Journal of Accountancy

Volume 64 | Issue 1 Article 5

7-1937

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Recommended Citation
Preinreich, Gabriel A. D. (1937) "Goodwill in Accountancy," *Journal of Accountancy*: Vol. 64: Iss. 1, Article 5.
Available at: https://egrove.olemiss.edu/jofa/vol64/iss1/5

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Goodwill in Accountancy

By Gabriel A. D. Preinreich

Definitions of Goodwill

As may be expected, accountants are interested chiefly in the value aspect of goodwill. Nevertheless, a few definitions appear to have been inspired at least in part by Lord Eldon and other nineteenth-century jurists. Thus it has been said that "goodwill is the monetary value placed upon the connection and reputation of a mercantile or manufacturing concern and discounts the value of the turnover of a business in consequence of the probabilities of the old customers continuing" (Lisle). It "may be taken as the typical form of immaterial assets . . . representing . . . the value of business connections, the value of the probability that present customers will continue to buy in spite of the allurements of competing dealers" (Hatfield). Other definitions describe it as "the value of the benefits or advantages which attach to a particular business, in addition to the actual value of the property used in its conduct" (Bentley) and as "the momentum acquired by a going business" (Couchman).

However, "unless a present or prospective future earning power or capacity larger than that of a newly established competing concern goes along with these elements, no one would be willing to pay anything for the goodwill of the old concern. Dormant or latent goodwill signifies the excess earning power that would exist, if it were not for poor management. The probability of the continuance of this advantage is the basic element in the valuation of goodwill" (Kester). "To have a sales value, goodwill should represent a substantial earning power in excess of ordinary interest on capital and the management salaries combined. The plea of bad management is overworked. Goodwill never attaches to a business which is not believed to possess possibilities of being made profitable" (Montgomery).

Several other writers emphasize the dependence upon excess profits. Goodwill is "the capacity to earn greater than ordinary profits" (Cole), "the profit-producing power of an established business beyond mere interest and replacement return" (Conyngton), "the capitalization of a differential profit which a par-

ticular enterprise enjoys" (Paton and Stevenson), or "the capitalized value of earnings in excess of a normal return" (Stone).

The basic thought underlying all these definitions is well expressed by Leake:

"Goodwill in its commercial sense is the present value of the right to receive expected future super-profits; the term 'super-profits' meaning the amount by which future revenue, increase or advantage to be received is expected to exceed any and all expenditure incidental to its production." That is the economic value-concept of goodwill.

Preliminary Steps in Valuation

The first point to remember in valuing goodwill is that the problem is concerned with the future, not with the past. It is necessary to look forward, not backward, because goodwill depends on future probabilities. But past events must usually be taken as a guide (Leake). However, "recorded earnings are notoriously unreliable and of varying significance, depending upon the circumstances of their determination" (Paton). Therefore, "the idea is to adjust the profits in such a way that an accurate figure is arrived at, which would have been the profit made for several years prior to the date of sale under such circumstances as will exist after the date of the sale" (Anonymous 1).

The translation of the record of the past into an estimate of the earning power of the future is achieved by paying attention to such factors as are enumerated by Stockwell: (1) Gross and net profits as compared with similar concerns, (2) trend of development, (3) future prospects, (4) operating expenses, (5) plant location, (6) labor conditions, (7) change of management, (8) are sales derived from articles sold under trade marks, brands, patents, copyrights, licenses or royalty contracts? or (9) has the name been associated with special quality? Browne lists the following additional points: (10) Tenure of premises and whether success depends on them, (11) future competition, (12) whether the business is steady or dependent upon a craze or fashion and (13) whether the earnings are due to the services of especially valuable employees.

In general, then, the preliminary analysis of earnings will be concerned with operating efficiency, the transferability and prob-

able duration of earning power and with opportunities for developing new sources of profit. With respect to transferability, Dicksee emphasizes the vendor's possible attitudes, while Kester and Freeman differentiate between patronage attached to the house, firm or institution and that adhering directly to the product. Relatively permanent earning power may be expected in case of a wide distribution in proportion to volume, when many different products are sold under a single trade name or if the business is in staple lines as distinguished from specialties (Freeman).

Taxation is also worth mention. "Some accountants contend that in ascertaining annual profits, income tax should not be treated as an expense of the business, while others are of a contrary opinion" (Dawson). Apparently "the value of the enterprise as a producer of taxes is not subject to purchase and hence may be ignored" (Paton). Since, however, "the purchaser takes on the burden of taxes" (Leake), he must carefully weigh the possibility that they may be increased. The act of "ignoring" taxes will therefore take the form of an appropriate adjustment of the estimated future earnings. The capitalization of future taxes against the vendor is a phenomenon observed already by John Stuart Mill.

"The next step is a critical appraisal of all the tangible assets of the enterprise, as they stand at the time that the value of the enterprise as a whole is being determined" (Paton). This step is necessary, because book values compiled in a balance-sheet do not, in general, reflect valuations from the viewpoint of a prospective buyer who has to take into consideration certain physical factors, such as "(1) The condition of the properties, (2) their ability to produce economically and effectively from a competitive standpoint, and (3) various engineering questions, such as whether the plant is designed so as to facilitate future enlargements, the modernness of apparatus and appliances and their adaptability to changes in technical processes" (Broad).

"The assets should be carefully scrutinized for items extraneous to the business" (Freeman). That is to say, unproductive assets (e.g., excess working capital) and groups productive in independent directions should be segregated to permit separate bargaining for each group on the basis of earnings similarly segregated. A number of writers mention the necessity of eliminating non-recurrent profits and go into more or less detail

concerning the procedure to be followed in specific circumstances cited by them (Cox, Dawson, Freeman, Kester, Kohler, Stone).

Methods of Valuation

The two principal methods employed by the courts have been described elsewhere in some detail,[1] so that only corresponding samples of thought on the part of accountants will be summarized.

The first of the two principal methods of valuation—that of averaging the entire net profits of several years and multiplying the result by a number of years which is "suitable and proper" [2] —is the only method mentioned by Dawson and De Zouche, and Cropper. The former suggest four years' purchase and the latter from one to three years for a professional business and two to five years for a trading concern. Several other textbook writers cite both the first method and the second or excess-profits method without discussing their respective merits. In this group, Cox's example of the first method uses a multiplier of three years, Bliss, and Curtis and Cooper use four years and Bell and Graham five years or more. Esquerré, Finney and Kester refer merely to a "certain" number of years. Walton and Finney hold that the first method is not so logical as the second, and Kohler correctly points out that the first should be used only when the capital invested has not been a material income-producing factor. Dicksee and Leake expound the same principle in greater detail.

The discussion of the excess-profits method (both by those who mention it as an alternative and those who do not refer to the first method at all) is marked by secondary differences of opinion. To avoid misunderstanding, the word "capitalize" will here be used only in the sense of dividing excess profits by the chosen rate of return. This means finding the value of a perpetuity at that rate. The process of computing the present value of a finite annuity will be referred to as "discounting."

Day expresses his conviction that "the most accepted method of computing the amount of goodwill is to take the total profits for the last five years and deduct from them five years' interest on the capitalization at 7 per cent. The balance is goodwill."

[1] Cf. Gabriel A. D. Preinreich: "The Law of Goodwill," *Accounting Review*, December, 1936. Pp. 327–29.

[2] *Ibid.*

Curtis and Cooper deduct 6 per cent. on capital and multiply one year's excess by six. Bell and Graham use 8 per cent. and five years in the same way.

Cole, Cox and Wildman subtract 6 per cent. interest on the invested capital from the net profits and capitalize the remainder at the same rate. Hatfield uses 8 per cent. in this manner and also points out that to capitalize at a given rate is equivalent to multiplying by the reciprocal number of years (i.e., 12½ years in his example or 16⅔ years in the former two).

A different group favors higher rates for capitalizing excess profits than for computing the normal return on the capital invested. For instance, Couchman considers 8 per cent. a fair return and capitalizes the excess at 15 per cent. Bliss uses 10 per cent. and 15 per cent., Eggleston 10 per cent. and 20 per cent., while Kohler suggests ranges of 6 to 10 per cent. and 10 to 20 per cent., respectively. Kester and Montgomery quote the method followed in appraising the stocks of the Press Publishing Co. (New York *World*) and the St. Louis *Post-Dispatch*, held by the Pulitzer estate. After various adjustments of net earnings, 6 per cent. interest on investment was deducted and the excess capitalized at 10 per cent. for both stocks. Walton and Bentley favor similar methods.

Finney mentions the capitalization of annual excess profits (i.e., their division by a rate) as one method and their multiplication by a number of years as another method. Esquerré confines himself to remarking cautiously that the rates used to capitalize excess profits are "said to vary between 5 per cent. and 50 per cent., but are . . . in reality connected in some way with a certain number of years' purchase of the excess itself." And Wildman clearly overlooks the reciprocal relationship between rates and years when he says that "as a means of valuing goodwill, this method . . . of capitalizing excess profits without regard to interest by what is known as the year's purchase method . . . seems fundamentally wrong."

A correct suggestion by Wildman is that the annuity of excess profits be discounted at the money rate. That is an alternative method, which is followed by Rorem, who uses 6 per cent. both as a normal return on capital and for discounting an annuity of five years' excess profits. Basset proceeds similarly, except that he prefers 7 per cent. and ten years.

A quotation from Paton may serve to clarify the basic principle:

"If the duration of the top layer of earnings is very conservatively estimated, it might be held that the investment in such earnings is no less secure than the investment in the layer matching the tangible assets and that the same rate of return may therefore be assumed in both cases. On the other hand, there is something to be said for the view that excess earnings are always more perilously situated than normal incomes and that a double dose of conservatism is desirable in estimating amounts which may reasonably be invested in prospective earnings of this type. From this standpoint the application of a substantially higher rate in the process of discounting the top layer is justified."

There is little theoretical merit in thus burning the candle at both ends. The question revolves around the risk, which may be expressed either in terms of years as a horizon of foresight or by adding an insurance premium to the money rate, but preferably not in both ways at the same time. The method of weighting the money rate for risk has been widely adopted, because it is well suited to the valuation of contractual obligations, to which the scope of the mathematical theory of investment has been well-nigh limited in the past. When the various considerations surrounding the goodwill of common stocks are approached, this two-in-one tool of analysis is not flexible enough. The mathematical analysis of goodwill as a probability is facilitated by divorcing the risk from the money rate and setting it up separately in terms of a future period. For this purpose, therefore, the horizon method is preferable to the capitalization method, although the latter is equally sound in theory, whether applied in the form of a weighted money rate, or in that of the reciprocal number of years.

The Treatment of Goodwill in Accounts

A great majority of accountants endorse the principle that goodwill ought to be recorded in accounts only if and only to the extent that it was paid for. Among those who are not content with making an unsupported statement to this effect, not all succeed in giving adequate reasons:

"Goodwill does not crystallize until a sale takes place and all attempts at intermediate valuation are idle. Indeed the only

excuse for the insertion of such an item as goodwill in accounts is that such an amount has actually been paid by the present proprietor of the goodwill of the business" (Dicksee). "Unless goodwill has been purchased from a predecessor, it should not be regarded as a live factor on the company's books" (Koehler). "The reason for this is that the purchaser has demonstrated his belief in the existence of goodwill by paying cash for it" (Gilman). "Accounting practice prudently, though perhaps illogically, forbids the firm which created goodwill to place in the balance-sheet any value on the clientele which it has built up and which it could at any moment sell for a large sum. This conservative restriction is doubtless necessary to prevent a harmful exaggeration" (Hatfield).

These comments do not touch the kernel of the matter, which can be laid bare only by examining what Hatfield considers illogical. The thought is expressed by Greendlinger thus: "If there are two similar companies and one has changed hands, there is no reason why one balance-sheet should state goodwill and the other not." To this it is not enough to reply that "the effect would be to forestall the future" (Leake). The essential thing is that the respective owners of the similar companies are not in the same position. Although the net business profits of both are the same, one has invested a greater sum of money than the other, and that is what their balance-sheets should show. By comparison with the earning records, the basic fact is disclosed that a dollar invested in one business is less productive than a dollar invested in the other. "The actual rate of return is the significant fact for the proprietor. He wishes to know just what the capital fund in his possession is yielding and if the rate is reduced to a nominal level by the capitalization of a part of the income, the actual situation is covered up" (Paton and Stevenson). "To register on the books a capitalization based on earning capacity is not only to register an unnecessary figure, but to bury the actual cost of the assets" (Cole).

It is well known, of course, that many a business man desires to cover up the situation and bury the actual costs. "The ratio of return to nominal capital might be abnormally high. For business reasons it might be to his advantage to increase his capital in accordance with the goodwill acquired and thus decrease the rate of return on the investment. In the same manner

a corporation might find it advantageous to reduce the apparent return on its capital stock by setting up goodwill and distributing the surplus arising therefrom by a stock dividend" (Wildman).

So long as such an asset remains offset on the credit side by a correctly described appraisal surplus, the situation is at least fully disclosed, but the eradication of the record by means of a stock dividend is most objectionable.

Couchman outlines the method of recording the purchase price of a business in part as follows: (1) The purchaser of a group of mixed assets may distribute that sum to the assets acquired without regard to the value at which they were carried on the books of the seller, and (2) if the aggregate purchase price exceeds the proper value of the other assets acquired, the difference may be recorded upon the books of the purchasing company as goodwill. But ". . . it must be borne in mind that in many cases the value decided upon for goodwill represents simply the difference between the book value of the business sold and the price paid for it, which may be the result of a compromise between bid and asked prices having little relation to any theoretical methods of computing goodwill" (Bliss). "In ordinary American practice, the accountants have assumed the existence of goodwill whenever the tangible property purchased is less than the par value of the stock issued therefor" (Hatfield).

"Because of the very widespread habit of overcapitalizing . . . a goodwill account is used very commonly to carry . . . the contra of watered stock, which is overcapitalization. Thus it is the difference between the property value of the issued stock . . . and the par value of that stock" (Bentley). As long as business reasons continue to be stronger than theory, this form of disclosure is welcome, because "it is manifestly better bookkeeping to show overcapitalization as goodwill than to bury it in such an asset as 'plant' or in some other tangible fixed asset" (Bentley). But "American corporations have very generally not set forth goodwill as a distinct item in the balance-sheet" (Hatfield), at least not in statements accessible to the general public.

The path of least resistance out of this conflict between theory and practice is to hold that "the treatment of intangible fixed investments in actual business is very largely determined by the company's financial policies rather than by accounting theory. The creation of goodwill . . . etc. . . . are questions that are

settled by the financial management and not by the application of some standard accounting principle. . . . Accounting procedure can only accept the situation as it exists" (Bliss). "So long as the item is separately stated, it is scarcely desirable that he (the auditor) should interfere with the discretion of the management" (Dicksee).

The importance of the goodwill account is often minimized on the ground that "the amount is absolutely meaningless, except as an indication of what the goodwill may have cost in the first instance" (Dicksee). The original cost, however, is too significant to be dismissed in this manner, even though it is perfectly true that "such statement is not intended to convey any guarantee that its present worth is fairly represented by the amount at which it appears" (Cropper). "The profit-and-loss record is the best evidence of it—that should guide us as to its valuation and not the value carried on the balance-sheet" (Kester), because "so far as fixed assets are concerned, a balance-sheet does not pretend to be an index of value. What it does purport to do is to record actual expenditure not hitherto charged against profits" (Anonymous 2).

The Amortization of Goodwill

On the subject of writing off goodwill—whether described as depreciation, amortization or extinguishment—Hatfield has attempted to point out two opposing camps: "Among accountants favoring the writing off of goodwill are Bell, Leake, Pixley, Webner and Wildman, while Cole, Couchman, Dicksee, Finney and Montgomery hold that it is unnecessary or even improper." Actually, this classification is neither comprehensive nor accurate enough. Most writers who, at first sight, seem definitely opposed to amortization, can conceive of reasons why goodwill ought to be written down after all. Many remarks are either of the cautious "yes and no" or the neutrally aloof and non-participating "some say yes, some say no" variety. Other authors go on record with equal emphasis on both sides of the question, but there are also not a few who are convinced that some plan of amortization is necessary.

The negative side is stressed in the following excerpts:

"If a business purchases the goodwill of another business, obviously the charge is a perfectly legitimate one and it should be carried as a permanent asset not subject to depreciation or

extinguishment" (Bentley). "It is such an elusive asset that it is not subject to wear and tear and the principles of depreciation certainly cannot be applied to it as to other items" (Montgomery). "When the transfer of goodwill involves an asset actually recorded on the books of the vendor . . . there has been an actual purchase of goodwill and there is no reason why it should be amortized. Goodwill of this nature has nothing to do with earning power. There appears to be no sane reason why organic goodwill, having been built up slowly, painfully and at great cost, should be put to death through the process of amortization" (Esquerré).

"Goodwill represents property to which the owner possesses a tenure in perpetuity and unless the nature of the business is such that the value of the goodwill must of necessity become reduced as time goes on, no depreciation can be said to take place" (Anonymous 3). "Ordinarily it need not be depreciated, especially if the organization makes reasonable efforts to maintain its good name among its customers. However, there are organizations which have apparently depended upon a good name previously created, rather than upon present success. In such cases goodwill is doomed to an early extinction" (Couchman). "If the special advantages purchased are permanent, the asset goodwill evidently need not be depreciated. Peculiar efficiency and monopolistic advantages, however, are seldom permanent factors and hence the problem of depreciation arises in most cases. When the advantages purchased disappear, goodwill should be written down" (Paton and Stevenson).

The main bulwark of opposition is the celebrated paradox which has been quoted and paraphrased by almost every writer on goodwill for the last fifty years. Couchman puts it with slogan-like brevity: "If you can write it down, you need not; if you cannot, you should." In other words, "the existence of earnings sufficient to write it off justifies its retention" (Montgomery), because "as long as the earnings of an enterprise equal those contemplated at the date of purchase, one cannot well say that there has been any depreciation in its value or that any provision for such depreciation need be made" (Bennett). "When profits are small, it would hardly be logical to write off any amount less than its decreased value, yet the profits at such a time are hardly sufficient to stand so heroic a treatment" (Kester). The answer to the paradox may be summarized as follows:

"It is sometimes loosely said that if the profits of a business are well maintained, the value of the goodwill cannot diminish. That is not necessarily always the case, because the value of goodwill at any time depends upon future prospects, and these may be deteriorating, even while profits are maintained. Supposing, however, that the value of the now-existing goodwill is not less than the value of the goodwill which existed at the date of purchase, yet it is equally necessary gradually to write off the cost of the earlier existing goodwill, because part of this cost has expired" (Leake). Purchased goodwill is a "portion of the business income which . . . has been prepaid to the vendor . . . [and] . . . does not represent physical assets available for the redemption of common stock in case of dissolution. That the intangible equity of the common stock should be replaced in due course by a tangible equity is a principle of finance and business economics" (Esquerré). "Eventually dividends will be paid out of capital, if the goodwill is not depreciated" (Yang).

Another argument against the amortization of goodwill is that "if written off, a secret reserve might be created; therefore no objection can be offered to its retention at cost" (Montgomery). "What is really effected by the process is to create a reserve fund without stating it as such—or in other words a secret reserve" (Dicksee). But "the dropping of goodwill from the balance-sheet is no secret, since any one can see that it is not there. The difference between charging off a building and charging off goodwill is that a business does not necessarily have to own a building and its absence from the accounts would imply that it did not own one" (Walton). That is to say, every business must have goodwill attached to it in an amount which may be positive, zero or negative, depending upon future prospects.

"Accountants of the more conservative school recommend that goodwill be depreciated over a term of years" (Cox), although many hold that "nothing need be done, unless the concern is desirous of being very conservative" (Bell and Powelson). "Depreciation does not occur in goodwill . . . [but] . . . writing off goodwill is a conservative practice" (Bliss). "Goodwill purchased is a permanent asset, not subject to depreciation or extinguishment . . . [but] . . . prosperous firms in many cases will write off this asset on account of its questionable actual value" (Bennett). "There is usually no logical reason for writing it off. [Nevertheless] the best course for all purposes is to retain

goodwill in the accounts at a nominal amount . . ." (Kester). "The original cost is rarely written down and should be stated in the balance-sheet at cost. . . . however, the directors may wisely decide to enhance the financial strength of the undertaking by reducing the book value of the goodwill" (Cropper).

In such circumstances some accountants are of the opinion that the same end can be more advantageously attained by creating a reserve fund (Cropper). "Goodwill does not depreciate, but rather improves with old age so long as the profits are maintained and to my mind the best course is in most cases to allow the goodwill to stand in the balance-sheet at cost and to gradually set aside out of profits a special reserve, until such reserve shall equal the cost of the goodwill" (Dawson). "Patents, goodwill and franchises are very much akin to one another. . . . Provided that the principle is admitted of building up a substantial reserve fund against whatever portion of the capital is invested in this class of assets, it would seem reasonable to merge the three items into one and treat them as part of the permanent invested capital of the business, which may be left to continue at its original value, as long as the business is a going concern" (Dickinson). Dicksee remarks that "the chances are that they will find it rather embarrassing to disclose this cost price at a subsequent date and thus there is a very powerful argument in favor of the amount standing to the debit of goodwill being written off with all convenient speed." Guthrie prefers a reserve fund, but agrees with Dicksee that the depreciation of goodwill should be left to the management.

A minor question is whether or not the amortization of goodwill ought to be charged against profits. It is said that "goodwill should be charged off, not against current profits, but against the capital invested" (Gilman); ". . . the amounts written off are not in any sense charges against revenue, but should take the form of appropriations of profits" (Cropper); ". . . anything which is credited to the goodwill account must be a premium set aside out of profits and not a charge against profits" (Dawson).

The merit of these statements hinges entirely upon whether it is desirable for the owner to earmark certain investments of business funds as personal and private items. The essential fact is that the purchaser "has prepaid income which he will actually receive during a series of years, but which will not constitute his

own earnings. As soon as the periods of earnings covered by the goodwill have expired, the new investor will enjoy the totality of the business income. In the meantime he will have periodically and proportionately amortized the debit account which recorded the prepayment of what both parties to the contract . . . have understood to be the vendor's earnings" (Esquerré). In general, it is simpler for the owner to hold that—along with plant and other fixed assets—"goodwill has been paid for in advance on revenue account, for the purpose of enabling the gross revenue to be earned, in which process all these things waste and are inevitably, though perhaps slowly, destroyed" (Leake). "When payment is made on the probability of excess earnings, the purchaser has paid a price for the tools of business operation. Hence the depreciation of intangible assets should constitute a charge against . . . operations" (Yang).

As to the method of amortization, Gilman believes that "the number of years' profits which have been purchased determines the number of years over which the goodwill shall be charged off." But "it is unfair to deprive the management of income for that period, when goodwill was acquired for the benefit of a greatly extended time" (Guthrie) and the suggestion is accordingly made of doubling the period, i.e., charging off only half-a-year's purchase annually. Wildman recommends that goodwill be written off "on the basis of life according to the most conservative estimate." A more specific suggestion is that "the cost may be written off over a period of from five to ten years" (Bell and Powelson). And Day is perhaps too definite when he says that "goodwill should be written off the books during five subsequent years by charging off one-fifth against each succeeding year."

"In calculating the amount to be depreciated, the method of computing an annuity is sometimes employed" (Cox). "Strict logic requires, at least where the price of goodwill is calculated as representing the present value of a series of excess annual profits, that it should be written off as any terminable annuity" (Hatfield). In other words, goodwill should be treated like a bond premium (Gilman and Walton). It follows that, when goodwill is computed by the years' purchase (of excess profits) method, "the purchaser has in fact bought the right to an expected annuity for a longer term of future years, although he may have

measured the value of this right as being equal to the amount of the profits for the last three or five years" (Leake). A valuation made by the years' purchase method must, therefore, be converted into the corresponding annuity, in order to determine the amounts chargeable against each succeeding year's profits. In addition "the judgment of the purchaser at the time of purchase must be deemed correct" (Yang), although that is an assumption altogether contrary to practical experience.

Changes in conditions subsequent to the date of purchase are considered in the suggestion that "goodwill paid for . . . should be amortized as the super-profits are realized" (Roth). This may mean either that the entire excess profits of succeeding years be credited to goodwill until it is extinguished, or a more flexible method of annual appropriations recommended by many of the older writers.

Created Goodwill

"Expenditures which are made by a corporation before it can begin business, are usually classified as organization expenses and . . . are properly treated as capital expenditures" (Eggleston). On the other hand "it is a fallacy to assume that . . . incorporation expenses, etc., have any of the attributes of an asset; and so the sooner the cost appears in the expense account, the better" (Montgomery). "In strict theory, the value of these costs will last as long as the corporate existence" (Kester). And since such expenditures have been incurred for the purpose of making profits which could not have been obtained in another manner, there appears to be little reason for insisting that organization expense differs in essence from purchased goodwill.

"Where it is clearly foreseen that the new undertaking must necessarily be run at a loss before it can be built up into a profit-making concern, such initial loss may be treated as the cost incurred in establishing the goodwill of the undertaking" (Dicksee). "There does not seem to be a valid objection to the charging of the operating shortcomings of what might be called the 'probation period' of a newly established business to an account which would record the cost of obtaining the goodwill of the community" (Esquerré). "Such expenses are charged to some such account as 'establishment outlay' . . . until the developed or expanded business reaches a point where the expense of ob-

taining new business can be paid out of the profits" (Stockwell). "A person buying an established business would be willing to pay for the capitalized values of the sums by which the actual earnings of a new business would fall short of the normal earnings of a developed business" (Yang).

"Whenever, however, expenditure upon advertising is capitalized, it is important to bear in mind that a business established by advertising will ordinarily require advertising for its maintenance" (Dicksee). "A distinction is made between what may be considered a normal value of advertising necessary to maintain a given volume of trade and the presumably greater amount of advertising necessary to increase the amount of sales, especially that necessary to establish a market for a new product" (Hatfield). "No capitalization of advertising costs should be passed by the accountant, unless the increased asset value is unquestionable or unless any other treatment would work an injustice to anyone or present unfair records of operating results of various accounting periods" (Couchman). When this principle is neglected "the balance-sheet showing the large deficit and the later balance-sheet showing the increased profit are both false" (Montgomery).

In general, "an auditor may pass the carrying forward of any legitimate expenditure which has been incurred solely for the benefit of future business, provided that in his judgment the setting up of a deferred charge and its consequent inclusion as an asset are justified by its probable value to the future business" (Montgomery). But the future periods benefited by deferred charges vary in length according to the nature of the charge. An analysis and classification of expenditures during the developmental period is therefore preferable to an indiscriminate capitalization of initial losses.

"The justification for this capitalizing of deficits is greater in the case of public utilities than in ordinary commercial enterprises" (Hatfield). The reason is that a public utility is entitled to a stated fair return, so that deficits, whether developmental in character or not, partake of the nature of accounts receivable from consumers. Reimbursement out of subsequent profits in excess of the allowable rate of return is therefore proper, although permanent capitalization is not.

As a rule, accountants are inclined to be quite strict in auditing deferred charges. "More than one enterprise has been wrecked by the failure to look preliminary or establishment expenses squarely in the face. The temptation to state the current operations in such a way as to show a profit was too strong; so those concerns have gone along from year to year, the burden increasing instead of diminishing, until the inevitable day of reckoning, when it was realized that liabilities cannot be liquidated with capitalized expenses. If the business is not successful, there will be no future profits to which the deferred items can be charged. Therefore the auditor should use every argument he can muster to induce his client to absorb these expenses as soon as possible" (Montgomery). This attitude is proper, but it should be remembered that the arguments are fully as applicable to that goodwill which the same auditors often accept as permanent. An admittedly genuine investment in goodwill and the various forms of deferred charges differ only in degree, not in kind, and therefore the only moot question is the rate or manner of extinguishment, not its necessity.

Reorganizations

In most accounting textbooks the elementary partnership problems form an important part of the discussion on goodwill. The typical procedure is to begin with the sole proprietor A, who takes unto himself a partner B. Later the two together admit C. One of the three then dies and his estate has to be liquidated, or else he merely retires and sells his interest to D. In all these situations, Dicksee proceeds systematically by first setting up the entire goodwill which the business is deemed to possess, as determined by a bargain concluded for a portion of it. The change in ownership is then recorded and the goodwill written off again in the ratio in which profits and losses are to be shared thereafter. The method of settling privately for the goodwill is also considered, it being pointed out that the resultant differences in the final capital accounts are offset by the payments which have not passed through the books.

Other accountants treat the subject in the same way, except that they are generally opposed to the total elimination of goodwill. The objections which have been raised against that procedure are discussed by Yang, whose observations may be sum-

marized as follows: (1) The question is whether or not the present owners have actually incurred business costs. Failure to recognize such costs would occasion an understatement of assets and an overstatement of revenue during the existence of the proprietors. (2) If the degree of change in ownership is not substantial, it might be improper to conclude, from the value of a part, the value of the whole goodwill. (3) The proportionate recognition of the entire goodwill would imply an accruing of future income, the depreciation on which would convert a portion of real earnings into capital. (4) If, however, goodwill is not recognized proportionately, the new partner would have to make an individual calculation to apportion his share of the profits between real earnings and what to him is but capital returned. (5) There is a natural inclination on the part of business men to increase the value of their assets, when there is a chance to do so. Dicksee himself admits that "it is in many cases perhaps expedient that the value of the retiring partner's share should be stated in the accounts as an asset, so as to avoid disturbing the amounts standing to the credit of the continuing partners. But it seems clearly desirable that such an item should, if possible, be got rid of at once."

If the expenditure of business funds has resulted in the acquisition of goodwill, the cost must evidently be absorbed prior to the date of liquidation, in order that the owners' investments be recoverable in full. The amortization of written-up goodwill is a form of saving which leads to liquidating values in excess of the original investment. If that be the purpose, it can be accomplished by simpler means. As for the new partner, to whom the goodwill represents actual cost, he is merely the ancestor, in point of evolution, of the investor who buys common stock in the market and is obliged, as a matter of course, to keep his own records. All elementary partnership problems, indeed, are valuable chiefly because they present simple analogies to corporate complications and often furnish the guiding thread through a maze of technicalities.

The natural inclination of business men toward inflated valuations is never more apparent than upon incorporation, when the legal theory of the separate entity provides the welcome excuse. Accordingly goodwill usually receives liberal recognition, even though no actual change of ownership has taken place and, there-

fore, no need for valuation has arisen. Accountants are usually confronted with a fait accompli in this respect.

In the case of consolidations, the situation is more complicated, because the earning power of the enterprises to be united must be considered when apportioning the stock of the new company. The general approach has been indicated; in many instances the valuation methods preferred by the various authors have been taken from illustrative consolidation or merger problems presented by them. The final steps are: (1) issuance of stock for the appraised value of the so-called tangible fixed assets plus the audited value of current assets; (2) deduction of an agreed rate of normal return from the audited and adjusted net profits; (3) capitalization or discounting of the excess profits to determine their fair present value; and (4) allocation of a second block of stock in proportion to the goodwill so computed. When two classes of stock are used, it is customary to issue preferred stock for assets and common stock for goodwill.

Dicksee and Leake strongly oppose capitalization of goodwill and suggest various remedies. Shares without par value have been in use for some time. When preferred stock is issued for assets, common stock without par value is entitled to all excess profits without the necessity of stating goodwill on the balance-sheet. The alternative plan consists of letting "the shares be issued at such a premium as would amount to the price to be paid to the vendor of the goodwill" (Dicksee). That would be sound theory, well adapted to take deception out of cash transactions, but it is poor sales-psychology and therefore unworkable. Leake also proposes redeemable shares, in order to amortize the goodwill in conformity with its original valuation, while Dicksee would state goodwill on the balance-sheet only if it could not possibly be omitted, and then only in a form making it clear that it was only discount on stock, after all.

Trading on the Equity

"Some authorities contend that it is better to use the average total assets—rather than the average tangible assets, less liabilities—employed in the business, as a basis for applying the interest element. It is claimed . . . that the variable factor of 'trading on the equity' is thereby eliminated and that a more nearly accurate valuation of the real goodwill is obtained" (Montgomery).

In so far as this comment refers to current liabilities, it may be observed that the custom of granting cash discounts for prompt payment makes it expensive to trade on the equity by holding up bills. The practice is therefore resorted to only by those who are in financial difficulties. Before computing the value of such businesses it will be more logical to determine the normal volume of current liabilities as a preliminary step in valuation. No enterprise can operate without having some current liabilities and therefore the "real goodwill" cannot be ascertained by starting with an assumption contrary to fact. For valuation purposes, current liabilities should be offset against current assets, with or without adjustment, as indicated by the circumstances.

"Corporations sometimes issue bonds because . . . a larger return is made on the funds thus borrowed than the interest rate paid. This is called 'trading on the equity'" (Kester). But "The value of the enterprise as a whole . . . is not affected by the nature of the sources of the funds supplied, by the form of capitalization. . . . There are two main possibilities, . . . on the one hand, earning power may be expressed in terms of the final amount after all charges accruing to the residual proprietary interest, and . . . on the other hand earning power may be stated from the managerial, all-capital point of view" (Paton).

Even when purchase means no more than the acquisition of a majority of the common stock, the prospective purchaser of an enterprise will look upon it from the all-capital point of view in the sense that he has his own ideas on the subject of trading on the equity. He is less interested in what the common stock is paying under the present capital structure than in what he can make it pay. And that depends primarily on what the business as a whole is paying. The record of the past must again be translated into an estimate of future prospects before computing the goodwill of the common stock in the usual manner from those estimates.

An extreme form of trading on the equity is the promotion of reorganizations and consolidations by selling to the public a full line of assorted securities in a new company. By using the proceeds to buy one or more enterprises previously secured through options and reserving the majority of the voting stock for themselves, promoters have in the past reaped handsome cash profits, in addition to retaining control over what they have sold.

The Goodwill of Holding Companies

"Goodwill may be defined as the purchase price of the control of excess earning power. Minority holdings in intercompany stock do not give rise to goodwill" (Newlove). That is, not on the consolidated balance-sheet. "The positive goodwill calculated . . . meets three requirements. A purchase has been made, the control element exists, and the potential excess earning power may be assumed, as a purchaser expects to receive his money's worth of the tangible (recorded book value) and intangible (goodwill) assets. The positive goodwill . . . is universally accepted, the disputes involving only the negative goodwill" (Newlove).

"In preparing a consolidated balance-sheet, the investment account is replaced by the things it represents. Therefore that portion which represents subsidiary net assets is eliminated; and the portion which represents excess payment . . . appears in the consolidated balance-sheet" (Finney). "Goodwill upon the consolidated balance-sheet may be said to be the algebraic sum of the goodwill items purchased from the subsidiaries by the holding company" (Bennett). But Newlove holds that "if a company's stock can, under ordinary market conditions, be purchased for less than its book value, some of the assets of that company are inflated. This inflation is in the assets of the company which is being analyzed and therefore this negative goodwill has no effect on the goodwill of the other companies." Dicksee expresses the same thought: "The mere fact that a company's shares were quoted at a discount would imply that it has lost some of its tangible assets, as well as the whole of its goodwill."

The last two opinions constitute a reversion to the pure property or capital value concept of accounting valuations. An inflation in tangible asset values may be present, but that is a matter for audit and adjustment. The mere fact that goodwill is negative does not prove that inflation exists. A balance-sheet, after all, can do no more than state figures resulting from an acceptable method of interpolation between original cost and salvage values. The goodwill is negative whenever prospective earnings fall short of the money rate on the interpolated values. For the same reason, the purchase of assets for less than their

admittedly proper balance-sheet value is not necessarily a "lucky buy" warranting a credit to capital surplus, although that is Newlove's alternative conclusion.

When stock is exchanged for stock and "the book value of the shares acquired is less than the book value of the shares issued, it is evident that goodwill has been purchased, unless . . . the shares issued are not worth their book value" (Sunley and Pinkerton). That is, unless the book value of the shares issued is based upon improper accounting methods resulting in overstatement, or unless the book value of the shares acquired is based upon incorrect accounting methods resulting in understatement, or unless the exchange of stock was effected on the basis of market prices manipulated in favor of the subsidiary, which is less frequent than the reverse. Apart from these possibilities, the difference between the book value of the shares issued and the shares acquired is the difference of the goodwills attaching to the respective blocks of stock. But even if the difference includes impurities of one sort or another, the book value of the stock issued by the holding company measures the total cost of the transaction to it and the investment should be recorded at that figure. To use any other method would be to repudiate one's own yardstick. That yardstick may indeed be false, but if so, it should be audited and corrected, not simply disregarded. To record a purchase at the market value of the stock issued for it amounts to writing up one's own goodwill not purchased.

"Goodwill created by the purchase of stock of a subsidiary company is determined definitely at the date of purchase, and remains unchanged ever afterward" (Bliss). "If the holding company has handled its investment accounts on an accrual basis, i.e. so that they reflect the holding company's share of the profits, losses and dividends of the subsidiaries, the consolidated goodwill is determined by finding the difference between the respective investment accounts and the book value of the portion of the subsidiaries' net worths owned by the holding company. If the investment accounts are carried at cost . . . the consolidated goodwill is determined in the same manner as at the date of acquisition. The book value of the subsidiaries' shares at that date and not on the date of the consolidated balance-sheet should be taken, because only the former book value was acquired" (Kester).

When the percentage of control over a subsidiary decreases, a corresponding portion of the goodwill originally acquired must be written off. If the cost of an increase in percentage is greater or smaller than its book value, the difference should be added to or deducted from the consolidated goodwill. Finney, Kester, Newlove, and Sunley and Pinkerton give illustrations of such adjustments.[3]

Goodwill Insurance

"The man who causes the world to 'make a path to his door' creates goodwill. A policy of insurance, payable to the firm, written on the life of a man who has been instrumental in building up such a business is, in a measure, capitalizing . . . such a personality" (Hunter). Life insurance as a goodwill problem is also mentioned by Guthrie, and Dicksee recommends it as a convenient means of liquidating goodwill upon the demise of a partner. He points out the proper way of defraying the cost of this insurance: "The equitable plan is to charge each partner with his due proportion of the cost of insuring the lives of each of his co-partners" (Dicksee). Thus, if A, B and C share profits and losses in the ratio of 3:2:1, B and C are to share the premium on A's life at the rate of 2:1, A and C that on B's life at 3:1 and A and B that on C's life at 3:2. The same principle evidently applies to private corporations, whose officers are also its stockholders. In public corporations, on the other hand, the net premium is a business expense, although not recognized as such by Federal income-tax regulations.

Conclusion

The outstanding characteristic of modern accounting literature on the subject of goodwill is its barrenness. Quotations taken from two papers written almost fifty years ago can be used to summarize most valid conclusions published since then. Limitations of space preclude a detailed demonstration, but the fact becomes evident upon perusal of a prize essay by J. H. Bourne [4] and an article by Francis More.[5] The latter has even made the valuable suggestion noted only by Hatfield "to split

[3] For graphic illustrations of the same basic problem see: Gabriel A. D. Preinreich: *The Nature of Dividends*. New York, 1935.
[4] "Goodwill," *Accountant*, Sept. 22, 1888. Pp. 604–5.
[5] "Goodwill," *Ibid.*, April 11, 1891. Pp. 282–7.

up excess profits into two or more parts and assign a value to each part. An excess of 5 per cent. over the ordinary rate is more likely to be maintained than an excess of 10 per cent. . . . and so on." This treatment, although cumbersome in the form suggested, shows an excellent understanding of goodwill as a probability, the theory of which is worth developing.

The only topics not covered by Bourne and More are created goodwill and the technique of consolidated balance-sheets. The capitalization of preliminary expenses and developmental deficits appears to have been first mentioned by Dicksee in 1897. Intricate corporate family relationships are a more recent development, but their analysis involves merely an extension of old principles.

[NOTE.—Limitations of space prevent inclusion of a list of about 150 references submitted by the author with this article. Any reader who wishes the references may obtain them from the author or from the library of the American Institute of Accountants.—*Editor*]