Goodwill Basics

Goodwill may be the most misunderstood concept in business valuation. A short story may provide some insight.

Last week, after a power outage a business appraiser bought an oil lamp. The business appraiser started to polish it *(bear with me)*. Out popped the Goodwill Genie. She offered to answer three questions about goodwill, so the Appraiser asked them.`

What Is Goodwill?

An accountant would answer this way. Goodwill balances the price paid for a collection of tangible assets with their fair market value. If the purchaser pays more than fair market, the excess is goodwill. Until recently, goodwill could be amortized *(written down in value)* over many years. Accounting rules (GAAP) now requires that goodwill and intangible assets be valued annually and written down to fair market value if they have depreciated *(but not written up if they have appreciated)*. Tax treatment is different: Goodwill can currently be amortized, for tax purposes, over 15 years.

Goodwill is one type of intangible asset. Intangible assets have little or no physical presence, and include things like brand names, customer lists, in-process R&D, and computer software expensed as incurred. Many, like the value of a trained workforce in place, are not on the books. When a business is purchased the buyer normally buys both tangible and intangible assets. Each intangible must be identified and valued. When this process is complete, if the price paid for the assets exceeds the sum of their individual fair market value, the excess is goodwill, a catchall.

A business appraiser would answer differently. Goodwill reflects the fact that a business earns more than the return expected solely from the tangible assets. The genie steps up and says: "Before I was a genie, I was a lawyer in sole private practice. My tangible assets were modest - cash, receivables, supplies, books, files, and equipment. I generated high billings, a nice paycheck, and profits for myself, far more than I could have earned had I sold my assets and reinvested them. The value of my practice was greater than that of my tangible assets. The difference was the value of my intangibles: ability, experience, knowledge, license, reputation, network, client list, etc. and goodwill."

How Do You Value Goodwill and Intangible Assets?

There are two ways: the "big pot" and "separation" approaches. The big pot approach is simple. Value the whole business using the Market *(comparable transactions)* or Income Approach (multiple of cash flow or earnings). Then value tangibles - cash, receivables, inventory, and fixed assets *(those may require a specialist)*, net of liabilities. The difference between business and net tangible value is the value of the big pot, which includes all intangibles and goodwill. The big pot approach is usually sufficient if the pot's value is small, zero, or negative, or if there is no need to separate the tangibles from the intangibles. This occurs in most tax-related appraisals, where a business interest is sold or gifted to a related party or philanthropy, in most divorce appraisals *(except that some jurisdictions treat goodwill attached to an individual differently from that attached to a business)* and in most dissenting shareholder matters. In each case, only the value of the business is needed, not an analysis of its tangible and intangible components.

In mergers and acquisitions *(because of the new accounting rules)*., specific intangibles and goodwill must be valued using the separation approach. The methodology is like that for conventional business appraisals, but the techniques and data sources differ.

What Is The Biggest Misunderstanding About Goodwill?

Harking back to the big pot, when a business is valued using the Market or Income Approaches, the value includes goodwill and intangibles. Many business owners think these should be sources of additional value, but they are not. Goodwill and intangibles cause the business to be worth more than its net tangible value, like the *(genies)* law practice. Those approaches implicitly include the intangibles. While on the subject, the goodwill of an entire business cannot be negative. If a business is worth less than its net tangible assets, logic would seem to suggest that its big pot has a negative value. True, but what really happens is that if the causes of implied "negative" goodwill cannot be eliminated, the business should be liquidate. The owners would realize the value of the net tangibles.

<u>There is one caveats about the last statement</u>: It does not apply to a minority interest. A minority owner cannot force liquidation except in limited circumstances: he or she is stuck with the lower value.

<u>The key thing to understand is that</u>:

Goodwill is an asset!

One that can be <u>created</u> or <u>destroyed</u> … *by* management actions.