Journal of Accountancy

Volume 32 | Issue 4 Article 2

10-1921

Some Considerations Involved in the Valuation of Goodwill

Herbert C. Feeman

Some Considerations Involved in the Valuation of Goodwill*

By HERBERT C. FREEMAN

So many definitions of goodwill have been given by the courts and by writers on economics and accounting that it appears to be almost as futile to attempt a new definition as to quote those already on record. The subject is, however, one of considerable interest and the opinion may be ventured, with all respect, that a new interpretation, let us say, rather than a definition, of the term is not untimely.

Stated as an asset in corporate banance-sheets, goodwill has been an object of grave concern to orthodox accountants since accountancy has been a profession. A natural repugnance to intangible, possibly ephemeral assets, combined with the feeling that the goodwill was inseparable from the business and, therefore, should not be stated as a distinct asset, led conservative men to take the position that the item of goodwill in a balance-sheet was an undesirable one. As well set a price upon the specific properties of a material, as distinguished from the value of the material itself, as place a value upon that which converted a mere schedule of property and debts into the balance-sheet of a going concern. To those whose economic creed remained sufficiently undisturbed by more modern thought, goodwill might almost as well be regarded as a liability as an asset, for it represented the inequality which would attract competition and thus in due course reduce the business to the inevitable dead level towards which was the trend of the reward of capital in all static communities. Viewed from this aspect, it was certainly an asset to be amortized as speedily as possible.

Nevertheless the hard facts persisted that business men were willing to give valuable consideration to acquire goodwill, that the courts recognized that goodwill had a specific and separate value although inseparable from the business to which it adhered and accountants were frequently and continually called upon to determine that value. In the series of industrial consolidations which took place during the period from 1860 on, the necessity for recognizing the variations between the proportions shown by the earning powers of the respective constituent businesses and

*A paper read at the annual meeting of the American Institute of Accountants, September 20, 1921.

those shown by the tangible assets contributed by them to the consolidation resulted, apart from any other actuating motive, in the establishment of valuations for goodwill, so-called, which appeared in the balance-sheets of the consolidated companies, in many cases merged with the values of other fixed assets.

Then followed the period of corporate promotions in which the manager-proprietor invited the investor-proprietor to take a participation in a business which he, the manager-proprietor or possibly his family for generations before him, had built up, on condition, however, that the goodwill value should be adequately recognized.

A formula for the determination of the value of goodwill, applicable to such cases, had been generally accepted and given legal sanction, but very considerable latitude remained in the application of the formula, and nothing approaching uniformity of practice had been developed. This fact, in conjunction with the almost complete discretion given to directors, acting in good faith, to determine the value to a company of any property acquired resulted in goodwill valuations being set up which in many instances exceeded in amount the entire value of the tangible assets of the company. In a few cases the directors acted upon the strength of specific appraisals of the goodwill made by accountants. In the majority of instances, however, accountants were not consulted as to the value of the goodwill, which was determined by the bankers and confirmed by the appraisal of a committee of independent appraisers, generally merchants of high standing, upon whose report the directors acted. The value thus established accordingly had due legal authority to support it, in the sense that the courts would not question the judgment of the directors and that the stock issued for the property, including goodwill, would be fully paid and the validity of its issue upheld. There was, at any rate, nothing in the procedure which could in any way mislead an investor or a speculator, and an accountant could certify to the accuracy of the balance-sheet without any misgivings as to the goodwill valuation. So many elements enter into the determination of market value that it is perhaps incorrect to say that the stock market passed judgment upon the basis of capitalization of goodwill in each particular case in establishing the price-level for the stock issued, in effect, against goodwill. In a broad sense, however, this statement is probably justified.

Accountants thus became accustomed to accept, at any rate without protest, goodwill valuations in the determination of which they may have had no part and the amounts of which they in all cases might not be prepared to defend. That this is the case is evident from a table given in a study of industrial flotations made from Johns Hopkins University by Kemper Simpson (*The Capitalization of Goodwill,* pp. 44-45) in which is shown the "probable percent earned on the common stock, after deducting preferred dividends from net profit," in the case of forty-six companies in which on the average the preferred stock represented seven-tenths of the tangible assets. In two cases the percentage is zero; in eleven cases it is five per cent. or less; in twenty-one cases it is between five and ten per cent.; in five cases it is between ten and twenty per cent.; in six cases it is between twenty and thirty per cent. and in one case it is over thirty per cent.—obviously too great a variation to be capable of substantiation by a uniform rule, uniformly applied.

It is to be feared that in the minds of many the item of goodwill in the balance-sheets of these companies was looked upon as merely a "balancing figure," of no particular significance, although understood to bear some relation to "earning power." The possibility that investors, small investors particularly, might be misled by the sale of certificates representing stock of so many dollars' par value, issued for a mixed aggregate of assets of which intangibles constituted a predominating or considerable part, did, indeed, lead to the passage of no-par-value stock laws in New York and several other states, it being one of the manifest intentions in the minds of the authors of these laws that stock of this character should be issued in the acquisition of property of which the value was so much a matter of arbitrary determination that no definite measure for it could be established. Whether this has been accomplished with any beneficial effect so far as the small investor is concerned does not enter into the present discussion.

It may be conceded, however, that the corporation which carried no valuation for goodwill in its balance-sheet was generally regarded as being conservatively capitalized, while the one in which goodwill was carried at any substantial value was frequently referred to as having "watered stock."

From this point of view, then, the revenue acts of 1917 and of 1918 penalized conservatism and put a premium on "watered stock," so-called, in permitting the inclusion of goodwill in invested capital, within certain limitations, not only in cases in which "payment has been bona fide made therefor specifically as such in cash or tangible property" (when indeed there could be very little question of its exclusion), but also in cases in which it had, prior to March 3, 1917, been also acquired by the issue of stock. The sections of the law (title I, sec. 207 of the law of 1917 and title III, sec. 326 of the law of 1918) are too well known to call for quotation here.

The principal limitation placed by the law upon the amount at which goodwill shall be included in invested capital is that it is not to exceed the actual cash value at the time of such purchase. Since in the vast majority of cases an independent cash offer for the goodwill at the date of purchase is not in evidence to substantiate the value at which it is sought to include the goodwill, the problem resolves itself into a valuation by formula or computation. The supplementary limitation placed by the law upon the value, viz: a maximum of twenty per cent. of the capital stock outstanding on March 3, 1917, in the act of 1917, and twenty-five per cent. (including other intangibles) under the act of 1918, might appear to render the determination of the actual cash value a matter of secondary importance, but the revision of tax returns for the year 1917 and subsequent years now in progress by the treasury department is being made on a basis which indicates that the proof of actual cash value is not to be regarded as any perfunctory matter. The point of view is somewhat changed. Most of the legal cases having to do with the valuation of goodwill arise from the desire of state governments to establish a value of goodwill in taxing the estates of decedents; now the federal authorities are interested in ameliorating the gross inequity arising from the failure of the law to permit any valuation of goodwill in cases in which no capital stock had been issued for it and, incidentally, in collecting taxes. Accountants on the other hand are taking a distinctly more liberal view of goodwill. One is strangely reminded of Pope's line concerning the "monster of so frightful mien" which "we first endure, then pity, then embrace." The embrace, however, must be given and received with due decorum. One must not permit a tax law or a series of tax laws to change him into a philanderer, even with intangibles! The question of the valuation of goodwill must be looked at from a strictly disinterested point of view, not with regard solely to taxes, and our reasoning on the subject must be as nearly abstract as the case will permit.

The time is opportune, however, to reconsider somewhat the nature of goodwill and to examine the basis or bases for its valuation.

The conception of goodwill has undoubtedly grown broader from time to time, the extension of the idea apparently following to some extent the increasing complexities of modern business, with the consequent application of the term to conditions of the most varied character. A tendency would appear to have developed to treat goodwill as synonymous with earning power to the extent that such earning power exceeds the ability to yield a certain arbitrary rate of income upon the tangible capital invested in a business. The development has taken place to some extent in a circle: the ordinarily accepted measure of the value of goodwill in its simple form was some multiple of the excess of the average profits over interest on capital and management remuneration; therefore excess earning power and goodwill were one and the same thing. The degree of fallacy involved in this method of approaching the subject has undoubtedly resulted not only in the valuation as goodwill of earning power arising from causes entirely unrelated to goodwill, but also in failure to recognize the existence of goodwill of undoubted value in cases in which, for one reason or another, the customary formula yielded no result. Before proceeding to discuss some matters of detail arising in connection with the valuation of goodwill according to the method generally accepted, the considerations particularly involved in some of these special cases will be mentioned. It will be seen that the same questions arise, though they are generally disregarded, in almost every case of valuation.

Let us first refer to certain of the definitions of goodwill which have been accepted as authoritative. Lord Eldon said in the earliest case recorded dealing with goodwill—*Crutwell v. Lye* (1810. Ves. 335): "The goodwill which has been the subject of sale is nothing more than the probability that the old customers will resort to the old place." Lord Cranworth said in *Austin v. Boys* (1858, 27 L. J. Ch. 714): "When a trade is established in a particular place, the goodwill of that trade means nothing more than the sum of money which any person would be willing to give for the chance of being able to keep the trade connected with the place where it has been carried on." Lord Justice Lindley said in *The Commissioners of Inland Revenue v. Muller, Lim.* (1901, A. C. 217): "Goodwill regarded as property has no meaning except in connection with some trade, business or calling. In that connection I understand the word to include whatever adds value to a business by reason of situation, name and reputation, connection, introduction to old customers, and agreed absence from competition, or any of these things, and there may be others which do not occur to me."

Mr. Justice Story says "goodwill may be properly enough described to be the advantage or benefit which is acquired by an establishment beyond the mere value of the capital, stock, funds or property employed therein, in consequence of the general public patronage and encouragement which it receives from constant or habitual customers, on account of its local position or common celebrity, or reputation for skill or affluence, or punctuality, or from other accidental circumstances or necessities, or even from ancient partialities or prejudices." (Story, *Partnership*, 7th ed., p. 99.)

Lord Eldon's definition, taken as a somewhat colloquial expression—and it seems to some extent to have been so intended—covers the ground as effectively as any of the others. All the legal definitions indicate very clearly that the thought in the mind of the court was the essential identity of goodwill with reputation, commercial standing, location and all other favorable conditions leading customers to deal with a business. There appears, however, to be only the authority of custom to bridge the gap between the definition and the almost invariable acceptance by the court of the rule that the value of the goodwill is measured by some multiple of the excess of the average annual profits for a term of years past over interest on the average capital employed during that period and management remuneration. In a retail business of a simple character this rule, it is true, may be an entirely acceptable one, but the least departure in the nature of the business from stereotyped form involves immediately the possibility either that what is being valued is something other than that covered by the definition or that the rule of valuation is being extended to cover cases to which it does not apply, except with such reservations as practically to call for a new rule.

It appears to be illogical, in the first place, to value the trade connections of a business, not in terms of volume of business or number of customers, more particularly not in terms of the growth of these factors over a period of years, but, instead, on the basis of a net resulting profit from the business, to the production of which a number of circumstances may have contributed which have no direct bearing upon the continued enjoyment of public patronage or trade connections.

Let the case be considered of two stores in a town, located in equally favorable positions, enjoying approximately equal advantages and handling substantially the same amount of business at the same rate of profit. Let it be assumed that the management of one of these stores decides upon a definite policy of building up trade by various means which involve for the time being increased expense or reduced gross profits, and that the other store is satisfied to make the same profit upon its old volume of business. The two stores might, over a series of years, continue to earn the same amount of profit as before, and yet it could hardly be contended that the business which had attracted more customers and built up its volume of trade had not measurably increased its goodwill over that of the more conservative store. The objection may be made that in order to hold the increased volume of trade the more progressive business must continue to operate at the restricted percentage of net profit and that accordingly its goodwill, though admittedly greater in terms of the legal definition, has no greater value than that of the other business. This, however, is theoretical and not consistent with general experience. The net profit of the growing business will tend eventually to outstrip that of the other. A more valid objection might be that a part of the expenses of the growing business should not be charged against income for determination of goodwill. Under the conditions assumed the increased expense or loss of revenue would probably not be represented by any specific item or even group of items, and this objection is in reality a recognition of the weakness of the accepted formula.

On the other hand, it is a well-known fact that although the profits of retail establishments at any rate did not diminish during the war period, the increased amount of business on which these profits were earned represented a smaller number of transactions with an actual loss in number of customers. It is a notorious fact that a real and effective "buyers' strike" set in in 1920 directed mainly against the retail stores. Without in any way going into the merits of the case, it will surely be admitted that the goodwills of retail businesses generally were never weaker than at the close of a period when, measured according to the conventional method, they would have shown the highest valuations.

In certain specific trades, the value of goodwill is based entirely on volume of business—in the case of saloons (chiefly under English practice) upon the volume of purchases and in the case of dairies upon the volume of sales. It may be a factor in these cases, first, that the volume is much more definitely determinable than any other element and, second, that given a certain volume, the normal profits can practically be computed by anyone familiar with the business. These instances are rather exceptions to the general rule. It is my opinion, that the value of goodwill is rather to be based upon the capitalized value of the normal net profit per unit sold, computed on the number of units sold during the last fiscal period, increased or decreased in the proportion which the number of units sold during the last period bears to the average for, say, the last five periods, or which the average for, say, the last three periods bears to the average for the last five or seven periods. This suggestion is put forward somewhat tentatively and perhaps to some extent as a basis for discussion. It is submitted, nevertheless, to serve as an indication of some measure of value which corresponds more accurately to the particular subject of valuation, unless goodwill is frankly to be identified with capitalized value of excess earnings based upon past performances. Unless some formula constructed broadly upon the lines indicated, or with the same object in view, is adopted, it is difficult to see what can be the validity of any valuation of goodwill determined, for example, upon the basis of results shown by the trading of the past five years.

It is recognized that the formula suggested in itself raises points of difficulty. The determination of the proper unit may in certain cases present an obstacle, but very few businesses are operated without the development of statistical data based upon units of quantity, measurement or activity and these will readily lend themselves to the purpose in view.

As to what constitutes the normal net profit per unit some difference of opinion may exist. The figure to be used is intended to represent the profit per unit in excess of interest on capital and management remuneration, under normal conditions, that is to say, with prices neither inflated nor over-deflated and with properly balanced costs. This profit may be greater or less than the actual average during the period used to determine quantities, depending upon any abnormal conditions existing in the trade or in the particular business, or upon contemplated changes in the conduct of the business, but as far as possible the element of conjecture or estimate should be eliminated and actual results used.

In arriving at both profit per unit, amount of capital upon which to charge interest and rate of interest to be charged, various points will present themselves for consideration. It is hoped that the comments which follow upon these points will be of interest, apart from the suggestions made with regard to the necessity for a revision in the orthodox formula, as bearing upon the determination of the figures required for the purposes of that formula.

First with regard to the profits upon the basis of which the value of goodwill is to be computed, it is obvious that profits or losses of an extraneous character must be excluded in arriving at the base. Extraordinary profits upon the resale of raw material or, in the case of a retail establishment, upon the sale of merchandise in bulk must be excluded. As to whether losses of a similar character should similarly be excluded depends upon the circumstances in each case, it being necessary to determine what relation the original purchase bore to the regular trading account of the business and the conditions which demanded that a sale be made.

The results of discontinued divisions of the business should be excluded but in doing this it is important to see to what extent the fixed charges and expenses of the business were absorbed by a distribution which threw any part of them against the portion of the business which requires to be disregarded, and to decide how far it may be necessary to reintroduce these expenses into the charges against the remaining departments.

The necessity for the valuation of goodwill frequently arises in cases of reorganizations in which the values of assets other than goodwill are being restated. Leases formerly not carried at any value may be valued and set up; fixed property may be reappraised; mineral rights or timber lands may be increased from a nominal or low valuation to one based upon surveys of the property and estimates by engineers of its value; property formerly leased may be acquired in fee; and changes of various kinds either in actual conditions or in statement of values subject to depreciation or amortization may be made. In arriving at the profits upon the basis of which the goodwill valuation is to be determined, cognizance must be taken of all such charges and charges made for depreciation, amortization, depletion of minerals and timber and for rentals and other items based upon the new values and conditions rather than the old, since it is under these conditions that the income of the business will in future be determined.

In the case of proprietary articles, where advertising is an important element of selling expense, it will frequently be found that much more intensive advertising is done in certain years than in others. An advertising campaign on a large scale is entered upon in one year or season with the object of giving the business great momentum. The expenditures for the succeeding year or two are on a more moderate scale and then before the momentum is lost a new campaign is undertaken. This method has undoubtedly lost favor during the past few years when equalization of profits from year to year has been so desirable from the taxpayer's point of view, but where it is found to have been followed it is important that complete cycles of years from the point of view of advertising appropriation should be taken in the statement of profits for goodwill purposes.

The question of the effect upon profits of shrinkage in merchandise values is one which presents some difficulty in considering profits for goodwill valuation, and the unprecedented extent to which this element enters into the accounts of practically every business during the past year and that now current will render it particularly necessary to decide whether or not it shall be ignored. In the valuation of goodwill for the capitalization or sale of a business, the problem would probably be dismissed, perhaps properly, by treating the years 1920 and 1921 as entirely abnormal and excluding them from the basis of the calculation. In doing this, however, it will be necessary to consider whether or not the preceding years were not years of such exceptional profit as to render them almost equally unreliable for the measurement of goodwill value.

Cognizance should unquestionably be taken of ordinary fluctuations in merchandise values. They represent conditions which are inseparable from business operation and if goodwill is to be measured by excess earning power, they must be taken into account. When it is remembered that the reduction in inventory value at the end of a period seldom if ever reflects the total shrinkage in value, some part of which is of necessity absorbed in the loss of gross profit on current transactions and, further, that appreciations in value, while never taken in inventorying merchandise, are nevertheless just as certainly absorbed in current transactions, it is evident that no justification exists for disregarding reductions in inventory values.

The question of what is to be done with regard to the years 1920 and 1921, however, cannot altogether be dismissed. Goodwill will require to be valued as an asset of decedents in many estates falling in in 1921 and the years immediately following. The state is hardly likely to be willing to treat the profits of the war years as abnormal; and since the invariable practice in valuing goodwill in the surrogate's court appears to be to capitalize excess earning power (a method which in this class of cases, particularly, appears to present the possibility of injustice, since the skill of the decedent may have contributed to the result to a proportion not to be measured by an allowance for salary) it appears only equitable that the exceptional hazards should be set against the exceptional gains.

In determining the amount of capital upon which an initial return is to be computed and charged against profits before ascertaining the basis for goodwill valuation, adjustments must necessarily be made corresponding to those made in the amount of profits or in arriving at the profit per unit as indicated earlier in this paper; that is to say, the value of assets subject to depreciation, depletion, rental, etc., must be brought into harmony with the conditions which will obtain in the situation for the purposes of which the goodwill is being valued.

The assets should be carefully scrutinized for any items of a character extraneous to the business. If a reserve fund is carried invested in gilt-edged securities, the return on which is lower than the rate of initial return which might reasonably be charged on capital invested, it is proper to exclude both principal and income from the bases of calculation. It is obvious, however, that as to investments or assets, even of an extraneous character, which yield an income substantially equal to a commercial return on capital, no purpose is served by eliminating them and the income upon them.

In considering generally the question of unproductive assets and of assets from which the income is negligible or which may even represent a dead expense, much caution must be exercised before it is decided to eliminate them. The ownership of such properties may indirectly contribute to the profits from the active part of the business. Interest may never be paid on the bonds of a country club owned by an hotel, but the country club facilities may be very strong factors in bringing patronage to the hotel. A theatre used for vaudeville or "legitimate" drama in a chain of motion-picture houses may be an unprofitable venture, but its ownership may prevent its use by other proprietors for motion-picture purposes in competition with one of the profitable houses in the chain. Instances of this kind can be multiplied, and similar conditions affecting manufacturing and trading concerns will frequently be met.

On the other hand, the question of treatment of investment in and expenses of carrying excess facilities for manufacturing or other purposes will in many instances need to be considered. A chemical company, let us say, constructs a plant for the manufacture of some product of the nature of a proprietary article in which it has previously built up a business. A reasonable estimate can be made of the increased volume of business which can be attained in, say, five years and the company is advised to construct a building and put in underground tanks and pumping system, together with certain other portions of the required equipment, adequate to handle the expanding volume, leaving only a part of the machinery and appliances to be added to from time to time as the volume increases. The cost of insurance, maintenance and general overhead of the temporarily unused facilities is clearly not a charge against profits for the determination of goodwill, nor is interest on the excess capital invested to be deducted therefrom. Even assuming that the valuation of the goodwill is required for the purposes of a sale and that the facilities are at the time of the sale still in excess of the requirements of the business, the goodwill valuation should proceed upon the basis of the facilities actually employed from time to time and the purchaser should make a reserve against the combined appraised value of the property and goodwill sufficient to cover the carrying charges on the excess facilities up to the estimated date of their employment in the business.

Having determined the profits of the business and the amount of the tangible investment, the question of the rate of initial return to be allowed on the investment must be considered. The proper rate would appear to be the normal rate at which capital could be secured, representing the whole of the net tangible assets, at the date as of which the goodwill is to be valued. This will depend largely upon the ratio of the earnings to the assets, the nature of the business and the character of the assets. It is well recognized that there are certain limits within which capital can be raised by the sale of bonds, and certain other limits within which preferred stock can be sold and so on. These limits naturally vary very considerably at different times, depending upon the condition of the money market and of the investment market. If at a given time, for example, capital can be obtained for an industrial by the issue of a 7% preferred stock to the full amount of the tangible assets, provided the dividend has over a series of years been earned, on the average, at least four times, then seven per cent. would be a proper rate to charge on the tangible assets, upon the valuation of goodwill as of that time, where this condition as to earnings was met. If under other money-market conditions a five per cent. bond could have been sold to an amount equal to, say, forty per cent. of the tangible assets with a six per cent. preferred stock for a further forty per cent. and a common stock on which it was expected to pay ten per cent. issued for the balance of the tangible assets and the goodwill, provided certain ratios of earnings to interest charges and dividends could be shown, then six and one-half per cent., approximately, would be a proper rate to use. The significant point is, that the conditions to be observed are those ruling at the date as of which the goodwill is being valued and not those existing at the time of any subsequent review of the valuation. This point is of special importance in connection with the valuation of goodwill as invested capital under the tax laws of 1917 and 1918. It must also be kept in view that the rate to be used must be one which is applicable to the entire amount of the tangible assets at the risk of the business. The legal rate of interest and the rate ruling on loans, even unsecured loans, is not necessarily any criterion. It is interesting to note, however, that in a number of decisions in the New York courts, the rate of six per cent. appears to have been adopted without question. On the other hand, the treasury department (*Bulletin* 10-20-777, A. R. M.

34) appears to consider ten per cent. a proper rate, which may be reduced to eight or nine per cent. in stable business—this without particular reference to the date as of which the valuation is to be made or the extent of the margin of safety as measured by the ratio of earnings to the required interest on capital. Apart from any other consideration, the actual facts attendant upon the capitalization of goodwill must be recognized, and if a preferred stock at a fixed rate of dividend was sold to third parties to an amount equal or substantially equal to the tangible assets, as happened in a great many cases, the rate of return on such preferred stock should govern.

In the absence of any such conclusive evidence, the nature of the assets as well as the ratio of the earnings to the tangible assets must be taken into account. For example, an investor would provide capital equal to the total tangible assets of a mercantile business at a lower rate if a substantial part of the capital were represented by a loft building, readily available for rental to other tenants, than if the entire tangible assets consisted of merchandise, accounts receivable and fixtures. The same would be true of a chain-store business in which a substantial part of the assets consisted of store properties located in various cities throughout the country. In other words, the freedom of any substantial part of the capital from the hazards of the particular business would tend to attract capital at a lower average rate. A combination of a tannery with a shoe manufacturing plant, of a throwing plant with a silk-weaving mill, of a foundry with a machine shop are examples of cases in which the more ready adaptability of a part of the assets to general uses will tend to reduce the rate at which capital could be obtained for the more specialized business.

There remains to be considered the percentage at which goodwill should be capitalized, or, using the general expression, the number of years' purchase to be paid for the goodwill. This is by far the most debatable point in connection with the matter of goodwill valuation, and the one as to which the greatest exercise of judgment is required. The problem has been somewhat complicated by the thought which has undoubtedly existed in the minds of accountants, that goodwill was an asset which had to be amortized, and the values set upon it have accordingly been fixed with the purpose of providing out of income for a proper return on the capital value and for the writing off of this latter item. One writer on the subject even holds that if five years' purchase of goodwill is paid, the goodwill should be written off in five years. This obviously provides for no return on the investment in goodwill during this period. That this is fallacious is manifest from the fact that, other things being equal, the older the business the more stable is the goodwill value, although on the amortization hypothesis the goodwill should have disappeared in such a business, and only a business which had just reached maturity would have a goodwill, the value of which would in turn tend to disappear. It is true that mortality among businesses is by no means a negligible factor, but probably as many failures and reorganizations are due to the inadequacy of capital to handle the volume of business springing from an increasing goodwill as are due to the disappearance of goodwill.

An important distinction to be considered in the valuation of goodwill is that between what may be called institutional goodwill and goodwill which attaches solely to a particular product. Heinz, for example, could as easily sell one hundred and fifty-seven varieties as fifty-seven, and the goodwill would attach to them all. If the human race ever achieves the unhappy state of absorbing nutriment in tabloid form, Heinz will undoubtedly supply us with tabloids. On the other hand, the goodwill which attaches to the well advertised brand of "Danderine" does not in any way attach to the equally well advertised brand of "Cascarets" which is a product of the same company, and neither of these brands helps or is helped by Bayer's "Aspirin," more recently acquired by the company. The goodwill of the proprietors of these branded goods cannot be said to be institutional. If we progress to the point where the race becomes independent of these remedies, the goodwill attaching to them cannot be transferred to some product more appropriate to our requirements in that era. We have seen the goodwill of the name "Studebaker" survive the passing of the spring vehicle and even the sale of the farm wagon business and continue with a value many times increased as an institutional goodwill. These are by no means isolated cases but can be taken as representing a condition. It may, therefore, be accepted as a principle that the value of an institutional goodwill is worth a greater number of years' purchase than a goodwill based on brands or trademarks.

The goodwill of a business which is country-wide should be valued upon the basis of a greater number of years' purchase than that of a more localized business. The goodwill of a chain-store business, spread over a large number of cities, should be measured by a larger multiple than that of a single store or even of a chain of stores in one large city. The goodwill of a mail-order business, dealing with customers direct in all parts of the country, upon a basis which necessarily implies particular confidence on the part of the customer should similarly be measured by a reasonably large multiple. The goodwill of a single theatre, except where it has somewhat of a neighborhood or institutional character, may be small. "The play's the thing!" But as one of a circuit or chain of amusement houses it may have a more permanent value.

In the case of any business, manufacturing or trading, it may perhaps be said that the following factors, in addition to those already mentioned, all tend to produce a goodwill of a relatively high number of years' purchase: (a) a wide distribution of product in proportion to the volume; (b) a wide diversity of products sold under one institutional or trade name; (c) a business in staple lines in general demand by the public, as distinguished from one in specialties of limited use.

Unless the effect upon the term of years' purchase of goodwill of the respective conditions of increasing, stationary or decreasing volume is expressed by some modification of the usual formula on the lines suggested in this paper, it will be apparent that it must be dealt with as an independent factor. It would appear to be beyond question that the goodwill of a business showing a steady increase in volume and profits is worth a greater number of years' purchase on an average of past profits than one showing more uniform volume and profit and, a fortiori, than one showing a declining volume and profit.

Particular consideration must be given to the possible effect of legislation or tariff upon the future of a business. Other things being equal, a business which is little dependent on tariff protection will have a goodwill value measured by a greater number of years' purchase than one which is more likely to be adversely affected by changes in tariff rates. The danger of a business being prohibited by law is one which would reduce the goodwill value possibly to a negligible amount. It would be impolitic in these days even to suggest any businesses which might be so affected!

A condition arising from a development almost within the present generation, in the form of business organizations, has to be taken into account in fixing the number of years' purchase of goodwill, viz: that the more general adoption of the corporate form, the vast increase in the number of corporations of which the securities are distributed among a relatively large number of stock-holders, and the increase in the number of trained experts available for the management of properties, all tend towards greater possibilities in the perpetuation of enterprises and the establishment of permanent goodwill. It is also necessary to recognize the fact that investments in goodwill, recognized and frankly expressed as such, are more sought after under existing conditions than under the conditions which obtained when many of the legal and accounting precedents by which we have been governed were established. An increase in demand is reflected in general by an increase in price.

While the courts do not seem for the most part to have approved valuations based on more than five years' purchase, the court, on the second appeal of *Von Au v. Magenheimer* (126 App. Div. 257) held it not to be an error to refuse to charge that in estimating goodwill by the net profits the number of years cannot exceed five, and in that case, in which the goodwill of a number of candy stores was involved, the multiple used was six years' purchase. In valuing the goodwill of Tiffany & Co., the court approved a multiple of ten years' purchase (*Matter of Moore,* 97 New York 238). This case was decided as recently as 1916, and represents probably the maximum valuation which has been approved by the courts.

The number of years' purchase which can be applied to businesses of various classes is not a matter upon which it is possible to dogmatize. No classification by kinds of business is possible, and each case, it would appear, must be considered on its merits. In view of the conditions to which reference has been made, however, it is felt that the approximate maximum of five years set by most writers on the subject is no longer justified. The extension of this multiple to eight years or even in extreme cases to ten years is fully justified, having in view the stability and apparent permanence of goodwill values established under modern business conditions by many industrial corporations dealing on a national or an international scale in commodities of a staple character.

It will be recognized, it is hoped, that this paper attempts to deal with only one phase of the subject of goodwill and even as to that phase is intended chiefly to stimulate discussion of the subject. A very comprehensive and useful textbook on the general subject of goodwill will be found in *Goodwill and its Treatment in Accounts,* by Dicksee and Tillyard, though certain opinions expressed in this paper will be found to be somewhat at variance with these authors. The article on goodwill by Mr. Sidney S. Dawson in *Lisle's Encyclopaedia of Accounting* will also be found very interesting, and many of the standard textbooks on general accounting deal with the subject of the treatment of goodwill in accounts in a manner which renders unnecessary any reference to this aspect of the matter in a paper of this kind.