Valuation Concepts

inside:

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Is it the driver or the car?

Personal vs. practice goodwill

In auto racing, the winning vehicle is usually pretty easy to spot — it's the one that crosses the finish line first. But one wonders how often arguments break out afterward about whether the victor was truly deserving. That is, did the driver really win the race, or did he or she simply have the best car?

In the business valuation world, a similar debate continues to rage over personal goodwill vs. practice goodwill. And though several court cases have dealt with the two concepts, there has been no consensus on methods for distinguishing between them. Thus, this can be a particularly thorny valuation area — especially in the divorce arena, where it quite often arises.

Defining the terms

Personal goodwill is intangible value based solely on the efforts or reputation of a business owner. In some instances, it may also include profits that would be lost if that individual weren't present. For example, a surgeon who is well known for her ability and experience would have personal goodwill because patients will likely come to her specifically for those skills.

As a business grows in size and structural complexity, its goodwill typically begins to change from personal to practice.

Meanwhile, practice goodwill is a *company's* intangible value that's not attributable to its owner. Over time, as a business grows in size and structural complexity, its goodwill typically begins to change from personal to practice.

When a company is small, the majority of its goodwill comes from the owner's personal relationships, know-how, reputation and personality. But as it develops, a greater portion of the goodwill relates to factors such as contractual relationships, location, facilities and work force.

Debating the relevancy

The objective of a typical valuation is to estimate a company's equity, including its tangible and intangible value. And traditional appraisal methods don't differentiate between personal and practice goodwill, which sometimes isn't a problem.

Other times, however, it is — particularly in divorce proceedings, where the personal vs. practice goodwill debate continues to rage. In some states, courts don't consider personal goodwill a marital asset subject to distribution between the two parties. As a result, a valuator must quantify the portion of value attributable to personal goodwill and exclude it from the value of the business.

Yet some courts *have* concluded that personal goodwill should be marital property. In *Dugan v. Dugan*, for instance, the Supreme Court held that both personal and practice goodwill are marital property because ignoring the nonowner spouse's contributions to the company's development would be inequitable. Clearly, it's important to understand the state case law in the jurisdiction applicable to the subject business.

Another instance that requires distinguishing between personal and practice goodwill is the allocation of purchase price for tax or financial reporting purposes. In cases involving the purchase or sale of a business, determining whether either — or both — types of goodwill exist in significant amounts can influence how the deal is structured.

For example, a buyer negotiating to have the seller sign a separate, personal noncompete agreement may indicate substantial personal goodwill because the agreement presumably restricts the seller from using his or her skills to generate similar value for a competitor. This may affect the appraisal methods applied as well.

Apportioning the value

When valuing a business using an income approach, there's an implicit assumption that all of the intangible value reflected in the company's earnings stream is transferable. Yet personal goodwill may not be transferable and would need to be quantified and deducted from the value of the business.

One of the methods a valuator may use to estimate personal goodwill is first examining the factors that relate to practice vs. personal goodwill and calculating the percentage of each. Then he or she can apportion the total goodwill of the business to personal and practice goodwill according to those percentages.

Addressing professional vs. commercial

In some jurisdictions, disagreement remains regarding the measurement of personal goodwill for a commercial business owner vs. that for a professional practice owner. Many observers believe personal goodwill typically arises solely in the context of a professional practice. And, they say, even if a commercial business has only one owner, it's difficult to attribute much of the value to personal goodwill.

For example, in *Frazier v. Frazier*, an Indiana appellate court dealt with the valuation of a single-location retail furniture store. The owner spouse's attorneys claimed that most of the goodwill was personal.

After the facts were reviewed, however, very little of the value could be attributed to the owner spouse. Many of the customers were from the general public and the owner spouse didn't have a special relationship with any of them — or with the company's suppliers.

At the end of the day, an appraiser needs to examine both the nature of a commercial business and its standard industry practices to determine whether personal goodwill exists.

Studying the case law

A number of other landmark cases have dealt with professional goodwill. In *Lopez v. Lopez*, a California appellate court's decision identified several factors that valuators should consider before expressing an opinion. These include the professional's:

- Age and health,
- Demonstrated past earning power,
- Reputation in the community for judgment, skill and knowledge, and
- Comparative professional success.

Also important are the nature and duration of his or her role in the practice, either as a sole proprietor or as a contributing member of a partnership or professional corporation.

A Tax Court case, *Norwalk v. Commissioner*, also sheds light on the issue. Here the court indicated that, generally, to transfer the goodwill of a professional practice, the parties must sign off on an enforceable noncompete covenant or other such agreement.

Recognizing the challenge

As mentioned, differentiating between personal and practice goodwill is often required in divorce and tax proceedings. But this creates a challenge in that there are no "standard" methods to distinguish between the two types of goodwill. In addition, different jurisdictions approach the matter differently.

Ultimately, whether goodwill of any kind exists and how to divide it equitably depends on the facts and circumstances of each case. And any methods a valuator decides to rely on should be well supported and well documented to withstand scrutiny.

Establishing the ground rules

The role of valuations in buy-sell agreements

In any business, an ownership transition can occur for many reasons. Retirement is the most obvious one, but sudden death or disability, withdrawal from employment, divorce, or a contemplated sale to a third party may bring about a leadership change.

A buy-sell agreement can establish the ground rules for the transition, including to whom the ownership interest can be sold and how a price is to be determined. As you might imagine, business valuations play an important role in creating these arrangements.

The standard of value

Among the most critical aspects of a buy-sell agreement is a clearly named and defined standard of value. Many agreements rely on fair market value, which U.S. Treasury regulations define as:

> The price at which the property would change hands between a willing buyer and a willing seller, neither being under any compulsion to buy or to sell and both having reasonable knowledge or relevant facts.

Fair market value also assumes an arm's length deal. It differs from investment value, which identifies a particular buyer or seller and the attributes that buyer or seller brings to a transaction.

A regularly updated formula

Value under a buy-sell agreement is typically estimated using a formula, which may be based on book value or a multiple of net income, defined in the agreement or negotiated by the parties. The formula created when the agreement is put in place, however, probably won't produce a fair valuation two, five, 10 or 20 years down the road.

A static valuation formula will probably fail to capture changing business conditions.

Why? Because the company won't likely remain the same, nor will its industry, competitors, suppliers or the economy and general market conditions as a whole. And a static valuation formula will probably fail to capture these changing conditions.

Ideally, a buy-sell agreement requires the business owners to obtain an annual appraisal, though some mandate a valuation only at the time of a triggering event (such as an owner's death, divorce or retirement). The agreement should also outline a process for choosing a valuator.

Family business issues

In most cases, a buy-sell agreement restricts the market for the company's stock to other shareholders, bloodline relatives and, in the case of S corporations, only those who wouldn't jeopardize the company's S election. Section 2703(a) of the Internal Revenue Code sets forth rules that apply generally to transfers

Buy-sell agreements and estate tax

For estate tax purposes, a buy-sell agreement is binding only if it:

- Applies during life as well as at death.
- Creates a determinable value as of a specifically determinable date,
- Contains terms comparable to similar arrangements entered into by persons in arm's length transactions,
- Embodies at least some bona fide business purpose (such as an orderly family ownership and management succession), and
- Results in a fair market value for the subject business, when executed. (Often, buy-sell agreements will generate future date of death or gift date values substantially above or below what the fair market value otherwise would have been, even though the value was reasonable when the agreement was made.)

If a buy-sell agreement doesn't meet these conditions, it may express a value that's legally binding for transaction purposes but not for estate tax purposes. And this may leave an owner's heirs without sufficient funds to pay estate taxes.

not. This includes all family members below the youngest generation that are already a party to the agreement. (For more on estate tax issues, see "Buy-sell agreements and estate tax" on page 4.)

Case in point

Failing to properly structure a buy-sell agreement can lead to particularly unfortunate circumstances should the matter ever arise in court. Take, for example, *Estate of True v. Commissioner*. This 2001 estate tax case was recently examined by the Tenth Circuit Court of Appeals as to the validity of a buy-sell agreement based on tax book value, which is similar to book value but based on depreciation used for tax purposes, not economic purposes.

of family-owned businesses occurring after Oct. 8, 1990, among family members.

Under these rules, a company is considered a family business if family members control 50% or more of its vote or value. Moreover, a shareholder agreement among family members that allows for a property acquisition or transfer at less than fair market value will be ignored for estate and gift tax purposes.

Agreements entered into on or before Oct. 8, 1990, that haven't been substantially modified are considered exempt. Sec. 2703(a) defines "substantial modification" as any discretionary modification of a right or restriction that results in anything other than a de minimis change to the quality, value or timing of the rights of any party subject to the agreement.

Failing to properly structure a buy-sell agreement can lead to particularly unfortunate circumstances should the matter ever arise in court.

For instance, adding an employee stock ownership plan that constitutes another shareholder or changing the payment terms of the purchase price would likely constitute a substantial modification. A change to a name of a shareholder as a result of marriage would

The appellate court rejected the buy-sell agreement's price as the stock's value, siding with the Tax Court and the IRS. Part of the reasoning for its position was that the buy-sell agreement's terms were never negotiated. The children didn't have independent legal or accounting advice, suggesting the value didn't represent an arm's length dealing.

In addition, the accountant who was consulted was closely associated with the family and stated he had no detailed understanding of valuation methods and no academic or practical experience in appraisals. The court was also critical that the buy-sell agreement didn't provide a mechanism for periodic review or adjustment to the tax book value formula. Ultimately, it determined that the agreement wasn't controlling.

Disputes and uncertainties

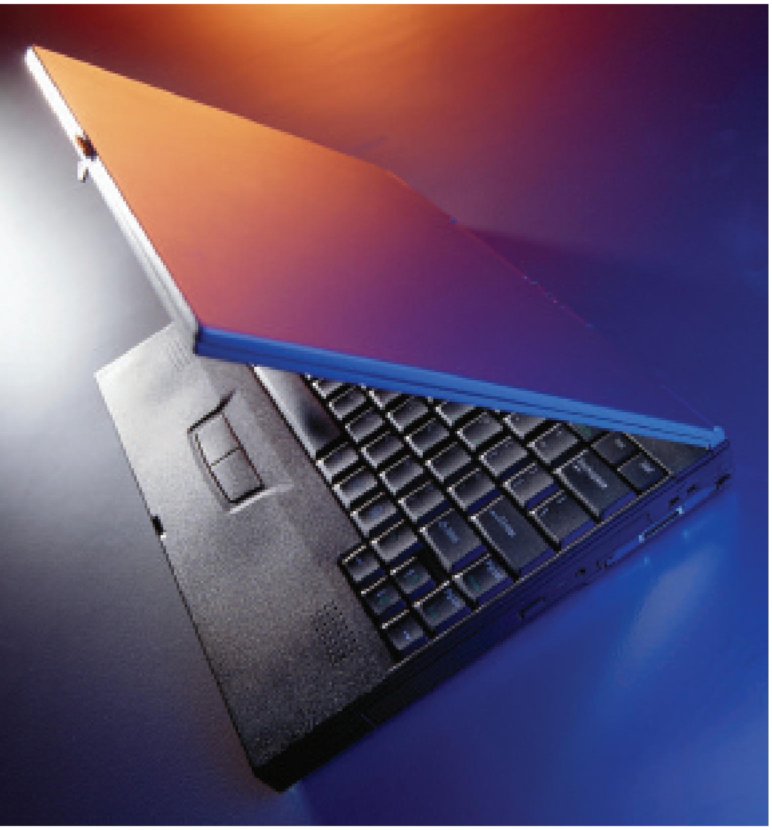
Without a carefully drafted buy-sell agreement, a business owner's departure — particularly under sudden circumstances — may trigger disputes and uncertainties that could very well send the business spiraling into crisis or even ruin.

An appraiser can assist in the drafting of a viable agreement by offering valuable advice on, among other things, the appropriate standard of value, how to determine a share price, Sec. 2703(a) requirements, and the mitigating effects of the company's industry and the local and national economies.

4 private transaction databases in use today

The transaction method (TM) is a market-based approach based on single transactions among many different private entities. It requires an appraiser to closely examine several (preferably five or more) valid transactions to ensure reasonable results. There are a variety of private transaction databases that provide the necessary information. Here are four in use today:

1. Institute of Business Appraisers (IBA) market data. The IBA's database offers about 23,000 transactions in 680 SIC codes based on input from brokers, intermediaries and others. It's the largest of the four private transaction databases discussed here but offers the fewest transactional details.



Transactions are recorded as, or converted to, asset sales, with most representing companies with sales volume less than $1 million. Only inventory, net fixed assets and intangible assets are included. Therefore, when estimating the equity of a business, a valuator will typically have to add back in cash, accounts receivable and other assets and deduct debt and other liabilities.

2. BIZCOMPS®. With approximately 8,000 business transactions totaling over $2 billion or averaging approximately $270,000 each, this is the next largest database of the four. Its transactions are also represented as only asset sales, including fixtures, equipment and goodwill. Thus, again, when estimating a company's equity, the appraiser needs to add all other short- and long-term assets less debt and other liabilities.

BIZCOMPS®, however, offers more information per transaction than the IBA, with 17 data points, including: SIC code, NAICS code, business description, asking price, annual gross sales, seller's discretionary earnings, sales date, sales price, terms, rent as a percentage of sales, days on the market and geographic region. The "days on the market" data point is particularly beneficial, as it can provide support for a discount for lack of marketability.

3. Pratt's Stats™. This database intends to provide background on about 7,700 privately held transactions as well as several hundred public transactions. (As of this writing, it contains data on about 4,300 private business transactions.)

Pratt's Stats™ presents comparable sale data on private business sale transactions primarily between $1 million and $100 million and calculates eight different value multiples using the listed financial information. It also contains up to 80 data points, including SIC code, NAICS code, business description, location, income statement data, asset data and transaction data.

Unlike the two previous databases, this one identifies each transaction as either a stock or asset sale. For asset sales, the database will typically provide some asset allocation details. Yet two asset sales within an SIC code may include different assets, and some transactions could be equity sales or other variations. Other factors, such as noncompete agreements, could further complicate an analysis.

4. DoneDeals. The smallest of the four, this database contains details on more than 5,800 private and public midmarket corporate transactions ranging in price from $1 million to $250 million. (The majority of businesses, however, are privately held.) Most of the information provided comes from company financial reports filed with the Securities and Exchange Commission.

Although this database does not have as many data points as Pratt's Stats™, it still provides more detail than BIZCOMPS® and the IBA. As with Pratt's Stats™, transactions could be either asset or stock sales, so the user should carefully assess each transaction. Overall, this database is most applicable when valuing large companies, as it contains only businesses large enough to be public or be purchased by one.

No matter which private transaction database an appraiser chooses, he or she needs to carefully select and thoroughly document the selection criteria. Moreover, the valuator must never mix transactions or assets from various databases, as either or both of these items may be treated differently by each.

Lastly, he or she should always consider how the subject company's performance, strengths, weaknesses and overall desirability compare with the selected transactions and the marketplace in general.

Facts and circumstances weigh heavily in any valuation

A common business valuation misconception is that, if an appraiser has valued other companies in the same industry as the one in question, he or she should be able to "cut and paste" most of the information from this past work into the new valuation report, saving time and money.

Of course, this just isn't the reality of most business valuations. An appraiser may leverage some economies of scale from having extensive experience in a specific industry and its distinctive value drivers. But each and every valuation carries its own facts and circumstances that he or she must consider.

For example, if a valuator appraises an auto parts shop during a low point in the local or national economy, its value may be higher than it would have been six months earlier when the economy was better. Why? Because, during slower periods, people are more inclined to do their own simple car repairs — and, thus, buy their own parts — than to pay a service station to procure the needed items and do the work.

Another, more sophisticated, instance where facts and circumstances come into play can be found when comparing two companies with similar product offerings, revenues and earnings. Suppose one of the businesses has a full management team with many personnel making key management decisions, while the other has no true management team and only one person driving the company's success.

The company with the full management team, which doesn't rely on a sole individual for its prosperity, would arguably be more valuable. After all, its infrastructure is likely more stable, making it more able to ride out tough times or abrupt management changes.

When it comes to business appraisals, a cookie cutter approach simply doesn't, well, cut it. Generalizing the facts and circumstances of a company could lead a valuator to substantially under- or overestimate its worth in the marketplace.