

A business may have a number of Intangible Assets including Goodwill, (see *Bizstats newsletter Feb 06 'Identifying Intangibles'*). However as 96.8% of New Zealand businesses have less than 20 employees, and most of those businesses are owner-operated, the goodwill of the business needs to be distinguished from the personal goodwill of the owner, when a business is valued.

Business Goodwill: If this is to have value, then by definition it must be the goodwill which is transferable with the business.

Personal Goodwill: This is the goodwill which is derived from the expertise and reputation of the business owner. (It may include not only relationships with key clients, but also relationships with staff, suppliers and other parties.)

A West Australian case (Parnell vs. Commissioner of State Taxation) stated "a business proprietor who has 'know how' and ability, and the personality to attract and hold customers, no doubt may be said to possess those customers' goodwill. This will certainly be of value to him, and just as certainly will increase his profits, but it does not thereby become for the purpose of commercial law, 'goodwill'. It is not a saleable asset. This is the test."

In the USA the 1944 D K MacDonald case established that goodwill does not attach to a business that depends on the owner's skill, ability, integrity or personal characteristics, unless by contract (or otherwise) the business has a future claim to the owner's services.

In a NZ case (Briggs v Briggs -1996)⁴ a constraint of trade (actual or assumed) did not automatically eliminate the element of personal goodwill from the valuation of a business.

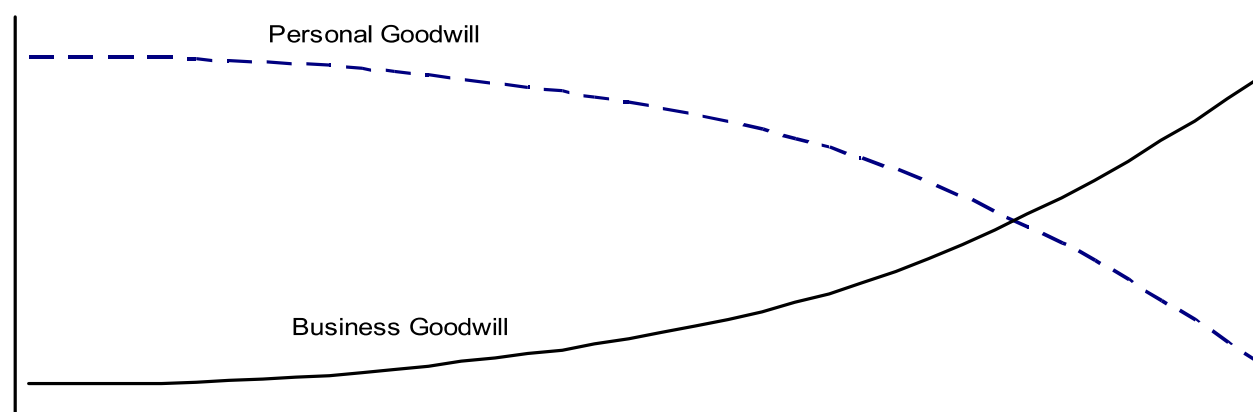
Indicators of personal Goodwill include:

- The business is highly dependent upon the owner's personal skills and relationships.
- Absence of contractual relationships
- Small entrepreneurial business with no significant investment in tangible or identifiable intangible assets
- Owner-operated business with few employees and reliant upon referrals for business

Personal Goodwill tends to diminish as the size of business increases, i.e. the larger the business, then (generally speaking) the less dependent the enterprise is on the owner's personal influence, with more systems, management layers, contractual relationships and market entry barriers.

Recognising the presence of personal goodwill in many SME's reinforces the importance of looking beyond the revealed earnings, and at the 'people' factors when producing a credible and defensible opinion of value.

Goodwill Transition: Personal to Business:



SMALL

Personal Relationships - customers, clients, suppliers, staff.

Reliance on referrals for business

Personal know-how, operations marketing & admin

MID-SIZED

Contractual relationships - customers, clients, suppliers staff

More formalised organisation structure & mang. info systems

Trained workforce, systems & procedures

LARGE

Market entry barriers - patents, trademarks, trade secrets.

Internal controls, independent board.

Key management incentive, compensation plans

(Source: Darrel V. Arne & James R Hamill) ¹

Bizstats data: one of the benefits of using market based data is that - by definition - it excludes non-transferable goodwill, as a component of the intangible asset value. The value recorded for the goodwill refers only to that which the negotiating parties deemed to be transferable.

A point to note about Professional practices: It is sometimes assumed that in professional practices, (especially various medical practices) that the goodwill is of a personal and therefore non-transferable nature. However whether the goodwill is personal to the practitioner should always be questioned in relationship to the specific circumstances in each instance.

Shannon Pratt ⁵ comments "A common misconception is that professional goodwill is not marketable because it is never transferable. Although the transfer of professional goodwill is more difficult than the transfer of practice goodwill, there are procedures by which the practitioner can facilitate the transfer of this personal goodwill or at least a portion of this personal goodwill, to another well qualified practitioner."

Bibliography:

1. Arne & Hamill - 'The Tax Advisor' June 2003
2. Lawrence W. Tuller - 'The Small Business Valuation Book' 19XX
3. Sloan & MacLeod - 'Buying, Selling & Valuing SMEs' 2004
4. Pedley & Parker - 'New Zealand Law Journal' August 1996
5. Shannon Pratt - 'Valuing Small Business and Professional Practices' 1986