Business Forward

Issue Twenty Three

Putting a Value on Goodwill

If land, building and stock were all that mattered then valuing a business for selling would be a breeze.

Far from it. Lots of intangible assets are involved in the makeup of any business and working out the value of these is a mite trickier.

Traditionally these assets such as copyrights, intellectual property, business systems, good reputation, and loyal customers, are generally referred to as the 'goodwill' of a business, and are often considered to be where the real profit of a company lies.

The difficulty though is working out how much this goodwill is worth. Often the vendor's view will vary considerably from that of the potential purchaser. You need to get an objective opinion from your accountant (or someone experienced in business appraisals), at least two-three years before selling, to review all the material and prepare a valuation of the business.

Valuing those hours of toil

Many small business owners tend to assume the thousands of hours spent building up their business must equate to a certain value in the marketplace, but unfortunately this value is unrealistic in many cases.

The potential purchaser is not going to pay a price merely to recompense the previous owner for his or her sweat and toil. They will want to know the future maintainable earnings of the company, based on, for example, the business' market reputation, the customer base, the enthusiasm and training of staff and the business systems in place.

Those long hours will be rewarded, however, if the owner has been effective in developing excellent foundations, based on those critical, yet intangible assets.

Attending to business

The valuation may well highlight areas where more attention is needed to either improve the overall business performance, or simply to address any oversights. In both cases the goodwill factor, and therefore the value of the business, can be enhanced. For example:

- Is your business based on efficient systems and do you have a business system manual explaining every function of the business?
- Have you developed particular marketing strategies, based on the differences in your customer makeup and are these documented?
- Do you maintain a detailed customer database and keep in regular contact with customers?
- Have you followed the legal procedures for registering trade marks or documenting ownership of intellectual property?
- Have you properly documented any trade secrets, recipes, formulas or agreements with suppliers?
- Can you renegotiate for a longer lease on your premises?
- Have you developed key contacts in negotiations for potential export markets and have these been documented?

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The value of employees

In most small businesses there are usually a number of key employees who are essential to the effective operation of the business. The last thing you would want during sale negotiations is for one of these key employees to leave – it could have a devastating effect, in particular on determining the value of goodwill.

As the business owner you need to seek assurances from the prospective purchaser that key employees will be retained and then give those assurances to the people concerned.

No room on the balance sheet

Putting a value on employees continues to be a topic of hot debate among analysts. The puzzle is that while employees are considered by many to be a business' most crucial asset, there is still no room to equate their value on a company's balance sheet.

In fact, businesses are now starting to realise there are a whole lot of things that make their business valuable but traditional accounting methods simply don't provide a means of including them.

For example, a business with excellent leadership, motivated and skilled employees, high standards of professional development and so on, is likely to be much more valuable than a competitor business without these resources.

Putting a value on them is difficult and several books have been written on the subject. In their book *Intellectual Capital - the proven way to establish your company's real value by measuring its hidden brainpower*, Leif Edvinsson and Michael S. Malone make a case for the importance of these intangible business assets or 'intellectual capital', and suggest a means of capturing their value into a universal, intellectual Capital reporting standard.

For small businesses – whatever the outcome of formally valuing intellectual capital – the debate highlights the value placed on intangible assets. And while it's not easy to put a figure on those assets, you can be assured any potential purchaser will be weighing them up very carefully.

When the balance sheets of two companies look the same, the one with excellent leadership, highly trained, motivated staff, effective personal development programmes, good customer relations and sound business systems, will more than likely secure a higher sale price.

Next Steps – Increasing the Goodwill Factor

If you're thinking about selling your business, don't leave it until the last minute to plan the event. You need expert advice and plenty of time to get the business ready.

- Have the business valued – plant, equipment and stock are easily agreed on; less obvious are the intangible assets – the goodwill factor. Work with your accountant to draw up a list of these assets.
- Be realistic – your many years of hard grind may, in reality, add up to very little in terms of goodwill; more valuable will be your excellent planning, leadership, systemising and customer relations and the retention of highly trained, motivated employees.
- Ensure documentation is up-to-date – have you legally registered patents, trademarks and copyrights and do you have documentation to protect intellectual property?
- Demonstrate your future planning – potential buyers will want to know your plans for growth and the strategies in place to reach them. Business plans, performance indicators, marketing plans and an effective customer database are critical intangible assets.
- Get expert advice – don't overlook the importance of professional advice from your accountant.

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Be sure to read each article with the mindset "How this could apply to our business". Thinking of it that way will guarantee that you get value. Also make copies for each team member. To really make sure something positive happens; work with your business development specialists to talk your team through ideas.

Let the Team Know

One of the quandaries when negotiating to sell a business is whether to tell the staff.

If you don't, you run the risk of rumours creeping in, and then some of them, especially key employees, may decide to leave the business – an undesirable outcome for both the seller and the potential buyer.

In most cases, it's appropriate for the owner to tell staff the business is up for sale. Once the parties have an agreement that all staff will be retained in the ongoing business venture, then this information should be conveyed to the team.

A potential purchaser is unlikely to disrupt a slick operation if the business is successful and showing good growth, if all employees are making a positive contribution and the owner has put in place effective delegation.

Strategies for Marketing Success

There's a subtle difference between marketing and selling.

If you ask enough people to buy something, someone ultimately will – at the right price. That's selling. But by essentially 'flogging something off' you are not setting yourself up for long-term success – you're not offering any after sales service, continuity of product lines or product knowledge.

Marketing, on the other hand, forces the small business operator to read the market very carefully. It involves a whole range of activities – from producing products that meet people's needs; to making those products available; to telling potential customers about them.

Marketing is concerned with everything involved in the transfer of goods and services to your customer. It's about working smarter, not harder, as long as you put the right strategies in place. Your marketing plan will need to include strategies on how your business will:

Answer the customer's need

You need to be able to analyse customers' needs on an ongoing basis – what they want and why they would want your product or service. You have to be flexible to head in another direction if you perceive customers' needs have changed. Being successful is about answering the customer's needs.

Demonstrate benefits

It's been said that people never buy the product – they only buy the emotional benefit that comes from it. You need to keep in mind that you are selling the benefits of the product and not the features. It's really important then to identify what purchasing benefits the customer is looking for.

Promote your competitive advantage

What can you offer that none of your competitors do, even the bigger brands? Think of what will give your business a competitive edge.

Promote your business image

Name and image of your business are very important. It is imperative that when someone thinks of your industry, they think of you first. Market exposure is important; you have to be seen.

Keep focused on the goal

Develop a clear vision of where you want to be in your business and keep focused. Keep learning – about your customers' needs, your products, your industry. Never give up!

__An important Message__
While every effort has been made to provide valuable, useful information in this publication, this firm and any related suppliers or associated companies accept no responsibility or any form of liability from reliance upon or use of its contents. Any suggestions should be considered carefully within you own particular circumstances, as they are intended as general information only.

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Checklist for Company Directors

As a company director, your responsibility is to ensure the company runs smoothly.

Many duties can of course be delegated to management, but overall the buck stops with the directors. In order to fulfil your duties properly, there are a number of things you should expect to receive from management, as shown in the following checklist:

Monthly report – chief executive officer
This is an update on the financial situation, stock value, staff analysis, trade practices, environmental issues, competitor activity, new developments and any major activities coming up.

Monthly report – chief financial officer
This provides a full financial analysis, including comparison to annual budget, cash flow forecasts, claims against the company, and income tax commitments.

Management meeting minutes
The directors should review minutes of management meetings to keep themselves abreast of all aspects of the company's operations.

Six monthly review
A review of performance covering: staff evaluations, customer relationships and service, business plan implementation.

Annual reviews
Some matters, such as income tax and insurance reviews need to be attended to on an annual basis.

Internal control
Directors need to check the company has implemented appropriate internal controls, for example: handling of cash, capital expenditure, drawing and signing of cheques, employment and payment of staff, stock control system, travel arrangements.

Other departmentalised reports
Directors should ensure they receive reports from all key management employees each month.

Audit/Accounts committee
This would normally be a committee established by the board of directors.

Statement of how the company does business.
Every company should have a written system on how the company does business, which directors should have approved.

"The core of the so-called 'knowledge economy' is huge investment flows into human capital as well as information technology. And, stunningly, neither of these appear as positive values in traditional accounting."

"Intellectual Capital - the proven way to establish your company's real value by measuring its hidden brainpower".
Leif Edvinsson and Michael S. Malone.

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