RETHINKING OUR APPROACHES TO DETERMINING DIVISIBLE GOODWILL UPON DIVORCE

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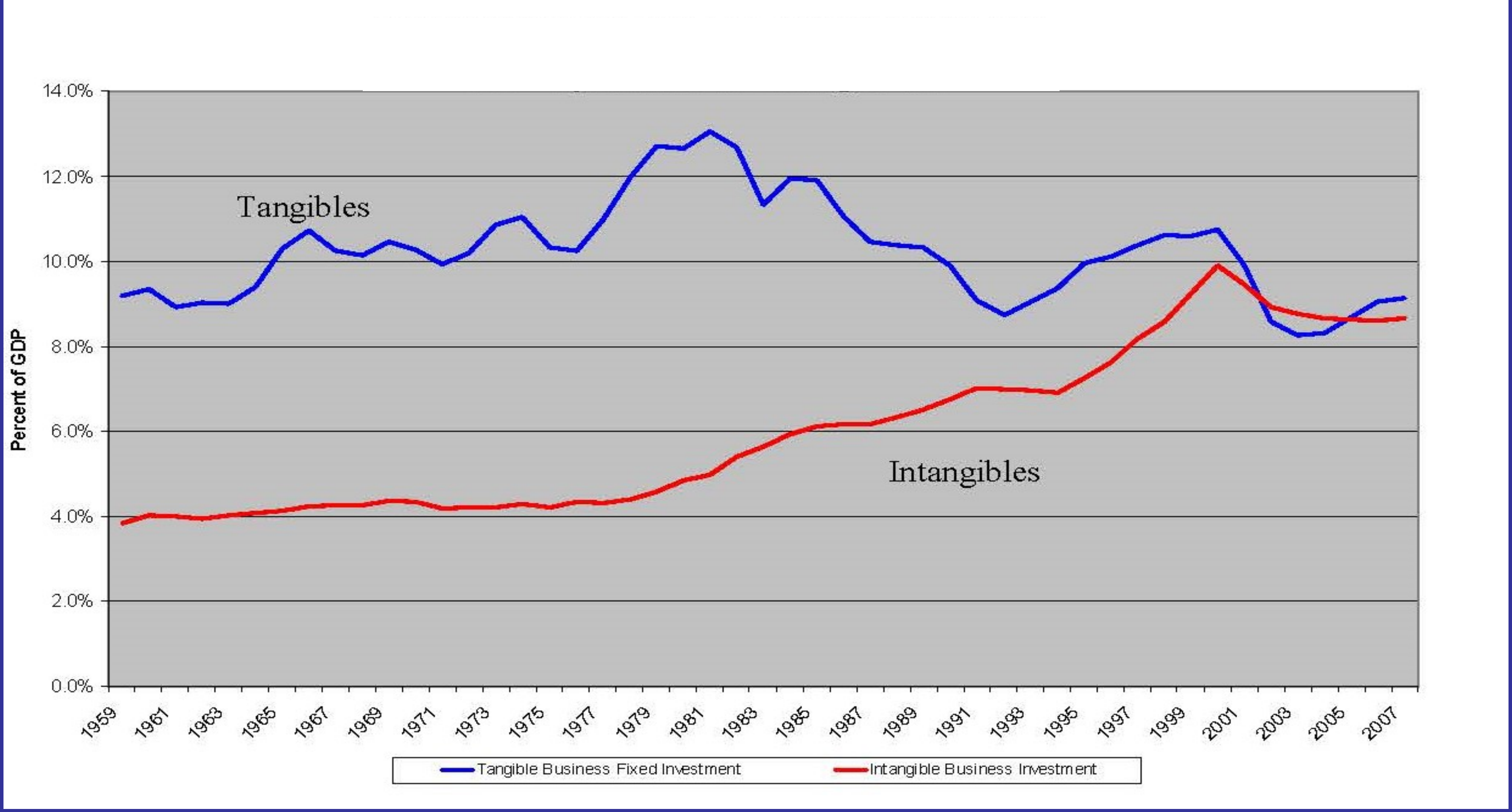
Toto, I've got a feeling we're not in Kansas anymore.

Top 5 U.S. Companies Based on Market Cap

1975	2020
IBM ($31 b)	Apple ($1.9 tr)
AT&T ($29 b)	Microsoft ($1.5 tr)
Exxon ($21 b)	Amazon ($1.5 tr)
*Eastman Kodak ($17 b)	Google ($1 tr)
*GM ($14 b)	Facebook ($730 b)

*GM filed for bankruptcy in 2009
Kodak filed for bankruptcy in 2012

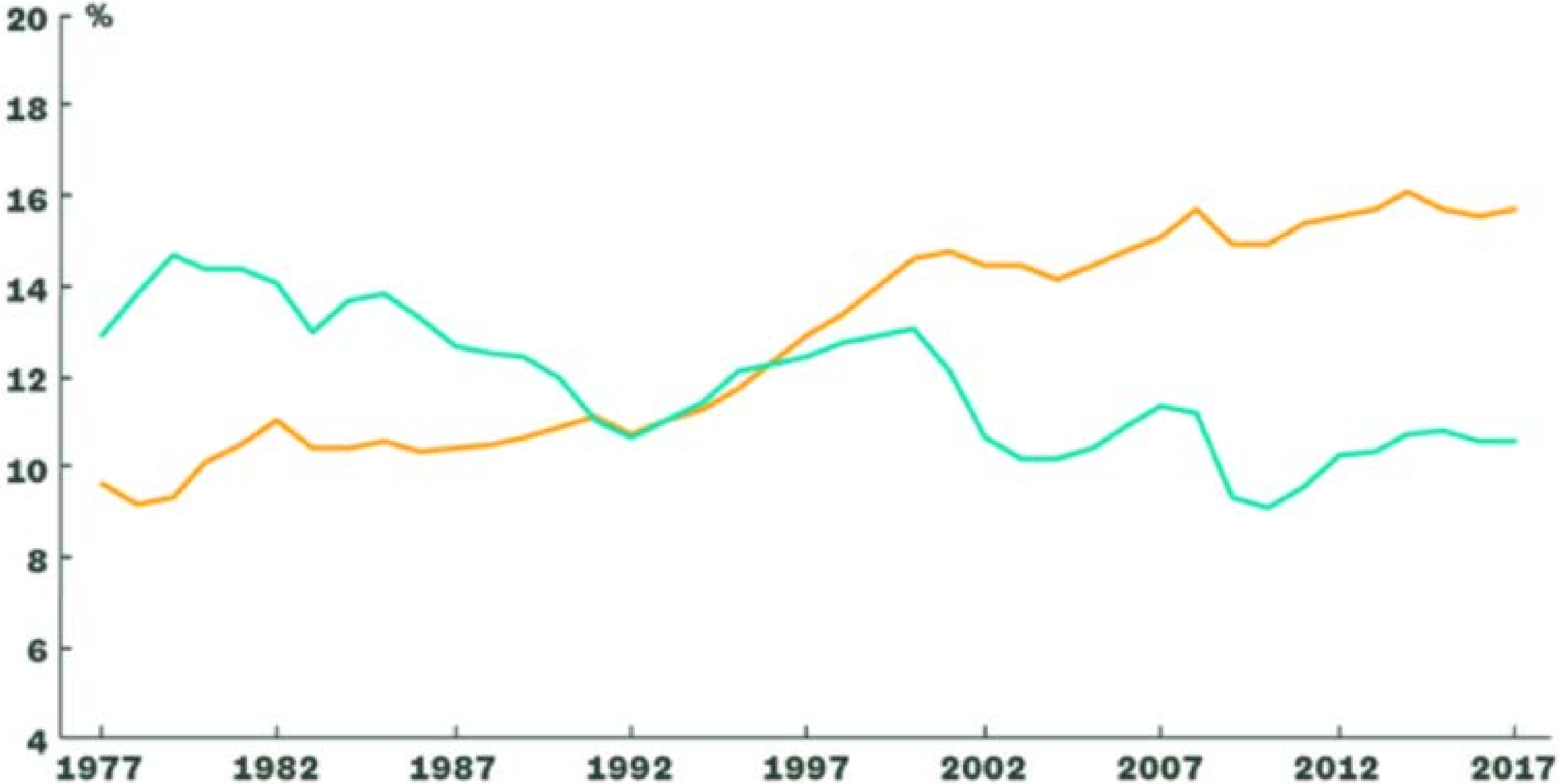
In 2003 the USA, Intangibles Became as Important as Tangibles



Nakamura, Intangible Assets and National Income Accounting: Measuring a Scientific Revolution (2009)

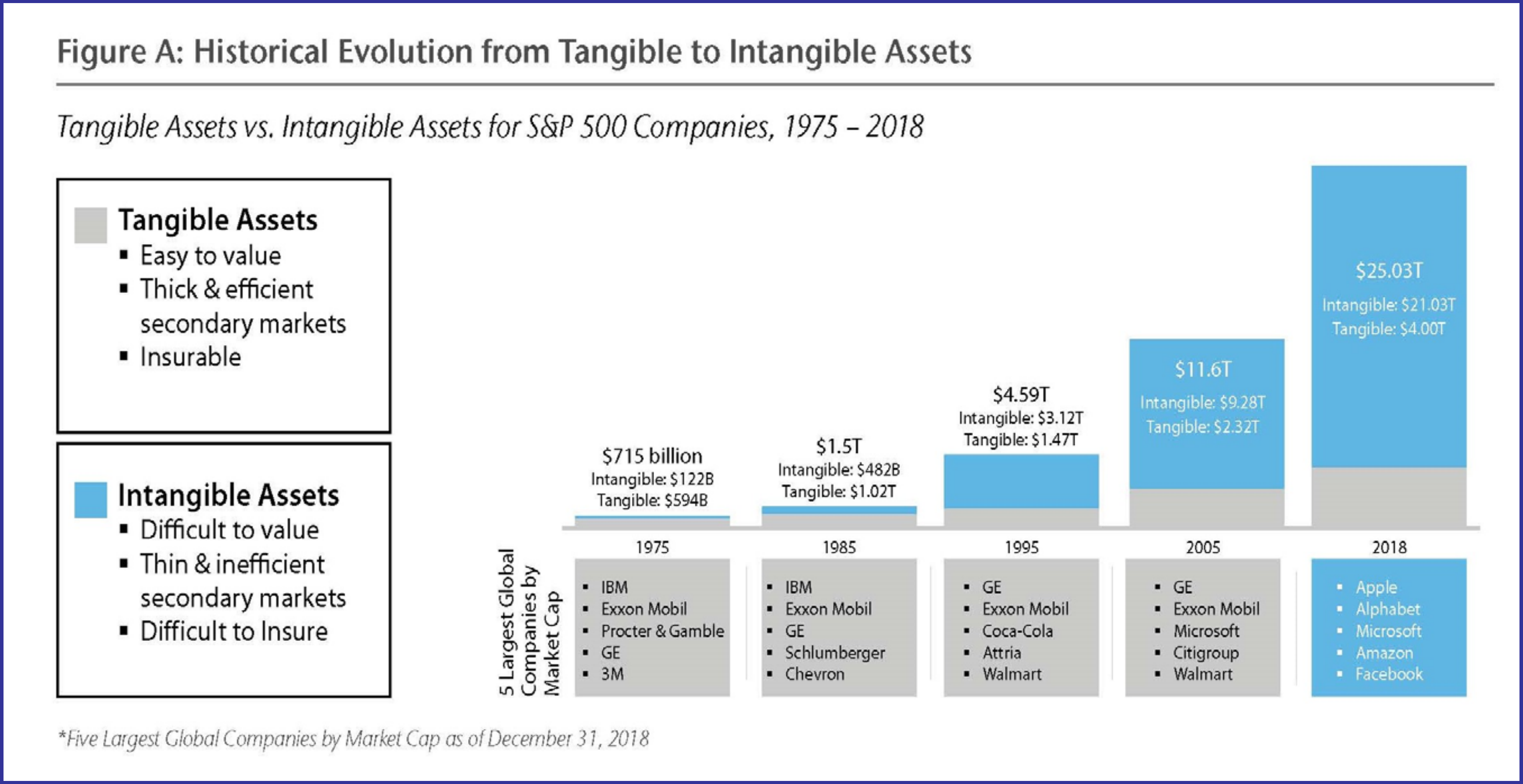
Figure 1: Investment rates, 1977 to 2017

Nonresidential business investment relative to business sector gross value added



Tangible investment rate
Intangible investment rate

Tangible vs. Intangible Assets for S&P 500 Companies, 1975-2018



Ponemon Institute LLC, 2019 Intangible Assets Financial Statement Impact Comparison Report

“The importance of intangible assets is the distinguishing feature of the new economy. By and large, existing financial statements recognize those assets only when they are acquired from others. Accounting standard setters should develop a basis for the recognition and measurement of internally generated intangible assets.”

Wayne S. Upton, Jr., Special Report: Business and Financial Reporting, Challenges from the New Economy, Financial Accounting Standards Board (April 2001)

Components of the Value of a Business

The value of a business consists of –

(i) the cash and A/R, plus

(ii) the value of tangible assets, plus

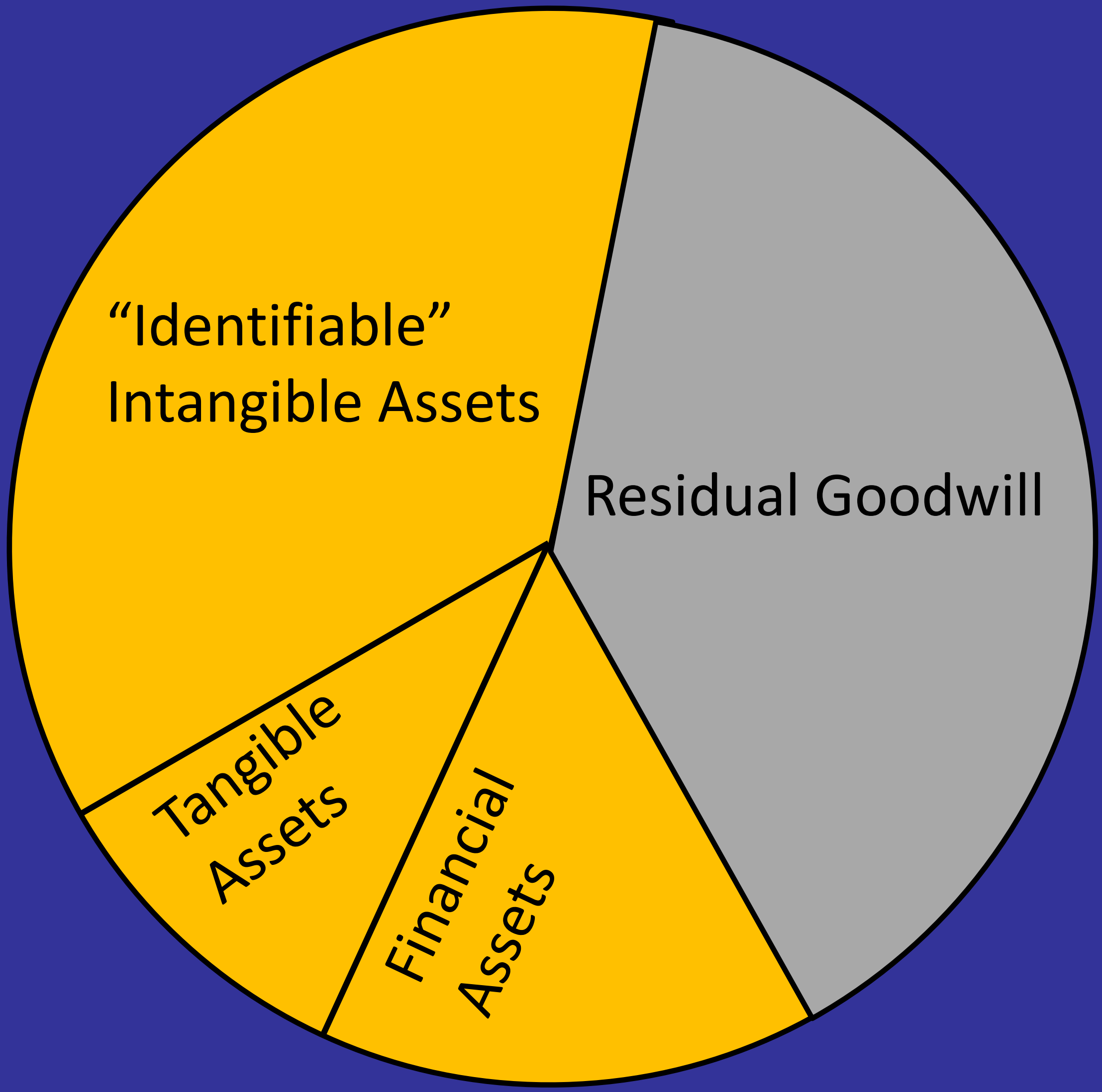
(iii) the value of intangible assets that are "identifiable", plus

(iv) the enterprise goodwill of the business, plus

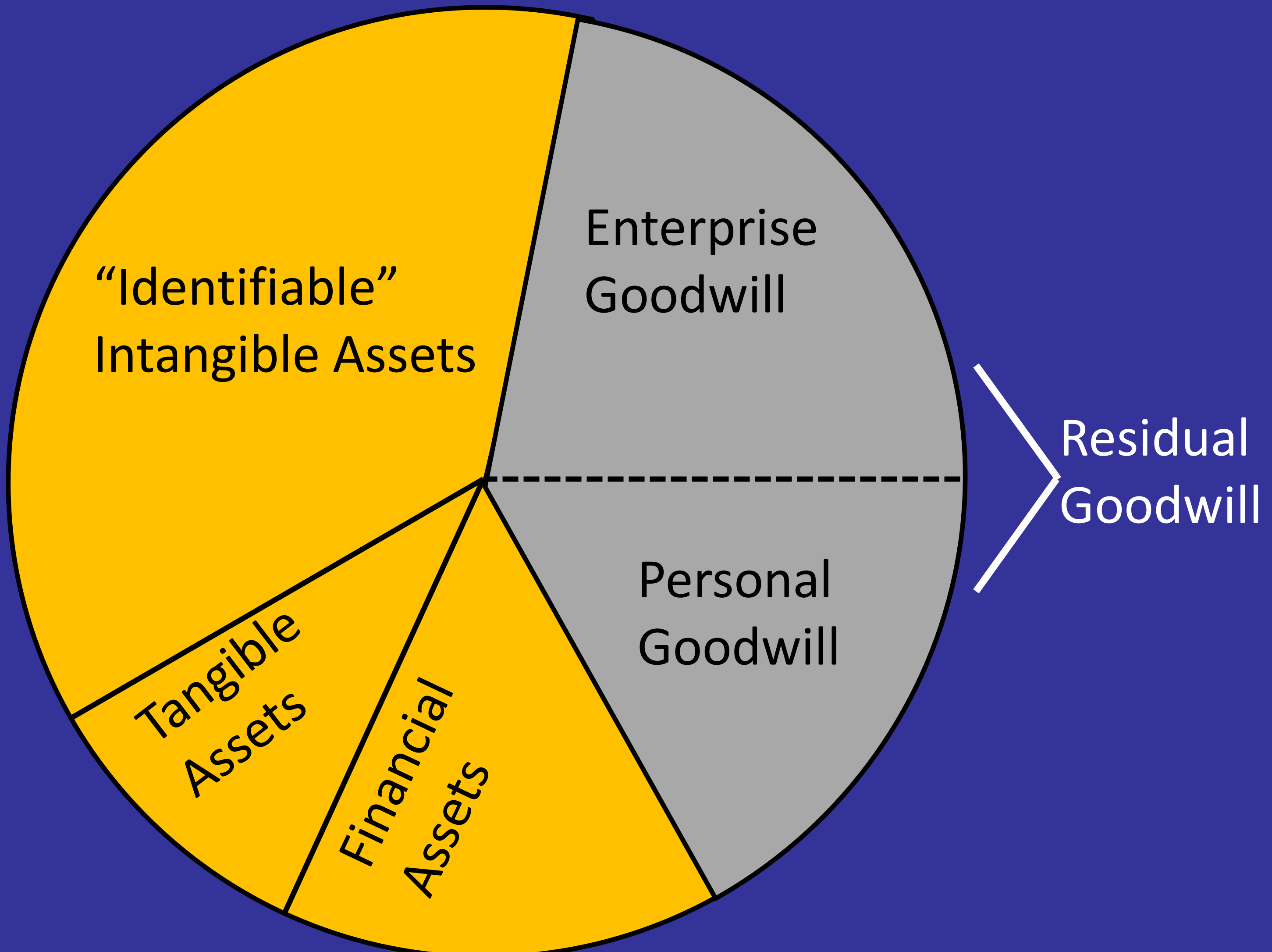
(v) the personal goodwill of the owner.

(iv) and (v) together are "residual" goodwill.

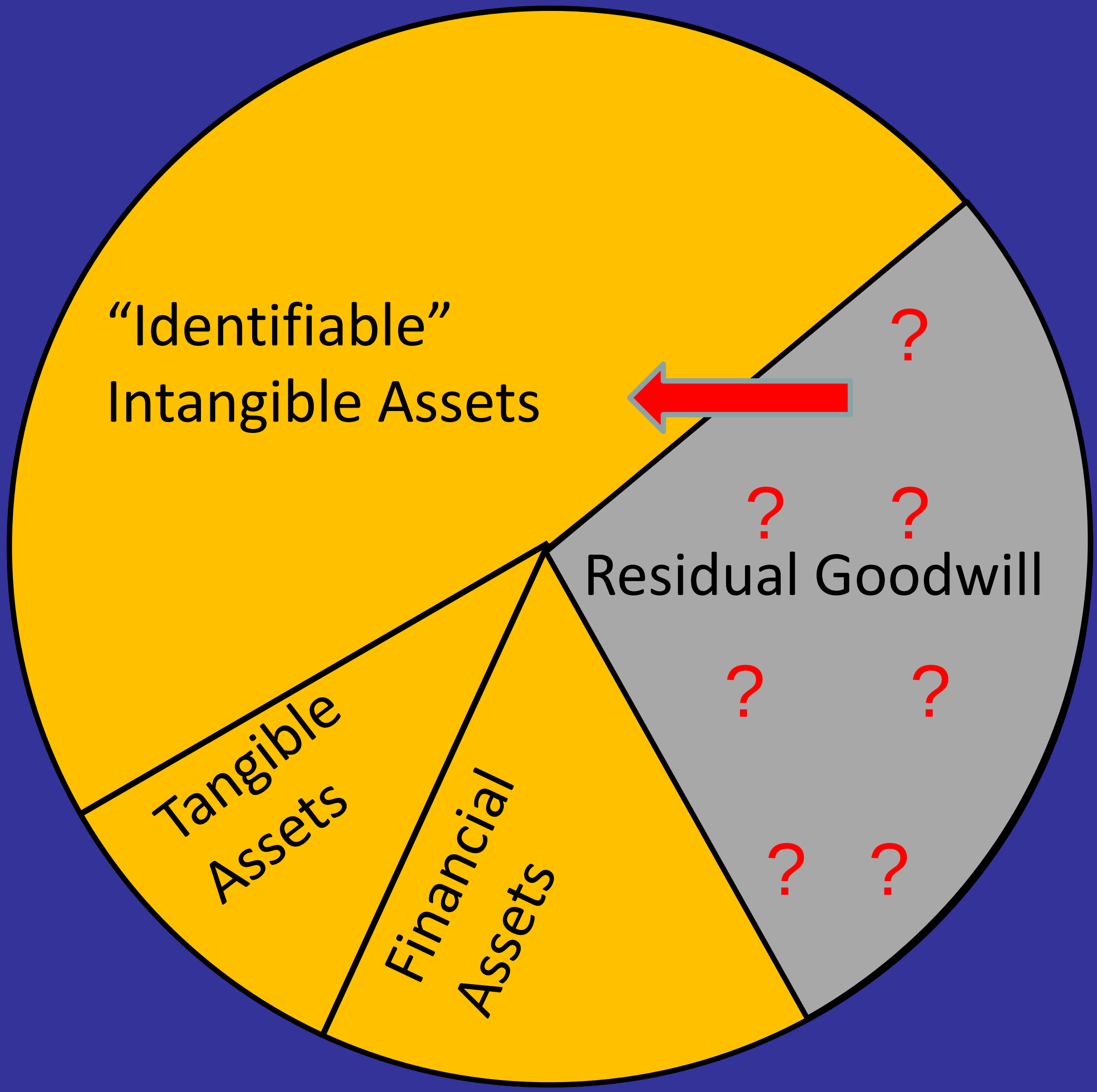
Total Value of a Business (Accounting Perspective)



Total Value of a Business (Business Valuator's Perspective)



We Should Try to Reduce the Unknowns (Business Valuator's Perspective)



WHAT IS
AN INTANGIBLE ASSET?

ARB 24, Accounting for Intangible Assets (1944)

- Dealt with purchased goodwill only.
- Required that goodwill (excess purchase price) be reported at cost, not value.

APB 17, Intangible Assets (1970)

“A company should record as expenses the costs to develop intangible assets which are not specifically identifiable.”

FAS 141, *Business Combinations* (2001)

FAS 141 supplanted APB Opinion 16. FAS 141 requires that intangible assets acquired through the purchase of a business be recognized as assets apart from goodwill if they are "*identifiable*," which means that they meet one of two criteria – the *separability criterion* or the *contractual-legal criterion*, concepts brought forward from APB Opinion 17.

FAS 141, Identifiability Criteria (2001)

¶ A19. The acquirer shall recognize separately from goodwill the identifiable intangible assets acquired in a business combination. *An intangible asset is identifiable if it meets either the separability criterion or the contractual-legal criterion* described in paragraph 3(k).

¶ A28. The identifiability criteria determine whether an intangible asset is recognized separately from goodwill....

FAS 141, Identifiability Criterion (cont.)

¶3k -- An asset is *identifiable* if it either:

(1) Is *separable*, that is, capable of being separated or divided from the entity and sold, transferred, licensed, rented, or exchanged, either individually or together with a related contract, identifiable asset, or liability, regardless of whether the entity intends to do so; or

(2) Arises from *contractual or other legal rights*, regardless of whether those rights are transferable or separable from the entity or from other rights and obligations.

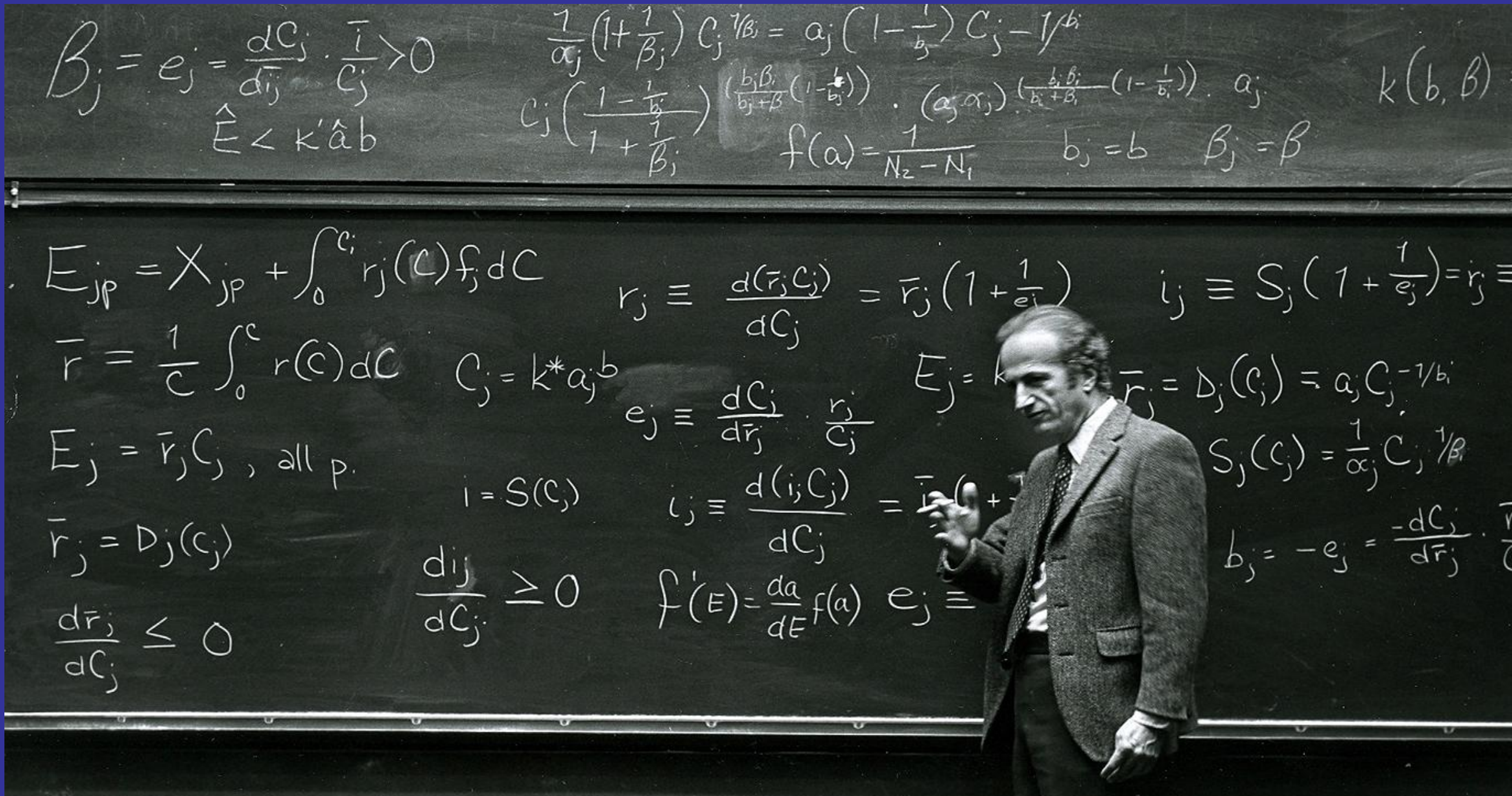
FAS 141, Assembled Workforce (2001)

A25. *The acquirer subsumes into goodwill the value of an acquired intangible asset that is not identifiable as of the acquisition date.* For example, an acquirer may attribute value to the existence of an assembled workforce, which is an existing collection of employees that permits the acquirer to continue to operate an acquired business from the acquisition date. *An assembled workforce does not represent the <u>intellectual capital</u> of the skilled workforce—the (often specialized) knowledge and experience that employees of an acquiree bring to their jobs.* Because the assembled workforce is not an identifiable asset to be recognized separately from goodwill, any value attributed to it is subsumed into goodwill.

FAS 141, Assembled Workforce (cont.)

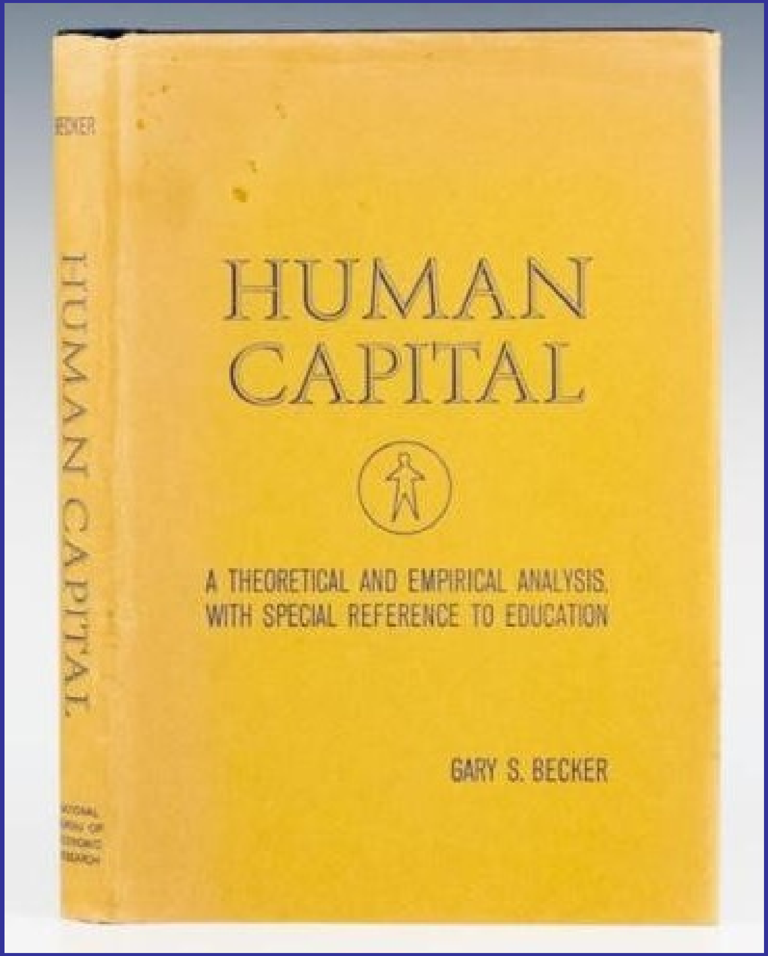
B176. In developing Statement 141, the FASB did not consider whether an assembled workforce met either the contractual-legal or the separability criterion for recognition as an identifiable intangible asset. Instead, *Statement 141 precluded separate recognition of an assembled workforce because of the FASB's conclusion that techniques to measure the value of an assembled workforce with sufficient reliability were not currently available.*

TO ECONOMISTS, “EMPLOYEES ARE ASSETS”



Gary Becker
Nobel Prize in Economics 1992
Presidential Medal of Freedom 2007

The Breakthrough--



Gary S. Becker (1964)

Becker on "Human Capital"

"To most people capital means a bank account, a hundred shares of IBM stock, assembly lines, or steel plants in the Chicago area. These are all forms of capital in the sense that they are assets that yield income and other useful outputs over long periods of time.

But *these tangible forms* of capital are not the only ones. Schooling, a computer training course, expenditures of medical care, and lectures on the virtues of punctuality and honesty also are capital. That is because they raise earnings, improve health, or add to a person's good habits over much of his lifetime. Therefore, *economists regard expenditures on education, training, medical care, and so on as investments in human capital. They are called human capital because people cannot be separated from their knowledge, skills, health, or values in the way they can be separated from their financial and physical assets*."

Gary Becker<https://www.econlib.org/library/Enc/HumanCapital.html>

WHAT IS GOODWILL?

"Accountants, writers on accounting, economists, engineers, and the courts, have all tried their hands at defining goodwill, at discussing its nature, and at proposing means of valuing it. The most striking characteristic of this immense amount of writing is the number and variety of disagreements reached."

John B. Canning, *The Economics of Accountancy* (1929)

Rev. Rule 59-60 (1960)

"In the final analysis, goodwill is based upon *earning capacity*. The presence of goodwill <u>and its value</u>, therefore, rests upon the *excess of net earnings over and above a fair return on the net <u>tangible</u> assets*. While the element of goodwill may be based primarily on earnings, such factors as the prestige and renown of the business, the ownership of a trade or brand name, and a record of successful operation over a prolonged period in a particular locality, also may furnish support for the inclusion of intangible value. In some instances *it may not be possible to make a separate appraisal of the tangible and intangible assets of the business*. The enterprise has a value as an entity. *Whatever intangible value there is*, which is supportable by the facts, *may be measured by the amount by which the appraised value of the <u>tangible</u> assets exceeds the net book value of such assets*.

A Legal Definition of Goodwill

"Although the definition of goodwill has taken different forms over the years, the shorthand description of good-will as "the expectancy of continued patronage," *Boe v. Commissioner*, 307 F.2d 339, 343 (CA9 1962), provides a useful label with which to identify the total of all the imponderable qualities that attract customers to the business."

Newark Morning Ledger Co. v. U.S., 507 U.S. 546, 555-56, (U.S. Sup. Ct. 1993)

FAS 142, Goodwill and Other Intangible Assets (2001)

"[A]n entity shall allocate the fair value of a reporting unit to all of the assets and liabilities of that unit (including any unrecognized intangible assets) as if the reporting unit had been *acquired in a business combination* and the fair value of the reporting unit was the price paid to acquire the reporting unit. *The excess of the fair value of a reporting unit over the amounts assigned to its assets and liabilities is the implied fair value of goodwill*." ["Assets" are <u>not</u> explicitly limited to tangible assets, as in RR 59-60]

Invitation to Comment, Identifiable Intangible Assets and Subsequent Accounting for Goodwill (FASB 7-9-2019)

"1. What is goodwill, or in your experience what does goodwill mainly represent?"

Letter No. 10: "We believe that *goodwill is a premium* paid by an acquirer for an acquiree over and above the fair value of the identifiable net assets acquired. Presumably, the acquirer is willing to pay this premium because it believes that there is *additional intangible value (e.g., synergy or strategic value)* associated with merging the acquiree's business with its business and operations that cannot be attributed to an identifiable tangible or intangible asset. That additional value is expected to result in *higher revenues, reduced costs, or higher profit margins* over some future period that at least equals the premium paid. This *strategic value* also could be attributed to a defensive measure to protect a public companies market share or acquiring certain technology that it currently does not possess."

Letter No. 15 (KPMG) : “How to account for goodwill is a question that has long perplexed the accounting profession, so much so that *goodwill has been defined by what it is not rather than what it is*. Given the challenge of even defining goodwill, we believe there are merits to *multiple perspectives* about what goodwill represents and how to account for it.” (Italics added.)

Letter No. 16 (Regions Financial Corp.): “We believe goodwill represents the premium paid above the price supported by the assets acquired. In our view, *this does not represent a probable future economic benefit, but is a deployment of capital*. The acquiring entity will use the acquired identifiable assets with the companies existing assets for future benefit in excess of the fair value of the identified assets.” [Adopts the buyer’s perspective]

Letter No. 19 (Price Waterhouse): "From an *accounting perspective*, goodwill represents the excess of the cost of an acquired business over the aggregate amount assigned to the identifiable net assets acquired. From an *enterprise valuation perspective*, the majority of goodwill cash flows are expected to extend beyond the lives of the identifiable net assets that exist at the acquisition date (e.g., the expectational value created through developing new technologies and winning new customers). From an *economic perspective*, it incorporates the established reputation of a business, excellence of management, future growth potential, culture, and the worth of corporate identity as well as the value of inseparable but important intangible assets, such as a skilled workforce and institutional knowledge that emerge from, and are maintained by, the ongoing operation of the business. ***

"Goodwill is *fully enmeshed* in the fabric and going concern nature of a business, and has value specifically because a business operates and is expected to continue operating in perpetuity. It is important to understand that *goodwill exists in almost all businesses, even in the absence of a transaction*." (Italics added.)

Letter No. 70 (from four members of the Business Value Resource Panel of the Appraisal Foundation): "We believe that goodwill is a measure of a portion of a *business entity's intangible value*. Business entity intangible value results from the aggregate investment returns of the business entity exceeding the required investment returns on underlying monetary and tangible assets. These so-called *'excess' investment returns* support additional (intangible) value above and beyond the entity's investment in monetary and tangible assets. *Such excess returns indicate the existence of non-tangible elements of the business entity (such as technology, brands, customer loyalty, etc.) which either might be viewed as specifically recognized intangible assets or lumped into an asset designated as 'goodwill'*."

Letter No. 74 (Ford Motor Company): "Goodwill is the difference between the consideration transferred and the identifiable assets and liabilities received in a business combination. *A company acquires other companies to achieve specific business objectives, such as achieving synergies, growth, competitive advantage, or improving economies of scale.*

"These same business objectives could also be developed internally. *Companies often choose to acquire versus develop internally because it may not be feasible within a reasonable time frame and can be more cost effective. Therefore, we believe goodwill represents a portion of the cost that a company would have incurred internally to achieve the same business objective."* [Italics added.] [Acquired goodwill measured by buyer's cost saving.]

Letter No. 77 (Houlihan Lokey): "Under. . . GAAP; goodwill represents consideration paid to acquire a business, as a going-concern entity, that is in excess of the fair value of the identifiable tangible and intangible net assets. *From a valuation perspective, goodwill represents future cash flows generated by assets that are not identifiable as of the acquisition date*."

FASB's Comment Letter Summary on the Invitation to Comment (7-15-2020).

8. Seventy-seven respondents provided comments on the conceptual nature of goodwill. Respondents often discussed their views of what goodwill represents and where its value is derived, while others stated their positions on the current definition of goodwill.

9. Some respondents noted that goodwill's value represents a *capital outlay* for the opportunity of future economic benefit. For example, an academic respondent stated that goodwill refers to the opportunity for future economic benefit, rather than an explicit benefit, because expected synergies often do not materialize. Others explained that the benefit goodwill provides frequently requires additional investment of financial or nonfinancial resources to be transformed into identifiable assets. Similarly, a preparer noted that *it is increasingly difficult to differentiate between acquired goodwill and internally generated goodwill*. ***

FASB’s Comment Letter Summary (continued)

11. Several respondents, based on their experiences in practice, cited major sources of the value of goodwill. For example, several respondents noted that *the value of goodwill is derived from the workforce acquired in an acquisition*. *** [R]espondents often cited the following sources of the value of goodwill:

    (a) Excess of fair values over the book values of the acquiree's net assets at acquisition.

    (b) Expected *synergies* created by the acquisition, including incremental increases in earnings potential.

    (c) *Going concern value.*

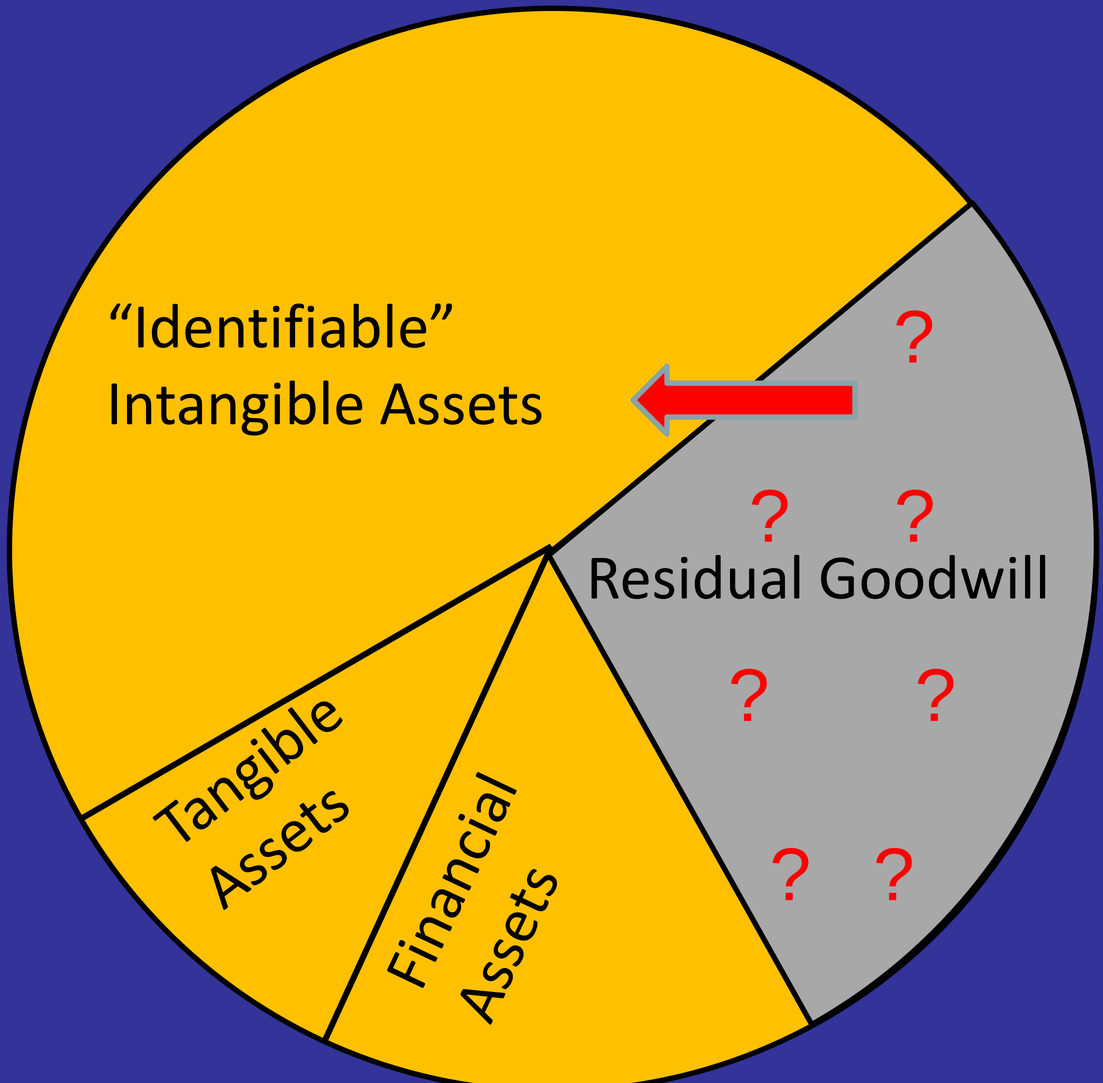
    (d) *Overpayment* by the acquirer.

Acquired, Yes; Developed, No.

"In the United States, intellectual property that results from research and development in the regular course of business does not end up on the balance sheet, whereas IP acquired through M&A does end up on the balance sheet through a purchase price allocation process."

Ponemon Institute LLC, 2019 Intangible Assets Financial Statement Impact Comparison Report

Goal: How Do We Reduce the Unknowns?



Identifiable Intangibles (Accounting Perspective)

Contract-Based Intangible Assets

- License Agreements
- Advertising Contracts
- Service Contracts
- Construction Permits
- Operating Rights
- Drilling Rights
- Timber Rights
- Development Rights
- Management Contracts
- Royalty Agreements
- Construction Contracts
- Supply Contracts
- Franchise Agreements
- Servicing Contracts
- Water Rights
- Route Authorities
- Exploration Rights
- Mineral Rights
- Standstill Agreements
- Management Contracts
- Broadcast Rights
- Employment Contracts
- Air Rights
- Airport Gates
- FCC Licenses
- Permits
- Above/Below Market Leases

Plante Moran (2016)

Identifiable Intangibles (Accounting Perspective)

Technology-Based Intangible Assets

- Patented Technology
- Unpatented Technology
- Trade Secrets
- Recipes
- Patent Applications
- Computer Software
- Databases
- Secret Formulas
- In-Process R&D
- Proprietary Processes
- Computer Mask Works
- Title Plants
- Processes
- Laboratory Notebooks
- Technological Documentation

Plante Moran (2016)

Identifiable Intangibles (Accounting Perspective)

Marketing-Related Intangible Assets

- Trademarks
- Collective Marks
- Newspaper Mastheads
- Brand Names
- Retail Shelf Space
- Cooperative Ventures
- Trade Names
- Certification Marks
- Internet Domain Names
- Distribution
- Subscription Lists
- Service Marks
- Customer Relationships
- Trade Dress
- Non-Competition Agreements
- Distribution Networks
- Supplier Relationships

Plante Moran (2016)

Identifiable Intangibles (Accounting Perspective)

Artistic-Related Intangible Assets

- Advertising Jingles
- Architectural Drawings
- Blueprints
- Product Designs
- Drawings
- Publications
- Slogans

Plante Moran (2016)

Intellectual Capital

Intellectual Capital consists of:

Human Capital

Relational Capital

Structural Capital

"*Intellectual Capital* is the intangible value of a business, covering its people *(human capital)*, the value relating to its relationships *(relational capital)*, and everything that is left when the employees go home *(structural capital)*. It is the sum of everything everybody in a company knows that gives it a competitive edge. The term is used in academia in an attempt to account for the value of intangible assets not listed explicitly on a company's balance sheets."

Wikipedia, *Human Capital*

Definitions: Wikipedia, *Human Capital*

"*Human Capital* is the stock of habits, knowledge, social and personality attributes (including creativity) embodied in the ability to perform labour so as to produce economic value. Human capital is unique and differs from any other capital. It is needed for companies to achieve goals, develop and remain innovative. Companies can invest in human capital for example through education and training enabling improved levels of quality and production."

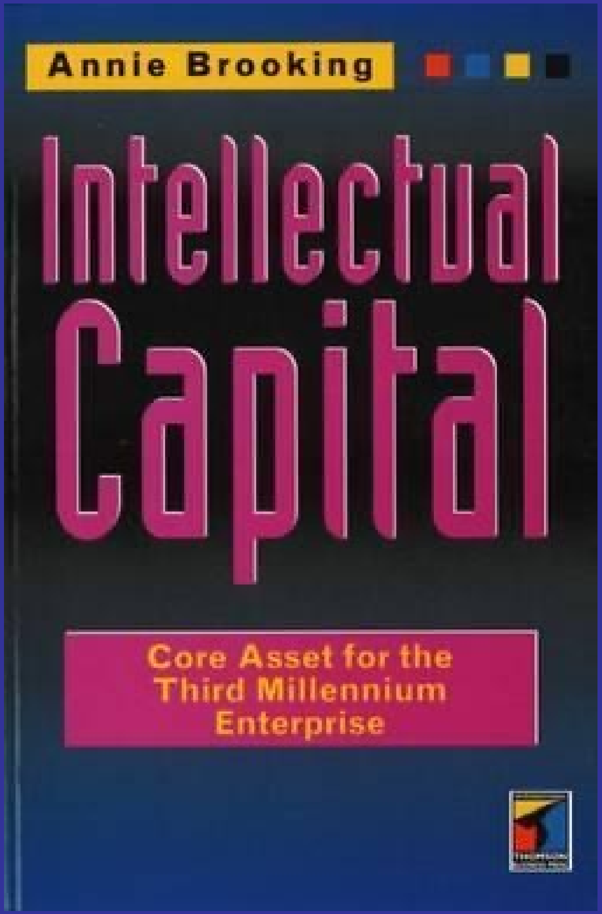
Definitions: Wikipedia, *Human Capital*

"*Relational Capital* ... consist[s] of such elements as customer relationships, supplier relationships, trademarks and trade names (which have value only by virtue of customer relationships), licenses, and franchises. The notion that *customer* capital is separate from *human* and *structural* capital indicates its central importance to an organization's worth. The value of the relationships a business maintains with its customers and suppliers is also referred as goodwill, but often poorly booked in corporate accounts, because of accounting rules."

Definitions: Wikipedia, *Structural Capital*

"*Structural Capital* [is] the supportive non-physical infrastructure, processes and databases of the organization that enable human capital to function. *Structural capital* includes processes, patents, and trademarks, as well as the organization's image, organization, information system, and proprietary software and databases. Because of its diverse components, structural capital can be classified further into organization, process and innovation capital. *Organizational capital* includes the organization philosophy and systems for leveraging the organization's capability. *Process capital* includes the techniques, procedures, and programs that implement and enhance the delivery of goods and services. *Innovation capital* includes intellectual property such as patents, trademarks and copyrights, and intangible assets. Intellectual properties are protected commercial rights such as patents, trade secrets, copyrights and trademarks. *Intangible assets* are all of the other talents and theory by which an organization is run."

Annie Brooking



1996

Annie Brooking's Components of Intellectual Capital of Business

Market Assets

- Service brands
- Product brands
- Corporate brands
- Champions
- *Customers*
- *Customer loyalty*
- *Repeat business*
- Company name
- Backlog
- Distribution channels
- Business collaborations
- Franchise agreements
- Licensing agreements
- Evangelists
- Favorable contracts

Annie Brooking's Components of Intellectual Capital of a Business

Intellectual Property Assets

- Patent
- Copyright
- Design rights
- Trade secrets
- Know-how
- Trademarks
- Service marks

Human-Centered Assets

- Education
- Vocational qualifications
- Work-related knowledge
- Occupational assessments & psychometrics
- Work-related competencies

Annie Brooking's Components of Intellectual Capital of a Business

Infrastructure Assets

- Management philosophy
- Corporate culture
- Management processes
- Information technology systems
- Networking systems
- Financial relations

KENTUCKY LAW ON GOODWILL IN A DIVORCE

Clark v. Clark, 782 S.W.2d 56,59-60, (Ky. App. 1990)

"This Court, in *Heller*, *supra*, specifically ruled that the goodwill contained in a business or professional organization is a factor to be considered in arriving at the value of the practice. This Court explained goodwill in *Heller*. Specifically, professional practices that can be sold for more than the value of their fixtures and accounts receivable have goodwill. *Heller*, *supra*, at 948. *Goodwill in essence is the expectation that patrons or patients will return because of the reputation of the business or firm. This goodwill has specific pecuniary value. Goodwill has also been defined as the excess of return in a given business over the average or norm that could be expected for that business*. *Hanson v. Hanson*, 738 S.W.2d 429 (Mo.1987). The age, health and professional reputation of the practitioner, the nature of the practice, the length of time the practice has been in existence, past profits, comparative professional success, and the value of its other assets, are all factors of goodwill. *Poore*, *supra*. It is the growing trend of courts in this country to consider goodwill in valuing a corporation....Thus, the trial court was correct in considering goodwill.

Clark v. Clark (cont.)

"The trial court in the case at bar adopted a *capitalization of excess earnings* method for evaluating the goodwill of this professional corporation. Under this method, the *goodwill value is based in part on the amount that the earnings of the professional spouse exceed those which would have been earned by a professional with similar education, experience, and skill as an employee in the same general area.* ***

"The capitalization of excess earnings method is a widely accepted method and the most often used…. *There are a number of acceptable methods which courts may adopt. There is no definitive rule or best method for valuing goodwill….The determination of goodwill is a question of fact rather than law, and each case must be determined on its own facts and circumstances….* Thus, the trial court was correct in adopting and applying the capitalization of excess earnings method."

Gomez v. Gomez, 168 S.W.3d 51, 56, (Ky. App. 2005)

Gomez v. Gomez, 168 S.W.3d 51, 56 (Ky. App. 2005): "In this case the trial court found the practice of Bluegrass Radiology with respect to those physicians entering or exiting the practice to be significant. *Eduardo testified and submitted affidavits from other physicians who had left the practice that when a physician joined or left the group an evaluation of the current accounts receivable was done. Based on that value a physician entering or leaving the practice had to pay or was paid a percentage of the accounts receivable value. No calculation for goodwill was included.* The trial court found this evidence to be persuasive along with evidence that when the group had discontinued its practice at another hospital it did not receive any payment for goodwill. The description of how the practice had historically valued itself is, in essence, a buy-sell agreement. And while buy-sell agreements or corporate by-laws have been rejected as the basis for valuing a professional practice where this would not accurately reflect the value of the business, *Clark*, *supra* 782 S.W.2d at 60, they may be used as a factor in reaching a determination regarding the value of a professional business…. *[T]he trial court's determination that no goodwill existed because of the historical way in which the practice valued itself is supported by substantial evidence."*

Gaskill v. Robbins, 282 SW3d 306, (Ky. Sup. Ct. 2009)

The distinction between enterprise and personal goodwill has a rational basis that accepts the reality of specific business situations. In a case such as this one, there can be little argument that *the skill, personality, work ethic, reputation, and relationships developed by Gaskill are hers alone and cannot be sold to a subsequent practitioner*. In this manner, these attributes constitute nonmarital property that will continue with her regardless of the presence of any spouse. *To consider this highly personal value as marital would effectively attach her future earnings*, to which Robbins has no claim. Further, if he or someone similarly situated were then awarded maintenance, this would amount to "double dipping," and cause a dual inequity to Gaskill. On the other hand, if she were willing to leave her name on the practice, such as "Gaskill's Oral and Maxillofacial Surgery," even though she herself did not continue to practice, there arguably could be some reputational reliance that she would stand behind the quality of the practice which could have some pecuniary value. Such scenarios do occur, but this is not the case here.

Gaskill v. Robbins (cont.)

Additionally, this type of distinction is as susceptible to expert valuation as goodwill on the whole is. *If the value of goodwill can be reasonably determined at all, the amount of enterprise goodwill, which is all that can be considered as marital property, can be determined.*

Therefore the trial court erred in failing to consider personal and enterprise goodwill."

Gaskill v. Robbins, 282 SW 3d 306, (Ky. Sup. Ct. 2009)

"In this case, both experts testified to multiple accounting methods of measuring value. Wheeler chose a specific method, gave his reasons for choosing that method, and explained where his data came from. Callahan, in contrast, did not directly obtain data, and calculated the value of the practice using four different methods, with a different value derived from each. He found all the methods to be reliable, and unable to choose, *averaged the numbers* to get a value.

While the trial court is free to determine the credibility of any witness, it cannot make a determination that is clearly erroneous or an abuse of discretion. *Using an average to obtain a value*, without some basis other than an inability to choose between con-

Gaskill v. Robbins (cont.)

flicting and competing valuation methods, is nothing more than making up a number, for there is no evidentiary basis to support that specific number. Employing all four methods, then averaging them, is tantamount to no method at all. If an expert believes four methods are valid, yet each produces a different number, this provides little or no help to the trial court. The trial court must fix a value, and there should be an evidence-based articulation for why that is the value used. *While an average may present the easiest route, it lacks the proper indicia of reliability*. Thus, the trial court abused its discretion in relying on Callahan's estimate of $669,075 as the value of the practice."

King v. King, (Ky. App. 2009)

"The value of Dr. King's medical practice was vigorously litigated by the parties and remains a subject of controversy in this appeal. Both parties presented expert testimony. Mr. York, Dr. King's expert, valued the practice at $636,000, and Terry Walker, Karen's expert, valued the practice at $1,013,000. The circuit court was persuaded by Karen's expert and valued the practice accordingly. Dr. King alleges that his expert offered the more accurate opinion because he considered two factors significant to his valuation: The hours worked by Dr. King and the shortage of OB/GYNs in the Daviess County area. ***

In the present case, *no distinction was made between enterprise and personal goodwill*. Based on the testimony of both experts, *Dr. King's higher than average income was the result of his work ethic and dedication, personal assets that are neither transferrable to others nor have a value to others*....[A]ny amount attributable to personal goodwill, including that attributable to Dr. King's work hours in excess of the norm in the profession, must be excluded when valuing the medical practice for the purpose of dividing the marital property."

Steps to Determining Enterprise Goodwill

1. Recognize identifiable intangible assets.
2. Recognize unidentifiable intangible assets such as--
   - IRC 197(d): going concern value; workforce in place; business books and records; operating systems; information base, customer lists; customer-based intangible, supplier-based intangible.
   - Intellectual capital: human; relational; structural.
   - Annie Brooking's components of intangible value.
3. Value 1 & 2 by cost, comparable, or income approach
4. The remaining goodwill is personal goodwill.

Valuing Workforce in Place

Mark O. Dietrich (2005) – workforce in place can be measured based on % of payroll reflecting longevity and skill, along with training and recruiting costs. Distinguish direct revenue producers vs. support personnel. Capitalize the revenue that can be generated by staff.

Willamette (2006)—possible to value workforce in place.

Willamette (2016) – discussed valuing workforce in place using the cost approach.

Measuring Intellectual Capital

Measuring Intellectual Capital. According to Wikipedia:

- the balanced scorecard framework (BSC),
- the Skandia Navigator,
- the Intangible Asset Monitor,
- the Value-Added Intellectual Coefficient method (VAIC).

Wikipedia, *Intellectual Capital*

MARK O. DIETRICH'S Article (2005)

IDENTIFYING AND MEASURING PERSONAL GOODWILL IN A PROFESSIONAL PRACTICE

By Mark O. Dietrich, CPA/ABV

Author's Note: This article builds upon the concepts originally laid out in my article "Valuing Covenants Not to Compete in a Professional Practice," which appeared in the Summer 2000 issue of CPA Expert. *That article contained a detailed quantitative model for such a valuation.*

In many situations, most notably valuation for marital dissolution and allocation of purchase price for tax or financial reporting purposes, distinguishing personal goodwill from enterprise goodwill is a critical undertaking.

In the marital arena, personal goodwill is not a divisible asset in some jurisdictions, and the status is uncertain in many, and therefore cannot be awarded by the Court. Given this norm, it is curious that many valuation analysts fail to provide evidence as to the separate values of personal and enterprise goodwill.

In tax planning, particularly for C Corporations, allocating the proceeds of a sale of a business to personal goodwill and/or a noncompete agreement can reduce or eliminate the amount recognized as corporate gain and the related corporate level tax. In valuation for purposes of a sale of a business, properly attributing value to different intangible assets may be critical to both buyer and seller obtaining the proper measure of the bargain.

There are two fundamental issues in differentiating personal from enterprise goodwill:

1. Identifying which portions of cash flow are attributable *directly* to the individual's characteristics.
2. Identifying which cash flows attributable to otherwise enterprise-level tangibles and intangibles would be lost if the individual competed.

ILLUSTRATIVE EXAMPLES

1. Personal goodwill flowing from individual characteristics
   - A physician at a renowned medical center is well known for his skill in diagnosing complex diseases. His ability to do so is due to his intellectual skills, knowledge base, and experience in similar cases.
   - An attorney has won several high profile cases because of her ability to relate to the jury and make complex issues understandable. In her current firm, she is also the principal "rainmaker."
2. Enterprise goodwill flowing from individual characteristics
   - The same physician is part of a group practice. Subsequent to the diagnosis, other group physicians, some of whom are employed, may treat the patient. The employed physicians generate a profit in excess of their compensation that the practice owners share.
   - The same attorney has attracted dozens of new cases and is unable to handle most of them, which are assigned to other partners or members of the growing staff. The "points system" in the law firm allocates profits based in large part upon who generated the underlying business.

Observation:

*The second set of examples is perhaps subject to some dispute in jurisdictions that treat personal goodwill as a non-divisible asset in marital dissolution. Some judges may treat any profit resulting from the personal goodwill of a marital litigant as non-divisible. For example, in a Florida appellate case (*Weinstock v. Weinstock *634 So. 2d at 777), the Court ruled that a dental practice had no divisible goodwill because the expert testified that a noncompete agreement would be required in any sale of the practice as well as the dentist's continued presence for a six-month patient transition period. Valuation analysts need to obtain a clear understanding from legal counsel as to the proper interpretation of state law or precedent.*

Personal goodwill, then, is the asset that generates cash profits of the enterprise that are attributed to the business generating characteristics of the individual, and may include any profits that would be lost if the individual were not present.[1] The value of a Noncompete[2] with that individual is the value of those cash profits, adjusted for the probability of the individual competing in each future year where the potential of competition exists. Thus, the noncompete is a portion of the value of personal goodwill and cannot exceed that value. Unless the probability of competition is 100%, the personal goodwill will always exceed the value of the noncompete.

ENFORCEABILITY OF NONCOMPETES

How much is an unenforceable promise to pay worth? Or, better yet, how much will the hypothetical buyer pay for an unenforceable contract with a hypothetical seller? "Not much" would seem to be the answer. To illustrate the concepts involved in

1 Subject to jurisdictional precedents.

2 A lawyer once told me to capitalize key terms to call attention to them.

What Is Personal Goodwill

- Dietrich described personal goodwill in the following terms:

  "Personal goodwill … is the asset that generates cash profits of the enterprise that are attributed to the business generating characteristics of the individual, and may include any profits that would be lost if the individual were not present."

  Mark O. Dietrich, *Identifying and Measuring Personal Goodwill in a Professional Practice* (2005)

Determining Personal Goodwill

Components of Personal Goodwill:

(i) the loss associated with losing the seller's knowledge, skill and experience (Human Capital);

(ii) the loss associated with losing employees, suppliers, customers, or referral sources as a result of the seller *leaving* the business; and

(iii) the loss associated with losing employees, suppliers, customers, or referral sources as a result of the seller *competing* with the business.

Adjusted Out the Seller's Human Capital

- Dietrich wrote that "some portion of the personal goodwill issue can often be minimized by properly addressing reasonable compensation." P. 8.

- The human capital component of the selling owner's personal goodwill should be assessed separately from the second and third components of personal goodwill, because the cost of hiring a replacement employee with knowledge, skill and experience comparable to that of the selling owner is built in to projected future profits.

- In normalizing the owner's compensation, a highly skilled, experienced manager or professional is entitled to a higher-than-average level of compensation reflected in national and regional compensation surveys.

- Excess earnings (super profits) in a professional practice may result from working harder, longer, or smarter than the norm. " [A]ny amount attributable to personal goodwill, including that attributable to Dr. King's work hours in excess of the norm in the profession, must be excluded when valuing the medical practice for the purpose of dividing the marital property." *King v. King*, (Ky. App. 2009).

Negative Effects of an Owner/Seller Leaving or Competing

The loss of the owner's personal goodwill contains three components –

(i) ~~the loss associated with *losing* the seller's knowledge, skill and experience;~~

(ii) the loss associated with losing employees, suppliers, customers, or referral sources as a result of the seller *leaving* the business; and

(iii) the loss associated with losing employees, suppliers, customers, or referral sources as a result of the seller *competing* with the business.

Comparing Two Methods for Determining Personal Goodwill

- The "With and Without" Approach
- The Multi-Attribute Utility Model (MUM)

THE “WITH AND WITHOUT” APPROACH

“With and Without” Approach

- Under the “with and without” approach, the valuator determines the reduction in profits resulting from the seller leaving the business, or competing with it, as the case may be. This reduction in value is attributed to personal goodwill.

- The first step in determining personal goodwill is to remove the owner’s knowledge, skill and experience as a factor by normalizing his/her compensation.

"With and Without" Approach

- The next step is to compare future profitability of the business with and without the selling owner:

  (1) Determine future profits or cash flows of the intact business, with the owner remaining, and discount back to present value.

  (2) Determine future profits or cash flows of the business assuming the owner leaves but does not compete, and discount back to present value. That is the loss to the business of the seller *leaving* the business.

  (3) Determine future profits or cash flows of the business assuming the owner leaves and competes, and discount back to present value. That is the loss to the business of the seller *leaving and competing*.

  (4) Subtract (3) from (2); that is the value of the covenant not to compete.

  (5) Subtract (3) from (1); this is the value of the seller's personal goodwill.

  Note: the seller's personal goodwill is more than the value of the covenant not to compete.

THE MUM APPROACH

The Multi-Attribute Utility Model

- The MUM was unveiled by CPA David N. Wood in a 2004 article in the American Journal of Family Law.
- The steps of the MUM are:

  (1) Assign attributes to enterprise and personal goodwill.

  (2) Assign a number for the “utility of importance” of each attribute.

  (3) Assign a number for the “utility of existence” of each attribute.

  (4) Multiply (2) x (3).

  (5) Total the product of step (4) for all attributes of enterprise goodwill; same for personal goodwill.

  (6) Allocate residual goodwill based on the relative % of total utility determined in step (5).

The MUM's First Court Test

- Wood used the MUM as the basis for a personal goodwill allocation in *In re Mg. of Alexander* (Ill. App. 2006).
- The appellate opinion explained the MUM in great detail.
- The opposing party challenged the MUM as not being generally accepted under *Frye*.
- The appellate court said *Frye* did not apply, because the MUM was not scientific.
- This was not a *Daubert* reliability decision.

In Re Marriage of Alexander

KeyCite Yellow Flag - Negative Treatment
Distinguished by In re Marriage of Bradley, Ill.App. 5 Dist., July 18, 2013

368 Ill.App.3d 192
Appellate Court of Illinois,
Fifth District.

In re MARRIAGE OF James O. ALEXANDER, Plaintiff–Appellant,
and
Valery M. Alexander, Respondent–Appellee.

No. 5–05–0109.
|
Sept. 7, 2006.

Synopsis
Background: Dissolution proceeding was brought. The Circuit Court, Saline County, Brocton Lockwood, J., dissolved marriage, divided marital property equally, and awarded monthly maintenance, child support, and attorney fees. Husband appealed.

Holdings: The Appellate Court, Welch, J., held that:

[1] expert's multiattribute utility theory did not constitute scientific evidence subject to *Frye* hearing, and

[2] circuit court erred by reducing value of investment accounts, in distributing marital assets, by considering tax consequences resulting from subsequent surrender of assets.

Affirmed.

West Headnotes (10)

[1] **Divorce** ⟵ Good will
"Enterprise goodwill" is that which exists independently of one's personal efforts and will outlast one's involvement with the business and is considered a marital asset for the purposes of the just division of marital property.

5 Cases that cite this headnote

[2] **Divorce** ⟵ Good will
"Personal goodwill" is that which is attributed to one's personal efforts and will cease when that person is no longer involved in the business and is not considered a marital asset for the purposes of the just division of marital property.

3 Cases that cite this headnote

[3] **Evidence** ⟵ Value
Expert's multiattribute utility theory, which he used to determine total goodwill in husband's medical practice, for purposes of marital asset distribution, did not constitute scientific evidence subject to *Frye* hearing; methodology did not rely on application of scientific principles but used basic math with observations and experience of valuators, alternatives, ranges, attributes, and values were all derived from subjective determinations of valuator, there were not universal or constant alternatives, attributes, utility values, or ranges, expert left just about everything to sole discretion of valuator, expert acknowledged that whole process was subjective, and type of mathematics used was not novel.

1 Cases that cite this headnote

[4] **Evidence** ⟵ Necessity and sufficiency
The *Frye* test is conducted to determine whether novel scientific evidence sought to be admitted by a party has gained general acceptance in the particular field to which it belongs.

[5] **Evidence** ⟵ Necessity and sufficiency
Because scientific evidence generally carries with it a heightened degree of reliability, a *Frye* hearing is conducted to weed out unreliable evidence that may fall under the guise of scientific evidence; if the novel scientific evidence has gained general acceptance in the particular field to which it belongs, then the evidence is presumed reliable and will be deemed admissible under *Frye*..

The MUM and *Daubert*

- In many states, expert testimony is governed by the standards set in *Daubert v. Merrell Dow Pharmaceuticals, Inc.*, 509 U.S. 579 (1993).
- *Daubert* laid out five non-exclusive factors which an expert opinion must meet:

    1. Whether the theory or technique can be and has been tested;
    2. Whether it has been subjected to peer review and publication;
    3. Its known or potential error rate;
    4. The existence and maintenance of standards controlling its operation; and
    5. Whether it has attracted widespread acceptance within a relevant scientific community.

The MUM doesn’t meet any of these criteria except perhaps widespread acceptance, but we need to see some surveys.

The MUM and *Joiner* and *Kuhmo Tire*

In non-scientific areas, many courts use the alternate standards laid out in two other U.S. Supreme Court cases:

- *General Electric Co. v. Joiner*, 522 U.S. 136 (1997): "Trained experts commonly extrapolate from existing data. But nothing in either *Daubert* or the Federal Rules of Evidence requires a district court to admit opinion evidence which is connected to existing data only by the *ipse dixit* of the expert. A court may conclude that there is simply too great an *analytical gap* between the data and the opinion proffered."

- *Kumho Tire Co., Ltd. v. Carmichael*, 526 U.S. 137 (U.S. 1999): "Rules 702 and 703 grant all expert witnesses, not just 'scientific' ones, testimonial latitude unavailable to other witnesses on the assumption that the expert's opinion will have a *reliable basis in the knowledge and experience of his discipline*."

The MUM Versus "With and Without"

Rating

= MUM is subjective, but so is "with and without":

\+ The MUM is simples.

\+ MUM forces the valuator to focus on relevant factors.

\+ MUM is subject to review by others.

\- The averaging step of the MUM creates an "air" of mathematical certainty that it does not have.

\- Experts who use MUM won't criticize it.

\- The fact finder might think MUM is less subjective.

\- In *Gaskill v. Robbins*, (Ky. Sup. Ct. 2009), averaging of values was rejected as being no evidence of anything.

\- The MUM allocates residual goodwill. If residual goodwill is too large, personal goodwill may be too large.

The Seller's Versus the Buyer's Perspective

- The seller and the buyer have different perspectives.
- The typical valuation is based on the assumption that the buyer will continue the seller's business as a separate entity.
- In actuality, many businesses are acquired by a larger business that plans to integrate the acquired business into its own organization.
- In that situation, the buyer has a different Return on Investment calculus based on its own needs and capabilities.

The Seller's Versus the Buyer's Perspective

- A business valuation limited entirely to the seller's perspective may miss the profit potential to the seller that could lead to a higher selling price than can be supported from the seller's perspective alone.
- In a business combination, the seller's ROI is what counts.
- A buyer may find that buying intellectual capital is quicker or cheaper than developing it. The buyer's price is based on accelerating profits or avoiding development costs.
- Using a potential buyer's replacement cost to value the business's Intellectual Capital may indicate a take-over value.
- The strategic motive of a buyer may add value beyond a conventional BV estimate based on the target company's metrics.

Take Aways

- Goodwill is no longer confined to the continued patronage of existing customers.
- Ignoring self-created intangibles is no longer viable.
- Residual goodwill under accounting standards is overbroad. Many unidentifiable intangible assets can in fact be identified and valued.
- Enterprise goodwill can be valued by including intangible assets that are not recognized for accounting purposes.
- Intellectual capital of a business can be valued.
- Assembled workforce can be valued.

Take Aways

- If enterprise goodwill is valued first, the rest of the goodwill is personal goodwill.
- If personal goodwill is valued first, the remainder of the goodwill is enterprise goodwill.
- The cost or value of a covenant not to compete does not capture all of the seller's personal goodwill. Costs may rise or revenues drop when the seller leaves, even if s/he does not compete.
- Comparing the "with and without" assessment against the MUM, both are subjective but the MUM has an "air' of mathematical accuracy that is unwarranted.

Take Aways

- The MUM is helpful for organizing thoughts, and it makes the factors visible and subject to review by others, but the mathematical component of the MUM is not mathematical.
- Business valuators must do what the accounting profession has refused to do for over 80 years--that is to put a value on the goodwill of a business in the absence of a sale.
- Economists are attempting to measure human capital at the aggregate level. Look to national and world-wide studies for guidance.
- The management profession is more awake to the importance of Intellectual Capital than the accounting profession. Look to management theories for guidance.

Take Aways

- Business valuation techniques applied to a company on the assumption that it will continue in its current form ignore the analytics of an acquiring company that will employ the resources of the acquired company as part of the larger organization.
- A buyer’s strategic considerations may drive up what the buyer would pay above a valuation based solely on the target company’s metrics.
- Valuing a business based on its own metrics may be the minimum value that a willing buyer might pay.
- Is a valuation based on a likely acquiring company’s projected ROI or strategic gains too speculative to be admissible in court?

My hat's off to you business valuators.
You are pioneers heading into the brave new world of intangible value. We're not in Kansas anymore!

Vaya con Dios!