

Intangible Asset Valuation Insights

VALUATION OF GOODWILL WITHIN THE FAMILY LAW CONTEXT

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Valuation analysts are often called on to value goodwill as part of a family law controversy. The valuation analyst is asked to value institutional (or business) goodwill when the marital estate owns a family-owned business or professional practice. The valuation analyst is asked to value personal (or celebrity) goodwill when one of the marital partners is a licensed professional, professional athlete, or professional entertainer. There are generally accepted approaches, methods, and procedures related to the valuation of goodwill. First, this discussion summarizes these generally accepted goodwill valuation approaches and methods. Second, this discussion presents a simplified illustrative example of one generally accepted goodwill valuation method.

INTRODUCTION

This discussion summarizes the generally accepted approaches, methods, and procedures related to the identification, valuation, and economic analysis of goodwill. In particular, this discussion describes the analysis of closely held business or professional practice intangible value in the nature of goodwill within the context of a family law controversy.

While there is no universally accepted definition of goodwill, this discussion summarizes (1) the common types of goodwill-related intangible assets and (2) the common components of goodwill-related intangible assets. The family law reasons why goodwill should be valued will be presented, followed by a discussion of the valuation approaches, methods, and procedures that valuation analysts may use to quantify goodwill value.

While the income approach is the most common approach to value goodwill, this does not eliminate the use of other intangible asset valuation approaches. Accordingly, this discussion will consider valuation methods using the cost approach, market approach, and income approach.

The elements of a goodwill valuation assignment—and how these elements affect the goodwill valuation—are presented next. The selection of the appropriate premise

of value helps to define the goodwill valuation assignment. The discussion includes:

1. the impact that the appropriate premise of value has on the goodwill valuation and
2. the impact that the goodwill valuation has on the appropriate premise of value.

Finally, this discussion presents a simplified illustrative example of the quantification of intangible value in the nature of goodwill.

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WHY VALUE GOODWILL?

The valuation of either personal or business goodwill is a common component of a marital dissolution valuation assignment. If the marital

estate includes an ownership interest in a closely held business, that entity’s institutional or professional goodwill may be included in the marital estate.

In contrast, the personal goodwill of the closely held business employer/shareholder may or may not be included as marital property. Therefore, the value of such personal goodwill may or may not be an issue in the marital estate valuation assignment.

It is noteworthy that the standard of value used in marital dissolution valuation assignments varies by jurisdiction. Not

all jurisdictions consider fair market value as the appropriate standard of value in family law matters. And, the jurisdiction-specific standard of value in family law analyses may affect the quantification of intangible value in the nature of goodwill.

COMPONENTS OF INTANGIBLE VALUE IN THE NATURE OF GOODWILL

There are three principal components of goodwill. These three components may be considered either as (1) the factors that create goodwill or (2) the reasons why goodwill exists in certain circumstances.

The first component of goodwill 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 elements of a subject 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 of the going-concern value enhances the value of the individual business enterprise elements. For example, the value of equipment is typically greater when the equipment is valued on a value in continued use (or going-concern) basis as compared to a value in exchange (or piecemeal, liquidation) basis.

Some of the going-concern value also attaches to discrete intangible assets. For example, the value of a patent, copyright, or trademark is typically greater when that intellectual property is appraised on a value in continued use (going-concern) basis as compared to on a value in exchange (or piecemeal, liquidation) basis. Finally, some of the going-concern value also inures to the goodwill intangible.

The second component of goodwill is the existence of excess economic income. This component is discussed at length in the methodology section of this discussion.

Excess economic income is income generated by a business enterprise that is greater than the amount considered a fair rate of return on all of the tangible assets and discrete intangible assets used in the business.

This excess economic income component relates to the concept of goodwill as that component of business enterprise value that cannot be specifically assigned to any of

the other tangible assets or identified intangible assets of the subject business.

The third component of goodwill is the expectation of future events that are not directly related to the current operations of the subject business enterprise. Goodwill may be created by investors’ expectations of future capital expenditures, future mergers and acquisitions, future products or services, and future customers or clients. This future expectations component relates directly to the concept of goodwill as the current value of future assets (tangible or intangible) that do not exist as of the valuation date.

“Goodwill may be created by investors’ expectations of future capital expenditures, future mergers and acquisitions, future products or services, and future customers or clients.”

Investors (and owners) assign a goodwill value to a business enterprise if they expect that the net present value of the income associated with future events is positive. Of course, the positive net present value of the expected future income associated with assets currently in place (e.g., capital assets, product lines, customers) are appropriately assigned to those respective tangible assets and intangible assets.

ACCOUNTANTS’ INTERPRETATION OF GOODWILL

Under generally accepted accounting principles (GAAP), the goodwill that a business enterprise develops in the normal course of business operation is rarely recorded on the company financial statements. This accounting recognition of internally created goodwill is different than the accounting recognition for purchased goodwill.

“. . . the instances in which a company’s internally developed goodwill (as opposed to its purchased goodwill) is recognized for accounting purposes are rare.”

In contrast, purchased goodwill is recorded on the buyer’s balance sheet as soon as the purchase transaction is completed. Current accounting principles require that the value (considered to be the allocated cost) of purchased goodwill is recorded on the buyer’s balance sheet.

This accounting treatment for purchased goodwill is determined by the Financial Accounting Standards Board (FASB) Statement of Financial Accounting Standards (SFAS) No. 141R, which eliminated the pooling of interest accounting treatment for business combinations. As they relate to goodwill, the provisions of SFAS No. 141R are discussed later.

There are a few instances when internally created goodwill is recorded on a company’s financial statements, such as under the push-down accounting rules related to

corporate reorganization. But the instances in which a company's internally developed goodwill (as opposed to its purchased goodwill) is recognized for accounting purposes are rare.

Accordingly, accountants use a fairly broad definition for intangible value in the nature of goodwill. This accounting interpretation of goodwill is most often the residual value that is calculated by subtracting from the total purchase price for the acquired company the fair market value of:

1. all the tangible assets and
2. all the identified intangible assets.

The accounting definition of goodwill sometimes quantifies all of the intangible value of the acquired company. This is the case when the acquired discrete intangible assets are not separately identified and individually appraised.

Therefore, the accountant's broad definition of intangible value in the nature of goodwill often captures the total intangible value of the acquired business enterprise (with little consideration to the individual or discrete intangible assets).

ECONOMISTS' INTERPRETATION OF GOODWILL

The economists' interpretation of intangible value in the nature of goodwill is somewhat less global than the accountant's interpretation. As a result, the economists' interpretation of goodwill may be more useful to analysts who are interested in the identification and valuation of the discrete goodwill intangible asset—as opposed to the total intangible value of the subject business enterprise.

First, typically the economist quantifies all of the economic income of a subject business enterprise.

Second, he or she allocates (or assigns) some portion of the total business enterprise economic income to each of the asset categories (both tangible and intangible) that contribute to the production of that income. These individual asset categories typically include: net working capital, tangible personal property, real estate, and identified intangible assets and intellectual properties (e.g., patents, trademarks, copyrights, contracts, licenses, etc.).

Third, the economist quantifies the portion of the total business enterprise economic income that cannot be associated with any other tangible or intangible asset. That residual economic income is often called excess income or excess earnings.

This excess income is then assigned to the goodwill intangible. The economic value of goodwill equals the total business enterprise value less the values attributed to each of the tangible assets and each of the identified intangible assets.

TYPES OF INTANGIBLE GOODWILL

There are two types of goodwill. These two types of goodwill affect (1) the identification and the ownership of goodwill and (2) the allocation of a business combination purchase price to goodwill. This categorization of business enterprise goodwill is often important in a family law context.

However, the categorization of goodwill into one of these two types does not affect the valuation of total goodwill. Intangible value in the nature of goodwill can be

separated into the following two categories or types: (1) personal goodwill and (2) institutional goodwill.

PERSONAL GOODWILL VERSUS INSTITUTIONAL GOODWILL

Goodwill is often considered to be the residual value that remains after all of the subject entity tangible assets and intangible assets are separately identified and valued. Under this residual concept, intangible value in the nature of goodwill can be a residual from (1) overall business enterprise value or (2) actual business combination purchase price.

Under this residual concept, the excess income associated with goodwill is the residual of (1) the total business enterprise income (however measured) less (2) an allocation to or a fair rate of return on all of the business enterprise tangible assets and discretely identified intangible assets.

However, goodwill can be separated into two types of categories:

1. personal goodwill and
2. institutional goodwill.

Personal goodwill, which is also called individual or celebrity goodwill, relates to an individual person. Typically, personal goodwill is not an asset that is owned by the business enterprise that employs the individual person.

"The economic value of goodwill equals the total business enterprise value less the values attributed to each of the tangible assets and each of the identified intangible assets."

"There are two types of goodwill."

Institutional goodwill, which is also called company goodwill, is associated with the subject. Typically, it is owned by the subject business enterprise (whether a corporation, personal services company, or professional practice).

It is often important to separately identify and individually value these two categories of goodwill. This is because there may be different legal, economic, and taxation consequences for each category or type of goodwill.

Some of the variables that affect whether personal goodwill exists include:

1. the type of service or product offered by the subject business enterprise,
2. the subject individual's personal relationships with the customers or clients, and
3. the subject individual's direct impact on the management and direction of the subject business enterprise.

Most of the goodwill is likely to be personal goodwill if:

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

"In practice, for both personal goodwill and institutional goodwill, the income approach is most commonly used to value goodwill."

In the early stages of a subject entity's business operations, most internally created goodwill is personal goodwill. As the business enterprise increases in size and complexity, goodwill typically shifts from the personal goodwill category to the institutional goodwill category.

HOW THE DIFFERENT TYPES OF GOODWILL ARE VALUED

All three generally accepted property valuation approaches (i.e., cost, income, and sales comparison) are appropriate to value the different types of goodwill. Typically, goodwill (whether personal or institutional) is not sold separately in the marketplace (i.e., the way income-producing real estate parcels are sold). Therefore, the sales comparison approach is less commonly used to value goodwill.

Because goodwill (whether personal or institutional) is often measured based on future earnings and not based on historical cost, the cost approach is less commonly used to value goodwill. In practice, for both personal goodwill and

institutional goodwill, the income approach is most commonly used to value goodwill.

Valuation analysts often use some version of the residual method in the valuation of either personal goodwill or institutional goodwill. In the valuation of either type of goodwill, the valuation analyst often estimates the amount of total goodwill associated with the subject business enterprise (however defined). Using the residual method, goodwill is often measured using the general accepted business enterprise valuation approaches.

Using the residual method, goodwill represents the residual of:

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

Valuation analysts also use some version of the before and after method (also called the with and without method) in the valuation of either personal goodwill or institutional goodwill. To use the before and after method, the valuation analyst estimates the value of the subject business enterprise with and without the subject goodwill. This method is more commonly used to value personal goodwill than institutional goodwill.

Typically, based on (1) the different sets of net cash flow projections and (2) the different present value discount rates, the business enterprise value is greater "with" the subject individual than "without" the subject individual. Using this before and after method, the value of the personal goodwill is estimated as the difference between the "with" business enterprise value and the "without" business enterprise value.

Accordingly, the personal goodwill value indication is the difference between the two business enterprise value estimates—based on the two alternative cash flow projections. The valuation analyst may then estimate the value of the institutional goodwill as the difference between:

1. the total business enterprise goodwill (based on the above-described residual method) and
2. the personal goodwill (based on this before and after method).

THE ANALYSIS OF GOODWILL

In most family law valuation analyses, intangible value in the nature of goodwill may encompass concepts from both

the accountants' definition of goodwill and the economists' definition of goodwill. Valuation analysts sometimes identify and value goodwill collectively as the total intangible value of a business enterprise.

In this regard, goodwill is often valued using a residual method (i.e., a residual from purchase price or a residual from total business value). In other words, goodwill is the unidentified residual after the values of the total identified tangible assets are subtracted from the total value (or total purchase price) of the business enterprise.

More commonly, valuation analysts quantify intangible value in the nature of goodwill as a discrete (or individual) intangible asset. Using this discrete definition of goodwill, goodwill is the remaining unidentified intangible value of the business enterprise after subtracting the values of:

1. the total identified tangible asset categories and
2. the total identified intangible asset categories.

In this regard, intangible value in the nature of goodwill is quantified using either (1) a specific residual method or (2) a capitalized excess earnings method. In other words, intangible value in the nature of goodwill is the residual business enterprise value (or capitalized business enterprise income) that is not allocated to the following assets:

1. working capital assets (e.g., receivables, prepaids, and inventory)
2. tangible personal property (e.g., machinery, equipment, and vehicles)
3. real estate (e.g., land, buildings, and improvements)
4. intangible personal property (e.g., patents, copyrights, trademarks, and trade secrets)
5. intangible real property (e.g., leasehold interests, rights of way, and easements)

GENERALLY ACCEPTED GOODWILL VALUATION IN APPROACHES AND METHODS

As with the valuation of all intangible assets, there are several generally accepted valuation methods applicable to the valuation of goodwill. After considering the fundamental similarities and differences of these methods, they may all be categorized into the three generally accepted property valuation approaches.

With regard to intangible value in the nature of goodwill, cost approach valuation methods are least commonly used. Sales comparison approach valuation methods are more commonly used. And, income approach valuation methods are most commonly used in the analysis of goodwill.

Cost Approach

Using the cost approach, the valuation analyst estimates the amount of current cost required to recreate the component elements of the goodwill intangible. The common cost approach methods typically involve a component restoration procedure.

The first step in the component restoration procedure is to list all of the individual components of the subject goodwill. The second step in the procedure is to estimate the amount of cost required to replace each component. This procedure is based on the concept of goodwill as indicated by the intangible value of all business enterprise assets in place and ready to use.

A common application of the restoration procedure is the analysis of forgone economic income (i.e., the opportunity cost) during the time period required to assemble all of the tangible and intangible asset components of the subject business enterprise. For example, let's assume that it would take two years to assemble all of the compo-

ponents assets (both tangible and intangible) of the subject business enterprise.

This hypothetical asset assemblage process would include the following:

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 all employees
6. the building of a level of consumer recognition and confidence
7. the re-creation of the current level of customer relationships

All of these component tangible and intangible assets would be assembled at the level required to immediately accommodate the actual level of operations of the business enterprise.

Let's also assume that the business enterprise will earn \$10,000,000 per years in income (however defined) during the two-year asset assemblage period. The present value of

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the \$20,000,000 in forgone income (or opportunity cost) during the asset assemblage period is one indication of the value of goodwill.

Sales Comparison Approach

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

Goodwill is rarely sold separate from other assets of a going concern business. Therefore, the selected guideline sale transactions usually involve the sale of going-concern business or professional practices.

The valuation analyst selects publicly reported transactions in which the allocation of the sale price between goodwill and all other assets is reported. Accordingly, this second sales comparison approach valuation method also relies on a residual from sale price procedure to estimate the value of goodwill.

In order to use the residual from purchase price goodwill valuation method, there has to be a sale of the business enterprise.

First, if there was a sale, the valuation analyst should confirm that the transaction was an arm's-length sale.

Second, the valuation analyst should confirm that the purchase price represents a cash equivalency price. If there are noncash consideration components or deferred payments (e.g., an earn-out provision) as part of the purchase price, the analyst should convert the entire consideration to a cash equivalency price.

Third, the valuation analyst should estimate the value of each of the identified tangible and intangible assets of the business.

Fourth, the valuation analyst should subtract the total value of all of the identified tangible and intangible assets from the purchase price. The residual represents intangible value in the nature of goodwill.

In order to use the guideline sale transactions methods, the valuation analyst should identify and select actual sales of business entities that are sufficiently comparative to the business enterprise. For purposes of this analysis, comparability should be considered based on the criteria of expected return and investment risk.

For certain industries (such as professional practices), guideline sale transactional data are fairly easy to assemble.

This is because such transactional data are reported in publicly available publications and periodicals. With regard to these sale transactions, goodwill is typically expressed as:

1. a percent of the total transaction price or
2. a percent of the total annual revenue earned by the subject business.

These market-derived pricing multiples are then applied to the subject business enterprise in order to estimate the subject intangible value in the nature of goodwill. It is noteworthy that the market-derived pricing multiples are also estimated—and are based on an allocation of the sale price for each business or professional practice included in that data source.

“For purposes of this analysis, comparability should be considered based on the criteria of expected return and investment risk.”

INCOME APPROACH

With regard to intangible value in the nature of goodwill, the common income approach valuation methods include the following:

1. the residual from business enterprise value method
2. the capitalized excess earnings method
3. the present value of future economic income method

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Each of these valuation methods is based on the concept of goodwill as the present value of future economic benefits not associated with either the subject entity's tangible assets or identified intangible assets.

Residual from Business Enterprise Value Method

The residual from business enterprise value method is based on the principle that the value of total assets (i.e., the “left hand side” of the balance sheet) equals the value of total liabilities and equity (i.e., the “right hand side” of the balance sheet).

In that regard, goodwill is valued as follows: subject company overall business enterprise value less:

1. the value of financial assets,
2. the value of tangible assets (i.e., real estate and tangible personal property), and
3. the value of identified intangible assets.

There are several generally accepted methods for valuing a going-concern business enterprise. Valuation analysts synthesize the value indications of one or more of these methods to estimate the value of the business enterprise. Since there are many judgments made as part of any valuation analysis, the objective of using more than one valuation method is to develop mutually supporting evidence as to the value conclusion.

The methods commonly used in the residual from business enterprise value method include the following:

1. the direct capitalization method (an income approach valuation method)
2. the discounted cash flow method (an income approach valuation method)
3. the guideline merged and acquired company method (a sales comparison approach valuation method)
4. the guideline publicly traded company method (a sales comparison approach valuation method)

The selection of these business valuation methods depends on both:

1. the valuation analyst's experience and judgment and
2. the quantity and quality of available financial and operational data.

While any of these business valuation methods may be used in the residual from business enterprise value method, the discounted cash flow method is a common method for the purpose of quantifying goodwill.

The discounted cash flow method is based on the premise that the business enterprise value is the present value of the future economic income to be derived by the stakeholders of the business. The discounted cash flow method typically involves the following valuation analyses: 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 subject company. This analysis may include consideration of the following market factors: sales volume, average selling price or contract rate, market dynamics, competitive pressures, price elasticities of demand, regulatory changes, technological changes, and so forth.

The expense analysis may involve consideration of the following factors: fixed versus variable costs, product versus period costs, cash versus noncash costs, direct versus indirect costs, overhead cost absorption principles, cost-

efficiency relationships, cost-volume-profit relationships, and so on.

The investment analysis may involve consideration of the following factors: required minimum cash balance, days sales outstanding in accounts receivable, inventory turnover, plant utilization, planned capital expenditures, and so forth.

The cost of capital analysis may involve consideration of the following factors: current subject company 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, marginal cost of capital, and so on.

The residual value analysis may involve the estimate of the value of the prospective cash flow generated by the subject business after the conclusion of a discrete projection period. The residual value may be estimated by various procedures, including: capitalization by capital-market-derived pricing multiples, direct capitalization method, the annuity in perpetuity method, and the constant growth model, among other methods.

Based on the results of these analyses, the periodic (typically annual) cash flow from the business operation is projected for a reasonable discrete projection period. The

term of the discrete projection period varies based on the valuation analyst's judgment. But, typically, the term of the discrete projection period approximately equals the average length of the subject industry business cycle. The discrete cash flow projection is discounted at an appropriate present value discount rate to determine the present value.

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

The summation represents the value of the business enterprise. The business enterprise value less (1) the value of the subject tangible assets and (2) the subject identified intangible assets indicates the subject intangible value in the nature of goodwill.

Capitalized Excess Earnings Method

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

"There are several generally accepted variations of the capitalized excess earnings method."

First, the excess earnings method requires the valuation analyst to estimate the required amount of income that investors would expect, given the risk of the business. This procedure often involves an assessment of industry average rates of return on investment.

Some analysts apply an asset-specific return on investment to each subject company asset category. Alternatively, the subject company's cost of capital may be used as the overall required return on investment. The subject company'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 subject company's net tangible assets in order to quantify the company required income. The value of the net identified assets of the company includes all of the company's financial assets (net of current liabilities), tangible assets, and identified intangible assets.

Second, the valuation analyst quantifies the difference between (1) the required amount of income and (2) the actual economic income of the company. If the actual economic income exceeds the required amount of income, then excess earnings exist.

Third, the valuation analyst capitalizes the excess earnings (if any) as an annuity in perpetuity, using an appropriate direct capitalization rate. The derivation of the appropriate direct capitalization rate should be consistent with the level of income used to measure:

1. required income and
2. actual earnings.

The result of the direct capitalization procedure is an indication of the subject intangible value in the nature of goodwill. A simplified illustration example of the capitalized excess earnings methods is presented below.

Present Value of Future Economic Income Method

The first procedure in this valuation method is to identify all of the future economic income associated with the business enterprise that is not already associated with the value of the subject tangible assets and identified intangible assets. This identification procedure may include future capital expenditures, future mergers and acquisitions, new product or services lines, new sales territories or new customers.

Typically, this future economic income is not included in the subject company's current business plans or

forecasts. And, typically, this future economic income is not associated with tangible or discrete intangible assets in place as of the valuation date.

Otherwise, that future economic income would be included in the value of the company's tangible assets or identified intangible assets. Obviously, creating a projection of such future economic income is a challenging procedure.

For purposes of illustrating the practical application of this method, let's limit the discussion to analyzing the present value of the expected future customers of the subject business. In either residual method to goodwill valuation, it is common for the valuation analyst to estimate and present value the prospective income associated with the company's current customer base.

This income projection (and the present value procedure) is made over the expected remaining useful life of the current customer relationships. Basically, the value of the subject company'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 economic 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 subject company's current customers as the identified current customers retire.

The present value of future economic income method requires a projection of the subject company's income-generating capacity. The projection begins with the expiration of the company's current income sources (i.e., the identified current customers) and continues into perpetuity.

The present value of this prospective income stream (which should provide for a fair return of and on all the tangible assets and intangible assets dedicated to service the unidentified future customers) is an indication of intangible value in the nature of goodwill. Using this valuation method, the value of goodwill is the present value of future income earned from future sales to future (unidentified) customers.

The present value of future economic income method is one of the most intellectually appealing and conceptually correct methods to value goodwill. Consistent with the economists' concept of goodwill, this valuation method quantifies and assigns all of the business enterprise income that cannot be associated with any of its identified assets.

"In either residual method to goodwill valuation, it is common for the valuation analyst to estimate and present value the prospective income associated with the company's current customer base."

In other words, goodwill is quantified as the present value of all prospective income that cannot be associated with the current sources of income (i.e., the subject company's tangible assets and identified intangible assets in place as of the valuation date).

However, long-term economic income projections derived from unidentified sources (i.e., from unidentified future customers) are uncertain. As a result, it is often difficult to use this valuation method to estimate intangible value in the nature of goodwill.

Goodwill under Alternative Premises of Value

A premise of value is an assumption as to the set of actual or hypothetical transactional circumstances applicable to a valuation 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 has a material impact on the value of goodwill, if any, that is recognized as an intangible asset.

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

1. value in continued use, as part of a going-concern business enterprise
2. value as an assemblage of assets in place, but not in current use
3. value in exchange, as part of an orderly disposition
4. value in exchange, as part of a voluntary liquidation
5. value in exchange, as part of an involuntary liquidation

Of course, the same goodwill of the same business enterprise will likely have a materially different value conclusion depending on the premise of value that is applied in the valuation analysis.

How Goodwill Is Affected by the Premise of Value

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

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

As a result, goodwill is often identified and quantified in business enterprise valuations that are conducted on a going-concern basis. However, business enterprise valuations on the various value in exchange bases typically do not include the contributory value of assembled tangible and intangible assets.

This is because the subject business tangible and intangible assets are analyzed on a separate or piecemeal basis. As a result, goodwill is limited in business enterprise valuations that are conducted on the alternative value in exchange premises.

For example, business enterprise valuations conducted on liquidation bases for bankruptcy purposes often do not involve the identification or valuation of intangible value in the nature of goodwill.

How the Premise of Value Is Affected by Goodwill

When the valuation analyst selects the appropriate premise of value on which to conduct a business enterprise valuation, he or she should consider whether the subject company has goodwill. If intangible goodwill exists within the subject business enterprise, it is likely that the subject company does not have going-concern risk.

In other words, the highest and best use of that company is as a going-concern business enterprise. Therefore, it would be appropriate to value the subject business (and the subject business tangible and intangible assets) based on the premise of value in continued use.

If, however, no goodwill exists within the subject business enterprise, then that subject company may suffer from going-concern risk. If there is no goodwill, the analyst may conclude that value in exchange represents the highest and best use of the subject business enterprise.

Typically, the selection of the appropriate premise of value is based on the highest and best use of the subject business and/or the subject business tangible and intangible assets. There are circumstances when the subject business is not being operated at its highest and best use. In those unusual circumstances, the goodwill intangible asset may have a greater value on a value in exchange basis than on a value in continued use basis.

GOODWILL ILLUSTRATIVE VALUATION EXAMPLE

This simplified illustrative example presents an application of the capitalized excess earnings method to estimate intangible value in the nature of goodwill.

“Typically, the selection of the appropriate premise of value is based on the highest and best use of the subject business and/or the subject business tangible and intangible assets.”

Fact Set and Valuation Variables

The physician owners of Healthfirst Physicians Clinic (“Healthfirst”) and Hypochondria Medicine, Inc. (“Hypochondria”) have decided to enter into a joint venture to provide certain acute care medical services. Healthfirst will provide the “newco” joint venture with:

1. the use of its recognized trademark and trade name and
2. access to its patient charts and records.

To simplify this illustrative example, let’s consider these discrete intangible assets collectively as intangible value in the nature of goodwill. This goodwill is the only asset contributed by Healthfirst to the joint venture. Hypochondria will provide all of the tangible assets and all of the working capital to the joint venture.

Hypochondria will contribute tangible assets and financial assets in an amount equal to the value of goodwill contributed by Healthfirst. The joint venture will be formed as of December 31, 2008.

Richard Kimble, M.D., is the owner of the Healthfirst Physicians Clinic and the principal architect of this joint venture. Dr. and Mrs. Kimble are involved in a marital dissolution during the time of this joint venture formation. Of course, Dr. Kimble’s ownership interest is a major component of the Kimble marital estate.

Purpose and Objective of the Analysis

The objective of the analysis is to estimate the value of the goodwill contributed by Healthfirst to the joint venture, as of December 31, 2008 (the valuation date).

The purpose of the analysis is to estimate the value of this component of the Kimble marital estate that is subject to equitable distribution.

Valuation Approaches and Methods Considered

Most of the value in the joint venture is related to its expected future revenue and earnings. Based on the specific facts of this case, the valuation analyst concludes that the income approach is the most relevant approach to valuing the goodwill intangible.

Within the income approach, the valuation analyst concludes that the capitalized excess earnings method is the most relevant valuation method.

Valuation Analysis

Exhibit 1 presents the projected balance sheet of the joint venture at its inception. Exhibit 2 presents the joint

venture projected income statement, based on the valuation analyst’s projection of revenue and expenses. The joint venture projected net cash flow is presented on Exhibit 3.

For purposes of this analysis, excess earnings are defined as the difference between (1) the projected total income of the joint venture and (2) a fair return on the joint venture tangible assets and net working capital. The fair rates of return applied to the joint venture financial assets, tangible assets, and intangible goodwill are based on market-derived evidence.

Intangible assets (including intangible value in the nature of goodwill) generally have greater financial and operational risk than tangible assets. And, tangible assets generally have greater financial and operational risk than financial assets.

Typically, intangible assets have a higher asset-specific cost of capital than tangible assets have. And, typically, tangible assets have a higher asset-specific cost of capital than financial assets have.

Exhibit 4 presents the estimation of the joint venture excess earnings. Exhibit 5 illustrates the procedure for capitalizing the excess earnings into an estimate of intangible value in the nature of goodwill.

Based on this analysis, the indicated value of the Healthfirst intangible goodwill contribution to the joint venture, as of December 31, 2008, is \$2,700,000.

SUMMARY AND CONCLUSION

Valuation analysts are often called on to value the goodwill of a closely held industrial or commercial business or of a professional practice. Valuation analysts are also called on to distinguish between:

1. institutional or enterprise goodwill and
2. personal or celebrity goodwill.

And, these valuation assignments are particularly common within the family law controversy context.

This discussion summarized the elements or factors that the valuation analyst typically considers in the valuation of goodwill. This discussion also described the generally accepted valuation approaches, methods, and procedures related to goodwill.

And, finally, this discussion presented a simplified illustrative example of a goodwill valuation within a family law context.

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Exhibit 1
Healthfirst Goodwill Valuation
Capitalized Excess Earnings Method
Balance Sheet
As of December 31, 2008

<u>Assets</u>	
Current assets	\$3,000,000
Property, plant, and equipment	<u>2,000,000</u>
Total assets	<u>\$5,000,000</u>
<u>Liabilities</u>	
Current liabilities	1,000,000
Long-term debt	1,000,000
<u>Equity</u>	<u>3,000,000</u>
Total liabilities and equity	<u>\$5,000,000</u>

Exhibit 2
Healthfirst Goodwill Valuation
Capitalized Excess Earnings Method
Projected Income Statement
As of December 31, 2008

	Projected Fiscal Year Ended 12/31/09
Net revenue	\$8,000,000
Operating expenses	
Cash expenses	5,400,000
Depreciation expense	1,000,000
Interest expense	<u>100,000</u>
Total expenses	<u>6,500,000</u>
Pretax income	1,500,000
Income tax expense	<u>(600,000)</u>
Net income	<u>\$ 900,000</u>

Exhibit 3
Healthfirst Goodwill Valuation
Capitalized Excess Earnings Method
Projected Net Cash Flow
As of December 31, 2008

	Projected Fiscal Year Ended 12/31/09
Net cash flow (to invested capital)	<u> </u>
Projected net income	\$ 900,000
plus: Tax-affected interest expense	<u>60,000</u>
equals: Profit after taxes	960,000
plus: Depreciation expense	1,000,000
less: Capital expenditures	1,000,000
less: Increase in net working capital	<u>100,000</u>
equals: Projected net cash flow	<u>\$ 860,000</u>

**Exhibit 4
Healthfirst Goodwill Valuation
Capitalized Excess Earnings Method
Estimate of Excess Economic Income
As of December 31, 2009**

<u>Valuation Analysis</u>	
Projected net cash flow	\$ 860,000
Net working capital value	\$2,000,000
Required rate of return [a]	<u>6%</u>
Fair return on net working capital	(120,000)
Net tangible asset value	2,000,000
Required rate of return [a]	<u>10%</u>
Fair return on net tangible assets	(200,000)
Fair return on total net working capital and net tangible assets	<u>(320,000)</u>
Excess economic income	<u>\$ 540,000</u>

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

**Exhibit 5
Healthfirst Goodwill Valuation
Capitalized Excess Earnings Method
Goodwill Valuation Summary
As of December 31, 2009**

<u>Valuation Analysis</u>	<u>Indicated Value</u>
Excess economic income	\$ 540,000
Divided by direct capitalization rate	<u>20%</u>
Equals intangible value in the nature of goodwill (rounded)	\$2,700,000
Intangible asset value	<u>\$2,700,000</u>
Fair market value of Healthfirst Physicians Clinic goodwill contributed to the proposed joint venture	<u>\$2,700,000</u>