THEME: VALUING GOODWILL

By John W. Day, MBA

ACCOUNTING TERM: Goodwill

Goodwill is the difference between the value of a business enterprise as a whole and the sum of the current fair values of its identifiable tangible and intangible net assets. Net assets are the assets that are left after subtracting the company's liabilities. Goodwill is only recorded when its amount is substantiated by an arm's-length transaction. Goodwill cannot be sold or acquired separately but has to be included in a purchase with the net assets of a business enterprise.

FEATURE ARTICLE: Valuing Goodwill

All my life I had heard the warning never to buy a "pig-in-a-poke". I understood the gist of it but didn't really know what a "poke" was. So I looked it up one day and found out a "poke" was a "bag". The saying refers to a scam in the late Middle Ages, at a time when good meat was scarce. If you bought a suckling pig in a bag without first looking at it, you might be surprised to find a scrawny cat jump out when you later opened it. In fact, that's where the saying, "Let the cat out of the bag", came from. In other words, finding out what was really in the bag.

Having worked in the field of accounting for twenty-five years, I have had ample opportunity to observe, first hand, many a client who has bought a "business-in-a-poke". In the old days, there were no accepted valuation formulas available to determine a reasonable price for a business. As a result, "rule-of-thumb" methods were used, but often had no correlation to the real worth of a business.

Choosing the correct valuation formula and applying it properly can be a daunting task and should be left to the auspices of an experienced professional. However, you can become familiar with the general guidelines of a widely used business valuation formula that will, at a minimum, give you an idea of what's involved. Armed with this information, hopefully you can avoid being scammed into buying a "business-in-a-poke".

Have you ever tried to sell or buy a business? It's not exactly a straightforward, easy thing to do. Most likely, if you are the seller, you will want to get top dollar for your business. After all, you worked hard to make your business work and would like to be amply compensated. Often, small business owners have a feeling for what they think the business is worth. When asked to justify the selling price, you may hear all kinds of stories.

For example, one of the most common reasons sellers give for their asking price is the *potential* of the business. This is sometimes better known as "blue sky" or "pie in the sky". There is no way to accurately estimate this *feeling* for potential, yet sellers will tell you that if you buy their business you will be in the "cat bird's seat" when this new technology arrives, or this big store moves in next door, or if you are willing to work extra hours, and on and on.

Another story you will hear is how much money the owner takes out of the business including salary and perks. Somehow the seller is equating compensation from work performed in the business to earnings. This may impress you if you are looking to buy a job. But even then, you need to pay only what the business is worth. So what do you have to do to determine the true value of a business? Rest assured that the process of valuing a business can be exceedingly complex. Much depends on the size and nature of the business you are buying or selling. The variables can seem unending. However, there is a core of knowledge that is not too complicated to learn that can at least keep you on the right track. The challenge is to keep it simple.

Let's say someone is selling a business and asking $100,000. The first question to ask is, "What exactly is he selling?" What assets are you going to receive in the deal and what, precisely, is their fair market value? After appraising the assets, are they worth $100,000? If not, the difference is what the seller construes to be Goodwill. For our hypothetical example, let's assume the assets have a fair market value of $60,000. This means the seller wants $40,000 for Goodwill.

Is this reasonable? Here are some general steps you can follow to find out:

> First, determine what a reasonable rate of return on an investment of $60,000 should be. (Determining this rate of return can be complex and probably requires the help of a professional.) For our purposes, let's use 8%.
>
> $60,000 x .08 = $4,800

This is the amount of *normal* earnings the company should be making each year.

> Second, determine from an average of five years of financial statements, backed up by tax returns, what the net profit is. Be sure to "normalize" the earnings, which is to say, remove expense items, such as depreciation and owner's perks, or add in a manager's salary if the owner worked in the business and didn't record a salary. Add or subtract any other appropriate items to arrive at a realistic net profit. Let's say the normalized earnings turned out to be $10,000.

Third, subtract the normal earnings of $4,800 from the normalized earnings of $10,000 to determine *excess earnings*.

$10,000 - $4,800 = $5,200

Fourth, determine a capitalization rate (cap rate). This also can be complex to develop. However, the idea behind a cap rate is this: The lower the risk, the lower the return on investment. The higher the risk, the higher the return on investment. For example, if you invest your money in your local bank, the risk of losing your investment is relatively low. Therefore, you only earn about 2%. Invest in the stock market and you can expect to earn up to 15% or higher in some cases, because it is a more risky investment. A small business can be a very risky investment, and a rule of thumb says you should at least expect to earn 20%. But, if the small business has factors that indicate less stability, then an even higher rate of return should be expected, perhaps 30% or 40%. Determining an appropriate and accurate cap rate is probably the hardest part of valuing a business.

However, let’s say our cap rate is 20%.

Fifth, divide the cap rate into the excess earnings to determine Goodwill.

$5,200 / 20% = $26,000

Sixth, add the net assets value and the Goodwill to determine the full value of the business.

$60,000 + $26,000 = $86,000

Our seller wanted $100,000 for the business. Now you can go to him and say, “Gee, I just don’t see it that way, take a look at my analysis”. Usually, the seller will back down when presented with a formula approach. If the seller hires his own accountant to provide a formula approach and his value of the business is higher than yours, (you can bet on it) then a common approach is to settle on a price that is the difference between the two.

How could the seller’s accountant come up with a different figure than yours? It’s in those rates and all the variables that go into developing them. It doesn’t take much to skew the percentage points one way or another. Here is a “what if”:

What if the seller's accountant came up with a rate of return for net assets of 6% instead of 8%?

$60,000 x .06 = $3,600   Normal earnings

$10,000 - $3,600 = $6,400   Excess earnings

And, what if the seller's accountant came up with a cap rate of 18% instead of 20%?

$6,400 / .18 = $35,556

$60,000 + $35,556 = $95,556

This is very close to the seller's original asking price of $100,000.

The name of this formula of valuing a business is called the **Net Assets plus Excess Earnings** method. It does not work on all businesses and there are other methods that can be used. The main point is to inform you that formulae do exist and not simply to accept the rationalizations of the seller. Yes, it can be a very complex process, but now you have a general idea about how to proceed.

TIP: A Quick Test For The Existence Of Goodwill.

This is a quick and dirty method to see if you want to waste your time negotiating a business offering. When the seller provides financial statements for your perusal, look at the bottom line. Take the time to normalize the earnings as mentioned above. Is there a profit? If not, you know there is not going to be any goodwill. What are the assets worth that you will be buying? Are they less than the asking price? If so, you can pretty much bank on the fact that the asking price is too high. Look at alternatives. Could you buy new assets for the amount the seller is asking and start your own business from scratch? Why pay for something that doesn't exist?

QUESTION: What Should I Do If The Seller Has Two Sets Of Books?

Business owners who keep two sets of books are not altogether uncommon. They keep one set of books for the government and another set for internal purposes. There is nothing wrong with this practice unless it is for the purpose of hiding income in order to pay lower taxes. The problem for these people arises when it comes time to sell their business. They want you (the buyer) to accept their internal books because they reflect more profit. However, you have no way of verifying that these books are accurate. That is why it is important to make sure that the tax returns of the business support the financial statements. Business owners who follow this practice of deception want it both ways. What they don't realize is that any wise and astute buyer is not going to go along with it. If a business owner is going to lie and cheat the government, surely that person is capable of lying to a potential buyer. My recommendation is to walk away or only pay a price based on information from the tax return.

John W. Day, MBA is the author of two courses in accounting basics: Real Life Accounting for Non-Accountants (20-hr online) and The HEART of Accounting (4-hr PDF). Visit his website at http://www.reallifeaccounting.com to download his FREE e-book pertaining to small business accounting and his monthly newsletter on accounting issues. Ask John questions directly on his Accounting for Non-Accountants blog.