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By Mark Kohn, CPA, CFE, CVA, ABV

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The issue of the superstar doctor, lawyer, actor, and similar professionals raises an important question with the excess earnings model. Under that model, you compare the actual earnings of the subject professional with what is considered reasonable compensation for that professional, and then, with some minor adjustments, capitalize the difference.

Reasonable compensation is what an investor would pay an employee to provide the same services as those being rendered by the subject professional.¹ In concept, the investor would hire a replacement professional, pay reasonable compensation, and then keep the excess earnings as the return on his or her investment.

This model works well in typical situations. Assume the subject is a 40-year-old internal medicine doctor who earns \$600,000 per year. The business appraiser calls up local hospitals and HMOs and looks at various databases and concludes, as an example, that reasonable compensation for such doctors is \$250,000. Simplifying the process,

Chart 1: Typical Goodwill Calculation

Actual compensation	\$600,000
Reasonable compensation	\$250,000
Excess (assumes minimal return on tangible assets)	\$350,000
Capitalization rate (hypothetical)	50%
Goodwill	\$700,000

one capitalizes the difference between \$600,000 and \$250,000 and that is the goodwill. (See Chart 1.)

Superstar Status

Let's say Doctor Primo, a world-renowned heart surgeon, earns \$10,000,000 per year. What is his reasonable compensation? If the investor wanted to replace Primo, what would he have to pay the replacement? Theoretically, since there would be very few such superstar surgeons, and since those few would probably all be earning ten million per year already, any replacement would cost the same ten million. Therefore, there would not be any goodwill, since the subject compensation and the replacement compensation would be the same. There would seem to be no difference to capitalize.

This leads to what seems to be a major anomaly. A doctor who earns \$600K would have significant goodwill, while a doctor earning \$10M would have none. This seems to be absurd, and it is for this reason that some feel that the excess earnings method is inherently defective.

While it is easy to use that anomaly to discredit the excess earning method, many courts have fully accepted the method. Alternative methods for valuing the goodwill of professionals, such as the capital asset pricing model, are completely inappropriate as a method of valuing small successful professional practices. In California, at least, one cannot use large publicly traded companies as the basis for valuing a very successful solo law or medical practice.²

(A recent appellate case in California³ has ruled that actors,

1. See "Reasonable Compensation in the Valuation of Professional Practices and Small Businesses," by Mark Kohn, *The Valuation Examiner*, NACVA, March/April 2004.
2. *In Re Marriage of Hewitson*, 142 Cal.App.3d 874.



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actresses, and producers do not have goodwill because they are not businesses, but doctors and lawyers do have goodwill.)

I believe that the excess earnings method, with its faults, remains a very useful tool in business valuations. One has to be aware of its limitations just as one has to be aware of the limitations of all of the other valuation models.

A Different Perspective

Consider goodwill from an incremental perspective. Most valuers would agree that that a heart surgeon who earns \$750,000 per year has goodwill. Once that is established, you would probably agree that a heart surgeon who earns \$760,000 per year has goodwill. Repeat this exercise 924 times, adding \$10,000 each time, and you would eventually have to agree that a heart surgeon who earns \$10,000,000 per year has goodwill. Further, the goodwill of a doctor who earns 10 million per year must be approximately twice that of a doctor earning \$5 million.

How can we reconcile that conclusion with the reasonable com-

pensation criteria, by which we concluded that in Dr. Primo's case there was no goodwill even though he earned \$10 million?

Resolution

To resolve this paradox, we must modify the definition of reasonable compensation. The excess earnings method demands that we define reasonable compensation as the salary that an investor would pay a very good doctor, even if the investor must replace a superstar doctor. (I define "very good professional" as a seasoned, similarly situated professional at a level somewhat above the 90th decile.)

Any amount in excess of the subject doctor's actual earnings, even a superstar's salary of \$10 million, is to be compared with the salary that one would pay to a very good doctor, which for discussion purposes will be \$400,000. Therefore, the goodwill of the \$10 million doctor will be approximately twice that of the \$5 million doctor because the excess of \$10 million over 400,000 is approximately twice the excess of \$5 million over \$400,000. (See Chart 2.)

Thus, the incremental thought process forces us to conclude that goodwill exists even for the superstar doctor. Once that is accepted, the same thought process will force us to conclude that reasonable compensation remains constant for all

analyses of doctors once the reasonable compensation number reaches the level of a very good doctor. Goodwill must necessarily rise as the income level soars, and therefore the number used as the comparative must necessarily remain constant. When calculating goodwill of the superstar, then, we compare the superstar's salary to a top-level professional's salary, not to another superstar.

The same logic applies to superstar lawyers and other professionals. One must compare the actual compensation with that of the reasonable compensation of the top-level professional, and not with the reasonable compensation of another superstar.

All of the above is based on the excess earnings method, as that method is used in Southern California. It may be that other jurisdictions have different conceptual approaches to the excess earnings method.

In summary, the excess earnings method remains theoretically valid, and with a proper calculation of reasonable compensation, one will arrive at goodwill for superstars that rises as their compensation rises. **VE**

Chart 2: Goodwill Calculation for the Typical vs. the Superstar

Actual compensation	\$600,000	\$5,000,000	\$10,000,000
Reasonable compensation	\$250,000	\$400,000	\$400,000
Excess	\$350,000	\$4,600,000	\$9,600,000
Capitalization rate (hypothetical)	50%	50%	50%
Goodwill	\$700,000	\$9,200,000	\$19,200,000

3. In Re Marriage of McTiernam & Dubrow (2005) 133 Cal.App. 4th 1090.