

Professional or Practice Goodwill A Fresh Approach

BY MAX A. COHEN, CPA, CVA

Florida courts have ruled Professional Practice Goodwill to be a marital asset. In *Thompson v. Thompson*, 576 So. 2d 267 (Fla. 1991) the Florida Supreme Court decided in a marriage dissolution proceeding that the value of a professional association's goodwill be factored in determining the professional association's value. The court stated that "if it exists and if it was developed during the marriage, professional goodwill is a marital asset which should be included in the marital estate upon dissolution." *Id.* at 268. The court emphasized that "such goodwill, to be a marital asset it must exist separate and apart from the reputation or continued presence of the marital litigant."

In computing the value of goodwill, the court requires that the fair market value standard be applied exclusively for measuring goodwill of a professional association. In determining fair market value of practice goodwill, the court did not require actual comparable sales as long as an expert formed an opinion on a reasonable and reliable basis.

In *Young v. Young*, 600 So. 2d 1140 (Fla. 5th DCA 1992), a marriage dissolution proceeding concerning the goodwill of a professional association, the court held that for practice goodwill to be valued there must first be proof of its existence. Once there is a proof of existence, the court required that fair market value be used as the exclusive standard of value. The Fifth District Court of Appeals, (citing *Hanson v. Hanson*, 738 SW 2d 429,

Mo. 1987, en banc, cited with approval), stated that "thus, as a matter of proof, the existence of goodwill is shown only when there is evidence of a recent actual sale of a similarly situated professional practice, an offer to purchase such a practice, or expert testimony and testimony of members of the subject profession as to the existence of goodwill in a similar practice in the relevant geographic and professional market. Absent such evidence, one can only speculate as to the existence of goodwill. Divisions of marital property may not be based on speculation as to the very existence of the property being divided." *Id.* at 1142.

Notwithstanding the court's rulings, the preponderance of marital dissolution cases concerning professional practice goodwill, have not found professional practice goodwill to be of substantial value.

This article suggests a method of proving the existence, if any, of practice goodwill and valuing such goodwill at fair market value should it exist.

Goodwill and Fair Market Value

Goodwill, professional goodwill, practice goodwill and fair market value must be defined before continuing.

In *Thompson*, the Florida Supreme Court defined goodwill "as the advantage or benefit a business has beyond the value of its property and capital." *Thompson* at 268. Simply stated, total goodwill is that part of the total fair market value of the professional practice, in excess of the market value

of its net tangible and specifically identifiable intangible assets. Marital dissolution valuations require that the fair market value of goodwill be allocated between professional (personal) nonmarital and practice (institutional) marital goodwill.

*Florida courts have ruled
Professional Practice Goodwill
to be a marital asset.*

Professional goodwill is attached to the practitioner and relates to the individual's reputation and personal success in the profession. By its nature, professional goodwill is difficult to transfer.

Practice goodwill on the other hand, is tied to the enterprise's reputation and its capacity to continue to generate and or maintain business, without the presence of a particular professional. The steam that drives the value of practice goodwill is the expectant fee income that a practice will be able to produce upon the withdrawal of a practitioner or the transfer of ownership.

In *Thompson*, the court describes fair market value as "what would a willing buyer pay, and what would a seller accept, neither acting under duress for a sale of the business." *Id.* at 270. The court's definition of fair market value comports with the definition used by the valuation profession. Fair market value would also assume that both sides of a hypothetical transaction would have reasonable knowledge of the relevant

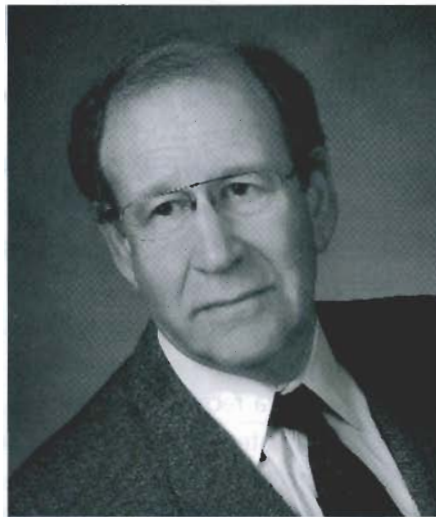
facts and that there would be an open and unrestricted market.

For an expert analyst to prove the existence or absence of goodwill and its components, (professional goodwill and practice goodwill), the fair market value of the entire professional practice must first be determined. This process can be complex and it will be discussed briefly. The balance sheet and income statement must be adjusted to reflect normal economic activities of the enterprise (on an accrual basis and not a cash basis of accounting).

In analyzing a balance sheet, all assets and liabilities should be adjusted to reflect fair market value. Particular attention should be given towards arriving at the fair market value of such non-operating tangible assets as investments, works of art and real estate, and operating assets such as instrumentation, machinery and accounts receivable. Intangible assets such as patents, copyrights, and trademarks should be identified and valued. Unbilled work in process and incomplete contingency matters must be identified, valued and included as assets and income. Recorded and unrecorded liabilities should be adjusted to their fair market value. The non-operating elements of the balance sheet should be separated from the operating elements when valuing the professional practice.

The income statement should be analyzed and adjusted to reflect the true economic income and expenses of the practice. Scrutiny should be given to transactions between related parties.

When valuing a professional practice and exploring the existence of goodwill, the expert should focus on the practitioner's compensation and fringe benefits. The practitioner's total compensation, including fringe benefits, should be adjusted up or down to



Max A. Cohen has devoted over 25 years working with entrepreneurial individuals and closely held companies in the areas of accounting, taxation, business valuations and litigation support services.

Mr. Cohen is also a Certified Valuation Analyst (C.V.A.). The C.V.A. accreditation is the premier designation awarded by the National Association of Certified Valuation Analysts for providing business valuation services. One must be a C.P.A. and complete a rigorous training and testing process before receiving the C.V.A. accreditation.

reflect a reasonable amount which would be paid to a competent professional to perform the functions of the litigant professional spouse. The actual compensation and fringe benefits attributed to the practitioner in excess of the reasonable compensation would represent a contribution towards the economic earnings of the practice for consideration of the existence of goodwill.

To assist in determining reasonable compensation, the expert can call upon compensation surveys published by professional societies. Employment search

The court stated that "if it exists and if it was developed during the marriage, professional goodwill is a marital asset which should be included in the marital estate upon dissolution!"

firms specializing in a specific profession can also provide information regarding professional compensation.

After normalizing the financial statements and obtaining details about the operations of the practice, the expert must ask, how is this practice different from all other practices? In order to answer this question, normalized financial statements and operational data should be analyzed and compared to comparable or similar practices. In the past, availability of empirical data to assist in valuing professional practices has been limited. Generally, prices and terms arrived at in most sales transactions are proprietary, limiting availability of comparable data. Lately, access to empirical data has become more readily available, especially for medical practices. Some sources of such data are: Goodwill Registry (The Healthcare Group), Pratts Stats (International Brokers Association), Bizcomps (Jack R. Sanders Asset Business Appraisers), IBA Market Data Base (The Institute of Business Appraisers), Risk Management Associates Annual Statement Studies and professional societies and organizations. Without comparable practice data, an expert could not express an opinion of value using the market approach.

After arriving at the economic income and analyzing the relevant data, the expert must select from one of several accepted methodologies to arrive at the fair market value of the professional practice. These methodologies are the income approach, market value approach and asset based approach. As this article is primarily concerned with the allocations between the two components of goodwill, professional and practice, there will be no discussion of the strengths and weaknesses of these methodologies.

In family law courts, the income

approach (capitalization of earning method) tends to be used more often than the other approaches. The capitalization of earnings method estimates economic income for a projected single period and divides that income by an appropriate rate of return. When valuing a professional practice for a divorce, no future period income is projected.

Since there is no intent to transfer the practice in a marital dissolution, marketability discount issues are not considered.

Remember, total goodwill is that part of the total professional practice's fair market value in excess of the market value of its net tangible and specifically identifiable intangible assets.

Assuming goodwill exist, its professional and practice components have to be identified and valued. Many elements can make up practice and professional goodwill. The bottom line in determining if practice goodwill exists

with a professional practice must be identified and analyzed. New client/patients are generally derived from three sources, client/patient referrals, professional referrals and paid marketing efforts and other external sources.

The bottom line in determining if practice goodwill exists is how many client/patients can be delivered should the practitioner leave.

Client/patient referrals are generally a measurement of individual consumer satisfaction and are indicators of the personal trust between the firm and/or the individual practitioner and its clientele. Depending upon the circumstance, client referrals can be attributable to either professional or practice goodwill.

Professional referrals exist because of a relationship between two professionals and are generally attributable to professional goodwill.

In today's economic environment it is not unusual for professional practices to deploy sophisticated and costly marketing programs. Many professional practices have created an identity based upon a trade name, type of service or special processes, which are not dependent on the individual practitioner or his personal reputation. The profits generated, after deducting the cost of these marketing efforts, tend to aid in creating practice goodwill. Likewise, practices which rely upon a particular location or a telephone number are less dependent upon the reputation of an individual practitioner.

Internal practice documents such as client/patient applications and acceptance forms provide evidence of client referral sources. The expert should be able to calculate fee income generated by referral source type by

relying upon information contained in these documents.

Client/patient relationships which manifest themselves in goodwill can represent the single most valuable asset of the professional practice as they are the source of both existing and recurring fees. Tangible evidence of these relationships can be found in such documents as client/patient files, land surveys, engagement contracts, tax returns, working papers and or professional papers. The relationships are the intangible and are only represented by the various underlying documents.

When inspecting client/patients documents, care should be taken to remove terminated relationships, as they have no economic value. It is important to document reasons why patients/clients relationships have terminated. Large numbers of clients leaving a practice because of personality conflicts with a practitioner would impede the value of professional goodwill. Internal documents can be relied upon to determine whether the nature

The expert must ask, "how is this practice different from all other practices?"

of the practice is transactional and dependent upon adding new clients/patients or to provide recurring services to the same population and dependent on the ongoing client/patient relationship. The expert must ask questions and rely upon internal documents to determine whether client/patient loyalties rest with the individual practitioner or with the firm due to the ongoing relationship. Situations where professionals within a practice share clients are examples where loyalties might rest with the practice and not with an individual practitioner.

The steam that drives the value of practice goodwill is the expectant fee income that a practice will be able to produce upon the withdrawal of a practitioner and or the transfer of ownership.

is how many client/patients can be delivered should the practitioner leave. Key to proving the existence and value of practice goodwill is to identify those attributes which are transferable by the practice and to value the attributes. Attributes which are not transferable inure to professional goodwill and not practice goodwill.

It is important to note that practices and not clients or patients are bought and sold. Therefore, the reasons why client/patients are attracted to and stay

Contracts for services to large institutions should be reviewed for content, terms and transferability.

Factors limiting the term of a practitioner's remaining working life such as years to retirement and the health of the individual should be considered when arriving at the value of professional goodwill in cases concerning marital dissolution. Such limiting factors should not influence the value of practice goodwill in marriage dissolution situations.

Once the practice's client and fee type profile has been developed, it should be compared to survey information obtained from professional societies or organizations to assist in measuring comparative economic success. These comparisons could include such items as billing rates and hours billed.

Finally, the attributes ascribed to the practitioner and the practice must be quantified to aid in determining the value of professional and practice goodwill. Fair market value of total goodwill was determined when the entire practice was valued. Reasonable formulas can be generat-

*It is important
to note that practices
and not clients or patients
are bought and sold.
Therefore, the reasons why
client/patients are attracted
to and stay with a
professional practice must
be identified and analyzed.*

ed to assign weighted values to referral source type and to reasons why a client/patient remains with a practice. Many multi-professional practices use similar formulas to determine the compensation of the individual practitioners.

The net economic income of the professional practice can be attributed to practice goodwill or professional goodwill by applying the appropriate formulas. Based upon the percentage of net economic income earned, from practice or professional sources, the market value of total goodwill can be separated into its two components. An example of a formula to allocate net economic income by referral

source and client/patient loyalty would be to assign a weight of 70% to the referral source and a weight of 30% to the reason for client/patient loyalty. In a simplified situation where all referrals were attributed to the individual practitioner and all of the client/patient loyalties were attributed to the practice, 70% of goodwill would be professional goodwill and 30% would be practice goodwill by applying such a formula. Depending upon complexities, there could be many variations of such formulas.

The article has suggested a fresh approach to solving the old problem of proving the existence of practice goodwill and valuing such goodwill at fair market value. By identifying the phenomena which attracts client/patients to a professional practice and creates client/patient loyalties, total goodwill can be bifurcated into its professional and practice components. Attribution of goodwill to the professional or to the practice can be quantified by using simple formulas. The proving of the existence of practice goodwill, in any circumstance, might be a subtle question of fact.



Max A. Cohen, C.P.A.*, P.A.

Certified Public Accountant

7600 Red Road • Suite 334 • South Miami, Florida 33143

TELEPHONE: 305 · 661 · 3500 • FAX: 305 · 661 · 3511 • E-MAIL: cpamax@aol.com

*Regulated by the State of Florida