

Goodwill - Commercial or Personal?

The issue of separating personal and commercial goodwill often arises in valuing professional service businesses such as medical, dental, accounting, or law practices, as well as other small privately owned companies that depend extensively on the personal skills, knowledge and effort of one individual.

Generally, courts do not recognise personal goodwill where value is defined as fair market value in a notional market context.

The key to understanding where goodwill fits in the context of a business valuation is to first consider the concept of intangible value. Intangible value represents the difference between the fair market value of a business 'FMV' and the going concern value (value-in-use) of the business' net tangible operating assets "NTOA".

Intangible value can be further subdivided into two groups: identifiable intangible assets such as patents, copyrights, licenses, or quotas, and non-identifiable intangible assets representing goodwill. NTOA represents the going concern value of net tangible operating assets and identifiable intangible assets.

Goodwill, as a non-identifiable intangible asset, is typically categorised as either commercial, personal, or individual goodwill.

Commercial goodwill represents transferable non-identifiable intangible assets, which represent value accruing to a business. Although, commercial goodwill cannot be separated from the business itself, it is easily transferred with the business when the business is sold. Examples of commercial goodwill include:

- ★ product / service - market share, recognition by existing and potential buyers
- ★ location - strategic importance of physical location to the business; (possibility of double counting - real estate appraisal may already include some or all)
- ★ other opportunities available only to the business but not separable from the business - good employee relations
- ★ individual goodwill

Personal goodwill represents personal characteristics, skills, knowledge, reputation and efforts of a specific person employed by a business.

The profits derived from personal goodwill typically terminate at the time the person responsible for those profits loses interest in, is unwilling, or unable to participate in the business. Since, personal goodwill cannot be transferred to another person and personal services cannot be sold upon the sale of a business, Courts generally consider personal goodwill to be excluded from the fair market value of a business determined in a notional market context. Value-to-owner includes personal goodwill and represents value that is over and above the fair market value of a business. The value-to-owner concept of value may apply in Family Law matters.

ie: $\text{Value-to-owner} = \text{FMV} + \text{Personal goodwill}$

Individual goodwill includes abilities, business contacts, good name, and reputation of individuals employed by a business. In contrast to personal goodwill, individual goodwill does not negatively impact the profitability of a business when an individual is unable or unwilling to further contribute individual goodwill because the business is able to find suitable replacement. However, competition from departing employees who provided individual goodwill has the potential to negatively affect profits of a business. Restrictive trade agreements in open market transactions generally represent the commercial value of individual goodwill.

Commercial goodwill is generally valued as a residual calculated as the difference between fair market value and tangible asset backing of the valued business.

ie: $\text{Commercial goodwill} = \text{FMV} - \text{NTOA}$

In some cases, a high degree of dependence on one key individual will demand very low multiples resulting in low FMV and require valuation of a business purely on asset basis.

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Munday Wilkinson

Our Aim

Munday Wilkinson is a boutique forensic accounting firm.

We offer the legal profession, and others, quality service and technical proficiency commensurate with that of the Big 4.

At the same time we are able to provide a more personalised service as we operate in a framework that enables us to be very responsive to our clients while at the same time delivering a high quality service in a cost effective manner.

Our Services

We have extensive experience in:

- ★ business and company valuations
- ★ quantification of economic loss
- ★ loss of earnings assessments /reviews
- ★ family law investigations, valuations, tax issues for proposed settlements
- ★ fraud reviews and investigations
- ★ due diligence reviews
- ★ professional negligence matters concerning accountants, tax advisors, auditors and directors
- ★ compulsory acquisitions
- ★ solvency issues
- ★ expert determinations
- ★ expert witness

Munday Wilkinson is now Melbourne's largest dedicated forensic accounting firm comprising three directors, a consultant and an administration assistant. We can provide forensic accounting services for a wide variety of dispute related matters from the small to the large.

When Is a Forensic Audit Required?

A **Forensic Audit** is unique. It is conducted to confirm or dispel suspicions of wrong-doing. The term "forensic" refers to information or evidence that is suitable for presentation in a court of law. A typical objective of a forensic audit is to obtain evidence to support criminal charges related to white-collar crimes such as bribery, fraud and theft. The reports are usually very lengthy and include a detailed, fully-documented and well supported chronology of the investigation and findings.

Here is a list showing indications that a fraud or other impropriety may have taken place in a business and therefore may warrant investigation:

- Large unexpected losses
- Material accounting adjustments at year-end
- Low morale among employees or management
- Performance based remuneration
- Unusually high expense items
- Non-compliance with corporate policy or internal controls
- Employees apparently living beyond their means
- Customers insisting on dealing with only one employee
- Staff not taking annual leave or who don't delegate
- Inventory shortages remain unexplained and poorly investigated
- Copies rather than original invoices are being paid
- Missing and/or altered documentation
- High level of journal entries adjusting account balances
- Shortages and overages in petty cash
- Adjustments to receivables
- Access to computers at unusual hours
- Old outstanding cheques on bank reconciliations
- Address changes followed by requests for payment

These are red flags that many times are not pursued during annual financial audits, as they are often explained away as isolated incidents by management.

Those responsible for corporate governance must take a role in developing anti-fraud policies that will reduce risk of loss. The most helpful measures for preventing fraud are:

- internal controls and segregation of duties;
- background checks on new employees;
- policy to encourage "whistleblowers"
- ethics training for employees;
- established fraud policies;
- ad hoc forensic audits;
- workplace surveillance; and,
- a willingness of the company to prosecute.



Rule of Thumb Valuations

Rules of thumb can serve as guides to the valuation of businesses in certain industries and are usually found in industries where there are a large number of participants with relatively predictable revenues and costs all following a common business methodology.

Rules of thumb have been developed over extended periods of time and as a result of market transactions.

They are mainly prevalent in the valuation of small businesses or readily comparable businesses. They are often based on multiples of gross revenue or net profit, although some rules of thumb may also consider activity-based ratios such as the number of litres pumped per month in the case of petrol stations. The following are examples of the few common rules of thumb that we have encountered:

- Travel agencies - 10% of gross sales, or one times gross commissions
- Insurance agencies - 100% to 200% of commission income
- Accounting practices - 60% to 120% of annual billings
- Employment agencies - 50% of annual gross income
- Financial planners - multiple of recurring commission
- Small-businesses - one year's net profit before the owner's wage plus the inventory valued at cost and the equipment at depreciated value
- Agedcare centres - an amount per bed
- Childcare centres - an amount per child enrolled
- Real estate rent rolls - a multiple of the rent rolls annual income.
- Petrol stations - an amount per litres of petrol pumped per month plus the cost of the petrol underground

Caution

Rules of thumb change through time. It is important to note that as social, economic and business environments change, the application of an outdated valuation factor could easily result in over-valuation and therefore inadequate returns on investment. Also, rules of thumb do not consider the particular characteristics of the business being valued.

Generally speaking, rules of thumb should only be used in support of other valuation methodologies and are never to be used as the sole method of valuation.

Qualities of a Good Forensic Accountant

A Forensic Accountant needs to look beyond the numbers and deal with the business reality of a situation.

Forensic accounting utilises accounting, audit, investigation and valuation skills.

Characteristics of good forensic accountants include:

- Curiosity
- Discretion
- Confidence
- Persistence
- Organisation
- Sound judgement

A forensic accountant needs to scrutinise the fine detail and, at the same time, see the "Big Picture".

He must also have the ability to clearly and concisely communicate his assessment of the financial information in a manner that will be understood in court.

Revised Munday Wilkinson Family Law Booklet

In August 2003 the Family Court of Australia issued Practice Directions No.2 of 2003. These Practice Directions were issued to provide guidelines for expert witnesses in respect of the overriding duty to the Family Court, the form and content of expert reports and the conduct of expert conferences.

These guidelines have now been incorporated into the *Family Law Rules 2004*, effective 29 March 2004, and are predominantly contained within Part 15.5 - Expert Evidence.

The major change effecting expert evidence, is the emphasis placed on the use of a single expert witness to tender a joint report and the ability of the Family Court to order that expert evidence be given by a single expert witness.

In recognition of the importance of the changes contained in the new rules we are updating our booklet "**Forensic Accounting for Family Law Matters**" and intend distributing the revised booklet later this month. Copies are to be forwarded to our list of family law solicitors, barristers and judges. If you would like to ensure you receive a copy please contact our office.



Post-Acquisition Disputes

We have been engaged as forensic accountants in numerous matters involving business sales / acquisitions disputes.

Typical areas of dispute relate to:

- Warranties (such as product costing)
- Deferred consideration based on future performance (multiple of “adjusted” earnings).
- Completion accounts determining the final purchase price.

Purchasers seek warranties in order to obtain a higher degree of certainty on the information provided to them on which they make price decisions. In the event that there is a dispute over misrepresentation – the measure of damages is the difference between what was paid for the business and what would have been paid, had the real position been known. We have recently prepared a report in relation to this particular situation involving representation as to the costing of stock.

When an element of the price is based on future performance, the risk to the vendor increases due to vendor losing control and information on the business after transfer. Often there are premiums to the purchase price based on the future business reaching set levels of profit. If the terms of how profit is calculated is not clearly defined, disputes frequently arise. Consistency of application of accounting policies between the vendor and the purchaser is usually the key issue or in accordance with Generally Accepted Accounting Principles (“GAAP”). We are currently involved in a case (engaged by the vendor) involving this type of issue.

Where completion accounts are required to determine the final price, judgemental valuation decisions can impact upon areas such as stock obsolescence, doubtful debts, value of work-in-progress. These can be manipulated and cause dispute between the parties. Again the key issue in such cases is consistency – are the policies applied to value such items consistent with that in the previous accounts upon which the Agreement was entered? Some time back we were engaged in an expert determination concerning a dispute between the purchaser and vendor of a poker manufacturing business over the appropriate level of stock obsolescence.

Also, we have been appointed on numerous occasions, by solicitors for an accountant’s professional indemnity insurer, to provide our professional opinion on whether accountants involved with business sales (acting for the vendor or the purchaser) have acted in a reasonably prudent manner. These matter have involved completion of Form 19 statements, due diligence work, advice on the value of the business, etc.

MW welcomes New Staff

We have recently employed an additional forensic accounting consultant , **Lilian Hung**.

Lillian has 5 years experience with Deloitte in Hong Kong and more recently worked with Knights in Melbourne. She is also currently studying the “Graduate Certificate in Forensic Accounting” course at Monash University.

Rosa De Roit has commenced as our administration assistant. Rosa has a background in accountancy and administration .

Lauren Stanley, our former assistant, has been offered a position in Switzerland assisting children with special needs. We wish Lauren all the best in her new career.

We are also delighted to announce that **Paul Spence**, who joined us in April 2003 after 14 years with Deloitte Forensic, will be promoted to become a Director of Munday Wilkinson Pty Ltd effective 1 April 2004.

Further Information

If you would like further information regarding this newsletter or our services, please contact either Russell Munday, Bruce Wilkinson or Paul Spence at:

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MW Forensic is a newsletter prepared on an ad hoc basis covering topical issues in the area of forensic accounting. We would welcome your thoughts on contents for future editions.

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