Best Practices Discussion

Practical Guidance to Identifying and Valuing Goodwill in a Family Law Context

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In family law matters, the valuation analyst ("analyst") may be retained to provide an independent estimate of the value of closely held service-oriented company ownership interests, or professional practice ownership interests, to assist in the equitable settlement of the marital estate. During these assignments, one common issue that analysts and legal counsel confront is the identification and treatment of any goodwill included in the value of the closely held service-oriented company or professional practice. In general, this goodwill can be identified as either (1) enterprise (or institutional) goodwill or (2) personal goodwill. This discussion summarizes the differences between enterprise goodwill and personal goodwill. This discussion addresses state statute guidance with regard to the treatment of enterprise goodwill and personal goodwill within a family law context. This discussion also summarizes (and provides an illustrative example) of the generally accepted valuation approaches, methods, and procedures that can be applied in the analysis of goodwill within a family law context.

Introduction

Many businesses, particularly service-oriented businesses, are worth more than the fair market value of their tangible assets and their cash on hand. This is because these businesses likely own some amounts of intangible asset value that is derived from the ability to generate substantial income with limited tangible assets.

The intangible asset value of a subject closely held service-oriented company, or professional practice, in a family law setting is sometimes referred to as "goodwill." However, goodwill technically represents the residual intangible asset value component of a business enterprise that cannot be specifically assigned to (or identified with) any of the other three intangible asset types (i.e., intangible financial asset instruments, general commercial intangible assets, and intellectual property).

In a broad sense, goodwill may be defined as "that intangible asset arising as a result of name, reputation, customer loyalty, location, products, and similar factors not separately identified."[1]

Within this broad definition, goodwill can also be classified into two distinct components when valuing a closely held service-oriented business, or professional practice, within a family law context:

1. Enterprise (or institutional) goodwill
2. Personal goodwill

The treatment of goodwill in a family law setting (i.e., the inclusion or exclusion of enterprise goodwill or personal goodwill as divisible property within the marital estate) varies from state to state.

Further, the classification of goodwill (i.e., the classification of enterprise goodwill versus personal goodwill) for marital estate property division purposes has historically been dependent on whether the goodwill intangible value is attributable to the subject company (i.e., enterprise goodwill) or attributable to—and inseparable from—an individual within the marital estate (i.e., personal goodwill), as proffered by various state judicial precedent.

With regard to the marital estate service-oriented business ownership interest, or the marital estate professional practice ownership interest, there should be a collaboration between the valuation analyst ("analyst") and family law counsel ("counsel"). In particular, the analyst can assist counsel with regard to identifying and quantifying the closely held company/practice enterprise goodwill and personal goodwill in a family law context.

Conversely, counsel can provide meaningful guidance to the analyst with regard to the interpretation of relevant statutory authority and judicial precedent associated with enterprise goodwill and personal goodwill in a family law context.

Once the analyst and counsel have collaborated with regard to the appropriate statutory authority and judicial precedent for the marital dissolution assignment, it is important that both parties understand the generally accepted valuation approaches, methods, and procedures that can be used in performing an analysis of goodwill within a marital estate closely held service-oriented business interest or professional practice.

This discussion provides a definition of goodwill, and addresses the differences between enterprise goodwill and personal goodwill. This discussion summarizes state statute guidance regarding the treatment of goodwill in a family law context. And, this discussion summarizes the generally accepted approaches, methods, and procedures that can be used in the analysis of goodwill within a family law context.

Goodwill

Goodwill is a common, but often misunderstood, term that is used consistently in the analysis of both public and private businesses. To understand and perform an analysis of goodwill within a family law context, it is important for both the analyst and counsel to first understand:

1. the definition of intangible assets and
2. the various types of intangible assets (such as goodwill).

While the distinction between a tangible asset and intangible asset may be intrinsically simple—many analysts pontificate that the distinction is whether you can physically hold or touch an asset (i.e., a tangible asset) versus an asset that you cannot physically hold or touch (i.e., an intangible asset)—from a valuation perspective, a more definitive distinction is required.

As presented in *Guide to Intangible Asset Valuation*:

> The important economic difference between a tangible asset and an intangible is this:
>
> - The value of a tangible asset is derived from its tangible nature.
> - The value of an intangible asset is derived from its intangible nature.[2]

Said another way, the physical components of a tangible asset—or value of the physical components of a tangible asset—<u>are</u> the asset. Conversely, the value of an intangible asset is derived from the legal rights associated with the intangible asset and the intellectual property content of the intangible asset (i.e., the value of an intangible asset does not flow from its physical components).

According to *Guide to Intangible Asset Valuation*, the four generally accepted categories of intangible assets are the following:

1. Intangible financial assets
2. General commercial intangible assets
3. Intellectual property intangible assets
4. Intangible value in the nature of goodwill[3]

While the analyst and counsel may not initially think of financial assets as intangible assets, the cash, accounts and notes receivable, and stocks and bonds presented on a company's balance sheet represent intangible financial assets.

This is because the value of these assets does not come from the actual tangible nature of the assets, but rather the value of these assets is derived from the fact that an owner has the legal right to exchange these assets for goods and services.

General intangible assets are typically created in the normal course of business operations. Company executives do not have to make special efforts to create these general intangible assets; rather they naturally develop as company executives manage the day-to-day operations of the business.

Examples of general intangible assets include customer contracts and relationships, supplier contracts and relationships, a trained and assembled workforce, certain licenses and permits, proprietary operating systems and procedures, and company books and records.

In contrast, intellectual property is typically created by specific and conscious intellectual activity of the intellectual property developer. The creativity involved in developing an intellectual property can typically be identified and attributed to a specific individual (or group of individuals).

Once created, intellectual property is a new and unique invention that can be either artistic, such as a book or a photographic image, or technological, such as a chemical process or computer software code.

Specifically, the four types of intellectual property are as follows:

1. Trademarks and trade names
2. Patents
3. Copyrights
4. Trade secrets

At a basic level, intangible value in the nature of goodwill is typically considered to be a residual intangible asset. This means that goodwill is often considered to be the intangible component of a business enterprise that cannot be directly assigned to, or identified with, any of the other three identifiable intangible assets.

However, while there are many professional interpretations of goodwill, these interpretations are typically grouped into two categories: residual-based interpretations of goodwill and income-based interpretations of goodwill (which are addressed in greater detail later in this discussion).

From both the analyst and the counsel perspective, while the income-based interpretations of goodwill generally are more useful in a marital dissolution context, the analyst and counsel should be familiar with the residual-based interpretations of goodwill as well. This is because both categories of goodwill interpretations generally agree on the components of goodwill and the types of goodwill (i.e., the factors that create goodwill and the situations in which goodwill arises).

There are three primary components of goodwill. As presented in the textbook, *Guide to Intangible Asset Valuation*:

> The first goodwill component is the existence of operating business assets that are in place and ready to use. This component is sometimes referred to as the *going-concern value* element of goodwill. The fact that all of the elements of a business enterprise are physically and functionally assembled creates an intangible asset.
>
> The second goodwill component is the existence of excess income (however measured) . . . This excess income component relates to the concept of goodwill as that portion of business value that cannot be specifically assigned to the owner/operator's tangible assets or identifiable intangible assets.
>
> The third goodwill component is the expectation of future events that are not directly related to the owner/operator's current operations. Goodwill may be created by the expectations of future capital expenditures, future mergers and acquisitions, future to-be-developed products or services, and future customers or clients. This future expectations component relates to the concept of goodwill as the current value of future assets (both tangible assets and intangible assets) that do not yet exist on the analysis date.[4]

While the above descriptions provide a summary of the goodwill component, they do not differentiate between enterprise (or institutional) goodwill and personal goodwill.

Enterprise Goodwill versus Personal Goodwill

Personal goodwill is often most applicable to professional practices and similar service-oriented businesses. Due to the nature of professional practices, their value is highly dependent on the skills, reputation, and knowledge of the individual professionals working at the practice.

Therefore, some (or much) of the value of these types of businesses is attributable to specific individuals rather than the business enterprise itself.

Generally, enterprise goodwill (sometimes referred to as business, practice, or institutional goodwill) is goodwill that is interpreted as representing intangible asset value that is owned and/or that has been created by a commercial enterprise (i.e., business or practice) and that can be readily transferred.

A simple example of enterprise goodwill would be when a company hires a large, recognizable international law firm to assist with a litigation because the company wants a "recognizable" law firm name. The "recognizable" nature and reputation of the large, international law firm would represent enterprise goodwill.[5]

Personal goodwill, on the other hand, is typically interpreted as representing intangible asset value (or, more appropriately, attributes) that is unique to and inseparable from an individual. Meaning, personal goodwill is typically represented by certain attributes (i.e., intangible asset value) that are incorporated into the very being of an individual as opposed to a business enterprise.

A simple example of personal goodwill would be if a company specifically requests an individual law practitioner to provide assistance with the litigation due to his or her reputation. Due to the company specifically requesting the individual law practitioner, this attorney likely has some form of personal goodwill.[6]

In the examples above, the existence of personal goodwill for the individual law practitioner is tied to the fact that a client is primarily engaging the individual, rather than a law firm. The implied assumption is that at some level, if the individual moved to another firm, the clients would migrate with him or her (due to the personal goodwill).

Conversely, the implied assumption in the existence of enterprise goodwill in the above examples is that the company would continue to work with the large, recognizable international law firm despite any change in ownership or in personnel.

Within a family law context, the difference between enterprise goodwill and personal goodwill can be an important and disputed issue. This is because many times the marital estate-owned closely held service-oriented business, or professional practice, can possess both enterprise goodwill and personal goodwill.

While the differentiation between enterprise goodwill and personal goodwill can be a difficult task, it is the responsibility of the analyst and counsel to:

1. identify and quantify any goodwill that is included in a marital-estate-owned closely held service-oriented business or professional practice and
2. appropriately analyze the identified and quantified goodwill as enterprise goodwill or personal goodwill—based on the appropriate state statutes and judicial precedent and on generally accepted business valuation approaches and methods (i.e., primarily the analyst's task in collaboration with counsel).

The following section presents a discussion of the state statutes and judicial precedent with regard to the treatment of enterprise goodwill versus personal goodwill within a family law context.

Marital Dissolution State Statute and Judicial Precedent Guidance

While most family law state courts and magistrates acknowledge the existence and differentiation of personal goodwill versus enterprise goodwill, not all courts and magistrates treat it the same. In fact, the treatment of goodwill in a marital dissolution setting (e.g., the inclusion or exclusion of goodwill as a divisible property within the marital estate) varies significantly between states.

Some state courts and magistrates have provided guidance that both forms of goodwill are to be included in the marital estate in cases of marital dissolution, while other states have determined that personal goodwill should be excluded from the equal division of the marital estate assets.

Still other state courts and magistrates have either not given a clear indication of whether or not personal goodwill should be included in the marital estate, or not provided any formal statutory or judicial guidance with regard to the treatment of enterprise goodwill and personal goodwill.

Generally, in a marital dissolution context, the majority of states recognize enterprise goodwill as a divisible marital asset but exclude personal goodwill as a divisible marital asset.

However, in family law matters where goodwill (and, specifically, personal goodwill) has been identified, it is important that the analyst work with counsel to ensure the proper treatment of goodwill in determining the equitable distribution of the marital estate assets.

According to *Valuing Goodwill in Divorce: State-by-State Breakdown of Enterprise & Professional Goodwill Jurisprudence*, 28 states (and the District of Columbia) currently recognize enterprise goodwill as a divisible marital asset. These states include Alaska, Arkansas, Connecticut, Delaware, Florida, Georgia, Hawaii, Illinois, Kentucky, Louisiana, Maine, Maryland, Massachusetts, Minnesota, Missouri, Nebraska, New Hampshire, Oklahoma, Oregon, Pennsylvania, Rhode Island, South Carolina, Texas, Utah, Vermont, Virginia, West Virginia, and Wyoming.[7]

Conversely, the states of Arizona, Colorado, Montana, Michigan, Nevada, New Mexico, New York, New Jersey, North Carolina, North Dakota, Ohio, and Washington (12 states) recognize both enterprise goodwill and personal goodwill as a divisible marital asset.8

There are also currently 6 states that have provided complicated or conflicting statutory or judicial guidance with regard to the treatment of goodwill in a marital dissolution context. These states include California, Idaho, Indiana, Iowa, South Dakota, and Tennessee.[9]

Two states, Kansas and Wisconsin, while providing statutory or judicial guidance that implies that professional goodwill (i.e., personal goodwill) is includable as divisible property within the marital estate, qualifies this guidance by noting that only professional goodwill (i.e., personal goodwill) that is "marketable" or "salable" should be included as divisible property within the marital estate.[10]

Finally, the remaining two states either have provided no statutory or judicial guidance with regard to the treatment of goodwill within a family law context (Alabama) or do not allow either enterprise goodwill or personal goodwill to be included as divisible property within the marital estate (Mississippi).[11]

While the above information, and the information presented in *Valuing Goodwill in Divorce: State-by-State Breakdown of Enterprise & Professional Goodwill Jurisprudence*, can be useful, the analyst should always rely on the expertise of counsel with regard to the treatment of enterprise goodwill and personal goodwill within a family law context.

Valuation Analysis of Goodwill

There are several generally accepted goodwill valuation approaches and methods available that may be applied in the marital estate service-oriented business or professional practice. The three generally accepted intangible asset valuation approaches include the cost approach, the market approach, and the income approach.

However, prior to discussing these three intangible asset valuation approaches, it is helpful to first present a more detailed summary of the two categories of professional interpretations of goodwill: the residual-based interpretation of goodwill and the income-based interpretation of goodwill.

As previously mentioned, while the income-based interpretations of goodwill generally are more commonly used in a family law context, the analyst and counsel should also be familiar with the residual-based interpretations of goodwill.

This is because both categories of the interpretation of goodwill generally agree on the components of goodwill (i.e., the factors that create goodwill) and the types of goodwill (i.e., the situations in which goodwill arises), and can be applied to analyze both enterprise goodwill and personal goodwill.

Residual Interpretation of Goodwill

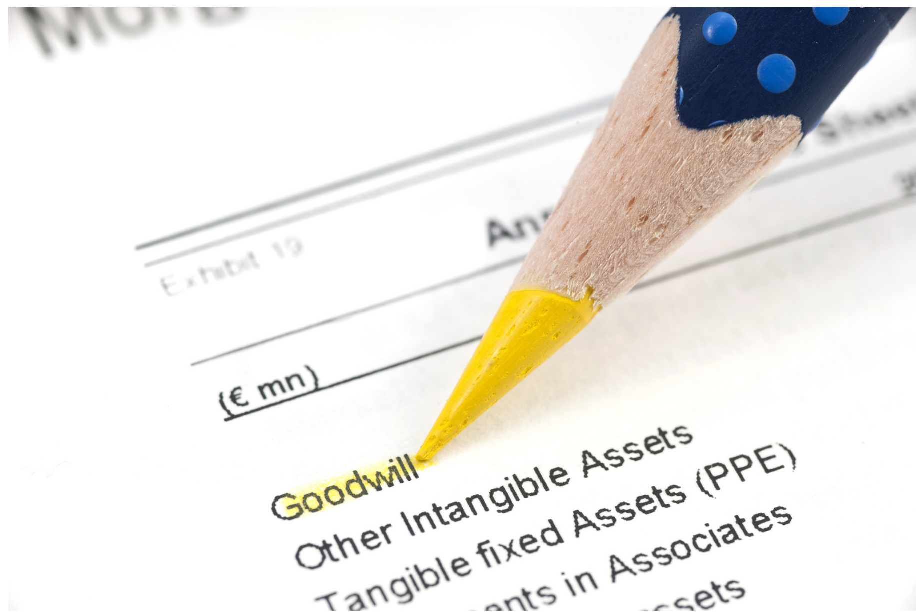
Under generally accepted accounting principles, goodwill that is developed through the normal course of business operations is rarely recorded on an entity's financial statements. And, the accounting recognition for internally created goodwill is different than the accounting recognition for goodwill that has been purchased or acquired.

While internally created goodwill is rarely recorded on the subject company/practice balance sheet, purchased goodwill is recorded on the acquirer's balance sheet once the transaction is completed. Under generally accepted acquisition accounting principles, the fair value of purchased goodwill is calculated as the residual value from the total consideration of the purchase (i.e., total purchase price), and is recorded as an intangible asset on the acquirer's balance sheet.

Often, accountants use a broad definition of goodwill, which represents the residual value of (1) the acquired entity's total purchase price less (2) the fair value of all acquired tangible and identifiable intangible assets.

However, sometimes this definition of goodwill quantifies all of the intangible value of an acquired company, such as when each of the individual identifiable intangible assets are not separately identified and valued. This means that, in some instances, the residual value definition of goodwill may capture the total intangible value of the acquired business entity with little consideration to the individual identifiable intangible assets.

Income Interpretation of Goodwill



The income-based interpretation of goodwill is likely more conceptually robust than the residual-based interpretation of goodwill. As such, the income-based interpretation of goodwill may be more useful to the analyst who is attempting to value goodwill specifically (such as within a family law context), as opposed to attempting to value the total intangible value of a business.

In the income-based interpretation of goodwill, the analyst will typically quantify all of the income of the subject business. For example, for purposes of an excess income analysis (i.e., an income-based interpretation analysis of goodwill), the total income of a subject business can be measured in a number of different ways.

The only requirement for income measurement is that it is calculated consistently and incorporates a fair rate of return on the business operating assets (both tangible and intangible).

Next, the analyst will typically assign or allocate a portion of this estimated total income of a subject business to each operating asset category that contributes to the income production (both tangible and intangible). The allocation of this estimated total income is typically based on a fair rate of return on the asset category (both tangible and intangible) multiplied by the value of the asset category.

The analyst will then quantify the portion of this estimated total income that cannot be assigned to any tangible or identifiable intangible asset. This excess income (or excess earnings) is then appropriately allocated to goodwill.

Finally, the value of goodwill is then quantified as this amount of excess income (i.e., the excess income or earnings that cannot be assigned to any tangible or intangible asset), capitalized into perpetuity using a risk-adjusted, and growth-adjusted, direct capitalization rate.

The result of this procedure indicates the total goodwill value of the subject business.

Generally Accepted Approaches and Methods for Valuing Goodwill

There are several generally accepted approaches and methods that are applicable to the valuation of goodwill within a family law context. After consideration of the similarities and the differences, each method may be categorized into one of the three intangible asset valuation approaches.

The following discussion summarizes the generally accepted goodwill valuation approaches.

The Cost Approach

When using the cost approach to value the goodwill of a subject business, the analyst estimates the amount of current cost required to recreate the component elements of the subject business goodwill. The cost approach analysis typically involves a component restoration method.

In the component restoration method, the analyst will list all of the individual components of the subject business goodwill. The next step is to estimate the amount of current cost required to replace each goodwill component (including personal goodwill). This procedure is based on the concept of goodwill as represented by the intangible value of all of the subject business entity assets that are in place and ready to use.

This hypothetical tangible and identifiable intangible asset component restoration method can include the following:

1. The purchase and installation of all subject business equipment
2. The construction or purchase of all subject business real estate
3. The selection of the subject business suppliers

4. The creation of the subject business distribution system
5. The hiring and training of the subject business employees
6. The building of a level of consumer recognition and confidence for the subject business
7. The recreation of the current level of the subject business customer relationships
8. The securing of all sources of the subject business' capital[12]

In the cost approach, component restoration method, all of the component tangible assets and identifiable intangible assets are assembled at a level required to immediately accommodate the subject business entity's current level of operations.

The Market Approach

There are two market approach valuation methods related to valuing the goodwill of a subject business. The first method is the residual from purchase price method. This method utilizes an actual purchase price of the subject business to estimate a goodwill value as the residual value.

The second market approach method for valuing goodwill is the sales comparison method. The sales comparison method relies on analyzing guideline subject business sale transactions that include goodwill.

However, goodwill is rarely sold separately from any other assets (both tangible and intangible) of a going-concern business. Therefore, the selected guideline sale transactions usually involve the sale of a going-concern total business enterprise, or professional practice.

In the residual from purchase price method, the key attribute is there must to be an actual sale of the subject business enterprise to perform the analysis. If there is an actual sale of the subject business enterprise, the analyst will then confirm certain characteristics of the sale (i.e., confirm that it was an arm's-length transaction, that there are no non-cash components or deferred payments, etc.) and perform a residual goodwill valuation analysis of the subject business.

In the sales comparison method, the analyst identifies and analyzes actual sales of guideline business entities that are reasonably similar to the subject business. This method relies on a residual purchase price analysis to estimate the value of the subject business goodwill.

The Income Approach

The income approach valuation methods related to the valuation of goodwill include the following:

1. The residual from business value method
2. The capitalized excess earnings method
3. The present value of future income method

Each of these valuation methods is based on the concept of goodwill (in all forms) as the present value of future income that is not associated with the subject company's tangible assets or identifiable intangible assets.

It is important for both the analyst and counsel to note that the cost approach and the market approach are less commonly used in the analysis of goodwill.

Generally, analysts will rely on the income approach when valuing goodwill (both enterprise goodwill and personal goodwill) within a family law context. Therefore, the following discussion presents an explanation of each of the goodwill income approach valuation methods.

Residual from Business Value Method

The residual from business value method is based on the principle that the value of the total assets of a subject company is equal to the value of the subject company total liabilities and equity.

Specifically, the subject business goodwill is valued as the overall business enterprise value less:

1. the value of all net working capital assets,
2. the value of all tangible assets, and
3. the value of all identifiable intangible assets.

When utilizing the residual from business value method in a family law context, analysts will generally rely on multiple indications of the subject business total value from other generally accepted business valuation approaches and methods. These approaches and methods can include the following:

1. The income approach, direct capitalization method
2. The income approach, discounted cash flow (or yield capitalization) method
3. The market approach, guideline merged and acquire company method
4. The market approach, guideline publicly traded company method

While any of these valuation approaches and methods can indicate a relevant value for the total

subject company business enterprise, the income approach, discounted cash flow method, is a common method for quantifying goodwill as the residual value from the total subject business enterprise value.

However, it is important for the analyst to properly apply the income approach, discounted cash flow method, in the analysis of the subject business goodwill. In the application of the income approach, discounted cash flow method, the goodwill analysis typically involves numerous considerations, including the following:

1. Revenue analysis
2. Expense analysis
3. Investment analysis
4. Cost of capital analysis
5. Residual analysis[13]

The revenue analysis typically involves a projection of the prospective revenue from the sale of products or services by the subject company. This analysis can include consideration of many market factors, including expected sales volume, average selling prices or expected contract rates, and macro factors such as market dynamics, competitive pressures, and regulatory changes.

The expense analysis involves a projection of the costs associated with the prospective revenue. This analysis can include consideration of fixed expenses versus variable expenses, cost efficiency relationships, cash versus noncash expenses, direct versus indirect expenses, product versus period costs, and cost-volume-profit relationships.

The third analysis, investment analysis, can include consideration of the minimum required cash balance of the subject business, days sales outstanding in accounts receivable, inventory turnover, expected capital expenditures, and manufacturing plant utilization.

The cost of capital analysis may include consideration of the subject company current capital structure, the subject industry current capital structure, weighted average cost of capital, risk-free rate of return, systematic and unsystematic equity risk premiums, and marginal cost of capital.

The residual value analysis (item 5 above) can include an estimate of the value of the prospective cash flow generated by the subject company at the end of the discrete discounted cash flow analysis period. This residual value can be estimated using various generally accepted income-based valuation procedures, including the direct capitalization method.

When applying the income approach, discounted cash flow method, to analyze the residual goodwill of a subject company, the typical length of the discrete period within the discounted cash flow analysis (i.e., the projected operating period prior to the residual value analysis) should approximate the average length of the subject business industry cycle. The discrete period discounted cash flow analysis is then discounted at an appropriate present value discount rate to determine the present value of the discrete period cash flow.

Next, the residual value of the subject company is estimated at the end of the discrete projection period analysis by using generally accepted business valuation approaches and methods (as previously mentioned), and is discounted to present value at an appropriate present value discount rate (equal to the discrete period present value discount rate).

The discrete projection period present value is then added to the residual present value, resulting in an estimate of the total value of the subject business enterprise (this is typically measured as total invested capital, or the sum of the subject company total long-term debt and total equity).

Finally, the subject company total goodwill value is calculated by subtracting the value of the tangible assets and the identifiable intangible assets from the above-estimated total value of the subject business enterprise.

Capitalized Excess Earnings Method

The second income approach method available to the analyst in estimating a subject company/practice goodwill value is the capitalized excess earnings method. The capitalized excess earnings method involves the quantification and capitalization of the excess income generated by the subject company.

While there are several variations of the capitalized excess earnings method, this discussion focuses on one of the more common applications of this method.

The first step in the capitalized excess earnings method requires the analyst to estimate the required amount of income that a hypothetical investor would expect given the inherent risk of the subject company. Some analysts may apply:

1. an asset-specific rate of return on investment to each asset category or
2. the subject company's cost of capital as the required rate of return on investment.

Typically the weighted average cost of capital is applied if the analyst selects the subject company's cost of capital required by a hypothetical investor.

Regardless of which rate of return the analyst estimates is required by a hypothetical investor, given the risk of the subject company, the next step in the capitalized excess earnings method is to multiply this required rate of return by the value of the subject business net identified assets (i.e., all of the subject company's net working capital assets, tangible assets, and identifiable intangible assets). This calculation quantifies the amount of income required by the hypothetical investor.

Third, the analyst will then quantify the difference between:

1. the required amount of income by a hypothetical investor and
2. the actual amount of income earned by the subject company.

If the actual amount of income exceeds the required amount of income, then the subject company is determined to have excess earnings.

Finally, the analyst capitalizes these excess earnings as an annuity into perpetuity, utilizing the appropriate direct capitalization rate. This direct capitalization rate should be consistent with:

1. the level of income used to estimate the required income of the subject company and
2. the actual amount of income of the subject company.

The result of the direct capitalization of these excess earnings provides an indication of the total goodwill value of the subject company.

Present Value of Future Income Method

The third income approach method available to the analyst in estimating a subject company total goodwill value is the present value of future income method. The first step in the present value of future income method is to identify all future income associated with the subject company that is not associated with the entity's tangible assets, or identifiable intangible assets.

This identification analysis may include identifying future capital expenditures, future mergers and acquisitions, new product or service lines, and new customers, for example.

Typically, this future income is not included in the subject company's current strategic plans or management-prepared financial projections. And, this future income is generally not associated with the subject company's tangible or identifiable intangible assets that are in place as of the analysis date. This is because this future income would be included in the value of the subject company's tangible assets or identifiable intangible assets.

It is important to note that, from an analyst perspective, creating a projection of this future income (i.e., the future income that is not associated with the subject company's tangible and identifiable intangible assets) is many times a difficult task.

The present value of future income method is conceptually correct and appealing from an intellectual point of view. However, long-term management-prepared financial projections of income derived from yet to be identified sources are not always available to the analyst.

As a result, in practice it may be difficult for a analyst to estimate the value of goodwill of a subject company using this method.

How Different Types of Goodwill, Such as Enterprise Goodwill and Personal Goodwill, May Be Valued

As previously mentioned, all generally accepted valuation approaches are appropriate to value both enterprise goodwill and personal goodwill. However, these forms of goodwill are not typically sold or otherwise transferred separately in the marketplace, so the market approach is, therefore, less commonly used when estimating the value of goodwill.

When the market approach is used to value goodwill, the empirical market data are often based on purchase price allocations of acquired entities (i.e., a residual-based interpretation of goodwill).

Further, because both enterprise goodwill and personal goodwill are often measured based on future income for a marital-estate-owned closely held service-oriented company, or professional practice, the cost approach is also less commonly used to value both forms of goodwill. In practice, the income approach is more commonly used to estimate the value of goodwill within a subject company.

One option that the analyst has is to use a version of a residual method analysis in the valuation of enterprise goodwill.

Similar to what was discussed in the "Residual Interpretation of Goodwill" section above, using a residual method analysis requires the analyst to estimate the residual of the overall subject company value (estimated by applying generally accepted business valuation approaches and methods, such as the income approach, market approach, and asset-based approach) less the total value of all

the tangible assets and all the identifiable intangible assets used in the subject business enterprise.

The analyst may also use a version of the "with and without" method (also referred to as the comparative business value method) in estimating the value of both enterprise goodwill or personal goodwill. The "with and without" method requires the analyst to estimate the value of the subject company "with" and "without" the relevant goodwill in place.

Generally, the "with and without" method is more commonly used to value personal goodwill than enterprise goodwill. Based on factors such as available management-prepared financial projections and different discount or capitalization rates, the total subject company value is typically greater with the subject individual in place than without the subject individual in place.

Using this method, the value of personal goodwill is estimated as the difference between the "with the individual in place" subject company value and the "without the individual in place" subject company value.

The personal goodwill in this method is identified as the difference between the two subject company value estimates based on the two alternative variable projections of:

1. "with the individual in place" and
2. "without the individual in place."

To help illustrate an analysis of the personal goodwill of a subject company held within a marital estate, the following example illustrates an application of the "with and without" method (when using the income approach, capitalized excess earnings method).

Personal Goodwill Analysis – Illustrative Example

For purposes of this example, let's assume that the marital estate holds an ownership interest in a closely held dental practice called Fuller's Dental. There are three active dentists at Fuller's Dental, and the wife, Freda Fuller, DDS, holds a 100 percent ownership interest in Fuller's Dental (the "Practice").

Let's assume that the appropriate valuation date is as of December 31, 2018.

In this scenario, the analyst has defined excess earnings as the difference between (1) the projected total income of the Practice and (2) a total fair return on the Practice tangible assets and net working capital assets (from a hypothetical investor perspective). The total fair return used for the Practice tangible assets, net working capital assets, and goodwill is based on market-based data.

When valuing goodwill (or other intangible assets) it is important to note that goodwill (and other intangible assets) typically have a greater level of financial and operating risk than tangible assets.

Further, tangible assets typically have a greater level of financial and operating risk than net working capital assets (or financial assets). This means that, in general, intangible assets are expected to earn a higher asset-specific rate of return than tangible assets. And, similarly, tangible assets are expected to earn a higher asset-specific rate of return than net working capital (or financial assets).

Exhibits 1 and 2 present (1) the analyst's estimate of the Practice excess earnings (with Freda as part of the Practice) and (2) the analyst's capitalization of the Practice excess earnings into an estimate of the total goodwill value for Fuller's Dental (with Freda as part of the Practice).

As presented in Exhibit 1, the total Practice excess earnings (with Freda as part of the Practice) are estimated at $310,000. And, as presented in Exhibit 2, assuming an estimated direct capitalization rate of 25 percent, the total Practice goodwill (with Freda as part of the Practice) is estimated at $1,240,000.

Next, in order to estimate the personal goodwill attributable to Freda Fuller, DDS (by applying the "with or without" method), the analyst similarly defines excess earnings as the difference between (1) the projected total income of the Practice (excluding Freda) and (2) a total fair return on the Practice tangible assets and net working capital assets (excluding Freda).

Exhibits 3 and 4 present (1) the analyst's estimate of the Practice excess earnings (without

Exhibit 1
Fuller's Dental
Goodwill Valuation
Estimate of Excess Earnings (with Freda)
As of December 31, 2018

Valuation Analysis		
[1] Projected Practice Net Cash Flow	$ 500,000	
[2] Net Working Capital Asset Value	$ 1,000,000	
[3] Required Rate of Return on Net Working Capital Assets [a]	7.0%	
[4] Fair Return on Net Working Capital Assets	$ 70,000	[2] x [3]
[5] Net Tangible Asset Value	$ 1,000,000	
[6] Required Rate of Return on Net Tangible Assets [a]	12%	
[7] Fair Return on Net Tangible Assets	$ 120,000	[5] x [6]
[8] Total Fair Return on Net Working Capital Assets and Net Tangible Assets	$ 190,000	[4] + [7]
Estimated Practice Excess Earnings	$ 310,000	[1] - [8]

[a] Required rates of return based on market-derived data.

Exhibit 2
Fuller's Dental
Goodwill Valuation
Capitalization of Excess Earnings Method Value Conclusion (with Freda)
As of December 31, 2018

Valuation Analysis		
[1] Estimated Practice Excess Earnings	$ 310,000	
[2] Selected Direct Capitalization Rate	25%	
Indicated Practice Goodwill Value (rounded)	$ 1,240,000	[1] / [2]

Exhibit 3
Fuller's Dental
Goodwill Valuation
Estimate of Excess Earnings (without Freda)
As of December 31, 2018

Valuation Analysis			
[1] Projected Practice Net Cash Flow	$	200,000	
[2] Net Working Capital Asset Value	$	400,000	
[3] Required Rate of Return on Net Working Capital Assets [a]		10%	
[4] Fair Return on Net Working Capital Assets	$	40,000	[2] x [3]
[5] Net Tangible Asset Value	$	400,000	
[6] Required Rate of Return on Net Tangible Assets [a]		17%	
[7] Fair Return on Net Tangible Assets	$	68,000	[5] x [6]
[8] Total Fair Return on Net Working Capital Assets and Net Tangible Assets	$	108,000	[4] + [7]
Estimated Practice Excess Earnings	$	92,000	[1] - [8]

[a] Required rates of return based on market-derived data.

Exhibit 4
Fuller's Dental
Goodwill Valuation
Capitalization of Excess Earnings Method Value Conclusion (without Freda)
As of December 31, 2018

Valuation Analysis			
[1] Estimated Practice Excess Earnings	$	92,000	
[2] Selected Direct Capitalization Rate		36%	
Indicated Practice Goodwill Value (rounded)	$	255,600	[1] / [2]

Freda as part of the Practice) and (2) the analyst's analysis for the capitalization of the Practice excess earnings into an estimate of the goodwill value for Fuller's Dental (without Freda as part of the Practice).

As presented in Exhibit 3, the Practice excess earnings (without Freda as part of the Practice) are estimated at $92,000. And, as presented in Exhibit 4, assuming an estimated direct capitalization rate of 36 percent, the Practice goodwill (without Freda as part of the Practice) is estimated at $255,600.

Based on the data presented in Exhibits 2 and 4, the indicated personal goodwill attributable to Freda Fuller, DDS, is equal to $984,400 (i.e., $1,240,000 – $255,600). This is the amount that may, or may not, be includable in the marital estate—based on state statutory guidance and judicial precedent (as previously discussed).

Conclusion

This discussion provided a general definition of goodwill, and addressed the differences between enterprise goodwill and personal goodwill within a family law context.

When a closely held service-oriented company, or professional practice, ownership interest is held within a marital estate, it is important that the analyst and counsel collaborate in order to properly analyze any potential goodwill.

This is because analysts can provide significant assistance to counsel with regard to (1) identifying and (2) quantifying enterprise goodwill and personal goodwill in a family law context.

Conversely, counsel can provide meaningful guidance to analysts regarding the interpretation of relevant statutory authority and judicial precedent when analyzing enterprise goodwill versus personal goodwill within a family law context.

Notes:

1. "International Glossary of Business Valuation Terms" in Statement on Standards for Valuation Services, VS 100, *Valuation of a Business, Business Ownership Interest, Security, or Intangible Asset* (New York: American Institute of Certified Public Accountants, June 2007).
2. Robert F. Reilly and Robert P. Schweihs, *Guide to Intangible Asset Valuation*, Revised ed. (New York: American Institute of Certified Public Accountants, Inc., 2014), 9.
3. Ibid., 14.
4. Ibid., 697–698.
5. Enterprise goodwill is typically associated with the business entity. The enterprise goodwill is attributable to the fact that clients engage with the business entity based on location, performance, reputation, facilities, and other factors.
6. Personal goodwill is typically associated with the individual. The personal goodwill arises out of an individual's expertise or reputation that attracts and keeps customers (i.e., generates revenue). Personal goodwill is most often found in closely held businesses in technical, specialized, service, or professional vocations. Also, businesses with a limited number of customers or suppliers typically have some form of personal goodwill due to the likely importance of personal relationships.
7. *Valuing Goodwill in Divorce: State-by-State Breakdown of Enterprise & Professional Goodwill Jurisprudence* (Portland, OR: Business Valuation Resources, LLC, July 13, 2018).
8. Ibid.
9. Ibid. For example, in the state of California, a seminal case was *In re Marriage of Lopez*, 38 Cal., App. 3d 93 (1974), which provided the following, "Consistent with the concept of community property, if professional goodwill is found to exist as an asset at the time of family law, it may be separate property, community property, or varying degrees of both depending on particular circumstances." Further, no rule was provided for determining the existence or value of goodwill of a law practice or any other profession as a going-concern business, but factors/attributes were presented that contribute to the value of professional goodwill.
10. Ibid. For example, the State of Kansas guidance includes, "All property owned by married persons . . . including for divorce or separate maintenance actions commenced on or after July 1, 1998, professional goodwill to the extent it is marketable for that particular professional . . . shall become marital property."
11. Ibid.
12. Reilly and Schweihs, *Guide to Intangible Asset Valuation*, 705.
13. For a more detailed description of the analysis related to the income approach, discounted cash flow method goodwill analysis, please refer to *Guide to Intangible Asset Valuation* by Reilly and Schweihs.

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