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A Look at Goodwill

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When asked to discuss the subject of goodwill a couple of weeks ago, I tried to explain that while the certified public accountant might be a member of the team that helps the buyer and seller agree on a price or that assembles data to convince a court concerning a fair amount for goodwill in a tax case or a case dealing with the interpretation of a buy-and-sell agreement, the accountant is not a "goodwill expert" on his own. There is no need to dwell on this—I just want you to know that I did not write the very flattering introductory biography.

DEFINITION OF GOODWILL

Before we get into this subject of goodwill, it might be well to decide why it is we are talking about it at all. There are a number of reasons.

From the standpoint of the trust officers present, we all agree that if there is not a good definition—a good formula—for making computations under a buy-and-sell agreement, the trustee is risking a long, drawn-out legal battle if he accepts the trust for an estate that is a party to such an agreement. Certainly the attorneys for the seller will insist that amounts under any loosely drawn buy-and-sell agreement were intended to be based on high present-day values—whether shown by the books or not—and will insist that values other than those related to recorded assets are part of the consideration to be paid by the surviving partner or stockholder. And the same attorneys can insist just as loudly on the other side of the argument if they happen to represent the surviving buyer.

PROBLEM AND OPPORTUNITY

Our life insurance representatives have the day-to-day problem—and opportunity—of seeing to it that the life insurance needs of a business and its owners are met, and these cannot be met without looking to the day when one or more of the owners must buy out the interest of an estate of one of his deceased associates. A difficult

problem is to see to it that the officers of the companies with which he deals have a proper appreciation of the problems that will arise when one of the group dies, and, what is more difficult, a proper appreciation of the problem of trying to evaluate those needs in dollars and cents.

We have to admit that some problems have to be faced by our trust officer and our life insurance representative. After all, their compensation, by definition, is in part a balancing factor for some inconvenience. But how much better if this compensation is in recognition of the ability of the people in our group to foresee problems that might arise, see to it that buy-and-sell agreements are not too loosely worded, and plan for enough liquid assets to be available for Uncle Sam when an estate tax is payable. I am assuming that each member of this Council is entitled to compensation for the reason that he does his planning to forestall problems, rather than worry about solutions at the time that problems surprise him.

SIGNIFICANCE OF GOODWILL

As a foundation, let us try to describe this thing we are discussing—goodwill. As I see it, the item we are discussing represents the portion of the expected profits of a business in excess of so-called normal profits for which a buyer is willing to pay and which a seller is willing to give up. We are not discussing other and various intangibles to which earning power of a business might be attributed, including patents, copyrights, trade marks, and that sort of thing—we certainly are not discussing the concept of "good will toward men." Tonight we are talking about the number of dollars to change hands that is attributable to earning power in excess of normal or representative rate of return.

What are some of the reasons for the existence of this excess rate of return that we always seem to have so much trouble measuring? When the courts talk of goodwill—and the courts' definitions probably are what we should be thinking about—they speak of earning power resulting from favorable customer attitudes, superior products, good locations. They speak, too, of favorable employee relations, stable management, favorable political climate, a favorable attitude on the part of investors, trade creditors, and other credit grantors. In other words, we think of goodwill as resulting from those various factors that bear on the general reputation of a business and the inclination for that reputation to show itself in more than a normal rate of return.

Every factor enumerated will have some bearing on the extent of

success of a business enterprise and every factor probably exists to some degree in most businesses. The mere existence of the factors, however, does not force a conclusion that we therefore have goodwill that should be included in an estate valuation or that must be paid for by the buyer. These factors have economic significance—and so goodwill arises—only when they result in profits in excess of our assumed basic rate of return.

VALUATION OF GOODWILL

I know many times we immediately think of goodwill when we see financial statements that show a rather good profit in relation to total assets or net assets as reported. We should keep in mind, however, that financial statements usually do not speak in terms of current values of operating and other income-producing properties. So often we have an investment in Los Angeles real estate stated at its cost of ten or twenty years ago and carrying values for buildings, machinery, and other assets in financial statements that do not purport to reflect fair market values. The seller knows that his property is more valuable than the amount shown by the books and when he talks of tangible property, he will be talking in terms of today's market—not in historical cost or depreciated book values. So what might appear to be a highly satisfactory rate of return might in fact be no more than normal—or possibly less than normal—when we first take into consideration that our buyer is expected to pay for the current value of the tangibles and intangibles. And the computed earnings on this required investment, with income reduced for depreciation on current values, might not appear so satisfactory as at first glance. There may be no excess earning power—no goodwill to be evaluated.

DETERMINATION OF EARNING POWER

One of the most difficult and complex problems to be solved in the operation of our income tax laws is that of making a fair determination of just what earning power is worth. And when we attempt to make any determination of a dollar-and-cents amount of goodwill, we realize that this particular computation cannot be the result of one man's effort. The certified public accountant often is looked upon for assistance in making the computation, for he is versed in the language of financial statements and transactions and has a fair idea of the reaction of the courts and his attorney friends to the factors that should be included. But an accountant who knows his business will be the

first to insist that other skills are required to develop a proper formula; here we should consider a team approach.

TEAM APPROACH

For one thing, we must know the fair values of the land, buildings, inventories, and other properties of the enterprise, and for this reason we should have the talents of an engineer-appraiser. The appraiser should be instructed that we are here dealing with values on a going-concern basis for those items required in the processing operations, and not merely with the aggregate of sound values of individual items of equipment present. The team should also include an attorney for his general assistance and for the careful drafting of instruments to express our intent. It should include a life insurance representative and a banker, particularly when the problem relates to or might concern a buy-and-sell agreement or the eventual placing of a decedent's assets in trust. An investment analyst might be required to furnish statistics on markets and current trends in the particular industry. With the combined skills of these people, we have a team that might—just might—arrive at a fair valuation.

STEPS IN PROCESS

Assume that we have this skilled team assembled and are about to attempt an evaluation. How do we proceed?

First, we want to decide on a fair price for the tangible properties, giving consideration to, but not necessarily adopting, our appraiser's views. Then we must decide on a fair rate of return on that price—not on some recorded book figure—and here our banker and investment counsel can lend a hand from their knowledge and experience. If we have concluded at this point that the properties are worth, say, $500,000 and that we should earn around 8 per cent as a normal figure in the particular industry, we know that prospective earnings must exceed $40,000 before our seller or the Treasury Department is in a position to claim goodwill in any amount.

PROSPECTIVE PROFITS

The next step in the process is to decide, based on the best information available on the amount of these prospective profits. And this is a difficult task since at this point we can do no more than lean on past history, survey the market and otherwise accumulate data

about the expected future, and, so armed, stare into our own private crystal ball.

HISTORY OF EARNINGS

A fairly detailed history of earnings should be of considerable use to our team, especially if fluctuations are analyzed for underlying causes so that a pattern or trend is displayed. It usually is helpful if any such earnings table is adjusted for special items of income or cost not expected in future operations, for salaries and similar items that might be over- or under-stated in relation to those of new management, with reasonably good display of each important product line.

FORECAST OF NET INCOME

Adjusted earnings information is a real necessity in most cases, but is a good tool only if used as just that. It is not of itself a view of the future, and it is the future, only, that we are attempting to predict. Competition has a nasty habit of cutting itself in on any lush profits situation—everyone likes to get into the act at this point—and earnings of the future might be materially different than reflected by the pattern of the past. New laws and regulations will have their effect, as will changing customer and employee attitudes, and many other factors. What we are striving for is a forecast of net income, with our history useful only as a guide. It requires the special talents of every member of the team to make this particular estimate.

COMPUTATION

Assume that we have made this estimate and that the company which a while ago we agreed is entitled to earn $40,000 a year as a normal return actually is expected to earn $60,000 a year in the foreseeable future without addition of more capital. Now, just how much would we be willing to pay for the privilege of owning the right to this excess earning power of $20,000 a year?

I would like to say at this point that the computation is easy—that it requires merely that we have access to a good standard textbook of financial statistics. Unfortunately, as you know, this is not true, for each one of us will have a different idea about the number of years of excess earnings that should be paid for—and our ideas might be slightly biased according to whether we are the buyer or the seller, the taxpayer or the Internal Revenue Service. The problem is not too

difficult a one for the team drawing a buy-and-sell agreement or assisting in negotiating a price, for the buyer and seller can then meet and trade. The buyer usually will cry that he should not pay for two or three years of excess earnings in a business he views as hazardous—the seller just as convincingly will insist that fair dealing dictates the payment of ten years of excess earnings.

RATE OF CAPITALIZATION

However, we do not always have a buyer and seller available to settle the point but must, in our life insurance work, make our own estimate of proper capitalization, and, along with our trust officers and executors, try to satisfy a court that the Internal Revenue Service or a surviving stockholder is making unreasonable demands. When we have this type of situation, we do have a task to face up to, for any decision made must, of necessity, be based entirely on judgment.

Arbitrary or not, we can take some comfort in precedent, for the courts have had to make this arbitrary decision regularly, and the cases do give us some idea of what the next court might look upon as being fair. There is no standard rate applicable to owners and taxpayers—it is hard to find the same rate applied to two or three companies even in the same industry. The cases on the point, though, give us some ideas for defining the battleground. The rates used seem generally to be between 6 per cent and 10 per cent on investment in tangible operating assets and intangibles other than goodwill, with higher rates—between 15 per cent and 20 per cent—on the excess earning power. The courts generally seem reluctant to use a percentage lower than around 20 per cent for excess earnings, apparently thinking that, with some exceptions, five or six years should be the maximum considered in the valuation.

Since our particular company, having excess earnings of $20,000 a year, is in a hazardous industry, the team might say that the $20,000 should not be capitalized at all or that some nominal amount should be paid. But if our company were in a stable industry with a rather steady pattern, our buyer might be persuaded to pay between $60,000 and $100,000 for this goodwill, representing the purchase of between three and five years of earnings in excess of the basic $40,000—or capitalization at 20 per cent. Of course, no business is so stable that the excess profit is guaranteed, else everyone would be in that business; and none is so hazardous—at least the legitimate businesses are not—that our $20,000 a year is not to be paid for at all. We usually

find that, presented with both sides of the argument, the court is able to make a decision fixing the amount somewhere between the two extremes. Or, if an especially good case is made by either party, it will accept that particular party's argument. An ideal objective, of course, is to be in a position to persuade the Internal Revenue Service or others that our position is proper and tenable, thus avoiding litigation.

Although I have mentioned specific rates of return on an assumed investment, it would be unfortunate if there were any inference here of certainty in any estimate of goodwill, for, you will agree, we cannot look for very much in the way of objective evidence. Goodwill is not to be paid for—in fact, it does not exist under my definition—if excess earnings are attributable to the personality or other characteristics of some individual or to a revocable franchise. And it is not associated with patents, licenses, or other items having a fixed life.

ADVANTAGES OF TEAM APPROACH

However, while we cannot be too definite about the amount eventually determined for goodwill in any situation, I do have one suggestion. It is this: There is no individual and no one profession capable of furnishing all of the factors required for a fair measurement of goodwill. The certified public accountant might be called on to corral the necessary information, organize it, and report on it; but he should not be expected to act also as an appraiser, an attorney, or a banker. He should not be expected to act in any capacity outside his profession and he is entitled to the ideas of the entire team when reporting. With a team approach, we at least have expert opinions in the various areas and these are helpful in drawing a buy-and-sell agreement, in negotiating, or in settling our tax case when that time arrives. Be careful of this computation—it is not a simple one and should not be completed in a few minutes on the back of an envelope. Give it the expert attention it requires as an important piece of your business planning and so avoid the trouble spots you might encounter without that planning.