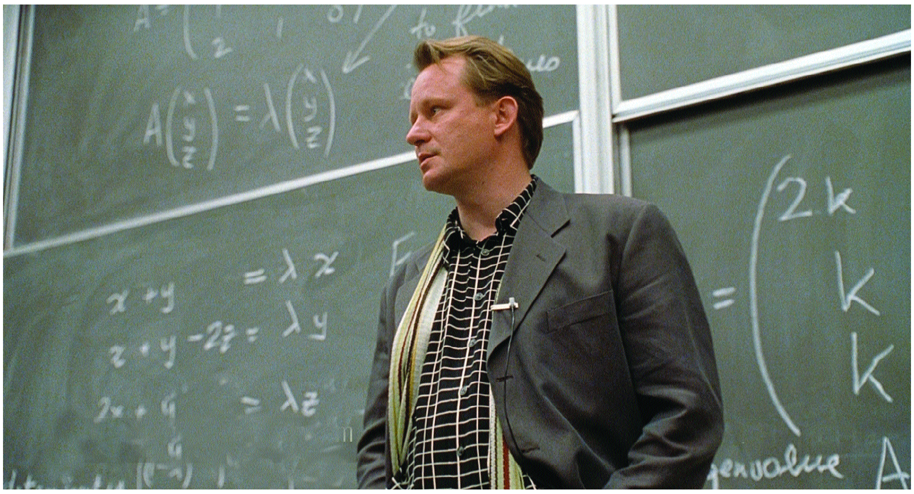

GOODWILL HUNTING

Mark Ridout explains the differences between free goodwill and personal goodwill, and outlines how good will can be valued

Goodwill – technically the difference between the price achieved through the sale of a business and the value of the tangible assets within it – can be fundamental to business owners, yet it is frequently misunderstood. It is typically the large majority of a business' selling price, and can have significant tax implications. The goodwill of an established business is often considerably greater than the combined value of the rest of its assets. Goodwill, therefore, is vitally important.

How is it defined?

By goodwill, a valuation specialist is usually referring to "free" goodwill, that is goodwill that is transferable in part or whole from one party to another. "Personal" goodwill, conversely, is goodwill that is only attributable to an individual, either due to their specific knowledge/skill/expertise, or the relationship they have with their clients. Personal goodwill, consequently, cannot be transferred from one owner to another.

Transferability is the key to defining free goodwill from personal goodwill – the value of free goodwill can be transferred and the value inherent in personal goodwill cannot. Free goodwill typically exists in a profitable business that includes these attributes:

- Some form of client list or database.
- Sits within a sector or industry with a ready market for business transfer and with existing business sales taking place.
- A low level of dependence on one (or more) individual's skills.
- An element of the business, if not the whole business, having both desirability and evidence of a financial return so that it could be advertised for sale and successfully sold to another party.

There will, of course, always be exceptions to one or more of the above. A newsagent may not have a client database but it may have an enviable location in terms of footfall and, assuming suitable levels of income and profitability, justify achieving a premium on the open market.

The separation of free and personal goodwill is not necessarily a clear-cut division in that one business has free goodwill and another does not. For example, a long-standing owner/stylist of a hairdressing business may sell their salon to a third party who was not previously connected with it. The value associated with the client base that frequented the salon purely due to the owner/stylist – and would move with him/her, or otherwise take their custom elsewhere – is goodwill personal to that individual. Evidently, in this scenario, the free goodwill of the business is calculated as the total goodwill less the personal goodwill associated with the existing owner.

Although a prudent purchaser of a going concern may not think of it technically in terms of the equation *Free Goodwill = (Total) Goodwill – Personal Goodwill* they should look at separating any income their target business is likely to generate on an ongoing basis from any income that may be lost due to a change in key personnel. In reality, and particularly with smaller businesses, buyers often consider that they can increase the current estimated total value of a business through more effective management, more effective marketing and so on, thereby underplaying the personal goodwill attached to the existing owner. They may even be bringing in their own personal goodwill from a nearby location.

Valuing goodwill is understandably important where there is a change in business ownership. Among many other reasons, businesses are valued during disputes, matrimonial settlements, for probate and when a business incorporates into a limited company.

How is it quantified?

Naturally, the more desirable and transferable the business is, the higher the free goodwill is likely to be. In a sector where business acquisition and disposal is prevalent, the value (goodwill) of the transferable element of the business is likely to be higher than a sector with little business transfer activity. Certain trends may appear, such as an increase in large organisations within a sector competing to acquire smaller, usually independent, businesses as part of their development strategy. It has been evident in the nursing and care home industry in recent years, ultimately increasing business values across the sector.

How do we calculate free goodwill?

Business valuation can be contentious, sitting somewhere between a science and an art, and it can often be difficult to determine purely on a simple arithmetic basis (e.g. as a multiple of gross fees or sustainable profits). Each case necessitates its own review, including an assessment of the dependence upon the incumbent owner(s) – namely, evaluating the personal goodwill, and it is hard to underplay the importance of an impartial approach. We typically employs a number of accounting methods, benchmarked against its extensive database of comparable sale price and other figures, to calculate goodwill as close to a realistic open market scenario as possible. Realism is imperative – the value of any business is ultimately what a person or organisation is prepared to pay for it, hypothetically or otherwise.

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