

Goodwill Hunting

Goodwill is a well recognised concept in the accounting and legal spheres although there can be differences in application.

The legal view of goodwill is based around a notion of "the attractive force of custom." The accounting view is that it is the residual after deducting net identifiable and quantifiable tangible and intangible assets from fair market value of equity. In most circumstances these concepts will be the same. Despite this general agreement, actually determining the value of goodwill can be an uncertain and contested process.

Expert testimony given by Value Adviser Associates CEO Michael Churchill was accepted by Justice Barker in a case which provides greater clarity on future valuations of goodwill (Origin Energy Power Ltd and Commissioner of State Revenue [2007] WASAT 302).

The case arose because Origin Energy, as purchaser of the shares in the cogeneration plant, had challenged the finding of the Commissioner of State Revenue in Western Australia that it was liable to pay stamp duty on the transaction. Origin called experts from PwC and Deloitte to give evidence that goodwill represented the difference between the present value of the predicted earnings of the business and the fair value of the identifiable net assets. In this case, net assets represented the written down value of plant and equipment.

The issue in contention in the Origin matter was whether the difference between the purchase price of shares in a cogeneration plant in Western Australia and the plant's net asset value could be ascribed to the suite of contracts for the sale of electricity and steam from the plant or to goodwill.



Justice Barker of the Western Australian State Administrative Tribunal (WASAT) agreed with the testimony that **there was no goodwill in the transaction** and that the difference between the purchase price and the value of net tangible assets reflected the value inherent in a suite of contracts (which included power purchase agreements, lease, gas supply agreement and several key contractual arrangements between the cogeneration plant and refinery).

The valuation method adopted by PwC and Deloitte ascribed little value to the suite of long-term off-take contracts for the sale of electricity and steam from the cogeneration plant.

This became the main point of legal argument.

In response, Mr Churchill asserted the following:

- the business would not exist without the contracts and therefore the residual intangible value (over plant and equipment) lies in the contracts, and the business could not continue to operate without the contracts
- based on financial modelling of the cogeneration plant, the present value of cash flows equated to the price paid by Origin Energy for its share in the plant. He considered that these cash flows arose because the various legal contracts that allowed the cogeneration plant to operate and for the customers (the Worsley Alumina refinery and Western power) to purchase electricity and steam.
- based on this reasoning, the owners of the cogeneration plant would not have committed to building the plant and the refinery nor would they have expanded its production capacity without the contracts for the sale of electricity and steam.
- these contracts had value because they provided the necessary business conditions for building and operating the cogeneration plant.

To assist in the understanding the concept of goodwill, reference was made to a High Court decision in a case between the *Tax Office* and *Murry* in 1998. Here the Court provided a set of relevant principles concerning the existence of goodwill for legal purposes. In a majority decision, the High Court stated that, "For legal purposes, goodwill is the attractive force that brings in custom and adds to the value of the business".

Origin Energy argued that, in the context of the cogeneration plant, the existing supply contract are sources of goodwill to the extent they attract future custom to the business. However, it was successfully argued that the contracts did not attract custom but rather express the clear intention of the refinery's need for electricity and steam over the long term in a form that greatly limits commercial risk. In other words, without a contract there would not be a customer for electricity and steam nor a supply of gas.

In his judgement, Justice Barker was unequivocal in his statement that "in the particular factual circumstances presented to the Tribunal, the expert opinion expressed support the view that the legal notion of goodwill is not satisfied in this case".

Justice Barker concluded that after the cogeneration plant commenced business there was likely to be little, if any, goodwill generated because there was no opportunity for attracting custom since all electricity and steam from the cogeneration plant was contracted for.

While the jurisdiction of the WASAT is relatively limited, the judgement of Justice Barker will potentially provide clarity to the High Court ruling in *Murry*.

The *Murry* case considered whether a taxi licence was a source of goodwill and the Court determined that although it authorises the lawful conduct of business, the licence does not attract custom. Rather the value of the licence reflected the profits that could be earned conducting the taxi business, but that until the business began, there could be no goodwill.

Justice Barker extended this reasoning to the cogeneration plant. He concluded that the contracts are identifiable assets that existed before the cogeneration plant commenced operation and their value reflected the profits that could be earned.

Indeed, Origin Energy attached value to the contracts before the business even commenced by purchasing its share of the business.

Justice Barker noted that, as in the *Murry* case, until there was a business, there could be no goodwill and the supply contracts, which existed before the cogeneration business began, had value because they provided a very high level of comfort to the purchaser.

This judgement by Justice Barker makes clear the distinction between the accounting method for calculating goodwill and the legal notion of goodwill.

The latter is the correct approach to test whether goodwill exists in a transaction. In applying the legal definition, Justice Barker accepted the arguments of Value Adviser Associates' Michael Churchill that value can be ascribed to sales contracts where these contracts guarantee custom and this value should not be considered as goodwill.

Value Adviser Associates is a specialist, independent business and securities valuation practice with offices in Melbourne, Brisbane, Adelaide and operating in Tasmania.

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