

GOODWILL: IN THE BEGINNING
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The authoritative literature on business valuation is replete with definitions of goodwill. Many of those definitions, in an effort to be complete and all encompassing, suffer from run-on sentence structure and, consequently, fall victim to ambiguity. For purposes of this article, let's define the term simply. Goodwill is that "certain something" that brings customers, clients or patients back to you as opposed to your competitor down the street.

That "certain something" can be anyone of, or any combination of, a variety of factors, including an attractive and highly visible store front, a convenient location with ample and convenient parking, pleasant and efficient personnel, the reputation of the proprietor, etc. Goodwill is an asset that generally is not reflected on your company's balance sheet. Yet any business owner will agree it is an asset nevertheless.

As difficult as it sometimes appears to define the term goodwill, quantifying its value can present even more of a challenge. Believe it or not, it was our very own beloved Internal Revenue Service that provided one of the earliest treatises offering methodologies for measuring the value of the goodwill of a business.

The concept of business goodwill has existed for centuries. But it was generally regarded as little more than that – a concept. Shortly after the turn of the 20th century, the federal government issued Appeals and Revenue Memorandum 34 (ARM 34). This pronouncement not only legitimized the concept of goodwill but also, and more importantly, offered mathematical formulae for quantifying its value to an operating business enterprise.

And what prompted the issuance of ARM 34? The pronouncement states that it is "intended to apply particularly to businesses put out of existence by the prohibition law...." One can well imagine that distillers and liquor distributors in the early 1900s were less than thrilled with prohibition. After all, they had been stripped of their livelihood. ARM 34 was prompted by situations, specifically with respect to the liquor industry, "...where deduction is claimed for obsolescence or loss of goodwill...."

Picture this. A law is enacted today that effectively makes your business illegal. So you lick your wounds and take steps to mitigate your loss, however slightly, by claiming a tax deduction for the value of the income producing asset you lost as a result of this new law. How is that tax deduction to be quantified?

Well, prior to ARM 34, apparently you would simply compile the salvage value of the sticks and bricks (i.e., the tangible net asset value) of your now defunct business and that would be the measure of your tax deductible loss. But what relationship would that bear to your actual economic loss? Probably very little. What about future earning capacity? Doesn't your loyal customer base have value? Isn't there an intangible value to your business attached to the profit it could generate in the future?

The authors of ARM 34 obviously thought so. And they offered several methods for measuring that intangible value.

Interestingly enough, though almost a century old, and despite its relatively simplistic language, ARM 34's suggested methodologies bear a surprising resemblance to methodologies and valuation concepts employed today.

The pronouncement offers that the value of a brand name of a particular product (specifically, liquor) can be measured by analyzing sales of the identical product under a lesser known brand name or under no brand name at all. "...the difference between the price at which whisky was sold under a given brand name and also under another brand name... multiplied by the number of units sold during a given year gives an accurate determination of the amount of profit attributable to that brand...." Capitalizing this average yield produces an indication of the value of the brand.

ARM 34, while not defining it as such, also describes a market approach for measuring the value of goodwill. It suggests the value of a trademark can be estimated through a comparison of the subject business' volume and profits to the "...volume of business and profit made in other cases where goodwill or trademarks have been actually sold for cash...."

The third methodology described by ARM 34 sounds amazingly like the capitalization of excess earnings method which is widely used today. The premise of this methodology is that the profits of an enterprise are derived from either tangible assets or intangible assets (i.e., goodwill). Earnings in excess of a reasonable return on tangible assets are regarded as a return on goodwill. Capitalizing those excess earnings, then, provides an indication of goodwill value.

So, in conclusion, let us raise a glass to the authors of ARM 34, whose insight provided an early framework for measuring the value of such an illusive asset. Cheers!