

Goodwill Valuation Considerations Involving Private Companies and Professional Practices



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The valuation of either business (also called institutional) goodwill or personal (also called professional) goodwill is a common issue in the family law context. The goodwill issue arises when the marital estate owns a private company or a professional practice or when one of the marital parties holds a professional license. The goodwill valuation may affect the value of the private company or professional practice ownership interest. The goodwill valuation may be relevant if the practitioner's personal goodwill either is— or is not— a marital estate asset. And, the goodwill valuation may be relevant if the marital estate includes only the appreciation (or the excess over a normal amount of appreciation) in the goodwill during the term of the marriage. This discussion summarizes many of the analyst's considerations in the valuation of goodwill in a family law context.

INTRODUCTION

This discussion summarizes the generally accepted approaches and methods related to the valuation of goodwill within the family law context. This discussion primarily considers the business (or institutional) goodwill that is included in the valuation of a family-owned private company or professional practice. This discussion also considers the personal goodwill that may be included in the valuation of a practitioner's professional license or a celebrity's status.

There is no single definition of goodwill that is applicable to all family law situations. Therefore, alternative definitions of goodwill are considered in this discussion. This discussion summarizes the common types of goodwill and the common attributes of goodwill. This discussion also describes the many non-family-law reasons to value goodwill.

The many interpretations of goodwill are generally grouped into two categories:

1. Residual interpretations
2. Income interpretations

From the valuation analyst (analyst) perspective in a family law

matter, the income interpretation (or measurement) of goodwill may be more useful. However, analysts and family law counsel (counsel) should be familiar with both categories of interpretations (or measurements) of goodwill.

Both interpretations of what goodwill is (and how it should be measured) generally agree on the following:

1. The components of (or the factors that create) goodwill
2. The types of goodwill (or situations in which goodwill arises)

THE GOODWILL COMPONENTS

There are three principal components of goodwill. Analysts consider these three components as either the factors that create goodwill or the reasons why goodwill exists in certain circumstances.

The first component relates primarily to business goodwill. The second component relates to both business goodwill and personal goodwill. And, the third component relates primarily to business goodwill.

For purposes of this discussion, business goodwill includes the goodwill of a family-owned private company or a professional

practice. Personal goodwill includes the economic benefits associated with an individual celebrity, a professional athlete, or a professional (including licensed) practitioner.

First Goodwill Component—Operating Business Assets

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 value element of goodwill.

The fact that all of the elements of a business enterprise are physically and functionally assembled creates an intangible asset. These elements include capital (e.g., equipment), labor (e.g., employees), and coordination (e.g., management).

Some analysts identify and measure this going-concern value as a separate intangible asset of a

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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.

private or professional practice. This separate identification may be appropriate for certain taxation or forensic analysis purposes.

Other analysts measure going-concern value as one component of the entity's business goodwill. For example, this aggregate identification of going-concern value and goodwill is appropriate for purposes of Financial Accounting Standards Board (FASB) Accounting Standards Codification (ASC) topic 805, *Business Combinations*, and the associated fair value accounting for business combinations.

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

This going-concern value will typically enhance the value of the private company/practice's individual operating assets. For example, the value of a private company's operating equipment is typically greater when the equipment is valued based on a value in continued use (or going-concern) premise of value—rather than based on a value in exchange (or piecemeal disposition) premise of value.

Some going-concern value will typically also attach to the private company/practice's identifiable intangible assets. For example, the value of an owner/operator's patent, copyright, trademark, trade secret, or computer software is typically greater when that intangible asset is valued based on a value in continued use (or going-concern) premise of value—rather than based on a value in exchange (or piecemeal disposition) premise of value.

Second Goodwill Component—Excess Income

The second goodwill component is the existence of excess income (however measured) related to either a business entity or an individual. This component is

described later in this discussion. For a private company/practice, excess income is typically measured as the amount of 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 private company/practice value that cannot be specifically assigned to the entity's tangible assets or identifiable intangible assets. For the private company or professional practice, this excess income may be measured at the level of earnings before interest and taxes (EBIT); earnings before interest, taxes, depreciation, and amortization (EBITDA); net operating income; net income; or net cash flow.

For an individual (e.g., professional practitioner, athlete, celebrity), excess income is income generated by the individual that is greater than the income that would be expected to be accrued by a comparably skilled individual working in comparable circumstances. For individuals, this excess income is often measured at the net income or net cash flow level.

Third Goodwill Component—Expectation of Future Events That Are Not Directly Related to the Entity's Current Operations

The third goodwill component is the expectation of future events that are not directly related to the private company/practice's current operations. For example, goodwill may be created by the expectations of future capital expenditures, future mergers and acquisitions, future to-be-developed products or services, future customers or clients, or similar future growth opportunities.

This future expectations component relates to the concept of goodwill as the present value of future assets (both tangible assets

and intangible assets) that do not yet exist on the analysis date.

Investors assign a goodwill value to a private company or professional practice 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 identifiable intangible assets.

GENERAL TYPES OF GOODWILL

There are three general goodwill types. These three goodwill types may affect the identification and the 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 business. However, in the case of a professional services business (for example, a manufacturer 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 medical, dental, legal, accounting, engineering, or other types of professional practice. This goodwill type is distinguished from the other goodwill types because it has two distinct components:

1. The practitioner (or personal) component
2. The business (or practice) component

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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 dissolution, shareholder dispute, or other types of litigation.

Ultimately, the ownership of the goodwill components is a legal question with a legal answer. However, the analyst 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 general 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, cler-

gy, 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 analyst to separately identify and individually value the three types of goodwill. There may be different legal, economic, and taxation consequences for each goodwill type.

Some of the factors that affect which type of goodwill exists include the following:

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

Even the goodwill associated with a private company/practice may 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 private company,
2. the operations of the private company or professional practice are not functionally or economically separate from the individual, and
3. the success of the private company is directly related to the activities of the individual.

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

OTHER REASONS FOR AN ANALYST TO VALUE GOODWILL

In addition to family law contexts, there are many circumstances that require the valuation of goodwill. Analysts and counsel should understand that goodwill is not just a marital dissolution issue or a creation of family law.

Some of the reasons why analysts may be asked to value goodwill are summarized below:

- *Economic damage analyses.* When a private company or professional practice 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 private companies or professional practices 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 private company or professional practice 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

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controlled by or developed by each partner, including the goodwill of each partner.

- *Solvency test.* The solvency of a private company/practice is an issue with regard to lender's fraudulent conveyance concerns during a financing transaction or a financial restructuring.

One of the specific tests to determine if a private company/practice is solvent is to ask this question: Does the fair value of the entity's assets exceed the amount of the entity's liabilities (after consideration of the financing transaction)? One of the private company/practice assets that is considered in a solvency analysis is goodwill.

- *Insolvency test.* The degree of insolvency of a private company/practice 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 private company/practice is insolvent for federal income tax purposes is to ask this question: 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 certain intangible assets are transferred between controlled corporations (for example, between a parent corporation and a wholly owned subsidiary), an arm's-length price should be estimated for the intercompany transfer of the assets.

Such intercompany transfers may have international, federal,

and state income tax ramifications. Such intercompany transfers may have federal income tax consequences if one of the controlled corporations is located in a foreign tax jurisdiction. Depending on the applicable tax regulations, goodwill may or may not be one of the intangible property assets included in the intercompany transfer.

- *Bankruptcy and reorganization.* Parties in interest to a bankruptcy estate often have to decide if the debtor company 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 company goodwill (if any) may be useful in assessing whether the business is worth reorganizing.

A valuation of the debtor company 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 of the assets that should be considered in the conversion valuation.

- *Business enterprise valuation.* The identification and quantifi-

cation 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 of a professional practice or professional service business. Such business valuations are routinely performed for taxation, ownership transition, financing, bankruptcy, corporate governance, litigation, and other purposes.

When such asset-based approach valuations are performed on a going-concern business enterprise, the analysis typically includes the valuation of the entity's goodwill (as well as its other intangible assets).

- *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. Analysts 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. The following are two examples of such litigation:

1. Marital dissolution cases (which involve the allocation of the business entity ownership interest within the marital estate)

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2. Dissenting shareholder appraisal rights and shareholder oppression cases (which involve the allocation of the business entity ownership interests to the dissenting or the 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. However, 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 taxpayer entity's goodwill.

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

These examples summarize some of the reasons why analysts may be asked to value goodwill. Of course, these examples do not provide an exhaustive list of all of the reasons to value goodwill.

HOW THE DIFFERENT GOODWILL TYPES ARE VALUED

All generally accepted intangible asset valuation approaches may be appropriate to value the different types of goodwill.

Typically, goodwill (whether personal or institutional) is not sold or otherwise transferred in the marketplace separately from other entity assets. Therefore, the market approach is less commonly applied 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 professional practice entities.

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

Analysts may also apply some version of a residual analysis in the valuation of personal or institutional goodwill. In such a valuation, the analyst 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:

1. the overall business enterprise value less
2. the total value of all tangible assets and identifiable intangible assets used in the business enterprise.

The analyst may also apply some version of the "with and without" method (also called the comparative business value method) in the valuation of personal or institutional goodwill. To apply the "with

and without" method, the analyst estimates the value of the subject business entity with and without the goodwill in place.

The "with and without" method is more commonly applied to value personal goodwill than institutional goodwill. Typically, based on the different sets of financial projections and the different discount or capitalization rates, the subject 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" private company/practice value and
2. the "without the individual in place" private company/practice value.

The personal goodwill value is the difference between the two business value estimates based on the two alternative sets of financial projections. The analyst 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 goodwill definitions and the income goodwill definitions.

Analysts sometimes identify and value goodwill collectively as the total intangible value of a business.
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ness 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:

1. a total business acquisition price or
2. a concluded business enterprise 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.

Analysts 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:

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

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. As a result, 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:

- Value in continued use as part of a going concern
- Value as an assemblage of assets in place, but not in current use
- Value in exchange as part of an orderly disposition of asset
- Value in exchange as part of a voluntary liquidation of assets
- 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.

As a result, 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 based on the various value-in-exchange premises of value may not include the contributory value of all assembled tangible assets and intangible assets because the entity's tangible assets and intangible assets are valued on

an individual or piecemeal basis.

As a result, 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 (say) a bankruptcy purpose often may not involve the identification or valuation of goodwill.

When the analyst 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 highest and best use (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 analyst 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 entity's 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.

CONCLUSION

This discussion considered the types of business and personal goodwill that are commonly considered in a family law valuation. The goodwill valuation may be relevant
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⁴ Note: Including TSCPA members who may not be members of the AICPA.
⁵ Comments on the proposed new professional standards can be sent to Barbara Andrews, the AICPA's Director for Forensic Services, at barbara.andrews@aicpa-cima.com.
⁶ FVSEC, Forensic & Litigation Services Committee, Business Valuation Services Committee, Certified in Financial Forensics Credential Committee, and Accredited in Business Valuation Credential Committee, "Exposure Draft: Statement on Standards for Forensic Services" (Exposure Draft), AICPA, December 2018, <https://www.aicpa.org/interestareas/forensicandvaluation/resources/standards/exposure-draft-statement-on-standards-for-forensic-services.html>.
⁷ Exposure Draft.
⁸ Ibid.
⁹ *Statement on Standards for Consulting Services*, (CS Section 100.)
¹⁰ Note: The AICPA Management Services Executive Committee no longer exists at the AICPA.
¹¹ CS Section 100, p. 1.
¹² Exposure Draft.
¹³ Ibid.
¹⁴ See definition of "Litigation Services" under the AICPA's Code of Conduct (Code) at § 1.295.140.04.
¹⁵ See definition of "Investigation Services" under the AICPA's Code of Conduct (Code) at § 1.295.140.03.
¹⁶ Exposure Draft. Note: The proposed standard suggests that members should modify the understanding with the client if such engagements convert to a Forensic Services engagement.
¹⁷ Exposure Draft.
¹⁸ See ET ¶ 0.400.07 for definition of "client."
¹⁹ Exposure Draft.
²⁰ Ibid.
²¹ This does not apply when the member is the trier of fact.
²² Exposure Draft.
²³ Ibid.
²⁴ Ibid.
²⁵ Ibid.
²⁶ <https://www.aicpa.org/news/aicpatv.5988435803001.html/p/3891251953001/c/Forensic-and-Valuation-Services/s/Webcast-Archives/>

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when a private company, professional practice, or individual's professional license or celebrity are part of the marital estate. This discussion summarized the common components and types of goodwill.

With consideration to any legal instructions obtained from counsel, the analyst should apply an approach and method that concludes the standard of value and the premise of value that are appropriate to the family law valuation assignment— given the relevant statutory authority and the relevant judicial precedent. 