

# Closely Held Business Goodwill Valuation Approaches and Methods

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*Valuation analysts are often called on to value closely held entity goodwill for various gift tax, estate tax, or generation-skipping transfer tax purposes. Analysts may also be asked to value the business entity goodwill for income tax or property tax purposes. These entity goodwill valuations may be performed for tax planning, tax compliance, or tax controversy purposes. This discussion summarizes the generally accepted approaches and methods that analysts typically consider in the valuation of business entity goodwill.*

## INTRODUCTION

There are numerous reasons why valuation analysts (“analysts”) may be asked to value corporate (also called institutional) goodwill within a gift tax, estate tax, and generation-skipping transfer tax context. Analysts may also be asked to value a business entity’s goodwill in an income tax and/or property tax context.

This discussion summarizes the generally accepted approaches and methods that analysts consider in the valuation of business entity goodwill.

## COST APPROACH GOODWILL VALUATION METHODS

Using the cost approach, analysts estimate the amount of current cost required to recreate the closely held entity goodwill components. The cost approach typically involves a component restoration method.

The first procedure in this method is to list all of the individual components of the subject entity’s goodwill. The second procedure is to estimate the current cost required to replace each component. This procedure is based on the concept of goodwill as the intangible value of all of the entity assets in place and ready to use.

One procedure in the restoration method is the analysis of forgone income (considered an “oppor-

tunity cost” in the cost approach) during the time period required to assemble all of the entity’s tangible assets and identifiable intangible assets.

Let’s consider the restoration method to value the goodwill of the Taxpayer Mining Company (“Taxpayer”). Let’s assume that it would take two years to assemble all of the Taxpayer tangible assets and intangible assets.

The Taxpayer tangible assets include the following:

1. Land and buildings
2. Mining equipment, transportation equipment, and mining office equipment

The Taxpayer intangible assets include the following:

1. Operating licenses and permits
2. Computer software
3. Operating manuals and procedures
4. Customer relationships
5. Supplier relationships
6. A trained and assembled workforce

This two-year time period represents the total elapsed time required for the assembled assets to reach the same level of utility, functionality, capacity, and income generation as it currently exists in the actual business entity.

This hypothetical asset restoration process includes the following procedures:

1. The purchase and installation of all equipment
2. The construction or purchase of all real estate
3. The selection of suppliers
4. The creation of a distribution system
5. The hiring and training of employees
6. The building of a level of consumer recognition and confidence
7. The recreation of the current level of customer relationships

In this method, all of these tangible assets and intangible assets are assembled at the level required to accommodate the actual Taxpayer operations.

## Illustrative Taxpayer Analysis

Let's assume that Taxpayer actually earns \$10,000,000 per year in income (defined as net cash flow) during an expected two-year asset restoration period. The present value of the \$20,000,000 forgone income during the restoration period is one component of opportunity cost.

Let's assume that Taxpayer would also incur \$5 million of interest expense each year for the two-year restoration period. This expense occurs because Taxpayer will have to finance the purchase and assemblage of all of its assets (with no offsetting operating income).

During the restoration period, Taxpayer will not earn \$10 million per year of positive cash flow (due to no business operations during the restoration), and Taxpayer will incur \$5 million per year of negative cash flow (that is, interest expense on the restoration investments).

The present value of these two opportunity cost components would indicate the subject entity goodwill value.

## MARKET APPROACH GOODWILL VALUATION METHODS

There are two common goodwill market approach methods. The residual from purchase price method values goodwill as the residual from an actual acquisition price. The sales comparison method values goodwill based on an analysis of guideline sale transactions.

Goodwill is rarely sold separately from the other tangible or intangible assets of a business. Therefore,

the guideline transactions usually involve the sale of a going concern business.

The analyst selects publicly reported transactions in which the allocation of the sale price between the purchased goodwill and all other acquired assets is reported. This market approach method effectively relies on a residual from purchase price procedure to value goodwill.

To use the residual from purchase price method, there has to be a sale of the subject entity.

First, if there is such a transaction, the analyst confirms that the transaction was at arm's length.

Second, the analyst confirms that the purchase price represents a cash equivalency price. If there are noncash consideration components or deferred payments (an earn-out provision) as part of the purchase price, the analyst converts the entire consideration to a cash equivalency price.

Third, the analyst values each of the tangible assets and identifiable intangible assets.

Fourth, the analyst subtracts the total value of all of the tangible assets and identifiable intangible assets from the purchase price. The residual amount represents goodwill value.

To use the guideline sale transactions method, the analyst identifies and selects actual sales of guideline entities that are sufficiently similar to the subject entity. Comparability is typically based on the criteria of investment risk and expected return.

For certain types of businesses, guideline sale transactional data are fairly easy to assemble. Such transactional data are reported in publicly available publications and periodicals. The purchased goodwill is typically expressed as a percent of the total transaction price or a percent of the total annual revenue earned by the entity sold.

These market-derived goodwill pricing multiples are then applied to the subject entity to value the entity's value. It is noteworthy that the pricing multiples are estimated; that is, these transactional pricing multiples are themselves based on an allocation of the purchase price for each business included in that transactional data source.

## Illustrative Closely Held Analysis

Let's assume that Closely Held Construction Consolidated (CHCC) is negotiating to sell its structural steel division. The parties can agree to value the division equipment at \$60 million. However, the parties cannot agree on the value of the division goodwill.

The buyer retains an analyst to value the division goodwill. The analyst decides to use the market approach. Researching various publications and

transactional databases, the analyst concluded that, over the last few years, the portion of goodwill in the purchase price of comparable structural steel contractor acquisitions was 40 percent.

Therefore, if the agreed tangible asset value is \$60 million and the goodwill portion of the total purchase price is 40 percent, then the total division value is \$100 million.

Based on that \$100 million value, 60 percent would be allocated to the tangible assets and 40 percent would be allocated to goodwill. Accordingly, the parties agreed to a transaction sale price of \$100 million.

## INCOME APPROACH METHODS

The income approach goodwill valuation methods include the residual from business value method, the capitalized excess earnings method, and the present value of future income method.

Each of these methods is based on the concept of goodwill as the present value of future income not associated with the subject entity's tangible assets or identifiable intangible assets.

### The Residual from Business Value Method

The residual from business value method is based on the principle that the value of total assets (the "left hand" side of the subject entity's balance sheet) equals the value of total liabilities and equity (the "right hand" side of the subject entity's balance sheet).

Goodwill is valued as the total entity value less:

1. the value of all working capital (or financial) assets,
2. the value of tangible assets (real estate and tangible personal property), and
3. the value of identifiable intangible assets.

The analyst typically synthesizes the value indications of one or more of the generally accepted business valuation methods to estimate the entity value.

The business valuation methods commonly used in the residual from business value method include the following:

1. The direct capitalization method (an income approach method)
2. The discounted cash flow or yield capitalization method (an income approach method)

3. The guideline merged and acquired company method (a market approach method)
4. The guideline publicly traded company method (a market approach method)

Any of these methods may be used in a residual from business value analysis. The discounted cash flow method is a common business valuation method for the purpose of quantifying entity goodwill as the residual from a business value.

The discounted cash flow method is based on the principle that business value is the present value of the total future income to be derived by the subject entity's stakeholders. The discounted cash flow method typically involves revenue analysis, expense analysis, investment analysis, cost of capital analysis, and residual value analysis.

Based on these valuation analyses, the periodic (typically annual) cash flow from the subject entity is projected for a discrete projection period. The term of the discrete period varies based on the analyst's judgment.

Typically, the term of the projection period approximately equals the average length of the industry business cycle. The discrete cash flow projection is discounted at an appropriate discount rate to determine a present value.

The residual value of the entity is estimated at the end of the discrete projection period. The residual value is also discounted to determine a present value. The present value of the discrete cash flow projection is summed with the present value of the residual value.

This summation calculation indicates the total entity value. The total entity value less the tangible assets value and the identifiable intangible assets value indicates the goodwill value.

### Illustrative Family Analysis

Let's assume that Family Corporation ("Family") is considering the purchase of the Target Corporation ("Target") business assets. Family wants to estimate the income tax consequences of the acquisition, including the expected amortization of purchased goodwill. Family is considering a cash for assets structure with no assumed liabilities.

Family management concluded the total value of the Target operating assets to be \$100 million. Family management anticipates the transaction purchase price allocation presented in Exhibit 1.

Family management expects that the proposed acquisition (at an assumed \$100 million purchase

**Exhibit 1  
Target Corporation  
Purchase Price Allocation**

Assumed Total Consideration Paid	\$100,000,000
Less: Fair Market Value of the Target Assets Acquired:	
Cash	5,000,000
Accounts Receivable	5,000,000
Inventory	5,000,000
Land	5,000,000
Buildings	20,000,000
Equipment	30,000,000
Patents and Technology	10,000,000
Trademarks and Trade Names	<u>10,000,000</u>
Subtotal	<u>\$90,000,000</u>
Equals: Fair Market Value of the Goodwill Acquired	<u>\$10,000,000</u>

price) will result in \$30 million of amortizable Section 197 intangible assets—including \$10 million of amortizable goodwill.

**The Capitalized Excess Earnings Method**

The capitalized excess earnings method involves the quantification and capitalization of excess income (as defined) earned by the subject entity. There are several versions of the capitalized excess earnings method.

The following discussion presents a common application of this valuation method.

First, the capitalized excess earnings method requires an estimate of required amount of income that an investor would expect, given the risk of the subject entity. This procedure often involves the assessment of industry average rates of return.

Some analysts apply an asset-specific rate of return to each asset category. Some analysts apply the entity's cost of capital as the overall required rate of return. The cost of capital is typically measured as the weighted average cost of capital.

In either case, the required return on investment is multiplied by the value of the identified net assets in order to quantify the amount of the required income. The identified net assets typically include all of the working capital, tangible assets, and identifiable intangible assets.

Second, the analyst quantifies the difference between this required income amount and the actual income earned by the subject entity. If the actual

income exceeds the required income, then excess earnings exist at the subject entity.

Third, the analyst capitalizes the excess earnings (if any) as an annuity in perpetuity using an appropriate direct capitalization rate. The derivation of the direct capitalization rate should be consistent with the level of income used to measure the subject entity's required income amount and the entity's actual income.

The result of the direct capitalization procedure indicates goodwill value.

**Present Value of Future Income**

The first procedure in this method is to identify all of the future income that is not associated with the subject entity's tangible assets and identifiable intangible assets. This identification procedure may include future capital expenditures, future mergers and acquisitions, new product or service lines, new sales territories, or new customers.

Generally, this future income is not included in the current business plans or forecasts. This future income is typically not associated with the tangible assets or intangible assets in place as of the analysis date. Otherwise, that future income would be included in the value of the entity's tangible assets or intangible assets. Creating such a projection of future income may present an analytical challenge.

For purposes of illustrating this method, let's limit the discussion to analyzing the present value of the expected future customers. In any residual method goodwill analysis, it is common for the analyst to estimate and present value the prospective income associated with the current customer base.

This income projection is typically made over the expected remaining useful life of the current customer relationships. The value of the current customer base is the present value of the income to be earned from providing future products or services to current customers.

Using the present value of future income method, goodwill is estimated as the present value of the future income to be earned from providing future goods or services to future, unidentified, customers. These future customers are unidentified new customers who (presumably) will take the place of the current customers as the current customers retire.

*Continued to page 70*

## GOODWILL VALUATION

*Continued from page 64*

The present value of future income method requires a projection of the subject entity's income-generating capacity. The projection begins with the expiration of the subject entity's current income sources (such as the identified current customers) and continues into perpetuity.

The present value of this prospective income stream (which typically provides for a capital charge or a fair return on all the tangible assets and intangible assets used to service the future customers) indicates a goodwill value.

Using this method, goodwill is the present value of future income earned from the future sales to future (unidentified) customers.

The present value of future income method is a conceptually sound method to value goodwill.

Consistent with the income-based concept of goodwill, this method quantifies and assigns all of the income that cannot be associated with any of the subject entity's tangible assets or identifiable intangible assets.

Goodwill is quantified as the present value of all prospective income that cannot be associated with the current sources of income (for example, the tangible assets and intangible assets that are in place as of the analysis date).

## SUMMARY

Valuation analysts are often asked to value a closely held entity's goodwill within a gift tax, estate tax, or generation-skipping transfer tax context. Analysts are also called on to value a business entity's goodwill for income tax or property tax purposes. Those valuations may be performed for tax planning, tax compliance, or tax controversy purposes.

This discussion explained that the income approach is not the only approach to value the subject entity's goodwill. The analyst should carefully consider which valuation approach is appropriate for the subject entity and the subject valuation assignment.

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