

Goodwill: The Key to Valuing a Professional Practice

Much of the value of a professional practice consists of goodwill: its reputation, client base, knowledge, technical skill, research, brand awareness, and associations that the firm maintains. Goodwill is the most intangible of all assets. It can only be valued in terms of a going-concern business and cannot be separated from the business as a whole.

To help you understand the importance of goodwill in a professional practice, I'll give you a hypothetical example, and then explain the steps in valuing goodwill.

Centralia vs. Beverly Hills

We will compare two solo veterinary practices: the Centralia Animal Hospital in Illinois, and the Beverly Hills Pet Clinic in California. They own identical computer systems, office furniture, and equipment. Their practices occupy identical buildings with the same amount of space, and they employ similar administrative staffs. They both bill roughly the same amount of revenue each year.

Centralia's practice consists primarily of routine annual checkups and inoculations of local pets in a stable community; it enjoys moderate but steady earnings and relatively low overhead.

Beverly Hills, on the other hand, has a clientele whose pictures appear regularly on magazine covers. The doctor has personal relationships with eccentric movie stars who are willing to pay whatever it takes to have this particular doctor available at whatever location they are filming at, on short notice. Beverly Hills earns significantly more profit, over a number of years, than Centralia.

Yet Centralia might be easier to sell, and for a much higher price, than Beverly Hills. To understand why, you first need to understand the difference between professional goodwill and practice goodwill.

Professional vs. Practice goodwill

"Professional" goodwill derives from the individual practitioner's reputation and personal success in the profession, and the trust and respect that the individual practitioner has engendered in his or her clients.

"Practice" goodwill relates to the firm's ability to continue to generate earnings without the presence of any particular professional. Location, computer systems, staff, operating procedures, and a recurring client base are all elements of practice goodwill.

Beverly Hills Pet Clinic, for example, enjoys strong professional goodwill because its success largely depends on the presence of one particular quasi-celebrity doctor. An outside buyer might find this practice difficult to take over without the personality and relationships of its current owner. Centralia Animal Hospital, on the other hand, has strong practice goodwill because it doesn't depend on the presence of a specific owner; an outside buyer has good chance of succeeding.

How to value a professional practice

The reasons for valuing a professional practice could include the sale of the practice, admittance or expulsion of a partner, death, divorce, or other disputes. It is important to realize that both the reason for the valuation and the jurisdictional precedents in the state in which the valuation is prepared can have a critical impact on the measurement of value.

The first step in the valuation is to determine the standard of value. Most often a standard of fair market value is used, although a liquidation or fair-value standard could be used if appropriate. Some recent divorce cases involving valuation of a law partner's interest have presented a new standard of value based on what that particular partner would hypothetically pay to retain his or her own income stream.

After determining the proper standard of value, choose the appropriate valuation methods (typically more than one). Depending again on the purpose of the valuation, the type of practice, and other relevant factors, these methods can include:

- Capitalization of economic income
- Multiple of revenues
- Market comparison data
- Capitalized excess earnings
- Discounted economic income

The valuator of a professional practice must then prepare normalized financial statements (see my previous article, "Valuing Small Businesses in Divorce Cases," at <http://www.michaelgoldman.com/normalization.htm>). Since most professional practices do their accounting on a cash basis, it is usually necessary to convert the statements to an accrual basis, unless the valuator is comparing them to statements of other practices that are also prepared on a cash basis.

Other items to which particular attention should be paid include unbilled work in process, intangible assets such as patents or copyrights, unrecorded liabilities, the collectability of accounts receivable, and non-operating assets such as investments and art.

Profit and compensation

After determining the firm's true economic profitability, focus on the practitioners' total compensation (salary, perks, benefits, etc.). The amount of revenue or profitability that each individual brings to the practice is a key factor in the analysis, and the best way to start gauging this is by looking at how the partners internally divide the profits. Note that since most professional practices effectively "zero-out" their firm's income each year (i.e., pay all profits out as salary), compensation is usually the relevant measure of profitability. This compensation data should be compared with industry standards obtained from professional societies, employment search firms, and surveys done by firms such as Pratt's Stats, Altman Weil Publications, and Robert Morris Associates (see the "[links](#)" section of my website, www.michaelgoldman.com, for their web addresses) to determine if the practitioner is earning more than other practitioners in similar circumstances. If the difference cannot be explained by visible factors such as the practitioners working above-average hours, state-of-the-art facilities and technology, or location and demographics, then it would indicate the existence of goodwill.

Allocate professional and practice goodwill

If goodwill exists, it can be allocated between practice and professional goodwill by understanding the reasons why clients are attracted to and retained by the firm. Particular brands, special processes, locations, catchy phone numbers, etc., that attract clients generate practice goodwill. Clients obtained through professional referrals are usually indicative of personal goodwill, while clients obtained through the yellow pages are an example of practice goodwill. Inspecting client files will often give good indications of the sources of new clients, the persistence of recurring business, the locations and demographics of clients, and the degree of client sharing among professionals within the firm. Other indicators of the type of goodwill include internal compensation or continuation agreements between partners, billing rates and billable hours, and transferability of contracts.

The portion of the goodwill that is attributed as "professional" is generally considered to be non-transferable – it is very difficult to sell (unless the seller is willing to stay on and implement a strong client retention plan), and depending on the jurisdiction it is generally not awardable to a spouse in a divorce case. On the other hand, in marital dissolution cases many jurisdictions do not discount professional goodwill, because the practitioner generating the goodwill is not leaving the firm.

Licenses and Regulations

Many of the professions are licensed by state governments. Some states consider those licenses to be valuable marital assets in divorce cases, while some state family law courts consider professional licenses to be included in personal goodwill. Licenses, registrations, and permits may or may not be transferable. Some states limit the ability of professional practices to be sold or transferred – law firms, for example, often are restricted from the sale of client files.

Professional practices have characteristics, distinctions, and value drivers that are different from other types of businesses. It is incumbent on the valuator to understand these factors and apply specialized knowledge and analyses that may be very different from what one would ordinarily expect in a business valuation.

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