaction environment. These goodwill valuations may be performed in the due diligence phase of the corporate transaction for transaction pricing and structuring purposes. These goodwill valuations may be performed in the consummation phase of the corporate transaction—as part of the preparation of a transaction fairness opinion or solvency opinion. And, these goodwill valuations may be performed within the controversy phase of the corporate transaction—to defend against dissenting shareholder appraisal rights claims or claims that the transaction resulted in a fraudulent transfer. For some transaction-related purposes, financial advisers may value goodwill as a residual amount (i.e., the residual of a total business or professional practice value minus the value of all identifiable tangible assets and intangible assets). For other transaction-related purposes, financial advisers may value goodwill as an individual, income-producing intangible asset. This discussion summarizes the generally accepted goodwill valuation approaches, methods, and procedures. And, this discussion presents an illustrative example of a goodwill valuation analysis.

Introduction

There are different types of goodwill, including (1) business or institutional goodwill and (2) personal or professional goodwill. Financial advisers are often asked to value these different types of goodwill for transaction, taxation, financial accounting, litigation, and other purposes. This discussion describes the various components of goodwill and the various reasons why independent financial advisers may be asked to value goodwill.

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This discussion summarizes the generally accepted approaches and methods related to the valuation of goodwill. This discussion focuses on business enterprise (or institutional) goodwill. However, this discussion also considers personal (or individual) goodwill.

This discussion starts with a definition of goodwill. Since there is no single definition of goodwill that is applicable to all purposes, this discussion considers alternative definitions. This discussion describes the types and attributes of goodwill. And, this discussion considers the many reasons why financial advisers are asked to value goodwill.

Finally, this discussion mentions many of the common internal and external data sources related to the goodwill valuation. These data sources primarily include sources of transactional data regarding the sale of goodwill within the context of a business acquisition.

Some financial advisers believe that only income approach methods are applicable to value goodwill. However, this discussion describes cost approach, market approach, and income approach valuation methods. This discussion concludes with an illustrative goodwill valuation example.

Goodwill Components

There are many interpretations of goodwill. These interpretations are generally grouped into two categories: residual interpretations and income interpretations. While income interpretations may be more common, financial advisers should be familiar with both categories of interpretations. Both interpretations agree on the components of (or the factors that create) goodwill and the types of goodwill (or situations in which goodwill arises).

There are three principal components of goodwill. Financial advisers consider these three components as either (1) the factors that create goodwill or (2) the reasons why goodwill exists in certain circumstances. The first and third components primarily relate to business goodwill. And, the second component relates to both business goodwill and personal goodwill.

The first goodwill component is the existence of operating business assets that are in place and ready to use. This component is sometimes referred to as the going-concern element of goodwill. The fact that all of the elements of a business enterprise are physically and functionally assembled creates intangible value. These business enterprise elements include capital (e.g., equipment), labor (e.g., employees), and coordination (e.g., management).

Some financial advisers identify and measure this going-concern value as a separate intangible asset of a business. This separate identification may be appropriate for certain taxation or forensic analysis purposes.

Other financial advisers measure going-concern value as one component of the entity's business goodwill. This aggregate identification is appropriate for purposes of Financial Accounting Standards Board (FASB) Accounting Standards Codification (ASC) Topic 805, Business Combinations, fair value accounting for business combinations.

Either identification procedure may be appropriate depending on the purpose and objective of the goodwill analysis.

This going-concern value may enhance the value of the business entity's individual operating assets. For example, a business entity's equipment value is typically greater when the equipment is appraised based on a value in continued use (or going-concern) premise of value—rather than on a value in exchange (or piecemeal disposition) premise of value.

Some going-concern value may attach to the business entity's specifically identified identifiable intangible assets. For example, an entity's patent, copyright, or trademark value is typically greater when that intangible asset is appraised on a value in continued use (or going-concern) premise of value rather than on a value in exchange (or piecemeal disposition) premise of value.

The second goodwill component is the existence of excess income (however measured). This component is described later in this discussion. For a business entity, excess income is income generated by the entity that is greater than the amount needed to provide a fair rate of return on all of the entity's tangible assets and identifiable intangible assets.

This excess income component relates to the concept of goodwill as that portion of business enterprise value that cannot be specifically assigned to the entity's tangible assets or identifiable intangible assets. For an individual (e.g., professional practitioner, athlete, celebrity), excess income is the income generated by the individual that is greater than the amount that would be expected to be accrued by a comparably skilled individual working in comparable circumstances.

The third goodwill component is the expectation of future events that are not directly related to the entity's current operations. Goodwill may be created by the expectations of future capital expenditures, future mergers and acquisitions, future to-be-developed products or services, and future customers or clients. This future expectations component relates to the concept of goodwill as the current value of future assets (both tangible and intangible) that do not yet exist on the analysis date.

Investors assign a goodwill value to a business entity if they expect that the net present value of the income associated with future events is positive. The positive net present value of the expected future income associated with assets that are already in existence (for example, capital assets, product lines, and customers) is appropriately assigned to those respective tangible assets and intangible assets.

The Residual Interpretation of Goodwill

Under generally accepted accounting principles, the goodwill that an entity develops in the normal course of business is rarely recorded on the entity's financial statements. And, the accounting recognition for

internally created goodwill is different than the accounting recognition for purchased goodwill.

Internally created goodwill is rarely recorded on the entity's balance sheet. In contrast, purchased goodwill is recorded on the acquiror's balance sheet as soon as the purchase transaction is completed. Under FASB ASC topic 805 acquisition accounting, the fair value (calculated as a residual from total purchase consideration) of purchased goodwill is recorded as an intangible asset on the acquiror's balance sheet.

Accountants often use a fairly broad definition of goodwill. This broad interpretation of goodwill is the residual value that is calculated by subtracting the fair value of all the acquired tangible and identifiable intangible assets from the acquired entity's total purchase price.

Sometimes this goodwill definition collectively quantifies all of the intangible value of the acquired company. This is the case when all of the identifiable intangible assets are not adequately identified and valued.

This collective goodwill valuation may occur when the fair values of the individual identifiable intangible assets are immaterial compared to the total business purchase price. In this circumstance, this residual definition of goodwill may capture the total intangible value of the acquired business entity, with little consideration of the identifiable intangible assets.

The Income Interpretation of Goodwill

The income interpretation of goodwill may be more conceptually robust than the residual interpretation of goodwill. As a result, the income interpretation of goodwill may be more useful to the financial adviser who is interested in the valuation of the entity's discrete goodwill—as opposed to the valuation of the entity's total intangible value.

First, the financial adviser typically quantifies all of the income of the entity. For purposes of this excess income analysis, income can be measured many different ways. The only requirement is that the measure of income is calculated on a basis consistent with the measure of the fair rate of return on the entity's operating assets.

Second, the financial adviser typically allocates (or assigns) some portion of this total income to each tangible and intangible asset category that contribute to the income production. These asset categories typically include working capital, tangible personal property, real estate, and identifiable intangible assets. This allocation of the entity's income is typically based on a fair rate of return on the asset category multiplied by the value of the asset category.

Third, the financial adviser typically quantifies the portion of the entity's income that cannot be associated with any other tangible or intangible asset. That residual income is often called excess income (or excess earnings). This excess income is then assigned to goodwill.

Fourth, goodwill value is typically quantified as this amount of excess income capitalized as an annuity in perpetuity. The excess income is capitalized by a risk-adjusted and growth-adjusted direct capitalization rate. The result of this direct capitalization procedure indicates the goodwill value.

Goodwill Types

There are three general goodwill types. These three goodwill types may affect the identification and ownership of the goodwill. But, the distinction of these three types of goodwill should not affect the valuation results.

The first goodwill type is institutional goodwill. This is the goodwill that relates to an industrial or commercial business enterprise. This goodwill type typically results from the collective operations of—and the collective assemblage of—the entity's assets. Institutional goodwill is typically owned by the industrial or commercial business.

However, in the case of a professional services business (for example, a manufacturers representative company or other professional sales organization), some or all of the institutional goodwill can be created by the individual employee/owners.

The second goodwill type is professional practice goodwill. This type of goodwill relates to a medical, dental, legal, accounting, engineering, or other type of professional practice. This goodwill type is distinguished from the other goodwill types because it has two distinct components: the practitioner (or personal) component and the business (or practice) component.

The practitioner component relates to the goodwill created by the reputation and skills of the individual professional practitioners (the actual physicians, dentists, lawyers, CPAs, engineers, and other professionals). The business component relates to the goodwill created by the location, reputation, longevity, assembled assets, and operating procedures of the institutional professional practice.

One issue that often arises with regard to this goodwill type is who owns each of the two components. This ownership question can be controversial

in marital dissolutions, shareholder disputes, or in other types of litigation.

Ultimately, the ownership of the goodwill components is a legal question with a legal answer. However, the financial adviser may be tasked with the identification and the valuation of these two components of professional practice goodwill.

The third goodwill type is celebrity goodwill. This is the goodwill associated with being a famous individual. Typically, there are three categories of celebrities who enjoy such goodwill: sports celebrities, entertainment celebrities, and achievement celebrities.

These various categories of celebrity goodwill are distinguished by the factors that created the goodwill. For example, the sports celebrity goodwill is created by the individual's physical prowess. That prowess (and the associated goodwill) may wane with the age of the athlete.

Entertainment goodwill relates to singers, musicians, actors, television talk show hosts, and so on. This type of goodwill also relates to the individual's skill and ability. But for many entertainers, professional skill and ability may increase (and not decrease) with age.

The category of achievement celebrities includes prominent corporate executives, politicians, clergy, or organizational leaders. The goodwill of an achievement celebrity often relates to the career or other professional accomplishments of that individual. Unlike the other types of goodwill, it may be difficult to transfer celebrity goodwill.

It is often important for the financial adviser to separately identify and individually value the three types of goodwill. There may be different legal, economic, and taxation consequences for each goodwill type.

The following factors affect which type of goodwill exists:

1. The type of services or products offered by the business entity
2. The individual's personal relationships with customers or clients
3. The individual's direct impact on the management and direction of the business entity

Most goodwill is likely to be personal goodwill (that is, goodwill owned by the business owner/operator, individual practitioner, or celebrity) if:

1. the individual makes essentially all significant management decisions regarding the business entity,
2. the operations of the company or practice are not functionally or economically separate from the individual, and
3. the success of the business entity is directly related to the activities of the individual.

In the early stages of an entity's operations, most internally created goodwill is typically personal goodwill. As the entity matures (as it increases in size and complexity), goodwill usually shifts from the personal category to the institutional category.

Reasons to Value Goodwill

There are many reasons why a financial adviser may be asked to value goodwill. Some of these reasons follow:

- Economic damage analyses. When a business has suffered a breach of contract or a tort (such as an infringement, breach of a fiduciary duty, or interference with business opportunity), one measure of the damages suffered is the reduction in the value of the entity's goodwill due to the wrongful action.

  This analysis may encompass the comparative valuation of the entity's goodwill before and after the breach of contract or tort. This before and after method is also useful for quantifying the economic effects of a prolonged labor strike, a natural disaster, or a similar phenomenon.
- Business or professional practice merger. When two businesses merge, the equity of the merged entity typically is to be allocated to the merger partners. One common way to allocate equity in the merged entity is in proportion to the relative value of the assets contributed, including the contributed goodwill.
- Business or professional practice separation. When a business separates, the assets of the consolidated business typically have to be allocated to the individual business owners.

  One common way to allocate the assets to the separating business partners is in proportion to the relative value of the assets controlled by or developed by each partner, including the goodwill of each business partner.
- Solvency test. The solvency of a business entity is an issue with regard to lender's fraudulent conveyance concerns during a

financing transaction or a financial restructuring.

One of the individual tests to determine if a business entity is solvent is: Does the fair value of the entity's assets exceed the value of the entity's liabilities (after consideration of the financing transaction)? One of the entity's assets that is considered in a solvency analysis is goodwill.

- Insolvency test. The degree of insolvency of a business entity may have federal income tax consequences if debt is forgiven (in whole or in part) during a refinancing transaction or financial restructuring. One of the specific tests to determine if a business entity is insolvent for federal income tax purposes is: Is the fair market value of the entity's assets less than the value of the entity's liabilities (before the debt forgiveness)?

  The cancellation of debt income is not recognized as taxable income to the extent that the taxpayer debtor is insolvent. The federal income tax regulations specifically indicate that one of the assets that should be considered in an insolvency analysis is goodwill.

- Intercompany transfer price. When intangible assets are transferred between related entities (for example, between a parent corporation and a less than wholly owned subsidiary), an arm's-length price should be estimated for the intercompany transfer of the assets.

  Such an intercompany transfer may affect the profitability and return on investment of, say, two subsidiaries—one that is wholly owned and one that has a 10 percent minority interest owner.

  While the intercompany transfer of goodwill is not subject to Internal Revenue Code Section 482 considerations, intercompany goodwill transfers may also have other income tax ramifications. Such intercompany transfers may have state income tax consequences if the various related entities are located in different state tax jurisdictions.

- Bankruptcy and reorganization. Parties in interest to a bankruptcy estate often have to decide if the debtor corporation is worth more as a going-concern business (pursuant to a plan of reorganization) or as a mass disposition of assets (pursuant to a plan of liquidation). A valuation of the debtor's goodwill (if any) may be useful in assessing whether the business is worth reorganizing.

  A valuation of the debtor's goodwill (for example, before and after the plan of reorganization) may be useful in assessing the reasonableness of the proposed plan of reorganization. Such an assessment may be of interest to the debtor in possession, the secured and unsecured creditors, the bankruptcy court, and other interested parties.

- Conversion of a C corporation to an S corporation. One factor in the analysis of the costs and benefits of converting an entity's federal income tax status from a C corporation to an S corporation is the quantification of any built-in gains (BIG) tax associated with the value of the corporation's assets.

  The federal income tax regulations related to the BIG tax are clear that the corporation's goodwill is one asset that should be considered in the valuation.

- Business enterprise valuation. The identification and quantification of goodwill is one procedure of the asset-based approach to business valuation. An asset-based approach is often used in the valuation of an industrial or commercial company or professional service business.

  Such business valuations are routinely performed for taxation, ownership transition, financing, bankruptcy, corporate governance, litigation, and other purposes.

- Deprivation analysis. The goodwill valuation may be one component in the damages analysis associated with a business that is subject to a condemnation, expropriation, or eminent domain action. Financial advisers sometimes only consider the value of the entity's real estate and tangible personal property subject to the condemnation or other "taking."

  However, even if the entity is relocated to a new location as part of the eminent domain action, the business may have suffered a loss of all or part of its goodwill. The loss of institutional or practice goodwill value may be a claim in the condemnation or eminent domain action.

- Ownership allocation litigation. Several forms of litigation involve the allocation of direct or indirect ownership interests in a business entity. Two examples of such litigation include the following:

1. Marital dissolution cases (which involve the allocation of the business entity ownership interest within the marital estate).
2. Dissenting shareholder rights and shareholder oppression cases (which involve the allocation of the business entity ownership interests to the dissenting or oppressed stockholders).

This second category of litigation involves both dissenting shareholder appraisal rights claims and shareholder oppression claims. In such litigation claims, the valuation of the entity's goodwill is often an important issue.

- Ad valorem property tax. In some taxing jurisdictions, state and local ad valorem property tax only applies to real estate and tangible personal property. The existence of economic obsolescence (a form of external obsolescence) may have a direct effect on the value of the taxpayer's real estate and tangible personal property. Accordingly, an assessment of the existence of economic obsolescence may be an important procedure in the valuation of such industrial or commercial operating property.

  There are several methods for quantifying economic obsolescence, and most methods incorporate some analysis of the entity's goodwill.

  Typically, if the entity enjoys positive goodwill value, then the tangible assets may not experience economic obsolescence. If the entity experiences negative goodwill, then the values of the industrial and commercial operating assets are likely to be affected by economic obsolescence.

How the Different Goodwill Types Are Valued

All generally accepted intangible asset valuation approaches are appropriate to value the different goodwill types.

Typically, goodwill (whether personal or institutional) is not sold or otherwise transferred separately in the marketplace. Therefore, the market approach is less commonly used to value goodwill. When the market approach is used to value goodwill (for example, the goodwill of medical, dental, or other professional practices), the empirical market data are often based on purchase price allocations of the acquired entities.

Because goodwill (whether personal or institutional) is often measured based on future earnings, the cost approach is less commonly used to value goodwill. In practice, for both personal and institutional goodwill, the income approach is more commonly used.

Financial advisers may also use some version of a residual analysis in the valuation of personal or institutional goodwill. In such a valuation, the financial adviser estimates the total amount of goodwill associated with the business entity (however defined). Using this residual analysis, goodwill is measured indirectly using business valuation approaches.

Using a residual analysis, goodwill represents the residual of the overall business value less the total value of all tangible assets and identifiable intangible assets used in the business enterprise.

The financial adviser may also use some version of the with and without method (also called the comparative business value method) in the valuation of personal or institutional goodwill. To use the with and without method, the financial adviser estimates the value of the business entity with and without the goodwill in place.

The with and without method is more commonly used to value an individual's personal goodwill than it is to value institutional goodwill. Typically, based on the different sets of financial projections and the different discount or capitalization rates, the entity value is greater with the subject individual in place than without the subject individual in place.

Using the with and without method, the value of personal goodwill is estimated as the difference between:

1. the "with the individual in place" entity value and
2. the "without the individual in place" entity value.

The personal goodwill value is the difference between the two business value estimates based on the two alternative sets of projections. The financial adviser may also estimate the value of the institutional goodwill using a combination of a residual method analysis and a with and without method analysis.

The value of the entity's institutional goodwill may be estimated as the difference between:

1. the business entity goodwill value (based on the residual method analysis) and
2. the personal goodwill value (based on the with and without method).

The Goodwill Valuation

In most valuation analyses, goodwill includes concepts from both the residual and the income definitions. Financial advisers sometimes identify and value goodwill collectively as the total intangible value of a business entity. In this regard, goodwill may be valued using an aggregate residual analysis.

In such an analysis, the goodwill can be either a residual from a total business acquisition price or a business value. In this analysis, the total goodwill value is measured as the unidentified residual amount after the values of the identified tangible assets are subtracted from the total business value.

Financial advisers often measure goodwill as a discrete (or separate) intangible asset. Using this definition, goodwill is measured as the remaining unidentified intangible value of the entity after subtracting the values of all tangible assets and all identifiable intangible assets.

Accordingly, this discrete goodwill may be quantified using either a residual analysis or an income analysis. In either type of analysis, goodwill is the residual business value (or capitalized excess income) that is not allocated to any of the following assets:

1. Working capital assets (for example, receivables, prepaid expenses, and inventory)
2. Tangible personal property (for example, machinery, equipment, and vehicles)
3. Real estate (for example, land, buildings, and improvements)
4. Intangible personal property (for example, patents, copyrights, trademarks, and trade secrets)
5. Intangible real property (for example, leasehold interests, rights of way, and easements)

Goodwill Valuation Approaches and Methods

There are several generally accepted methods applicable to the goodwill valuation. After considering the similarities and differences, each method may be categorized into one of the three intangible asset valuation approaches.

As stated above, cost approach and market approach valuation methods are less commonly used, and income approach valuation methods are more commonly used in the goodwill analysis. The following discussion summarizes these valuation methods.

The Cost Approach

Using the cost approach, the financial adviser estimates the amount of current cost required to recreate the goodwill component elements. The cost approach typically involves a component restoration method.

The first procedure in the component restoration method is to list all of the individual components of the entity's goodwill. The second procedure is to estimate the amount of current cost required to replace each goodwill component. This procedure is based on the concept of goodwill as represented by the intangible value of all entity assets in place and ready to use.

One procedure in the restoration method is the analysis of forgone income (considered an opportunity cost in the cost approach) during the time period required to assemble all of the entity's tangible assets and identifiable intangible assets.

For example, let's assume that it would take two years to assemble all of the entity's component tangible assets and identifiable intangible assets. This time period represents the total elapsed time required for the assembled assets to reach the same level of utility, functionality, capacity, and income generation as exists in the actual going-concern business entity.

This hypothetical asset restoration process may include the following procedures:

1. The purchase and installation of all equipment
2. The construction or purchase of all real estate
3. The selection of suppliers
4. The creation of a distribution system
5. The hiring and training of employees
6. The building of a level of consumer recognition and confidence
7. The recreation of the current level of customer relationships

In this method, all of these component tangible assets and identifiable intangible assets are assembled at the level required to immediately accommodate the actual entity's current level of operations.

Let's consider a simple example of the restoration method. Let's assume that the actual entity earns $10,000,000 per year in income (however defined) during an expected two-year asset restoration period. The present value of the $20,000,000 in forgone income during an asset restoration period is one indication of the opportunity cost component in the goodwill value restoration method.

The Market Approach

There are two common market approach methods related to goodwill. The first method estimates the value of goodwill as the residual from an actual business acquisition price. This method is called the residual from purchase price method. The second method estimates the value of goodwill based on an analysis of guideline sale transactions. This method is called the sales comparison method.

Goodwill is rarely sold separately from any other assets (either tangible assets or intangible assets) of a going-concern business. Therefore, the selected guideline sale transactions usually involve the sale of a going-concern business.

The financial adviser selects publicly reported transactions in which the allocation of the sale price between the purchased goodwill and all other acquired assets is reported. Accordingly, this market approach method effectively relies on a residual from purchase price procedure to estimate the goodwill value.

To use the residual from purchase price method, there has to be a sale of the actual entity.

First, if there is such a sale transaction, the financial adviser confirms that the transaction was an arm's-length sale.

Second, the financial adviser confirms that the purchase price represents a cash equivalency price for the entity. For example, if there are noncash consideration components or deferred payments (for example, an earn-out provision) as part of the purchase price, the financial adviser converts the entire consideration to a cash equivalency price.

Third, the financial adviser estimates the value of each of the entity's tangible assets and identifiable intangible assets.

Fourth, the financial adviser subtracts the total value of all of the tangible assets and identifiable intangible assets from the business purchase price. The residual amount represents the goodwill value.

To use the guideline sale transactions method, the financial adviser identifies and selects actual sales of guideline entities that are sufficiently similar to the subject entity. For purposes of this analysis, comparability is typically based on the criteria of investment risk and expected return.

For certain types of businesses, such as certain types of professional practices, guideline sale transactional data are fairly easy to assemble. Such transactional data are reported in publicly available publications and periodicals. With regard to these sale transactions, the purchased goodwill may be typically expressed as a percent of the total transaction price or a percent of the total annual revenue earned by the entity that was sold in the transaction.

These market-derived goodwill pricing multiples are then applied to the subject entity to estimate the entity's goodwill value. It is noteworthy that the multiples are also estimated; that is, these transactional pricing multiples are themselves based on an allocation of the purchase price for each business or professional practice included in that transactional data source.

The Income Approach

With regard to goodwill, the income approach methods include the residual from business value method, the capitalized excess earnings method, and the present value of future income method.

Each of these valuation methods is based on the concept of goodwill as the present value of future income not associated with the entity's tangible assets or identifiable intangible assets.

The Residual from Business Value Method

The residual from business value method is based on the principle that the value of total assets (the "left hand" side of the entity's balance sheet) equals the value of total liabilities and equity (the "right hand" side of the entity's balance sheet).

Goodwill is valued as the total entity value less:

1. the value of all net working capital (or financial) assets,
2. the value of tangible assets (e.g., real estate and tangible personal property), and
3. the value of identifiable intangible assets.

There are several generally accepted business valuation methods. Financial advisers typically synthesize the value indications of one or more of these methods to estimate the value of the subject entity. Because there are many judgments made as part of any valuation, the objective of using more than one valuation method is to develop mutually supporting evidence as to the business value conclusion.

The business valuation methods that are commonly used in the residual from business value method include:

1. The direct capitalization method (an income approach method)
2. The discounted cash flow or yield capitalization method (an income approach method)
3. The guideline merged and acquired company method (a market approach method)

4. The guideline publicly traded company method (a market approach method)

The selection of these business valuation methods depends on the following:

1. The financial adviser's experience and judgment
2. The quantity and quality of available financial and operational data regarding the subject entity

Any of these methods may be used in a residual from business value analysis. The discounted cash flow method is a common business valuation method for the purpose of quantifying goodwill as the residual from a business value.

The discounted cash flow method is based on the principle that business value is the present value of the total future income to be derived by the entity's stakeholders. The discounted cash flow method typically involves revenue analysis, expense analysis, investment analysis, cost of capital analysis, and residual value analysis.

The revenue analysis involves a projection of prospective revenue from the sale of products or provision of services from the entity. This analysis may include consideration of the following market factors: expected unit sales volume, average selling price or contract rate, market dynamics, competitive pressures, price elasticities of demand, regulatory changes, and technological changes.

The expense analysis may include consideration of fixed versus variable costs, product versus period costs, cash versus noncash costs, direct versus indirect costs, overhead cost absorption principles, cost efficiency relationships, and cost-volume-profit relationships.

The investment analysis may include consideration of required minimum cash balance, days sales outstanding in accounts receivable, inventory turnover, plant utilization, and planned capital expenditures.

The cost of capital analysis may include consideration of current entity capital structure, current industry capital structure, optimal (or target) capital structure, cost of the various capital components, weighted average cost of capital, risk-free rate of return, systematic and nonsystematic equity risk premiums, and marginal cost of capital.

The residual value analysis may include the estimate of the value of the prospective cash flow generated by the entity at the end of a discrete projection period. The residual value may be estimated by various procedures, including the direct capitalization (or annuity in perpetuity) method.

Based on these valuation analyses, the periodic (typically annual) cash flow from the subject entity is projected for a discrete projection period. The term of the discrete projection period varies based on the financial adviser's judgment. Typically, the term of the discrete projection period approximately equals the average length of the industry business cycle. The discrete cash flow projection is discounted at an appropriate discount rate to determine a present value.

The residual value of the entity is estimated at the end of the discrete projection period. The residual value is also discounted to determine a present value. The present value of the discrete cash flow projection is summed with the present value of the residual value.

This summation calculation indicates the entity's total value. The entity's total value less the tangible assets value and the identifiable intangible assets value indicates the entity's goodwill value.

The Capitalized Excess Earnings Method

The capitalized excess earnings method involves the quantification and capitalization of excess income (as defined) earned by the entity. There are several variations of the capitalized excess earnings method. The following discussion presents a common application of this method.

First, the capitalized excess earnings method requires the financial adviser to estimate the required amount of income that an investor would expect given the risk of the subject entity. This procedure often involves the financial adviser's assessment of industry average rates of return on investment.

Some financial advisers apply an asset-specific rate of return on investment to each asset category. Alternatively, some financial advisers apply the entity's cost of capital as the overall required rate of return on investment. The entity's cost of capital is typically measured as the weighted average cost of capital.

In either case, the required return on investment is multiplied by the value of the net identified assets in order to quantify the amount of the required income. The net identified assets typically include all of the entity's working capital assets, tangible assets, and identifiable intangible assets.

Second, the financial adviser quantifies the difference between this required amount of income and the actual amount of income earned by the entity. If the actual amount of income exceeds the required

amount of income, then excess earnings exist at the entity.

Third, the financial adviser capitalizes the excess earnings (if any) as an annuity in perpetuity using an appropriate direct capitalization rate. The derivation of the direct capitalization rate should be consistent with the level of income used to measure the required amount of income of the entity and the actual amount of income of the entity. The result of the direct capitalization procedure indicates the goodwill value.

The Present Value of Future Income Method

The first procedure in this method is to identify all of the future income that is not associated with the entity's tangible assets and identifiable intangible assets. This identification procedure may include future capital expenditures, future mergers and acquisitions, new product or service lines, new sales territories, or new customers.

Generally, this future income is not included in the entity's current business plans or forecasts. This future income is typically not associated with entity's tangible assets or identifiable intangible assets in place as of the analysis date. Otherwise, that future income would be included in the value of the entity's tangible assets or identifiable intangible assets. Creating a projection of that future income is a challenge.

For purposes of illustrating this method, let's limit the discussion to analyzing the present value of the expected future customers of an entity. In any residual method goodwill analysis, it is common for the financial adviser to estimate and present value the prospective income associated with the current customer base.

This income projection (and the present value procedure) is typically made over the expected remaining useful life of the current customer relationships. The value of the entity's current customer base is the present value of the income to be earned from providing future products or services to current customers.

Using the present value of future income method, goodwill may be estimated as the present value of the future income to be earned from providing future goods or services to future, unidentified, customers. These future customers are unidentified new customers who (presumably) will take the place of the entity's current customers as the identified current customers retire.

The present value of future income method requires a projection of the entity's income-generating capacity. The projection begins with the expiration of the entity's current income sources (such as the identified current customers) and continues into perpetuity.

The present value of this prospective income stream (which typically provides for a capital charge or a fair return on all the tangible assets and intangible assets used to service the unidentified future customers) indicates a goodwill value. Using this method, the goodwill value is the present value of future income earned from the future sales to future (unidentified) customers.

"Using the present value of future income method, goodwill may be estimated as the present value of the future income to be earned from providing future goods or services to future, unidentified, customers."

The present value of future income method is a conceptually sound method to value goodwill. Consistent with the income-based concept of goodwill, this method quantifies and assigns all of the entity's income that cannot be associated with any of the entity's tangible assets or identifiable intangible assets.

Goodwill is quantified as the present value of all prospective income that cannot be associated with the current sources of income (for example, the entity's tangible assets and identifiable intangible assets that are in place as of the analysis date).

Long-term projections of income derived from unidentified sources (for example, from unidentified future customers) are uncertain. As a result, it may be difficult in practice to use this method to estimate goodwill value.

Goodwill under Alternative Premises of Value

A premise of value is an assumption about the set of actual or hypothetical transactional circumstances applicable to the analysis. The premise of value describes the facts surrounding the operational environment in which the defined standard of value transaction will take place. The premise of value may have an impact on the value of an entity's or an individual's goodwill.

All intangible assets, including goodwill, can be valued under the following alternative premises of value:

1. Value in continued use as part of a going concern

2. Value as an assemblage of assets in place but not in current use
3. Value in exchange as part of an orderly disposition of asset
4. Value in exchange as part of a voluntary liquidation of asset
5. Value in exchange as part of an involuntary liquidation of assets

The same goodwill of the same entity will likely have a different value conclusion depending on the premise of value that is applied in the analysis.

A value in continued use, going-concern value indication is influenced by the relative contribution and mutual economic benefits that are created by all assets of the entity.

Accordingly, the business value of most companies is greater than the sum of the values of the component tangible assets and identifiable intangible assets. One goodwill component relates to the incremental value that is created by assembling these tangible assets and identifiable intangible assets in an income-producing, going-concern business.

Goodwill is often identified and quantified in a business valuation that is conducted based on a going-concern premise of value. However, a business valuation conducted on the various value in exchange premises of value may not include the contributory value of all assembled tangible assets and intangible assets. This is because the entity's tangible assets and intangible assets are valued on an individual or piecemeal basis. Goodwill value is often limited in a business valuation that is conducted based on one of the alternative value in exchange premises of value.

For example, a business valuation that is based on a value in exchange or liquidation premise of value for a bankruptcy purpose often may not involve the identification or valuation of goodwill.

When the financial adviser selects the appropriate premise of value on which to conduct the business valuation, he or she considers whether the entity has goodwill. If goodwill exists within the entity, then it is likely that the entity does not have going-concern risk. In other words, the entity's HABU is likely to be as a going concern. Therefore, it is likely to be appropriate to value the entity (and the tangible assets and intangible assets) based on the premise of value in continued use.

However, if no goodwill exists in the entity, then that entity may suffer from going concern risk. If there is no goodwill, the financial adviser may conclude that a value in exchange premise of value represents the HABU. Typically, the selection of the appropriate premise of value is based on the HABU of the entity or the tangible assets and intangible assets.

Of course, there may be circumstances when the entity is not being operated at its HABU. In those circumstances, the goodwill may have a greater value based on a value in exchange premise of value rather than on a value in continued use premise of value.

Goodwill Data Sources

Goodwill data sources can be either internal or external to the entity.

Internal data sources typically relate to documentation regarding the entity's historical or prospective results of operations.

External data sources typically relate to empirical pricing data with regard to the goodwill of guideline business or professional practice sale transactions.

Internal Data Sources

The financial adviser considers all available data sources regarding the goodwill owner/operator. These internal data sources typically fall into the following categories:

1. The existence of identified tangible assets and intangible assets, including a detailed listing of working capital accounts, real estate, tangible personal property, and identifiable intangible assets (including intellectual property)
2. The valuation of tangible assets and identifiable intangible assets, including recent appraisals of any asset category
3. The historical results of business operations, including historical income statements,

balance sheets, cash flow statements, and capital statements

4. The prospective results of business operations, including current budgets, plans, forecasts, and projections prepared for any purpose

Information from these internal data sources can be used in the goodwill valuation.

External Data Sources

For certain industries (principally professional practices), there are publications, periodicals, and online data sources that report on the goodwill components of actual business sale transactions. Some of these data sources are listed in the next section.

Directors, Periodicals, and Newsletters

- *Bank M&A Weekly* (Charlottesville, VA: SNL Financial, weekly). *Bank M&A Weekly* is the only source dedicated to comprehensive coverage of bank and thrift industry consolidation, including branch deals and other asset transactions. Delivered via e-mail every week, each issue includes key deal ratios, buyer and target financials, industry trends, and feature stories.
- *Cable TV Investor: Deals & Finance* (Charlottesville, VA: SNL Kagan, monthly). *Cable TV Investor: Deals & Finance* provides access to data, deals, and valuation metrics in the cable TV sector. In each issue, *Cable TV Investor*: Deals & Finance brings in-depth analysis of the latest market trends and what they mean for the future.

  Data covered include private market values of public cable TV stocks, details on recent top cable TV deals, analysis of cable multiple-system operator (MSO) key growing revenue streams, operating data analysis, stock commentary, trends in financing, details on initial public offerings (IPOs), quarterly MSO census, and annual detailed cable industry forecasts.
- *Goodwill Registry* (Plymouth Meeting, PA: The Health Care Group, annual). The *Goodwill Registry* is the nation's largest database of health care practice transactions and the only source of actual goodwill values paid. Published every spring since 1981, the *Goodwill Registry* contains data organized by medical and dental specialty, state, location, and other practice characteristics.

  Many medical and dental practice consultants, financial advisers, and others find the information published in the *Goodwill Registry* to be an extremely useful tool, not only for ad hoc and formal practice valuations, but also for practice value trend analysis and more.
- *The Lawyer's Competitive Edge: The Journal of Law Office Economics and Management* (Eagan, MN: West, monthly). Practical management information to minimize falling profits, client loss, and employee dissatisfaction.
- *Merger & Acquisition Survey of Architecture, Engineering, Planning & Environmental Consulting Firms* (Natick, MA: Zweig White & Associates, annual). This comprehensive report includes all the latest data on the state of merger and acquisition activity in the design and environmental consulting industry.
- *Public Accounting Report* (Chicago: Commerce Clearing House (CCH), biweekly). The newsletter provides competitive intelligence for public accounting firms and the profession. It is renowned for its straight reporting and analysis of the news, developments, and trends that have defined the profession for more than 20 years.

  Public Accounting Report is written for public accounting firm partners and professionals, opinion leaders, and industry observers. A subscription includes 23 issues plus periodic special reports and extras, including the exclusive *Public Accounting Report* Top 100 ranking of accounting firms.
- *Valuation Survey of Architecture, Engineering, Planning & Environmental Consulting Firms* (Natick, MA: Zweig White & Associates, annual). *Valuation Survey of Architecture, Engineering, Planning & Environmental Consulting Firms* is the definitive resource for architectural, engineering, planning, or environmental consulting firms.

  The survey data included in this report and the Zweig White exclusive Z-Formulas are useful for a firm sale or merger or internal purposes, such as ownership transition or employee stock ownership plan (ESOP) purposes.

Financial Ratios

- *Almanac of Business and Industrial Financial Ratios*, by Leo Troy (Chicago, CCH, annual). This source contains financial ratios derived from federal tax returns.

Ratios for each of about 200 industries are arranged according to company asset size.

- *Industry Financial Analysis Profiles* (Camp Hill, PA: BizMiner, database). Five-year comparative analysis includes income statements, balance sheets, and key financial ratios for more than 10,000 lines of business.

  Income statement analysis includes cost of sales, officer compensation, payroll, rent, taxes, interest, amortization and depreciation, advertising, employee benefits, and other selling, general, and administrative expenses in both dollars and as a percentage of sales. Available in all firms, small business, sole proprietor, and business start-up versions.

- *Integra Industry Reports* (Kennesaw, GA: Integra Information, Microbilt Corporation, database). Available in QuickTrends, 3-Year, and 5-Year versions, which include income statements, balance sheets, and key business ratios by sales size range for over 900 industries.

  The five-year report includes cost of sales, officer compensation, employee benefits, advertising, bad debts, rent, depreciation, and other selling, general, and administrative expenses in both dollars and as a percentage of sales.

- *FINTEL Industry Metrics Reports* (Madison, WI: Fintel LLC, database). Reports provide financial information drawn from a database of over 900,000 privately held firms in over 2,500 industry groups as classified either by standard industry classification or North American Industry Classification System. Size breakdowns are into small, medium-sized, and large segments specific to each industry rather than breakdowns based on fixed size thresholds.

  Common-sized income statement and balance sheet data (major accounts) for each size segment (as-if statements) are displayed as are 14 commonly used and insightful financial ratios for each industry.

- *IRS Corporate Ratios* (Libertyville, IL: Schonfeld & Associates, annual or database). Ten years of corporate tax return data and financial ratios for over 250 industry groups is provided.

  Information provided includes income and expenses, balance sheets, and key business ratios, with data categorized within an industry group by asset size.

- *RMA Annual Statement Studies* (Philadelphia: PA: The Risk Management Association, annual). Five-year comparative analysis includes income and expenses, balance sheets, and key industry ratios categorized by sales and assets size range for over 740 industries.

  Income and expense ratios include gross profit, operating expenses, officer compensation, and depreciation and amortization expense as a percentage of sales.

Trade and Professional Organizations

- *American Bar Association*. 321 North Clark Street, Chicago, IL 60654. Phone: (800) 621-6159 or (312) 988-5000, www.americanbar.org.
- *American Institute of Architects*. 1735 New York Ave., NW, Washington, DC 20006. Phone: (202) 626-7300, www.aia.org.
- *American Institute of Certified Public Accountants*. 1211 Ave. of the Americas, New York, NY 10036-8775. Phone: (800) 862-4272 or (212) 596-6200, www.aicpa.org.
- *American Medical Association*. 515 N. State St., Chicago, IL 60610. Phone: (800) 621-8335, www.ama-assn.org.

Goodwill Value Illustrative Example

This simplified example applies the capitalized excess earnings method to estimate the professional practice goodwill value in a small corporate transaction.

In this example, let's assume that the physician owners of Zeta Physicians Clinic (Zeta) and Eta Medicine, Inc. (Eta), have decided to enter into a joint venture to provide certain acute care medical services. The joint venture will be called the Theta Medical Group ("Theta").

In this transaction, Zeta provides the Theta joint venture with the following:

1. The use (but not the ownership) of its trademark and trade name and its associated positive reputation
2. Access to (but not the ownership of) its patient charts and records and the associated patient loyalty

To simplify this example, let's assume that the financial adviser is asked to value these discrete intangible assets collectively as goodwill. Let's assume that this goodwill is the only asset to be contributed by Zeta to Theta. Eta will provide all of the tangible assets and all of the working capital assets (but no liabilities) to Theta.

Eta will contribute tangible assets and working capital assets to the Theta joint venture in an amount equal to the goodwill value contributed by Zeta. The Theta joint venture will be formed as of December 31, 2014.

The owners of Eta and Zeta have to divide the equity ownership of the Theta joint venture. The owners have agreed to allocate the equity value based on the relative values of the assets contributed by each party.

The objective of the analysis is to estimate the value of the goodwill contributed by Zeta to the Theta, as of December 31, 2014 (the valuation date). The purpose of the analysis is to allocate the Theta equity ownership.

Most of the value in the Theta joint venture is related to its expected future revenue and income. Based on the specific facts of this assignment, the financial adviser concludes that the income approach and the capitalized excess earnings method is appropriate to value the Zeta goodwill.

Exhibit 1 presents the projected balance sheet as of the December 31, 2014, date of inception of the joint venture. Exhibit 2 presents the joint venture projected next year income statement as of December 31, 2014. The projected income statement is based on the financial adviser's projection of revenue and expenses. The joint venture projected net cash flow as of December 31, 2014, is presented in Exhibit 3 on the following page.

For purposes of this analysis, the financial adviser defines excess earnings as the difference between the Theta projected total income and a total fair return on the Theta tangible assets and working capital assets. The fair rates of return applied to the Theta working capital assets, tangible assets, and goodwill are based on market-derived evidence.

Intangible assets (including goodwill) generally have a greater level of financial and operational risk than do tangible assets. And, tangible assets generally have a greater level of financial and operational risk than do working capital (or financial) assets.

Typically, intangible assets are expected to earn a higher asset-specific rate of return than tangible assets are expected to earn. Typically, tangible assets are expected to earn a higher asset-specific rate of return than financial assets are expected to earn.

Exhibit 4 presents the financial adviser's estimate of the joint venture excess earnings. Exhibit 5 illustrates the procedure for capitalizing the excess earnings into an estimate of goodwill. Based on this illustrative analysis, the value of the Zeta goodwill contribution to the Theta, as of December 31, 2014, is $2,700,000.

Exhibit 1
Zeta Physicians Clinic Goodwill Valuation
Balance Sheet as of December 31, 2014

Assets	
Current assets	$3,000,000
Property, plant, and equipment	2,000,000
Total assets	$5,000,000
Liabilities	
Current liabilities	$1,000,000
Long-term debt	1,000,000
Total liabilities	2,000,000
Owner's Equity	3,000,000
Total liabilities and owner's equity	$5,000,000

Exhibit 2
Zeta Physicians Clinic Goodwill Valuation
Projected Income Statement as of December 31, 2014

	Projected Fiscal Year Ended 12/31/15
Net revenue	$8,000,000
Operating expenses	
Cash expenses	5,400,000
Depreciation expense	1,000,000
Interest expense	100,000
Total expenses	6,500,000
Pretax income	1,500,000
Income tax expense	(600,000)
Net income	$900,000

Exhibit 3
Zeta Physicians Clinic Goodwill Valuation
Projected Net Cash Flow as of December 31, 2014

Net Cash Flow (to invested capital)		Projected Fiscal Year Ended 12/31/2015
	Projected net income	$900,000
plus:	Tax-affected interest expense	60,000
equals:	After tax net operating income	960,000
plus:	Depreciation expense	1,000,000
less:	Capital expenditures	1,000,000
less:	Increase in net working capital	100,000
equals:	Projected net cash flow	$860,000

Exhibit 4
Zeta Physicians Clinic Goodwill Valuation
Estimate of Excess Income as of December 31, 2014

Valuation Analysis	
Projected net cash flow	$860,000
Working capital asset value	2,000,000
Required rate of return [a]	6%
Fair return on working capital assets	(120,000)
Tangible asset value	2,000,000
Required rate of return [a]	10%
Fair return on net tangible assets	(200,000)
Total fair return on working capital assets and tangible assets	(320,000)
Excess income	$540,000

[a] Based on market-derived rate of return evidence.

Exhibit 5
Zeta Physicians Clinic Goodwill Valuation
Capitalized Excess Earnings Method Value Conclusion as of December 31, 2014

Valuation Analysis	Indicated Value
Excess income	$540,000
Divided by: Selected direct capitalization rate	20%
Equals: Intangible value in the nature of goodwill	$2,700,000
Value of the Zeta Physicians Clinic goodwill contributed to the Theta joint venture (rounded)	$2,700,000

Accordingly, Zeta contributed $2,700,000 of intangible asset value to Theta. And, Eta will contribute $3,000,000 of current assets and $2,000,000 of tangible assets ($5,000,000 in total) to Theta. Therefore, the Theta equity will be allocated 35 percent to Zeta ($2,700,000 ÷ $7,700,000) and 65 percent to Eta ($5,000,000 ÷ $7,700,000).

Summary

There are different types of goodwill, including (1) business or institutional goodwill and (2) personal or professional goodwill. Financial advisers are often asked to value these different types of goodwill for transaction, taxation, financial accounting, litigation, and other purposes. This discussion describes the various components of goodwill and the various reasons why financial advisers—particularly independent financial advisers—may be asked to value goodwill.

This discussion considered the types of business goodwill and personal goodwill and summarized the common components and types of goodwill.

This discussion explained that the income approach is not the only approach to value goodwill. The cost approach and the market approach may also be appropriate to a goodwill valuation.

The independent financial adviser should carefully consider which valuation approach is most appropriate for the specific type of entity and the specific type of assignment.

In addition, with consideration of any instruction provided by legal counsel, the financial adviser should apply a valuation approach and valuation method that concludes the standard of value and premise of value appropriate to the purpose and objective of the goodwill valuation.

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