Business Valuation and Forensic Accounting CONFERENCE

The valuation of personal goodwill

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Introduction

Arguably, any enterprise valuation that yields an economic value for goodwill should be accompanied by an analysis as to whether that goodwill is "enterprise goodwill" or "personal goodwill". This, of course, requires the components of the overall enterprise value to be allocated between net tangible assets, identified intangibles and goodwill, which unfortunately is not always explicitly stated in the reports of some valuers. Leaving that aside, in many instances the analysis of goodwill is a very quick exercise, when the nature of the goodwill is abundantly obvious. However, there are many occasions when the exercise is really not that simple.

Regardless of the **purpose** of the valuation, due regard must be had to the nature of the goodwill. In a commercial transaction, a buyer should only part with valuable consideration for components of the business that will continue to provide a benefit after the transaction has taken place. Inalienable personal goodwill of the selling party must therefore be identified in the valuation process. The allocation of goodwill may also be relevant in partnership / shareholder disputes, estate matters and various other instances requiring the alienability of the asset to be considered.

Consideration of the nature of goodwill is particularly important when the valuation is undertaken as a consequence of the breakdown of a marriage, either to assist the parties in resolving a property dispute by consent or assisting the Family Court[1] in reaching a finding in relation to the quantum of the property pool.

The decision of the **Full Court** of the **Family Court of Australia** in the matter of ***Wall and Wall*** *(EA83 of 1999)*[2]*,* contained an important clarification of the application of the "value to the owner" approach widely adopted in Family Law matters. The upshot of ***Wall and Wall*** is that in property proceedings in the Family Court, "personal goodwill" is considered to be a "financial resource"[3], not "property"[4].

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1 A reference to "Family Court" in this paper includes the Full Court of the Family Court of Australia, the Family Court of Australia, Federal Circuit Court of Australia and the Family Court of Western Australia.

2 The substantive appeal decision remains unreported, and was delivered on 26 October 2000.

3 The term "financial resource" is not defined in the Family Law Act 1975. Per https://www.hhg.com.au/what-is-the-difference-between-property-and-financial-resources-in-family-law-and-why-does-it-matter/, A "financial resource" can be thought of as something which is not property included in the asset pool but is a factor for the Court to take into account under section 75(2)(o) of the Act because it has a future financial benefit to one party.

4 Property is defined in Section 4 of the *Family Law Act 1975*, as follows:

"Property, in relation to the parties to a marriage or either of them, means property to which those parties are, or that party is, as the case may be, entitled, whether in possession or reversion."

The existence of personal goodwill should therefore only affect the **split** of the matrimonial asset pool, but not the quantum of the pool itself, as it will be excluded from the pool. The judgment also considers the potential double counting of a party's business profit as both property and a financial resource.

Despite the time that has elapsed since ***Wall and Wall*** and the material effect that the proper classification of goodwill might have on the outcome of a property dispute, the issue is very poorly considered by "expert" valuers. Whilst it is not necessarily an easy issue, in many instances it is completely ignored, resulting in an erroneous or inequitable outcome if the "error" goes undetected.

In view of the Family Court's approach of excluding personal goodwill from the property pool, it is of course just as important to identify what is **not** personal goodwill. It is my experience that any slightly entrepreneurial business person will attempt to convince the valuer, and then the Court, that without them their business would be worthless. That is, all the goodwill in the business enterprise is personal, when in fact it may be enterprise goodwill.

Part A of this paper seeks to explore the issues surrounding the proper identification of personal goodwill and to promote awareness in the business valuation community of the importance of the matter. Any practitioner genuinely interested in the topic would benefit from reading the various papers and texts published by ***Business Valuation Resources*** (bvresources.com) on the topic, written by experts[5] who are eminently more qualified than myself.

In **Part B I** will endeavor to deal with the related issue that arises regularly in valuations undertaken for the purpose of Family Law matters, being the **misapplication** of the "value to the owner" premise of valuation. Unfortunately we regularly see reports containing overstated, unjustified valuation conclusions on the basis that the subject interest has some "special value" to the party, not available to any other purchaser, which when critically reviewed is unfounded.

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[5] Including but not limited to Mr David Wood, Mr Thomas Gillmore and Dr Shannon Pratt.

Part A: Personal versus enterprise goodwill

What is goodwill?

Goodwill, per the **International Glossary of Business Valuation Terms**[6], is *that intangible asset arising as a result of name, reputation, customer loyalty, location, products, and similar factors not separately identified.*

Goodwill per **AASB 3, Business Combinations**, Appendix A Defined Terms, is *An asset representing future economic benefits arising from other assets acquired in a business combination that are not individually identified and separately recognised.*

A more comprehensive definition can be found in **Lonergan[7],** as follows:

Goodwill - *That part of the difference between the market value of the equity of an entity and the value of its net tangible assets which is not attributable to an* ***identified intangible asset****. Goodwill is the unidentifiable intangible asset arising from benefits such as the reputation of a business, its location, its market penetration, good management, good customer relation and good labour relations. Goodwill is distinct from identifiable intangible assets such as brand names, licences, patents, trademarks etc, and may be purchased (in which case its value can be recognised for accounting purposes) or internally generated (which is not generally brought to account).*

Regardless of whether goodwill was purchased in a previous transaction, was booked on the occasion of a restructure or has been internally generated (and is unbooked), its existence and value must be determined as part of the business valuation process. It is acknowledged that there may be "goodwill" in a business arising from the return of customers, however it only becomes of value when the earnings generated exceed a reasonable rate of return on the assets employed, and after appropriate allowance for the personal exertion effort / expertise of the proprietor.

The application of a valuation methodology premised on future earnings or cashflows generally implies the existence of some level of goodwill. For example, if the capitalised value of the earnings of an entity is $5million, and there are net tangible assets and identified intangibles totalling $4million, the implied goodwill is $1million. In the event that there are undisclosed or under-valued tangible assets or identified intangible assets, the actual goodwill value may be less than the value implied.

Not all businesses have a measurable level of goodwill, even though they may be profitable, as the value of capitalised earnings may be less than the net tangible assets or identified intangibles employed in the conduct of the business. This outcome is not uncommon where the business requires a heavy investment in its plant and machinery or trading stock, for example if goods are imported from overseas or have a long manufacturing lead time.

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6 International Glossary of Business Valuation Terms per American Institute of Certified Public Accountants ("AICPA").

7 Lonergan, The Valuation of Businesses, Shares and Other Equity 4th Ed, page 765.

To the contrary, some businesses may have an intangible value that appears disparate with its profitability due to a particular industry approach taken to the valuation of goodwill – eg., insurance broking, financial services, real estate, certain franchises and the like. There are many exceptions and these are merely examples.

While goodwill in its entirety has a definition, it is essential to understand that there are essentially three types of goodwill:

- **Enterprise** (Commercial) goodwill;
- **Personal** (Professional) goodwill; and
- **Non-transferrable goodwill** (which essentially relates to **pure personal goodwill** but may have a component of enterprise goodwill due to a contractual nuance or some case specific matter).

The AICPA's International Glossary of Business Valuation Terms does **not** contain a definition for either Enterprise Goodwill or Personal Goodwill. **Lonergan** discusses goodwill in the context of Personal, Location and Name goodwill, and suggests that **Personal Goodwill** *derives from and attaches to the people or a particular person in the business because of their know-how, experience, ability and the personality to attract and retain customers*[8].

Given the importance of the division of goodwill into its components, and therefore the definition, a review of other expert opinions is warranted.

Helpfully, an American expert, Mr David Wood CPA/ABV, CVA undertook a search for a definition and in doing so completed a review of text books, articles and US divorce case law in the quest to secure a definition[9]. This issue is very topical in the United States where a state based approach is taken to the inclusion of goodwill in matrimonial proceedings, and in this regard I note (other than being thankful that we have a Federal approach to Family Law, with WA applying consistent principles):[10]

- In **29** states **personal goodwill is not a marital asset**, enterprise goodwill is;
- In **13** states **both** personal and enterprise goodwill is a marital asset;
- In **1** state **neither** personal or enterprise goodwill is an asset;
- In **2** states the focus is on **"saleability"** or **"marketability**";
- In **6** states **"it's complicated"**; and
- In **1** state there is **no decision**.

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8 See **Lonergan**, page 346.

9 See *"Personal Goodwill In Search of a Functional Definition"* , published in BVR's Guide to Personal v Enterprise Goodwill 2010 Edition, Business Valuation Resources LLC, since updated as "*Personal Goodwill: A Current Survey of Definitions"*, Adam Manson and David Wood, published by BVResources.

10 See BVResources – Charting Goodwill Jurisprudence (as of June 2018), formerly known as "Goodwill Hunting in Divorce".

The issue is also a hot topic in the US as there is also a distinction when it comes to taxation[11], as gains from the sale of personal goodwill are taxed using a long-term capital gains rate, which is generally lower than the short term capital gains tax rates.

Interestingly, while the ATO acknowledges the existence of personal goodwill, for the purpose of income tax and capital gains tax there is no distinction between personal goodwill and enterprise goodwill (termed "site goodwill" and "name goodwill" by the ATO). The goodwill of a business is a single CGT asset, per tax ruling TR 1999/16. Furthermore, guidance available from the ATO[12] suggests that *the absence of goodwill in a value allocation may indicate that: (i) the business does not generate economic profit; (ii) the sale price was undervalued (and hence the purchaser did not pay a component for goodwill); or (iii) excessive value has been allocated to other assets.* There is no suggestion that perhaps the goodwill was personal goodwill of the vendor and therefore excluded when negotiating the consideration.

However, I digress. As detailed in his paper "**Personal Goodwill In Search of a Functional Definition**"[13], Wood details the following definitions of enterprise and personal goodwill:

Personal goodwill *is the value of earnings or cashflow attributable to attributes of the individual that results in earnings from consumers that return because of the individual, in earnings from new consumers who seek out the individual, and in earnings from referrals made to the individual*.

Enterprise goodwill *is the value of earnings or cashflow directly attributable to attributes of the enterprise that results in earnings from consumers that return because of the enterprise, in earnings from new consumers who seek out the enterprise, and in earnings from referrals made to the enterprise.*

As suggested by Wood, *Personal goodwill is the yin to the yang of enterprise goodwill*.

A review of the various texts as US case law details consistent principles with those set out in Wood's functional definitions set out above.

It is important to note that personal goodwill relates to revenue associated with **skill, knowledge and reputation,** not necessarily **time and effort.**

It is also essential to distinguish between **pure personal goodwill (not transferrable) versus transferrable goodwill.** This is particularly so in the Family Court jurisdiction, as there is insufficient case law to guide the valuer as to whether the intent behind ***Wall and Wall*** was the exclusion of pure personal (non-transferrable goodwill) versus any personal goodwill, which may in fact be transferrable. In my opinion it must be the earlier, the exclusion of pure personal goodwill, however that is just my opinion.

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11 Martin Ice Cream 110 TC 189 (1998).

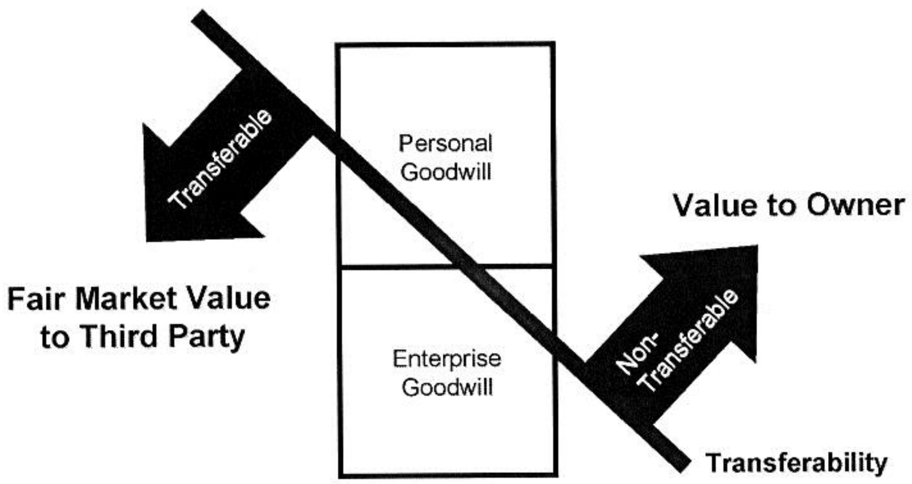
12 https://www.ato.gov.au/General/Capital-gains-tax/In-detail/Market-valuations/Market-valuation-for-tax-purposes/

13 See BVR's Guide to Personal v Enterprise Goodwill 2010 Edition, Business Valuation Resources LLC.

Pure personal goodwill is simply not transferrable and arises due to the specialised personal skills and relationships, where even a covenant not to compete ("CNTC") will be ineffective in transferring the value to a new owner. The simplest example to highlight this concept is the personal goodwill of a barrister. If the exiting barrister from the chambers enters into a covenant not to compete with the new barrister, it will have no bearing on the new barrister's ability to derive income. The new barrister has to demonstrate their own skill and reputation to build a practice, the goodwill of the exiting barrister is not transferrable.

The following diagram highlights the importance of the distinction between personal and enterprise goodwill and transferability[14]:

Fig 1



In situations where the goodwill may be transferrable personal goodwill, as opposed to pure personal goodwill, the "transferability line" can be moved by the existence of a restraint or CNTC, and the motivation of the vendor to achieve a successful transition of his business or otherwise. The diagrams below (**Fig 2 and Fig 3**) illustrate this concept[14]:

[14] BVR's Guide to Personal v Enterprise Goodwill 2010 Edition, *"Goodwill: Where Are We? How Did We Get Here? What Do We Do About It?"*, David Wood, CPA/ABV, CVA – Intro-5 and 6.

Fig 2

Without a Covenant-Not-To-Compete In Place

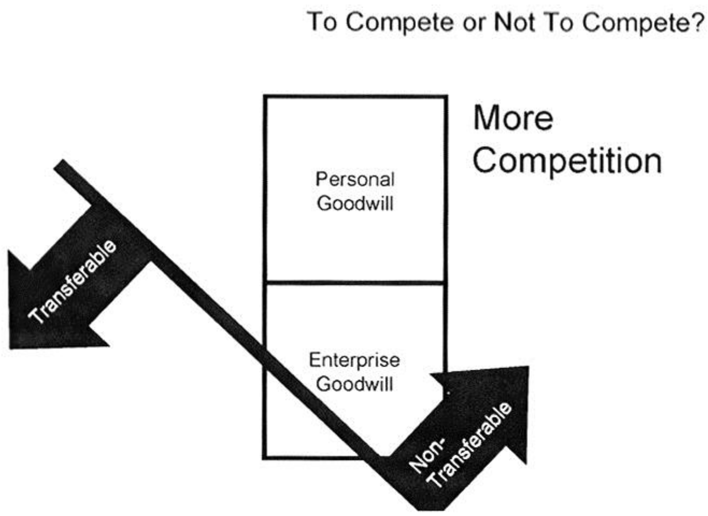
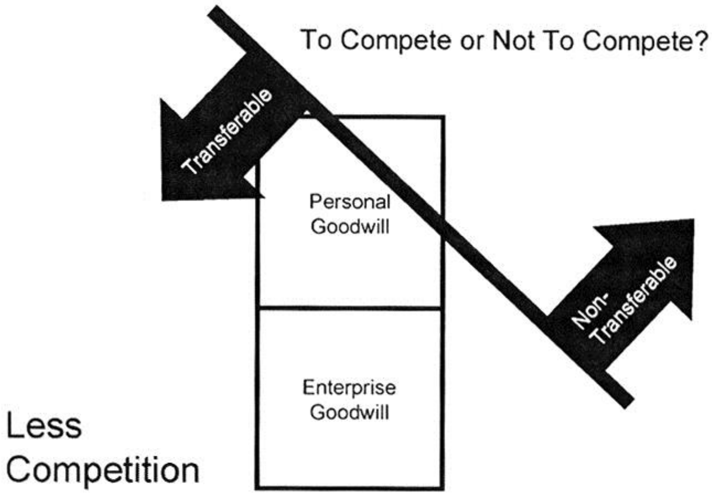


Fig 3

With a Covenant-Not-To-Compete In Place



By definition, as is evident per the diagram on the previous page (**Fig1**), the assessment of fair market value ("FMV") excludes personal goodwill that is not transferrable. The fully informed hypothetical purchaser will not pay for something they cannot get. FMV may include personal goodwill that is transferrable by training or development, the transfer of customer lists and a covenant not to compete, but should exclude non-transferrable (inalienable) personal goodwill.

Therefore, if the standard of value applied is FMV, there should be no need to further dissect the goodwill. To deduct personal goodwill from fair market value would result in an undervaluation of the equity interest.

These types of issues arise consistently regardless of the purpose of the valuation, and it is therefore essential that the valuer obtains sufficient information to be able to identify whether the goodwill is personal or enterprise goodwill, and whether or not it is transferrable.

How do we identify personal goodwill?

There are a myriad of factors that must be examined in order to dissect goodwill into its enterprise and personal components. While the task is an imprecise one, taking an orderly, analytical approach will assist in demonstrating to the user of the report, or a Court, the approach that has been taken in analysing and then deconstructing the goodwill.

Dr Shannon Pratt notes simply[15], *goodwill should be considered enterprise or practice goodwill only if it would continue to exist in the enterprise if the practitioner were not present. Therefore, a good "litmus test" of whether goodwill is practice or personal is the extent to which truly "excess" earnings (over and above adequate return to capital and adequate compensation for work performed) would continue to exist in the absence of the key individual.*

While this all sounds simple enough, in practice it can be very difficult to assess the effect on the earnings and profitability of the business of the key individuals involved in it. As noted at the outset, it is my experience that any slightly entrepreneurial business person will attempt to convince the valuer, and then the Court, that without them their business has no value.

It is therefore useful to consider the factors that are likely to drive this analysis, and which should form the basis of a series of questions to be put to the business owner. The factors and circumstances surrounding the business, its services, customers and people must be carefully examined as follows[16]:

Size of the business - is the business a small owner operated enterprise, dependent on one, two or only a few individuals, including their personal skills and relationships? Or, is it a larger business with many individuals, more than one location, a formalised organisation chart and no particular reliance on any one individual?

Covenant not to compete - would a CNTC be effective in retaining revenue and customers in the event of the sale of the business by the current owner (even if there is no sale contemplated)? Or, are the skills and relationships of the owner such that the value would not be retained by the business in the event of the departure of the current owner?

Services offered (a) - is the provision of personal services an important component of the revenue derived? Or, is the business not solely dependent on the provision of personal services, with products also forming part of the revenue achieved?

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15 Dr Shannon Pratt "**Overview of Enterprise and Personal Goodwill**", Shannon Pratt Valuations Inc.

16 The starting point for this list is drawn from "**Separating Personal and Business Goodwill**", Darrell Arne CPA, ASA and James Hamill PhD, CPA – see BVR's Guide to Personal v Professional Goodwill 3-125.

Services offered (b) - do the services provided require a high degree of skill or knowledge? Does the person derive revenue at a higher level than other practitioners (eg. the tax specialist vs the compliance accountant)? Or, could the services be provided by any one of a great many people?

Capital investment - does the business have a significant investment in capital, either tangible or identified intangible assets? Goodwill may attach to specialised equipment as opposed to a person.

Customer relationships - are relationships principally held by the employee-owner? Or, is there business name recognition, a sales team, sales contracts and company owned intangibles that give rise to revenue?

Product/service knowhow - is the knowledge of the products and services sold by the business held by a key individual? Or, does the enterprise have formalised production methods, patents, copyright and business systems?

Industry reputation - is the business known for its excellence generally, or does the reputation reside in one or a few key individuals?

Once identified, how do we value the personal goodwill?

To my knowledge, there is no precise methodology applied in Australia, or the US for that matter, in determining the value of personal goodwill or for allocating an overall goodwill value between personal and enterprise components.

It is generally accepted that the allocation may be made using a **Top-down approach**, a **Bottom-up approach** or a **With and without approach**. These approaches are widely described in texts on the subject, and I have set out below the definitions per Rod Burket, CPA/ABV, CVA[17]:

> ***Top-down approach:*** *This approach gets its name because the business is valued at its highest (top) value and then whittled away to arrive at the value for equitable distribution. An appraiser would value the business as it would be done under any other circumstances. The most likely methods used to value an operating business would be discounted cash flow, capitalisation of cash flow, completed transactions, and/or guideline companies.*
>
> *Since these methods would collectively value all of the enterprise's intangible assets, the appraiser would then identify all of the discrete components of personal goodwill (using the chart above as a starting point[18]), value them, and subtract them from total business value. One example of a personal goodwill intangible might be the name of the in-spouse owner if it is firmly established as the name of the business. Another example is the value of the in-spouse owner's customer relationships (which may or may not be the same as the customer list).*

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17 **"Separating Personal and Business Goodwill of Operating Companies in Divorce Valuations",** BVR's Guide to Personal and Enterprise Goodwill, 2010 Edition at 3-42.

18 See page 3-48 of the paper referred to at ref 17 above.

> ***Bottom-up approach:*** *This approach gets its name because the business value would start at a floor (bottom) and then be built up with the value of the identifiable intangibles belonging to the business and the value of the business goodwill. The floor value would be calculated using adjusted book value, which adjusts the reported book values of a company's assets and liabilities to their fair market value. In this context, assets are defined to be tangible assets (such as accounts receivable, inventory and fixed assets) and identifiable intangible assets (such as patents, copyrights, and trademarks). Added to this would be components of business goodwill, such as business location, workforce in-place, proprietary software, blueprints and drawings and internet web site, etc.*
>
> ***With & without approach:*** *This approach requires two separate valuations. First, the business would be valued with the in-spouse owner as of the valuation date (an "as is, where is" valuation). Next, the business would be valued without the in-spouse owner as of the same date. Presumably the value of the former would exceed the value of the latter (because without the personal goodwill of the in-spouse, the business would have less revenue and/or higher expenses), and the difference would be the value of the personal goodwill.*

An "objective" and scientific" approach to the bifurcation of goodwill, as developed by David Wood, is the use of a "MUM" model, being the adoption of **Multiattribute Utility Theory**[19]. It is suggested that the adoption of this scientific, step by step model, offers a reasonable position against evidentiary challenges, allows for the adoption of a consistent allocation from case to case, and a comprehensive method that **objectively addresses the imprecise task**. The model aims to move the bifurcation of goodwill from a subjective to an objective process. Wood describes the MUM steps as being relatively straight forward as follows:

- Define an objective;
- Establish alternatives;
- Define attributes;
- Measure the utility of each attribute (importance vs existence);
- Aggregate the results (do the maths);
- Evaluate the alternatives; and
- Express an opinion.

However, does the model developed by Wood involve too much precision for an imprecise task? Not only does the valuer have a degree of discretion in determining what the attributes are, in measuring the utility of each attribute, being importance and existence, a weighting is given to each of the attributes at the discretion of the valuer. This brings a significant level of subjectivity back into the model.

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[19] See **"An Allocation Model for Distinguishing Enterprise Goodwill from Personal Goodwill**", BVR's Guide to Personal v Enterprise Goodwill, 2010 Edition, at 3-53.

The formula (the maths) used to allocate the goodwill is as follows:

$$TMU\ PGA = \sum[IU^{PGA \text{ for } 1 \text{ to } N} \times EU^{PGA \text{ for } 1 \text{ to } N}]$$

$$TMU\ EGA^{20} = \sum[IU^{EGA \text{ for } 1 \text{ to } N} \times EU^{EGA \text{ for } 1 \text{ to } N}]$$

$$TMU = TMU\ PGA + TMU\ EGA$$

$$\text{Personal Goodwill} = \frac{TMUPGA}{TMU} \times \text{Total Goodwill}$$

Where: TMU PGA = Total Multiplicative Utility for Personal Goodwill
TMU EGA = Total Multiplicative Utility for Enterprise Goodwill
TMU = Total Multiplicative Utility
PGA = Personal Goodwill Attributes
EGA = Enterprise Goodwill Attributes
IU = Importance Utility
EU = Existence Utility
1 to N = Each of the attributes selected for the analysis.

The application of the model is best illustrated in the following table[21]:

Multi-Attribute Utility Model

Professional Goodwill Attributes (PGA)	Importance Utility	Existence Utility	Mult. Utility	Percent	Enterprise Goodwill Attributes (EGA)	Importance Utility	Existence Utility	Mult. Utility	Percent
Ability, Skill and Judgement	5	4	20	13.07%	Business Location	5	2	10	6.54%
Personal Reputation	3	4	12	7.84%	Business Reputation	5	2	10	6.54%
Work Habits	3	4	12	7.84%	Repeating Revenue Stream	5	2	10	6.54%
Closeness of Contact	3	3	9	5.88%	Systems and Organization	5	2	10	6.54%
In-bound Personal Referrals	3	3	9	5.88%	Multiple Service Providers	5	1	5	3.27%
Staff, Personal	3	4	12	7.84%	Business Name	3	3	9	5.88%
Age and Health	1	4	4	2.61%	Inbound Referrals	3	2	6	3.92%
Important Personal Nature	1	2	2	1.31%	Staff, Enterprise	3	2	6	3.92%
Marketing and Branding	1	4	4	2.61%	Marketing and Branding	3	1	3	1.96%
Personalized Name	1	-	-	0.00%	Multiple Locations	1	-	-	0.00%
Total Multiplicative Utility (PGA)			84	54.90%	Total Multiplicative Utility (EGA)			69	45.10%
Personal Goodwill Allocation (Rounded)				55%	Enterprise Goodwill Allocation (Rounded)				45%
Total Multiplicative Utility (PGA+EGA)			153	100.00%					

(1) Importance Utility is ranked in three categories - key (5), more important (3), important (1).
(2) Existence Utility is weighted from 0-4. 0 indicates no presence, 4 indicates strong presence.

While the Wood MUM has been accepted in some cases, in others it has not been favorably received. To this end, Thomas Gillmore, CPA/CVA, CFE[22] suggests that removing the subjectivity associated with assigning an importance weighting to each attribute, and simply stating whether or not the attribute exists, removes the complication of the model being subjective.

[20] The maths set out in the Wood paper details this input as "PGU", however I have assumed this is an error.

[21] Being a vet practice example presented by Seth Webber of Berry Dunn.

[22] See **"Simplified MUM for Determining Personal Goodwill"**, per BV Resources Business Valuation Update Vol 22, No 2, February 2016.

In the example model described by Gillmore, in an effort to generate a level playing field in the analysis, an equal row count is given to personal and enterprise attributes. In practice this may not always be the situation, and may in fact lead to an early conclusion as to the nature of goodwill. An example of the simplified MUM suggested by Gillmore is as follows:

Simplified MUM Schedule			
Enterprise Attributes	**Add to Scale (0,1)**	**Personal Attributes**	**Add to Scale (0,1)**
Assemblage of assets	0	Ability, skills, judgement	0
Barriers to entry	0	Age and health of practitioner	0
Business location (GEO preferred)	0	Closeness of contact	0
Business locations (multiple)	1	Comparative professional success	0
Business name	0	Marketing and branding	1
Business reputation	0	Personal referrals	1
Patient base	1	Personal reputation for judgement, skills, knowledge	1
Repeating revenue stream	0	Personal staff	0
Systems and organisations	1	Personalised business name	0
Workforce in place	1	Work habits	0
Total enterprise attributes	**4**	**Total personal attributes**	**3**
Enterprise: 57% Personal: 43% Total: 100%			

Adoption of the simplified MUM certainly has some attraction, and would arguably give rise to fewer cross examination points. I am not aware of either the Wood MUM or Gillmore MUM being tested before the Family Court, however adoption of either at least focuses attention on the bifurcation issue that is more often than not completely ignored.

Do only professional practices have personal goodwill?

The majority of reported decisions and texts dealing with this topic are centered around the valuation of a professional practice, which may range in size from one to many owners. However, can it be argued that any business could potentially have personal goodwill?

While case law in some states of the US may be unsupportive of my opinion[23], I suggest that any commercial enterprise can potentially have an element of personal goodwill. The concept is not limited to professional practices. This seems not only a theoretical conclusion based on an analysis of the attributes that go into the allocation models described above, but also a practical consideration often faced in succession planning transactions, where the purchaser argues great risk associated with the retirement of key personnel / owners. For example, if we were retained to value “Dinner by Heston” or “The Fat Duck”, how could we possibly argue that the “Heston” factor should not be taken into account in reaching a conclusion as to the value of goodwill?

Leaving aside unusual non-professional cases, in assessing the personal goodwill in a commercial (non-professional practice enterprise), it may well be that the application of a key person discount in the assessment of the capitalisation rate appropriately excludes any personal goodwill from the valuation conclusion, with further assessment being unwarranted. However, a “with or without” exercise may provide a better indication of the quantum of any personal goodwill.

Reasonable remuneration and care not to double count

The assessment of an appropriate commercial return for the owner who works in the business is an essential element of determining future earnings / cashflows, and consequently an essential element in the determination of goodwill. An understatement of the level of commercial remuneration will result in an overstatement of enterprise value and therefore goodwill, regardless as to whether that goodwill is personal or commercial, transferrable or inalienable. The reasonable commercial salary allowance for the owner should be the amount required to remunerate a non-owner for the role undertaken by the owner, inclusive of both qualifications, relationships, wow-factor and sheer effort.

In a Family Law matter it is essential to ensure that there is equity between the income included as a financial resource, and the capitalised value of that income stream if there is enterprise goodwill. The profit from the business should not be included as a financial resource if the continued derivation of that profit forms the basis of an enterprise value included in the matrimonial property pool.

For example, an individual may draw a salary of $180,000 from their business, with the level of salary determined by either history or tax planning considerations. If in valuing the business the salary of $180,000 remains unadjusted, the following may be the valuation outcome.

Enterprise value with wages unadjusted	**$**
Earnings before interest, tax and owner wages	500,000
Owners wage per amount actually paid	(180,000)
EBIT	320,000
EBIT Multiple	3
Value of the business enterprise	**960,000**

23 See ***Brave v Brave 2014 Ark 175,*** Supreme Court of Arkansas decision regarding the goodwill in a restaurant business that was found to be marketable and therefore the personal goodwill exclusion (of that State) did not extend to the business goodwill.

Under this scenario, the property for the purpose of s79 is $960,000 and the resource for the purpose of s75(2) is $180,000.

However, the commercial remuneration of the owner may be say $300,000, and the valuer of the business makes an adjustment for that level of remuneration. All other things being equal, the effect on the valuation of the higher salary allowance is as follows:

Enterprise value with wages adjusted	**$**
Earnings before interest, tax and owner wages	500,000
Owners wage per commercial salary	(300,000)
EBIT	200,000
EBIT Multiple	3
Value of the business enterprise	**600,000**

The value of the business under the second scenario is $360,000 less than under the first scenario and it is important to ensure that the higher salary level is taken into account when assessing the resources of the person. Under this scenario, the value of the property for the purpose of s79 is $600,000 and the resource for the purpose of s75(2) is $300,000. It would be erroneous to include the lower business value without reflecting the higher resource. Similarly, it would be erroneous to include the lower business value in the property pool, while at the same time including the salary actually paid as a financial resource.

Case review – Family Court of Australia decisions

Wall and Wall (unreported EA 83 of 1999)

The decision in ***Wall and Wall*** was important as it examined the distinction between personal and commercial goodwill and also considered the potential double count between earning capacity and capitalised value.

The decision provided a reality check on the blanket application of the “value to the owner approach” and highlighted the need for careful analysis of the valuation outcome. There is an inherent problem, particularly in professional practice valuations, where the income of the professional is double counted as both a financial resource and property, by virtue of its capitalisation into a lump sum value. If personal goodwill is excluded the double count is avoided as the income is only included as a resource.

The subject equity interest in *Wall and Wall* was neither a minority interest (where the value to the owner premise was developed) nor a traditional professional practice, and the decision therefore has important application to many businesses, whether they be professional practices or otherwise.

Background

An appeal was made by the husband from orders made by the trial Judge, Cohen J. At issue was the value applied to the business conducted by the husband (in particular the value ascribed to goodwill), and other issues pertaining to a boat and contribution (which are not relevant to this discussion).

The husband was a film producer and operated his own business through a company "Off The Wall Pictures Pty Ltd", of which he and his de facto wife, Ms Lee (not the wife in the proceedings), were the only and equal shareholders. It was claimed that business relied entirely on the skills of the husband and Ms Lee.

The trial Judge concluded that the value of the husband's 50% shareholding in the business was $55,043, and in determining the value of the company included an amount for goodwill of $102,000.

As set out at paragraph 32 of the Full Court judgment, the trial judge rejected the argument advanced for the husband that, *"……because the business [of the company] relies wholly on the skills of the directors [the husband and Ms Lee], the goodwill is worth nothing and that, in reality, the business is merely a resource which is a manifestation of their earning capacity rather than property."* At paragraph 100 of the first instance judgment, his Honour said:

> *"The simple fact is that the husband and Ms Lee have chosen to operate the business through the medium of a company in which they own shares. The husband's share is property. It has to be valued. Its value is to be ascertained in the husband's hands. The goodwill is, in any event, a manifestation of only two years super profitability and not the income of the husband for the rest of his working life in it. The husband's earning capacity is quite a different thing from the value of the goodwill of the business. It is not double counting to rely on both the goodwill for the purpose of s.79 and the husband's earning capacity for the purpose of s.75 (2)."*

The husband challenged the trial Judge's valuation of his share under three elements. The first element related to the trial Judge's acceptance that the company had any goodwill to value. The second related to the finding that the husband's share had any value of significance "in the husband's hands".
The third related to certain add backs that were made in determining maintainable super profit.

The Full Court judgment

The Full Court accepted the trial Judge's statement that the value to be ascertained in relation to the husband's share in the company is its value "in the husband's hands", with authority found in *Turnbull & Turnbull*, *Sapir v.Sapir (No.2)* and *Harrison & Harrison.* Furthermore, the Full Court found that it was open to the trial Judge to reject the submission that because the business relies wholly on the skills of the directors the goodwill is worth nothing, as follows:

> *67. "Such a proposition ignores the fact that "goodwill" in relation to a business may attach to such features as the business name or its location, and many small businesses, which rely entirely on the skills of their operators (eg. Professional practices) are considered to have some goodwill. As Mr Bell said in his report "... an ordinary person prefers taking over an existing business, rather than setting up a new business". Certainly, an important aspect of that is the setup of an existing business, which would usually include its tangible assets, and possibly some intangible assets other than goodwill, but the mere fact that a business name and clientele who habitually resort to, is, or at least may be, an intangible asset (categorised as "goodwill") of some value. As Wayne Lonergan says:*

> *"The reality is that goodwill exists because a business has a demonstrated capacity to earn cash flows exceeding the cash flow which one would normally expect if one were to invest the same level of tangible and identifiable intangible net assets in a similar business starting from scratch."*

However, the Full Court rejected the approach taken by the trial Judge in valuing the goodwill of the company at $102,000:

> *68. At the same time we think it was important for his Honour to recognise what is really adverted to in the evidence of Mr Bell, particularly the statement quoted in paragraph 62 hereof, and in his oral evidence quoted in paragraph 64 hereof, namely that there is a significant element of personal goodwill attaching to both the husband and Ms Lee in this case, which is clearly not transferable, and which, in the case of the husband at least, is* ***really part of his earning capacity rather than property****.*
>
> *69. The difference between commercial and personal goodwill is described, thus, by Lonergan, with particular reference to the valuation of professional partnerships:-*
>
>> *"The goodwill of professional practices may be attributable to the combined personal attributes of the partners which revolves around their skills, reputation and personal relations between each other and their clients. Alternatively it may reflect commercial goodwill which relates to their clients' favourable attitudes towards the practice as a whole.*
>>
>> *This favourable attitude may have been gained through the reputation of the firm or through prior connections and dealings with the firm.*
>>
>> *The value of commercial goodwill is reflected in the advantages that a prospective partner would obtain by entering into a practice with a recognisable name, established clientele, a range of services, research and precedent databases, well trained staff and recognised programmes and procedures. Personal goodwill attaches to the individual and is attached to that person's own ability, skills, experience, training and reputation. As a general rule personal goodwill is likely to be disproportionally higher than commercial goodwill in a sole practice or small specialist practice of say two or three partners whereas commercial goodwill is likely to be of more value in a larger practice trading under a well recognised name or national or international affiliation."*
>
> *70. With respect to his Honour, we think that in saying, as he did (in paragraph 100) that "the husband's earning capacity is quite a different thing from the value of the goodwill of the business", he failed to appreciate the important distinction between commercial goodwill and personal goodwill and failed to have regard to that evidence of Mr Bell to which we have referred in paragraph 68 hereof. In valuing the goodwill of the business as he did, we think that his Honour effectively treated the personal goodwill attaching to the husband as part of the commercial goodwill attaching to the business, and this resulted in the adoption of a grossly inflated value for the business, for the company and for the husband's share in the company.*

In considering the second element of the appeal in relation to the value of the share in the company, in relation to the value of the share in the husband's hand, the Full Court said:

> *74. We think it was open to his Honour to find that the husband's share had <u>some</u> value in his hands because it conferred on him <u>some</u> benefits which he could not have obtained as a sole trader (eg., the benefit of Ms Lee's input into the company of which she too was a shareholder, and the benefits flowing from the continued use of the company name and reputation, in the conduct of the business, rather than in his own or some other name which he might need to adopt and take time to attract clients to). However, we do not think that it was open to his Honour to place a value on that share in the husband's hands by simply capitalising the adjusted net profits of the business, adding the value of the net tangible assets, and dividing it by two because the husband was a 50% shareholder in the company. As we have said above, to do so involves attributing entirely to the business whatever personal goodwill attaches to the husband which, on any view, would be substantial in this case.*

The appeal was allowed, relevant parts of the trial Judge's orders were set aside and directions were given for the filing of written submissions.

Therefore, while still having the objective of arriving at the "value to the party", the Full Court made a clear distinction between the value of enterprise goodwill and personal goodwill and earning capacity versus property.

Where commercial goodwill exists and is appropriately valued using a super profit approach, care must be taken not to double count the profit cashflow as both property and a financial resource. The resource in these instances should be the notional salary allowed for the proprietor, not the profit from the business activity.

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Background

This is a case involving an architect practice that was conducted in both Perth and Thailand, that was controlled by the Husband and his brother. The companies operated a design orientated architecture practice, managing a wide range of projects including architecture, landscape architecture, urban planning and design and interior design. Clients included individuals, corporations and governments throughout Australia and Asia (particularly Thailand and Singapore).

The business operations of the Australian and Thai company were closely integrated, with the Australian company responsible for the design direction of each project and management services, and the Thai company responsible for the majority of the production of the projects and their on-site implementation.

The Husband was a qualified architect and his responsibilities included management, business development, developing design concepts, establishing project costings, and oversight of each project.

The responsibilities of his brother, a qualified civil engineer, included management, strategic planning, supervision, preparation of budgets, monitoring financial performance, oversight of contracts and the development and monitoring of the scheduling of each project. The business in Australia employed a graduate architect and a part time administrative assistant in addition to the Husband and his brother. The business in Thailand employed five graduate architects, a draftsperson at its Bangkok office, with a further three architects being employed at a site office in Phuket.

It was evident that the business was dependent on the Husband for his design ability, but that there were various other qualified architects and support people employed by the business.

In this instance, while it was appropriate to value the business on a capitalised future maintainable earnings basis, it was important to highlight the personal goodwill issue. The valuer did not seek to split the goodwill between the personal and enterprise components but noted:

> *"I understand that the business activities are dependent on the Husband and that he is the creative focus of the practice and clients are gained through his skill and reputation. The Husband is supported in these endeavours by his brother, employed architects and consultants in both Australia and Thailand. The goodwill associated with the continued conduct of the practice may be considered to have both a commercial and a personal element. On the assumption that there is no intention to sell the practice, and that the practice profits are generated by the collective efforts of a group of architects and draftsman, it may be argued that the profit is achieved as a result of more than the relationship and creative expertise of the Husband. However, consistent with the approach of the Family Court in Wall and Wall (unreported EA 83 of 1999) any personal goodwill may constitute an additional financial resource (not property) of the Husband".*

The judgment

The trial judge found that the goodwill of the business was **all** personal goodwill of the Husband, and excluded the goodwill in its entirety from the value of the company. The trial judge split the $1.4 million asset pool 62.5/37.5 in favour of the Wife and made a 27.5% adjustment in favour of the Wife in view of 75(2) factors.

The Wife appealed on the basis that the trial judge did not accept the goodwill figure "assigned by the single expert". This point of appeal in the context of the single expert's conclusion was poorly founded as the single expert highlighted the personal goodwill issue as detailed above.

In any event, the first instance decision notes:

> *(32) Given the above the remaining component of the valuation requiring comment is that of goodwill. The single expert attributes a figure of $459,000 to the goodwill of the company, to include the interest of [I]. I am satisfied that most of the goodwill centres on the personal goodwill of [the husband]. [The wife] made the point that [the husband] had considerable skill, experience and good relationships with his clients. This is evidenced by the gift of the [P] shares to him. He accepted he had good working relationships with the people he dealt with.*

> *As the single expert points out, these personal skills are not transferable. I have little trouble accepting that the business activities are dependent on [the husband] and that he is the creative focus of the practice. He works with his brother and they form a team. In the main the clients are gained through [the husband's] skill and reputation. I consider that any commercial element of the goodwill is minimal.*

The trial judge dealt with the issue via a percentage adjustment in the Wife's favour as follows:

> *(105) It is now necessary to revisit the issue of [TD]. Although I expressed some disquiet about attributing a specific value to it over and above its separately identified assets, I accept it is likely to have an additional value in the future that is not capable of exact quantification. Presently its value is at a low ebb but, given [the husband's] ability, I consider that in the future it is likely to be a business of some worth.*

The Full Court found that the Wife's appeal had no merit and affirmed the exclusion of all goodwill from the value of the Husband's interests in the entities. The single expert was not cross examined.

Case review – other matters

"Welsh" – matter did not proceed to trial

The Husband in this matter was also an architect, conducting his business through a company owned by himself and his business partner. The practice was conducted from small leased premises in a Sydney suburb, with the revenue and profitability of the practice building from a small base over the previous few years. In the year immediately preceding the valuation date, the business achieved revenue of $1million and a profit in excess of commercial salaries for the very first time. The Husband and his business partner were the only employees of the company, they held all of the relationships with developers and builders and also held the design expertise that resulted in referrals to the practice. Subcontract drafts-people were employed from time to time as required.

The single expert concluded that the value of the 50% interest held by the Husband in the company on a capitalised future maintainable earnings basis was $300,000, which implied a goodwill value at the valuation date of $480,000. The single expert ultimately opined that the value of the interest held by the Husband was $175,000, having erroneously averaged out the valuation conclusion achieved under three different methodologies (which was complete nonsense, but not relevant to this paper).

While the valuation conclusion was astounding in view of the size and profitability of the business, the issue was further compounded by the failure of the expert to give any consideration to the nature of the goodwill. When challenged, the expert failed to concede that the goodwill was personal goodwill.

Had the expert taken himself through the list of matters that should be considered in dissecting goodwill, the unavoidable conclusion was that the goodwill was personal goodwill of Mr Welsh and his business partner. Furthermore, in view of the specialised design skills held by the Husband and his business partner, the goodwill was not transferrable. Applying ***Wall and Wall***, the personal goodwill was a financial resource, not property.

The property component of this case ultimately settled, however the enormous additional cost of solicitors and experts caused by the erroneous conclusions of the single expert were of great concern. Add to this the delay that it caused in an acrimonious children's case, the conduct of the expert is inexcusable.

Part B: Misapplication of "value to the owner"

The decisions of Justice Warnick in ***Ramsay and Ramsay*** *(1997) FLC 92-742*, and ***AJW v JMW*** *(2002) FLC 93-103* are important in providing an explanation of the meaning of "value to the owner" and its application. Importantly, there is clarification that "value to the owner" is the **objective** of the valuation process and not a valuation methodology. In ***AJW v JMW*** Justice Warnick says:

> *14. There can be no doubt that the objective of the valuation is to assess the value of the share to the husband (owner) (see Harrison and Harrison (1996) FLC ¶92-682 at p 83,087). That is so whether there are "special benefits" or not, though if there are special benefits, they must be valued in achieving the objective. However, the use of the term "value to the owner" in Family Law property cases, should not be dependent on the existence of special benefits, but rather, as descriptive of the objective of the valuation exercise.*

It is necessary therefore for the valuer to consider whether there are any "special benefits" associated with the particular ownership interest. If there are no special benefits, fair market value is likely to represent the value to the owner, and the objective is achieved.

See also the matter of ***Scott & Scott (2006) FamCA 1379***.

Consideration of these issues is best demonstrated by a case study.

"Bloomfield"[24]

Mr Bloomfield is an environmental consultant, specialising in asbestos removal. He is a junior partner in a large Brisbane based environmental consulting practice. The consulting business had been acquired from some of the current directors by a multi-national US based firm some years earlier, however it had undergone a management buyout 12 months prior to the valuation date.

At the time of the valuation the business was owned by ten directors, with four senior consultants owning 60% of the equity in the newly formed company. The remaining six partners owned varying minority interests in the company, with Mr Bloomfield owning 5%. While the four senior consultants owned 60% of the company, they controlled over 80% of the fee base.

As noted above, the business had been de-aggregated from the US parent company just 12 months before the valuation date. Warnick J made certain observations in ***Ramsay***, which were reaffirmed in ***AJW and JMW***, paraphrased as follows:

[24] The facts of this case study have been varied to protect the identity of the parties, and any similarity to a real case or people is unintentional.

(a) A question to be answered in each case is whether there is a market for the shareholding;

(b) If there is a market, evidence of the market value is highly likely to be relevant, even if there is no intention to sell;

(c) Where there is a market for the shares, evidence of market value may well be one and the same as “value to the owner”.

In my opinion there can be no better evidence of “market value” than a completed third party sale transaction in relative close proximity to the valuation date. The value of the business on de-aggregation was almost fully funded by external borrowings, and had a net value of $1million. The value of the Husband’s interest in the company per the Purchase Agreement was $50,000. The Shareholders’ Agreement entered into at the time of the de-aggregation also stated that in the event of the death of a shareholder, the value was the initial consideration paid, and in all other circumstances the value was $Nil (exclusive of any shareholder loan account balance that may have been outstanding on the relevant date).

Given the existence of a market and evidence of the market value, the market value of the shares was the same as their “value to the owner”, being somewhere between $Nil and $50,000. The 5% interest in the practice held by the Husband was of no greater value to the Husband than any other environmental consultant, nor did the interest give him any “special benefits” that were not available to the hypothetical purchaser.

I note that the factual situation in this case distinguishes it from ***Scott***, where the goodwill clause in a 30 year old partnership agreement did not prevail, rather a fresh calculation based on capitalised maintainable earnings was preferred.

Despite the available information, the single expert opined that it was necessary to determine an alternative “value to the owner”, and proceeded to do so using a present value of proportional profits to retirement at 65 (the Husband was 40). This approach resulted in a value in excess of $500,000, some 10 times greater than the fair market value. Not only was this valuation outcome vastly overstated in view of the reality of the situation, the whole exercise was unnecessary in the first place.

While I have made comment about this case in the context of a “misapplication” of value to the owner (as it simply wasn’t necessary), it is equally relevant to the discussion above in terms of personal goodwill. The value of the business in the absence of the four senior consultants would have been materially less than the value inclusive of their fees and profit, yet no mention of this was made by the single expert.

The “value to the owner” of $500,000 was grossly overstated for many reasons and fortunately the matter settled on the basis of the fair market value of the interest. The profit distribution achieved by the Husband was properly included as a financial resource in determining the split of assets between the parties.

Unfortunately these erroneous valuation outcomes are all too common, and the case above is certainly not an isolated occurrence.

Conclusion

The proper identification of personal goodwill is a critical element in the business valuation process, and it is undeniably a tricky, and somewhat subjective, exercise. This paper does not provide anything more than food for thought on the matter, and a range of suggestions as to how goodwill may be better analysed and then allocated between its various components to ensure an equitable outcome for the ultimate users of a valuation report.