Technical Factsheet 171

Valuing goodwill

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1. INTRODUCTION

1.1 This Factsheet aims to provide the user with a summary of the issues that need to be considered when valuing goodwill in most types of companies.

1.2 The Factsheet will deal with valuing goodwill via means of whole company approaches, simple multiple approaches and turnover approaches. In addition, it will look at personal and corporate goodwill and, finally, will provide a summary of the new guidelines provided by HMRC when looking at goodwill with regard to trade-related property and the like.

1.3 Goodwill has been addressed by the courts over a very considerable period of time. As early as 1810 the courts defined goodwill as “nothing but the probability that the old customers will resort to the old place”.

1.4 In the case of Whiteman Smith Motor Company v Chaplin (1934) KP35 we find the “zoological” definition of goodwill classifying customers into cats, dogs, rats and rabbits. The cat represents a customer who will go to an original shop no matter who owns that shop, and therefore represents local goodwill. The dog represents goodwill attaching to a person rather than a place, and therefore represents personal goodwill. The rat has no attachment and is a free agent, and the rabbit merely visits a business premises because of its closeness and the difficulty in visiting businesses further away.

1.5 One of the standard definitions of goodwill that has been in use for many years is that provided in re Commissioners of Inland Revenue v Muller & Co Margarine (1901) AC215. Lord MacNaghten speaks of goodwill as follows “what is goodwill? It is a thing very easy to describe, very difficult to define. It is the benefit and advantage of the good name, reputation and connection of the business. It is the attractive force which brings in custom. It is the one thing which distinguishes an old established business from a new business at its first start … Goodwill is composed as a variety of elements. It differs in its composition in different trades and in different businesses in the same trade. One element may preponderate here: and other there”.

1.6 A good definition of goodwill taken from a book on that subject written in the 1930s defines commercial goodwill as “the right which grows out of all kinds of past effort in seeking profit, increase of value, or other advantage … the exchangeable value of the right depends upon the probability of earning future super profit – the term “super profit” meaning the amount which revenue, increase of value or other advantage received exceeds any and all economic expenditure incidental to its reduction”.

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1.7 The legal cases that have addressed goodwill give little or no particular help in valuing goodwill in practical terms. This factsheet, therefore, restricts itself to a purely practical consideration of the computation of goodwill via various methodologies.

1.8 This is one of a series of factsheets numbered 167 to 171 looking at various valuation issues.

1.9 For matters to consider when reporting on valuations refer to technical factsheet 170 section 7.

2. WHOLE COMPANY APPROACHES

2.1 Perhaps the most common approach in valuing goodwill is to be found by valuing the entirety of a company or business and then deducting the tangible and other intangible assets. The residual can then be termed goodwill. Examples of intangible assets other than goodwill are licences, brands, trade names, quotas, patents, copyright, franchises and trade marks.

2.2 In this Factsheet we do not address this further complication, restricting ourselves to the calculation of the entirety of the goodwill including any other intangible value.

2.3 The valuation of the whole company will proceed along the lines outlined in Factsheet 167 and this Goodwill Factsheet does not, therefore, address the technicalities of a whole company valuation approach in any detail.

2.4 Normally, however, the whole company valuation approach will be based on a multiple applied to maintainable profits. Where this computation gives a value less than the adjusted net asset value then the implication is that there is little or no goodwill within the business and any surplus is deemed to be goodwill.

2.5 Valuers should be aware however, that the goodwill in certain types of business is not valued by reference to profitability as is discussed in paragraph 4 below.

2.6 When applying a whole company methodology the valuer needs to be aware that assets within the balance sheet need to be brought to market value where appropriate (as opposed to the lower of cost or market that will be appropriate in the compilation of the balance sheet itself).

2.7 A short example is given below.

Example

- Small machine tool Company with a wide variety of customers, established for many years and with much repeat business.
- Turnover stable and growing steadily at £10million as is profits after tax of £500,000.
- No one off or exceptional items in the accounts and directors fees at a commercial rate for the services provided.
- Net assets £500,000, but original commercial premises in the accounts for many years at £100,000 have a current market value of £1.1million.
- Research shows an appropriately adjusted P/E ratio is 5.

Company Valuation	£500,000 x 5 =	£2,500,000
Net Assets	£500,000	
Property Uplift	£1,000,000	£1,500,000
Goodwill		**£1,000,000**

2.8 In the above example a single asset needs to be adjusted making a material difference to the calculation of the goodwill. It should however be borne in mind that other factors may need adjustment, the more common of which include:

- Assets not contributing to the business profitability may need to be removed, for example premises let out.
- Any income from non trading activities (such as rent from let premises) will need to be removed.
- The Company may have surplus cash that needs to be accounted for, as will the interest on the cash.

2.9 The valuer needs to look at the business in the round to isolate only those income streams and assets that directly contribute to the goodwill of the business, and exclude those that are not contributing.

3. SIMPLE MULTIPLE APPROACHES

3.1 It is possible to ascertain a rough and ready valuation for goodwill in simple straightforward businesses via the application of a multiple applied to maintainable profits before any form of managerial/owners' remuneration or the like. Over the years this approach has found some favour with the courts, particularly in dealing with cases of compensation claims in cases where for example a new road is to be built that will result in the destruction of a business.

3.2 A summary of the various cases is contained within Dymond's Capital Taxes which give brief details of at least some of the individual cases. Dymond's Capital Taxes is published by Sweet & Maxwell and can be obtained from the following address:

http://www.sweetandmaxwell.co.uk/Catalogue/ProductDetails.aspx?recordid=443&productid=7019

3.3. Within these cases the courts have used a simple multiple approach in valuing goodwill not only in small "one man band" types of business, but also in dealing with goodwill in small limited companies.

3.4 The range of multiples used by the courts in calculating the goodwill is between 1 and 5, and a brief summary of these multiples and the types of business to which they relate is outlined below:

- A multiple of 3 in the valuation of a joinery business.
- A multiple of 3 in the valuation of a used car business.
- A multiple of 3 in the valuation of an opticians business.
- A multiple of 2.5 in the valuation of a butcher's shop.
- A multiple of 2.5 in the valuation of a chip shop.
- A multiple of 4 in the valuation of a plumber's business.

3.5 In the author's view, the level of multiple will depend on factors such as the rate of growth of the business, and the margins that can be generated. Businesses that are growing quickly and are making strong margins will command multiples at the upper end of a range, with businesses showing poor or declining turnover and weak margins being at the bottom end of this scale.

3.6 Often the valuation of the goodwill using a simple multiple can be looked at by way of a basic whole company approach to act as a cross check. A simple example follows.

Example

- Small husband and wife owned limited company selling products via the internet, established and stable with a web site, trading name and broad customer base and repeat business. Business is growing at 5% per annum.
- Turnover £2,000,000 and pre tax profits (after directors' fees of £50,000) of c£50,000.
- Net assets are small – business operated from home and computer equipment is the principal asset in net assets of £20,000.
- Valuation: £50,000 + £50,000 remuneration gives £100,000 profits. A small multiple of say 1 indicates **goodwill of £100,000** and a business valuation of £120,000.
- As a cross check, a value for the business of £120,000 indicates a P/E ratio of 3 based on after tax profits of c£40,000 (£50,000 less tax of c21%).

4. TURNOVER AND OTHER APPROACHES

4.1 Under this heading we address not only those businesses valued by reference to turnover but also other businesses that are frequently valued by reference to factors other than profitability.

4.2 The principal application of a turnover multiple to value goodwill is found in the valuation of goodwill in professional practice. Often, but by no means always, the turnover used as the basis for the computation is defined as gross recurring fees, and not overall turnover.

4.3 A multiple is then applied to these fees. Usually, this multiple is between 0.5 and 1.5, however occasionally this range can be as low as 0.25 and as high as 2.5.

4.4. As with the multiples appropriate in simple multiple cases the level of turnover multiple is subjective. It will depend upon the quality and nature of the clients, the growth shown historically and the margins that the business has made in the past. Again, the better the growth and margins then the higher the multiple is likely to be.

4.5 It is possible to research for deals that indicate turnover multiples, and also to look at the ratings of companies in the quoted sector to ascertain the turnover multiple implied in the market capitalisation. Statistics from either of these sources will need to be adjusted for points of difference between those companies and the subject business. A simple example is outlined below.

Example

- Non-quoted corporate recovery business, well established with a strong client base and growing strongly. 3 principals and with rented premises.
- Turnover £1,500,000. Making industry standard margins.
- Research shows quoted comparators trading at about 1.3 x turnover.
- Valuation: £1,500,000 x 1.0 (reduced from 1.3 to take account of the small scale of the business, reliance on key individuals and lack of asset backing) to give **£1.5million goodwill**.

4.6 There are various other businesses where turnover can be a crucial factor including the following:

- Chemist shops.
- General corner shops.
- Betting shops (where the multiple is frequently expressed as a number of weeks purchased per shop, with the multiple rising steeply the higher the turnover of the shop is).
- Garages (but not any gallonage aspect).

4.7 In addition to turnover based approaches there are many different industry specific valuation criteria, some of the more common being as follows:

- Pawnbrokers – sometimes the business is valued as the book value of the debts plus an agreed premium for goodwill expressed as a percentage of total pledges.

- Funeral Directors – the goodwill can be expressed as a notional price per adult funeral, although articles in the trade press also support a normal capitalised earnings approach.

- Hotels – often “ball park” valuations can be arrived at by reference to a price per bedroom, although capitalisation of earnings and/or discounted cash flow (DCF) approaches are also principal methodologies.

Further information relating to the use of discounted cash flow calculations can be found at the following address:

http://www.accaglobal.com/pubs/students/publications/student_accountant/archive/sa_apr08_coulthurstIRR.pdf

4.8 It should be borne in mind that industry specific methodologies and turnover based methodologies need great care in their application and (with the exception of the valuation of professional partnerships) in the view of the author these methodologies tend only to have use as a secondary methodology, perhaps in cross checking a valuation arrived at via the adjusted net earnings of the business.

5. PERSONAL AND CORPORATE GOODWILL

5.1 In certain types of business the nature of the goodwill is such that it does not attach to the business itself, but to the person of the owner/director. In these circumstances it is difficult for the goodwill to be transferred or sold if the business is disposed of.

5.2 This is likely to be the case to at least some degree in many transfers, but the purchaser will seek to maximise the value that they obtain by tying in the key individual in such a way that all of their personal goodwill is subsumed into the business over time. In this way the seller achieves the best price as well.

5.3 However, in certain trades the personality of the owner is crucial – for example a chef in a small restaurant. Unless the chef is famous (in which case the name and concept can perhaps be franchised or otherwise leveraged), it is likely that the goodwill in the small restaurant will die with the change of ownership.

5.4 It is in the interests of both the purchaser and the seller to maximise the value of any "personal" goodwill and to try to get as much of this as possible into the business itself. Therefore the circumstances where there is absolutely no business goodwill and all of the value resides in the person of the owner are likely to be rare, and to exist only in very small business with few staff were the personality and skill of the owner might be crucial and cannot be subsumed into the new ownership.

6. TRADE RELATED PROPERTY - NEW REVENUE GUIDELINES

6.1 The valuation of goodwill in trade related properties (for example public houses, hotels, petrol filling stations, restaurants, care homes and the like) has long been debated within organisations such as the Royal Institution of Chartered Surveyors ("RICS") and HMRC. The HMRC website provides the following quotation – "In the past, HM Revenue & Customs have taken the view that it was unlikely that there would be "free goodwill" of any significant value in businesses carried on from trade related properties because the occupation and use of the particular, specially adapted premises was usually essential and integral to the generation of the business income. However it is now acknowledged that when a business is sold as a going concern the sale price will reflect the combined value of the tangible assets together with the benefit of other business assets such as any contracts with customers, staff and suppliers, records of previous customers etc. Substantial value can be realised by combining the tangible and other business assets together for sale as a going concern but this enhanced value may be reduced if the assets are split and sold separately."

6.2 The valuation of goodwill in trade related properties within HMRC is, in practical terms, split between Shares & Assets Valuation based in Nottingham and the Valuation Office Agency ("VOA").

6.3 At the time of issuing this factsheet it is understood that the VOA and RICS are still discussing the valuation of goodwill in this area, and that material difficulties still exist. One issue is that goodwill is not subject to Stamp Duty Land Tax (SDLT) whereas the business premises are. The Valuation Office contends that Goodwill should be valued by reference to the profit-making potential of the Premises. Whereas RICS contend that a just and reasonable apportionment should be made according to market practice and must be just and reasonable to both HM Revenue & Customs and the Taxpayer, rather than automatically in accordance with the Revenue's practice note.

6.4 However, a practice note has been issued entitled "Apportioning the price paid for a business transferred as a going concern". This practice note provides a background to the problem, outlines the statutory provisions and legal definitions of goodwill, discusses goodwill in trade related properties and goes on to discuss the valuation of goodwill and other intangible assets, outlining how their preferred approach will apply in cases of CGT and SDLT,

as well as cases under Schedule 29 FA 2002. The practice note referred to above can be found at the following address:

http://www.hmrc.gov.uk/svd/practice-note.pdf

6.5 In addition, as an appendix the practice note gives the RICS guidance to members dated July 2006.

6.6 This Factsheet is restricted to a resume of the practical aspects of the practice note only.

6.7. In cases where it is necessary to value the business as a going concern (perhaps because the sale price was not at arm's length) then this valuation is the responsibility of HMRC Shares and Assets Valuation ("SAV"). Similarly, if it is necessary to apportion the excess value between goodwill and any other intangible assets this is also the responsibility of HMRC SAV.

6.8 HMRC takes the view that, in cases where the going concern value of the business is known (for example following an arm's length sale) then "the difficulties in arriving at the value of the goodwill is usually related to the assumptions and approaches to be adopted when arriving at a valuation of the tangible assets".

6.9 HMRC then goes on to describe two potential approaches that might be used in valuing trade related properties on a profits basis – capitalised IBITDA/Fair Maintainable Trade ("FMT") approach and a rental value/investment based approach.

6.10 HMRC sees considerable problems in the application of the latter of these two approaches and is of the view that a capitalised EBITDA/FMT approach "will nevertheless give a reliable valuation in most cases".

6.11 As HMRC point out "the difficulty with this approach is that in cases where the contracts with customers, staff and suppliers are of some value it is necessary to reflect this in the valuation". It appears that this approach is likely to materially undervalue these aspects of goodwill.

6.12 For information, we outline below an example of the valuation of the goodwill using HMRC's approach (with the example being based on the HMRC Practice Note).

Example

- Nursing home sold as a going concern for £3million based on a fair maintainable trade (FMT) of £500,000 and a 6 year purchase.
- Assume that it will take 12 months to get the business properly staffed, fully occupied and trading at FMT level again.
- Valuation of goodwill would be price paid less value of the tangible assets. Value of the tangible assets using the fair maintainable trade approach would be £500,000 for 6 years (£3,000,000) deferred for one year at 10% (3,000,000 x (1/1.1) to give £2,727,273. Goodwill is then £3,000,000 less £2,727,273 which is £272,737 say £273,000.

6.13 In practice, the best approach is to set out a reasonable basis for the valuation of the goodwill and then negotiate with HMRC in order to try and reach a settlement. Cases have not yet gone before the Courts to provide additional guidance in this difficult are.

6.14 HMRC has, using the methodology outlined above and in the practice note, managed to clear the majority of the backlog of cases and it can, therefore, be surmised that frequently the application of this methodology will give an answer that, after negotiation, is acceptable to all sides.

6.15 However, there will inevitably be cases where this methodology does not satisfy all of the parties and in the author's view it is only a matter of time before there is further litigation in this area.

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