

Relatively Speaking



Goodwill

Do you know the value of your business intangibles?

It's not uncommon for two independently owned businesses with similar products, revenues and size to be worth substantially different amounts to their owners, potential buyers and others.

There are countless reasons why your business may be worth more than others just like it. Many of these reasons are collectively referred to as the "goodwill" of your business.

Webster's dictionary defines goodwill as "an intangible asset which takes into account the value added to a business as a result of patronage, reputation, etc."

But, it is much more than that. In a business sense, goodwill can be thought of as the difference between the value of your established business and one just being started.

Think of all the time, money and sweat equity you've put into your business, taking it from an idea to where it is today.

Goodwill is a measure of your successful efforts to put your ideas into motion, creating life and identity beyond the equipment, inventory and other tangible assets used in your business operations.

Why is goodwill important to help determine the value of your business?

Because a buyer or other successor will look for elements of this important factor to explain why your business earns more or less than others similar to it.

Here are three important elements of goodwill and why they have such an enormous impact on the value of your business:

Customer base There is nothing more important to your business than loyal, satisfied, paying customers or clients.

It takes years, perhaps decades, to build a strong customer base that, absent any compelling reason to change, will return time and time again to purchase your product or service.

It takes but a fraction of your effort, time and money to retain an existing customer compared to what it takes to coax a customer away from a competitor. This is why your customer relationships have significant value to you and others interested in your business.



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For family businesses from the office of:



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Case study:

A business's value may not be obvious

Business valuation: A process and a set of procedures used to estimate the economic value of an owner's interest in a business that are used by financial market participants to determine the price they are willing to pay or receive to consummate a sale of a business. The same tools are often used to resolve disputes related to estate and gift taxation and divorce litigation, allocate business purchase price among business assets, establish a formula to estimate the value of partners' ownership interest for buy-sell agreements and other business and legal purposes.



A father dies leaving 25 percent of his contracting business to each of his four adult children. The two sons are active in the business. The two daughters are not.

The company's CPA informally values the business for federal estate tax purposes, determining the value to be only modestly in excess of net book value.

Relationships among the four shareholders become increasingly strained over the next two years. Disenchanted with the

situation, the sisters sell their shares to their brothers at the same price determined for estate tax purposes. Again, a formal valuation of the business is not considered to be necessary.

Over the subsequent few years, the contracting business prospers and expands into industrial maintenance contracts. Aware of the company's growth and success, the sisters bring legal action against their brothers and the company's CPA.

The former shareholders allege failure to disclose relevant financial and operating information about the business. They further allege misrepresentations as to the value of their stock, which caused them to sell at substantially less than fair market value.

The suit is settled prior to trial, but the family relationships are permanently severed.

Lesson to be learned

The father's concern over treating his children equally created an unworkable relationship among the siblings, which inevitably led to open conflict. The problem was compounded by the lack of an independent business valuation. Had the stock transactions been based on a professional appraisal, the distrust and confrontation might have been avoided.

Different purpose – Different value

The fair market value established for the father's estate would not be the appropriate value for the buyout of the estate's beneficiaries. Factors creating the difference in value would include:

- Loss of the father as a key person in the company
- Corporate life insurance proceeds from the father's death
- Minority ownership interests of the children compared with the father's 100 percent controlling interest
- Intervening business operations ■

Goodwill *continued from front*

Operating systems and processes Day after day, your business operates according to a complex web of interrelated systems and processes. These define how sales are initiated, consummated and eventually converted to cash; how inventory and other resources are ordered, received and processed into salable products or services; and how bills are received, processed and paid on time.

Trained, assembled work force There is no doubt that the success of any business is critically dependent on the quality of its human resources. It is difficult to place a value on the fact that your employees show up regularly for work, know their jobs and create the products or services that make your business profitable.

The more loyal, happy and effective your people are, the more successful your business will be. Just consider the enormous

Consider the enormous cost, time and effort you would have to expend to replace your entire work force and train new employees to the level of your existing people. ■

cost, time and effort you would have to replace your entire work force and train new employees to the level of your existing people. This intangible asset is vital to the value of your business. ■

Is performance ranking the way to evaluate employees?

Did you know that in recent years one-third of American companies have switched to a performance “ranking” system to conduct evaluations?

As opposed to the traditional performance appraisal, performance ranking is a controversial procedure in which employees are evaluated against each other instead of against objective performance standards. Its purpose is to identify talent, deliver differential rewards – and to develop or terminate those who come out on the low end.

There are two forms of performance ranking (also sometimes called forced ranking). In the first, all employees in a similar job class are ranked in sequential order from best to worst.



In the second, employees are sorted into several groupings – for example, *exceeding expectations*, *satisfactory/high*, *satisfactory/medium*, *satisfactory/low and needs improvement*. In this system, managers are forced to assign a certain percentage of employees to each group, including the bottom group, whether they agree with that ranking or not.

Proponents say performance ranking is the best way to identify high-potential employees for rewards, training and grooming for promotion – and to identify low-performing employees to receive

help or be let go. They claim that performance ranking is the best way to turn a mediocre company into a powerhouse and cite research showing that top performers outperform average (not even bottom-ranked) performers by 40 to 100 percent.

Critics of performance ranking say it causes low morale, stifles teamwork and cooperation, leads to bad publicity and often incurs costly litigation. Some say the managers who do the ranking lack adequate information to make such fine distinctions among employees’ performances. Managers are also subject to human biases, favoring employees whom they like personally, and vice versa.

Jack Welch, former CEO of GE, advocated purging the bottom 10 percent of employees every year.

Critics of that policy say, what if you have a high-functioning team? Some companies attract top-notch people and don’t have 10 percent dead

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weight. Moreover, if you get rid of the low performers the first year, why do you still have low performers in year two and year three?

Legal experts say the practice of performance ranking is not illegal per se, though it can become so if it causes disparate impact.

For example, if most of the employees in the lowest category are minorities, women or older workers, the process might be judged to be discriminatory, especially when these employees are being summarily terminated.

Another consideration is cost. It is expensive to replace employees, and then there are the potential lawsuits – costly, even if you win.

Finally, if the nature of your business requires close cooperation and teamwork, performance ranking might be a bad idea. Employees may ask, “Why would I lend assistance or make suggestions that help my co-worker look good if we are going to be judged against each other come appraisal time?”

There is no defining research that shows whether performance ranking is beneficial or not. You will have to weigh the pros and cons and decide if it is worth a try at your company. – Jeff Van Pelt, Ed.D., SPHR

How to prevent inheritor syndrome in your business heirs

You work hard to build your family business, looking forward to the day when your children will reap the rewards.

But when a substantial portion of the ownership or assets of a family business is transferred to one or more children, it can cause a phenomenon known as inheritor syndrome.

Inheritor syndrome (a subset of sudden wealth syndrome) is a set of problems that may result when a younger generation inherits a windfall created by the work of the preceding generation.

If heirs have not had to work for this windfall, they can face significant psychological and practical problems. These include feeling disconnected from themselves and others, being out of touch with reality and a lack of meaning, passion and drive. It can also cause feeling overwhelmed and helpless.

Other outcomes may include a lack of depth in relationships and substance abuse. In addition to personal problems, inheritor syndrome can also be problematic to the family business if the heir receives some control over the organization. The phrase “running the business into the ground” is a potential outcome of inheritor syndrome left unchecked.

Making the syndrome even more problematic is that it's rare for the person affected to admit he or she has a problem because of

guilt or shame. Parents and other family members will also often deny there's a problem until it has caused significant disruption. And even if the problem is noted before it causes damage, a family that waits until after the inheritance has occurred may find it difficult to prevent a negative outcome. So it's important to plan early.

Some ways to help prevent inheritor syndrome include appropriately designed trusts, the use of family charitable foundations, financial training and ongoing, age-appropriate education about the family business and managing the family funds.

Teaching younger children the value of money and saving can also be effective. Making certain heirs who will receive ownership have hands-on knowledge of all aspects of the business can reduce their feeling of being overwhelmed in the event they suddenly find themselves in control.

The sooner preparation begins, the more likely it will be effective, so it's best to start when the heirs are young. The good news is that raising responsible, knowledgeable and involved children will reap rewards not just in business, but in all areas of family life. – *Yvonne Aileen*

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