EXCESS EARNINGS, COMPETITIVE ADVANTAGE, AND GOODWILL VALUE

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ABSTRACT: GAINS EXCEDENTAIRES, AVANTAGES COMPETITIFS ET VALEUR DU FONDS DE COMMERCE

Le fonds de commerce est un actif incorporel qui représente un facteur de poids dans la détermination de la valeur d'une firme. Ayant une valeur économique, les conditions nécessaires pour établir l'existence d'un fonds de commerce sont discutées dans cet article. La valeur du fonds de commerce est une condition de la faculté d'adaptation de gestion dans l'établissement d'un avantage compétitif stable, produisant une performance de gains supérieure. L'implication de ces faits dans l'estimation, ou en cours de négociations sur la valeur de marché d'un fonds de commerce, fait l'objet d'une discussion dans le contexte d'une stratégie de gestion.

The question "How much is my business worth?" is as significant an issue for owners of small or closely-held businesses as it is for the management and shareholders of the largest corporations. The periodic determination of the value of a business is a sound financial management practice that provides management with a "report card" on the viability of the enterprise—it is a tool for evaluating the progress of the firm and the effectiveness of its competitive strategy. Yet the absence of organized markets for the sale or exchange of ownership interests in small or closely-held corporations makes the determination of the market value of such companies problematic, and the valuation process is no less complex for proprietorships and partnerships. Without a knowledge and understanding of those economic and competitive forces that create or dissipate the value of assets, small business owners may either underestimate or overestimate the worth of their businesses.

Earlier articles in this journal have focused on the methods and techniques of small business valuation, and a number of excellent texts provide more technical discussions of valuation methods appropriate for small or closely-held firms. Goodwill, an unidentifiable intangible asset, represents one
possible element of value in determining the full economic worth of a business enterprise. Revenue Ruling 59-60, which establishes the foundation and provides the guidelines for determining (or negotiating) the value of the closely-held business, clearly recognizes the possible existence of economic value attached to goodwill as a fundamental element of potential enterprise value. Goodwill may often be a sizable asset and, on occasion, it may represent the major part of the price paid for an enterprise. Nevertheless, goodwill does not automatically accrue to the owners of any business enterprise, and the fact that the business is a going concern is insufficient evidence to substantiate the presence of goodwill.

That intangible assets such as goodwill may have economic value is indisputable, but the source and the magnitude of that value are debatable and subject to negotiation. Such considerations can become focal points in the valuation and bargaining process preceding a transfer of ownership. Owners will be better able to increase enterprise value if they understand what goodwill is, and recognize how goodwill value is created or dissipated. To the extent that goodwill value can be created and sustained, the total value of the enterprise will be enhanced. Potential sellers improve their bargaining positions if they are able to convincingly demonstrate to potential buyers that goodwill exists as an intangible asset with real economic value. Potential buyers likewise improve their bargaining positions to the extent that they are able to recognize when goodwill is present, how it was created, and the likelihood that its economic benefits are sustainable and transferable.

Although goodwill can be one of the most valuable assets of any business enterprise, it is also one of the least understood. Like any other asset, its value may rise or fall, disappear or reappear, as business conditions change. For goodwill to have economic value, two elements are necessary: (1) the presence (or prospect) of excess earnings, and (2) a competitive advantage.

This article focuses on goodwill as one component of potential enterprise value from a nontechnical, strategic management perspective. Combining concepts of business strategy with recent case law, the elements of goodwill value are reviewed within a strategic management context to illustrate how such value is created, increased, or dissipated. Goodwill accrues to the firm as a result of a competitive advantage that yields superior performance in the form of above-average earnings. Implications for establishing or negotiating the value of goodwill as an intangible asset of the small business are derived from this strategic management perspective.

GOODWILL AND EXCESS EARNINGS

The term “goodwill” defies precise definition. Traditionally, goodwill has been associated with an established firm’s ability to attract and retain its clientele as a result of the firm’s reputation for service, reliable distribution, product quality, dependability, friendly management-labor relations, and/or its favorable location. Under conditions of “goodwill competition,” it connotes a stable, uncertainty-reducing, amicable market relationship between buyers and sellers. It is assumed that the presence of these intangible advantages allows the firm to be more profitable than it would be if earnings were

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4 Intangible assets lack physical substance but possess economic value. They may be identifiable or unidentifiable. Identifiable intangibles are usually represented by a legal title and may be separable from the business (e.g., copyrights, patents, licenses, and trademarks); unidentifiable intangibles cannot be specifically identified and are generally not separable from the enterprise. See Accounting Principles Board (APB) Opinion 17, “Intangible Assets.”


derived solely from the use of tangible assets.\textsuperscript{8}

In an effort to quantify the economic benefits of goodwill, attention is usually focused on the historical earnings of the firm, its current sustainable earning power, or its earnings potential. According to Revenue Ruling 59-60, "the presence of goodwill and its value . . . rests upon the excess of net earnings over and above a fair return on the net tangible assets."\textsuperscript{9} The excess earnings test has become the contemporary standard by which to judge the presence of goodwill.\textsuperscript{10} In other words, goodwill is evidenced by "excess" earnings (or, alternatively, "economic profits")—that is, a level of earnings that exceeds the reasonable rate of return on tangible assets that would induce entrepreneurs and other suppliers of capital to invest in ventures having a similar degree of risk (see figure 1). It is this profitability that allows the firm's owners to command a premium price for the business. The valuation of goodwill is based primarily on assumptions about the likelihood and magnitude of expected future (excess) earnings. Thus construed, goodwill is defined as "the differential ability of one business, in comparison with another or an assumed average firm, to make a profit."\textsuperscript{11}

**Earnings and Market Structure**

In the aggregate, "normal" earnings can be defined as that level of profit that is just high enough for firms already in an industry to continue to sustain investment in that industry, and a level just low enough to discourage firms not already in the industry from attempting to enter it. Normal earnings are just sufficient to pay entrepreneurs a return on their investment equal to the return they could earn from their best alternative investment opportunity with equivalent risk. At any given time, and in any given industry, some firms may either enjoy above-normal profits or suffer below-normal profits due to certain factors that may cause market disequilibrium in the short run (e.g., shifts in consumer demand, changes in availability of materials, or technological breakthroughs).

The existence of above-normal profits in the short run will induce entry in the long run; conversely, the existence of below-normal profits in the short run will induce exit in the long run. In the long run, therefore, when all factor inputs are variable, there is sufficient time for new firms to enter the industry and for existing firms to leave. As a result, only "normal" profits (i.e., the opportunity cost of capital) will be earned by the firms in the industry.

Economic theory suggests that this equilibrium condition exists whether markets are characterized by "perfect" competition (i.e., many sellers, undifferentiated products), or by "imperfect," or "monopolistic" competition (i.e., many sellers, differentiated products). As a result, excess earnings are difficult to sustain—they are an economic anomaly not consistent with long-run equilibrium conditions in these models of market structure.\textsuperscript{12}

**Competitive Strategy**

Competitive strategy is most often conceptualized within one of two theoretical economic frameworks—industrial organization economics and Chamberlinian economics—and normative theories of competitive strategy.

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\textsuperscript{8}D. R. Blaine, "Valuation of Goodwill and Going Concern Value," *Mergers & Acquisitions* (Spring 1979), pp. 4-11.


have developed to guide firms in achieving above-average returns on investment within these frameworks. The industrial organization paradigm stresses that return on investment is largely determined by industry structure. Superior financial performance is a function of the firm's ability to position itself favorably relative to its competitors in light of the competitive forces that determine the overall attractiveness (and average profitability) of the industry. The Chamberlinian paradigm emphasizes the impact on strategy of the unique assets, resources, and capabilities of individual firms. Superior performance is a function of the firm's ability to exploit these differential capabilities.

The essential strategic management challenge is to achieve and maintain above-normal earnings in the short run and to forestall indefinitely the tendency toward earnings equilibrium in the long run. In other words, a primary strategic objective of the firm under the most competitive conditions is the creation of goodwill. Without astute management intervention, however, excess earnings will be competed away and goodwill will cease to exist, thus depriving the firm's owners of the opportunity for increasing enterprise value. The firm can forestall this tendency toward earnings equilibrium to the extent that it possesses a competitive advantage vis-a-vis its rivals.

**Goodwill and Competitive Advantage**

Precedent in case law holds that the mere presence or prospect of excess earnings is not sufficient in and of itself to establish the existence of goodwill. The courts have determined that there must also be a reasonable and "transferable expectancy" of excess earnings that will survive a change

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*Figure 1*

_Earnings, Business Risk, and Goodwill_

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in the ownership of the business. The strategic source of excess earnings is now a necessary element in establishing goodwill and enterprise value.

**Case Examples**

In the case of Wilmot Fleming Engineering Co., for example, a partnership was dissolved and the two partners sold the assets of the partnership business to a corporation that continued the business. The Tax Court did not accord much significance to the partnership’s profitability; instead, a more crucial issue was the ability of the business to provide its purchaser with the expectancy of both continuing earning capacity and a competitive, advantage or continued patronage. While conceding that the partnership enjoyed a favorable business reputation, the Tax Court nevertheless noted that increased competition in the contract-bidding procedure by which the firm acquired its customers belied any “competitive preference” attached to the business. As a result, no part of the sales price was attributable to goodwill.

Similarly, in the case of Concord Control, Inc., the petitioner had acquired ownership of K-D Lamp Company several years earlier. At issue was whether the adjusted basis of the assets acquired was properly computed and the resolution of this issue rested upon whether or not goodwill was one of the assets acquired. The Tax Court ruled that the expectancy of both continuing excess earning capacity and competitive advantage or continued patronage was a precondition to the possession of transferable goodwill. It also noted that, at the time of the purchase, K-D Lamp was operating in a highly competitive industry characterized by little customer loyalty. In addition, K-D’s product line was almost identical to that of the competition, and K-D Lamp was especially vulnerable to the demands of its largest customer. As a result, the Court ruled that Concord Control had no reasonable expectation of continued customer patronage stemming from a competitive advantage, and therefore it had not acquired any goodwill in the purchase of K-D Lamp. In each of these opinions, the Tax Court recognized that excess earnings are not sustainable (or transferable) in the absence of some form of competitive advantage.

**Competitive Advantage**

A “competitive advantage” may be defined as the unique position a firm develops relative to its competitors as a result of the firm’s decisions regarding the product-market scope of its operations and its pattern of resource allocations. It is assumed that such a position will enable the firm to earn a high return on investment despite competitive pressures.

A competitive advantage that will yield superior performance requires: (1) a perception in the marketplace that consistent, significant, and valuable differences exist in a firm’s product/service offerings vis-a-vis the competition sufficient to enable the firm to instill buyer loyalty in a substantial customer base; (2) durable distinctive competencies that are not readily imitated; and (3) sustainability (see figure 2).
Competitive advantage ultimately depends upon the firm's ability to create stable market relationships with a loyal clientele of viable size that prefers the firm's products and services to those of its competition because of the perceived superior value of its product/service offerings. Superior value is created through the firm's ability (1) to achieve a competitive position whereby it offers standardized (i.e., undifferentiated) products of an acceptable delivered quality at the lowest delivered cost, or (2) to achieve a competitive position whereby it offers better or unique (i.e., differentiated) products and services at an acceptable delivered cost such that the perceived benefits more than offset the higher price usually attached to them. More generally, a competitive advantage is a matter of strategic positioning, and it is achieved through an organization's ability to defend itself against the competitive forces in its industry, or its ability to influence those forces in its favor.21

Competitive advantage is spawned from the firm's distinctive competencies. Exactly what constitutes a distinctive competence is open to interpretation, but it is generally agreed that a distinctive competence involves more than just the capabilities of the firm. Instead, the term represents the unique values, resource deployment patterns, specific knowledge and technologies, critical functional skills, and methods of operation that result in a differential ability to perform (or potentially per-

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Distinctive competencies are the building blocks of a competitive advantage when they are the keys to success in an industry or in a particular product-market segment. A recent study identified eleven distinctive competencies that may be present in small businesses.

**Sustainability of Competitive Advantage**

Sustainability is the ultimate test of competitive advantage, and it is a prerequisite for establishing the presence and value of goodwill. A sustainable competitive advantage exists when rival firms are not able to easily duplicate or imitate the distinctive competencies that are the sources of such an advantage. The ability of a firm to achieve a sustainable competitive advantage that yields above-average earnings (and thus creates goodwill) is a function of (1) the economic and competitive structure of the industry, which determines the long-term attractiveness and profitability of the industry; (2) the firm's choice of strategic direction as it attempts to position itself relative to its competitors; and (3) the durability of the capability gap (i.e., distinctive competence) between a firm and its rivals, and the significance of the barriers that make strategy imitation difficult.

To the extent that competitors are unable or unwilling to close the capability gap, the more sustainable is the competitive advantage. The sustainability of a competitive advantage based on cost leadership is enhanced if the sources of the cost advantage (e.g., scale efficiencies, proprietary learning and experience effects, and proprietary product or process technologies) are difficult to replicate. Superior profitability will accrue to the firm that is able to deliver acceptable levels of value to the customer without nullifying its cost advantage by having to charge a lower price than its competitors.

Similarly, the sustainability of a competitive advantage based on differentiation is enhanced if the product/service attributes retain their perceived value, if buyers incur high switching costs in seeking a new source of supply, or if the bases for differentiation are not easily imitated. Superior profitability accrues to the firm that is able to create perceived value that exceeds the cost of providing the unique benefits of the product or service. If a firm is to outperform the competition, a sustained competitive advantage rests on the ability to develop an outpacing strategy, whereby it has the capacity to switch its strategic emphasis between process cost reductions and perceived product value.

Because no competitive advantage is sustainable indefinitely, the investment risk associated with goodwill is substantial. This risk, and the economic value of goodwill, is inversely related to the sustainability and transferability of the competitive advantage that created the excess earnings. In assessing the level of business risk for the firm and the sustainability of any competitive advantage, management...
must focus on three related issues: (1) the separate and collective strength and impact of the competitive forces that determine industry attractiveness and profitability; (2) the strengths and weaknesses of the firm; and (3) the appropriateness and viability of the strategies employed by the firm in light of its resources and the competitive forces in its industry. In establishing the rate at which excess earnings will be capitalized, specific consideration must be given to the likelihood that the firm will be able to defend itself against the inevitable attempts by some rivals to close the capability gap by imitating the distinctive competencies, thus rendering any competitive advantage less meaningful, less valuable, or nonexistent.

GOODWILL VALUE AND GOING CONCERN VALUE

It might be argued that all businesses that are capable of surviving in a competitive economic environment possess some amount of goodwill. In the absence of actual (or potential) excess earnings resulting from a competitive advantage, however, any price premium paid for a business that exceeds the value of the firm's tangible assets reflects "going concern value" rather than goodwill.28 Going concern value, in contrast to goodwill value, represents the incremental value of the firm's assets that accrues as a result of the configuration of those assets into a productive operating system. Moreover, it represents the firm's ability to continue to generate uninterrupted revenues despite a change in ownership.29

From a prospective purchaser's point of view, going concern value reflects the avoidance of start-up costs, and the benefits of operating, marketing, and administrative efficiencies that may have developed through organizational learning and experience. All things being equal, an established business is likely to be more profitable than a newly formed enterprise.

The presence of going concern value does not necessarily imply the existence of excess earnings, but only a level of earnings that exceeds the earnings of firms new to the industry. Going concern value inheres in the presence of property, plant, equipment, and other productive assets that are configured into a system that is up-and-running. Goodwill, on the other hand, is associated with the incremental value created by the existence, continuation, or expectation of excess earnings over and above the normal rate of return for the industry as a whole. Going concern value is thus "savings"-oriented, and goodwill value is earnings-oriented.

IMPLICATIONS FOR ESTABLISHING ENTERPRISE VALUE

The value of a business reflects the owner's (or potential owner's) assumptions regarding the enterprise's power to earn and to generate future economic benefits. Differences in the assumptions, perceptions, anticipations, and tolerance for risk between potential buyers and sellers virtually guarantee that the investment value (and, hence, the fair market value) of any business enterprise will be very subjective. The value of a business, then, is an outcome of both direct valuation approaches and the bargaining process itself, including the relative strength of the bargaining positions of buyer and seller. As Helfert has noted, "value rests partly upon whatever reasonable and generally acceptable judgments can be made, but largely upon the personal attitudes, inclinations, and

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28VGS Corp., 68 T.C. 563 (1977); see also G. A. Baker, "Goodwill, Going Concern Become Harder to Avoid," Mergers & Acquisitions (Summer 1984), pp. 58-62; Blaine, "Valuation of Goodwill and Going Concern Value"; Paulsen, "Goodwill and Going Concern Value Reconsidered."

circumstances surrounding the negotiation."³⁰

Whatever investment value is associated with goodwill is derived from the expectation of continued future economic benefits accruing to the firm as a result of the competitive advantage that makes excess earnings possible. As an intangible asset, the very nature of goodwill virtually ensures that its value will be determined largely by the bargaining and negotiation process, which is itself influenced by the strength and persuasiveness of the facts, evidence, arguments, and assumptions that can be brought to bear by each party to the transaction.

Bargaining over the investment value of goodwill entails the two issues discussed earlier: (1) the existence of, or potential for, sustainable above-average profitability; and (2) the existence of, or potential for, a sustainable competitive advantage that gives rise to excess earnings. On one hand, the prospective seller will attempt to convince the prospective buyer that goodwill definitely exists, and has considerable economic value. On the other hand, the prospective buyer will attempt to demonstrate that goodwill does not exist as an asset with economic value, or if it does exist, that it has minimal economic and investment value. Inasmuch as goodwill is amortized but is nondeductible for income tax purposes, potential buyers surely will attempt to minimize the amount of purchased goodwill, favoring instead to allocate the purchase price to the tangible assets.

The burden of proof for showing that goodwill exists as an intangible asset with economic value rests with the current owner of the business. The seller must be prepared to document that the enterprise generates above-average profitability; failing this, the seller must be prepared to convincingly show why the firm has not earned above-average profits, but why it will be possible to do so in the near future. In addition, the seller must equate the current or prospective level of excess earnings with an identifiable and sustainable competitive advantage founded on one or more distinctive competencies. Failing this, any argument made in support of goodwill as an intangible asset with investment value is severely weakened, and the prospective buyer will immediately acquire a much stronger bargaining position on the goodwill issue. At this point, the enhanced enterprise value (if any) associated with intangible assets turns on the ability of the seller to establish the existence of "going concern value" by focusing on the investment "savings" to be realized by purchasing assets that are already bundled into a productive operating system.

CONCLUSION

In determining the worth of the firm, goodwill must not be overlooked as a potential source and component of enterprise value. The presence of goodwill having economic value is evidenced by the presence of a "competitive advantage" and "excess earnings" that are sustainable and transferable.

The preceding discussion suggests two important areas for further research on the relationship between excess earnings and sustainable competitive advantage in establishing the value of goodwill. First, indices of competitive advantage, sustainability, and transferability should be developed that can measure the firm's capacity to generate above-average earnings in light of the competitive dynamics of a given industry. Second, a goodwill valuation

model should be developed that links these indices to the level of excess earnings attributable to goodwill and the economic value of goodwill. The effect would be to more effectively operationalize the guidelines in Revenue Ruling 59-60 concerning the factors to be considered in selecting the appropriate capitalization rate for excess earnings.

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