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# Understanding Goodwill

## When Buying or Selling Accountancy Fees

**Goodwill is a word or term that is used frequently in business scenarios and certainly one that accountants come across when preparing balance sheets for clients. But what about when they are looking at the value of their own business - their own accountancy practice, whether in its entirety or a block of fees – or when considering the purchase of an accountancy practice or a block of fees?**

Let's start with some standard business orientated definitions:

- the established reputation of a business regarded as a quantifiable asset and calculated as part of its value when it is sold. www.investopedia.com/terms/g/goodwill.asp
- business: the amount of value that a company's good reputation adds to its overall value. www.merriam-webster.com/dictionary/goodwill
- Goodwill is the excess of the purchase price paid for an acquired entity and the amount of the price not assigned to acquired assets and liabilities. http://www.accountingtools.com/dictionary-goodwill

The 3rd definition should come as no surprise to members of the accountancy profession but it does focus the mind somewhat to compare and contrast with the 1st and 2nd definitions.

Typically an accountancy firm's tangible assets are worth a fraction of the price the firm would sell for in its entirety and may not even figure at all in some negotiations, especially if the accountancy practice was to be relocated, but where only a block of accountancy fees is being sold the actual tangible value being acquired is the sum total of zero!

It is exactly this that makes the valuation of goodwill so difficult to tie down precisely in any given circumstance.

However, our old friend "the marketplace" does most of the workload for us as it usually does. Therefore the only way to know for sure, or as near to sure as one can get, is to find out what the going rate is for the sale and purchase of accountancy fees, either as a standalone block or as an entire practice. But there is no published list of deals that buyers and sellers can refer to, so the most reliable means is to undertake research by speaking to accountancy practice sales agents and brokers, and even then it is difficult to be precise as no two deals are exactly the same.

The value of an accountancy practice is typically defined as a multiple of the gross recurring fees – in other words, the fee income that can be expected to be earned in the following financial year based on the current year. The accountancy profession is fortunate that most clients come back each year for the same service because of the mandatory filing of returns. Unlike a trip to the dentist, a tax return can only be put off for so long!

So where does that leave us then? Well, at the time of writing (October 2016) the normal multiple is between 1 and 1.2 times the gross recurring fees, whether for a block of accountancy fees or the sale of an accountancy practice in its entirety. If we were to plot a distribution curve it would peak between these figures with a sharp drop off and a long tail on either side, perhaps

stretching to almost zero on the left and possibly as much as two or three times to the right.

Given that a typical practice ( with the exception of a true one-man band practice without any assistance ) will post a net profit of around one third of its turnover, their valuation can be seen in perspective when compared to the multiple of around five times net profit that the average trading business would be aiming to achieve were it to be sold.

At the one extreme is a fire-sale, where a firm is essentially sold at a knockdown price very quickly, perhaps due to illness or insolvency (or even in my experience due to imprisonment of a very naughty accountant). At the other is a firm with a laser sharp focus in a particular field of expertise with a longstanding contractual relationship to service members of a trade body or membership organisation, causing the valuation to deviate from a strictly professional one towards that of an "ordinary" trading business.

With any given firm there will be many intrinsic factors that could affect the valuation of the goodwill. These would typically be: charging basis, level of fee recovery, location, staffing, adverse publicity, claims history, average fee size, client profiles, ethnicity of staff or clients, opportunity for value added and opportunities that may be peculiar to a particular buyer.

At this point it is worth reminding ourselves that the only thing an accountancy practice has available to sell is its goodwill. It cannot and never sells its clients – slavery was abolished a very long time ago and the accountant has absolutely no control over the freedom of their clients to walk away and choose another accountancy practice to act for them.

So, in light of this timely reminder, why pay anything for a block of fees if there is nothing to prevent your "asset" or perhaps more precisely, your "expected income stream" vanishing into the ether? Simply put, the facts on the ground are that if the sale is handled properly the overwhelming majority if clients will stay with the accountancy practice (if sold in its entirety) due a combination of inertia and goodwill built up. Where a block of fees is sold the same holds true although it needs handled in a slightly different manner as the practice name itself is not necessarily taken by the purchaser, but there are safeguards in place to ensure that the seller of the accountancy fee block has carefully selected the accountancy fees (i.e. the clients) they are divesting themselves of and will take every step to ensure that the clients are satisfied with his or her choice of purchaser. The same holds true with the sale of an accountancy practice via a contractual and payment mechanism known as "clawback".

For most sellers and buyers of accountancy practices or accountancy fees blocks, only one big question remains outstanding. Namely, if the demand for accountancy practices outstrips supply of accountancy practices on the market why has the multiple not increased dramatically in line with the fundamental economic law of supply and demand?

I refer you to our old friend - "the marketplace" – who has decided thus, based on a host of factors ranging from interest rates to the general perception of traditional business loyalties or pricing pressures in the broader economy. What is does mean however, is that sellers can pick and choose with whom they wish to deal, especially if the goodwill they have accrued truly is goodwill and not simply a list of clients.