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GOODWILL

One of the most commonly quoted definitions of goodwill, so far at least as accounts are concerned, is the one given by Lisle in his book on *Accountancy in Theory and Practice*: "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 the business in consequence of the probabilities of the customers continuing."

Another definition, is the one appearing in the opinion of Lord Elton in the English case of *Crutwell* v. *Lye,* which is about one hundred years old: "The goodwill which has been the subject of a sale is nothing more than the probability that the customers will resort to the old place."

Lord Elton's definition gives the impression that goodwill is a purely local matter, and that if a concern having acquired the business of another, subsequently transfers it to a different locality, it loses the right to expect that the old customers will continue. This is indeed the stand taken by a Pennsylvania court in the case of Elliott's appeal,* in which it was held that the goodwill of an inn or tavern did not exist outside of the premises where the business was conducted at the time of the sale.

Still, Lord Elton's definition has been the subject of much criticism in and out of American courts, owing to its narrow conception of the valuable asset goodwill. Nor does it seem that English courts have shared his views. Vice Chancellor Sir W. Page Wood, says: "Goodwill, I apprehend, must mean every advantage * * * that has been acquired by the old firm in carrying on its business, whether connected with the premises in which the business was previously carried on, or with the name of the late firm, or with any other matter carrying with it the benefit of the business."

Purely local as the character of goodwill is under certain

* 60 Pa. St., 161.

conditions, as for instance in the case of a hotel whose attractive and convenient location is primarily responsible for the vogue which it enjoys, it may be said to be more commonly personal. If Steinway and Sons were to sell their business and their name to a firm who found it advisable to transfer the plant and the selling agency from New York to Boston, it is certain that the goodwill of the musical world would not be affected by the change.

It is precisely that element of personality, possessed by goodwill, which links it so naturally to types of organization in which the names of the supposed proprietors are known, that is to say, sole proprietorships and copartnerships. It is also on that account that the courts have ruled that the goodwill of a partnership does not inure to the benefit of the surviving partners, but belongs to the purchasers of the firm name,* and that the goodwill of a market stand or stall, the lessee of which has died, is independent of the stand itself, and belongs to the estate of the deceased.†

Goodwill is very frequently referred to as an "intangible asset," that is to say something the existence of which is spoken of, but is not palpable. Intangible as it may be by itself, it must nevertheless rest upon something tangible; it is not conceivable, for instance, that a skilled surgeon, whose fame is far-reaching, could sell the goodwill of his practice to an unknown confrere whose skill has yet to be demonstrated. There is nothing tangible in the assurance of the vendor surgeon that his patients will be willing to entrust their lives to his successors. Goodwill, in this case is non-existent as a marketable value, since it depends upon personal skill, which is not to be acquired through purchase. On the other hand, a physician practising without competition in a rural district could in all propriety place a value on the goodwill of his practice, provided he were to agree to recommend the purchaser to his patients as fully capable of giving them equally skilled service, the vendor at the same time agreeing to retire, or to move to another state or to another part of the same state. Goodwill, in this case would rest upon the monopolistic prerogative of the vendee. This is so true that if the vendor subsequently performed an act which would tend to

* *Slater* v. *Slater*, 175 N. Y., 143, 1903.
† *Journe's Succession*, 21 La. Ann., 391.

defeat the certainty of monopoly—such for instance as announcing the resumption of his practice in the field of his former activities—the courts would invalidate the contract, and relieve the aggrieved vendee of his pecuniary obligations under the contract of sale.*

The nature of the goodwill of corporations appears to be quite different from that of the goodwill of sole proprietorships and of copartnerships. When corporations sell their assets, it often happens that the identity of the vendor is lost in that of the vendee. In this case the purchaser does not expect that the customers of the vendor will resort to the old place. He acquires the earning power of an established business whose products will sell, no matter who offers them for sale. He may also, perhaps, figure that with more up-to-date methods of conducting the business, through the application of scientific economy and the union of forces which, up to now, have been antagonistic, larger profits will be obtained than could be had before the consolidation of interests took place. For this he is willing to pay a sum of money which may be far in excess of the value of the tangible properties acquired.

In the absence of a better term accountants as well as laymen are generally satisfied to call their excess price goodwill; but the frequency with which the excess of cost over the intrinsic value of the properties acquired is distributed by boards of directors over the value of the individual property units included in the purchase, no mention whatever being made of goodwill, indicates that there is some deep-rooted objection to the term, at least from the point of view of corporations.

There are, in fact, many instances of consolidations of corporations, where the application of the word goodwill to the excess price paid by the consolidating interests over the intrinsic value of the properties acquired would be equivalent to an attempt to mislead, or to an admission of ignorance of the conditions which brought about the combination. The earning power of, say, three corporations to be consolidated, may have been reduced to a negligible quantity by the keenness of the competition in which they have engaged. If that earning power were to be used as the basis for the computation of the value of goodwill in accordance with the rules which are said to prevail in such

* *Townsend* v. *Hurst*, 37 Missouri, 679.

cases, there would remain a minus quantity to express it; and yet the stockholders of the three competing companies may not feel disposed to combine, unless they receive a considerable amount over the intrinsic value of the properties which they control. Thus, so far as earning power is concerned, the bonus paid does not apply to past performances, but to confidence in the future. If the word goodwill applies to anything, under these conditions, it must be to that harmony which the consolidation has brought about among forces which up to now were only desirous of destroying one another.

It should be said, however, that while any reference to goodwill may properly be eliminated from the books of a corporation which absorbs other interests in such a manner as to cause the identity of the vendor to be entirely lost, it should be retained as an asset of a corporation which takes over a copartnership or a sole proprietorship, principally when the vendee concern retains enough of the name of the vendor to preserve the personal character of the goodwill purchased.

The importance of the asset goodwill, when it has been acquired by purchase, cannot be over-estimated. There is no other asset of a concern, the sale of which would be so effective in bringing operations to an end. In some instances it has been held by courts of law that under the terms of a contract for the sale of goodwill, the vendor has no subsequent right to solicit trade in the section of the country in which he previously operated, even among people who were not his customers at the time of the sale.* The sale of goodwill may even prevent an individual from using his own name in connection with the line of business in which he was engaged prior to the sale. JUDGE BATES (*Law of Partnerships*) quotes a case in which Beatty and Gage formed a partnership whose most valuable asset was a series of copy books, known as *Beatty's Head Line Copy Books*. They dissolved, Gage buying out Beatty's interest for $20,000.00. It was shown that a large part of the price was for the right to the copy books. A publishing company, with Beatty's assistance, got out a new series called *Beatty's New and Improved Head Line Copy Books*. This was held to be an infringement of Gage's

* *Munsey* v. *Butterfield*, 133 Mass., 492.

rights, the word Beatty, as applied to the books, being a valuable asset which passed to Gage.*

Why goodwill, having been acquired at a cost which is somewhat considerable, and constituting in some instances the only truly valuable asset of a concern, should be outlawed, and sentenced to gradual expulsion from respectable books of account, is one of the perplexing puzzles which accounting offers to its students. Accountants who would never permit the reduction of a physical asset by the estimated amount of depreciation which it may or may not have suffered during a given period have no scruples at all when it comes to goodwill. Still, it seems that if a concern has paid a large sum to acquire the goodwill of another, and has not only retained it, but even increased it, there is no apparent reason why so-called conservatism should demand the writing off of the asset, to the detriment of the very profits which its purchase gave the right to expect.

One of the reasons frequently advanced in favor of this writing off policy is that the valuation of goodwill, being based on a given number of years' average net profits of the vendor concern, less a fair return on capitalization, its cost is consumed concurrently with the effluxion of the period for which it has been purchased. This is, indeed, an extreme view. It is unequivocally expressed in DAY'S *Accounting Practice*: "Goodwill is a legitimate asset in an industrial enterprise and 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 seven per centum per annum; the balance is goodwill. The rate of interest is based on the assumption that no capitalist would invest in an enterprise unless he were assured at least seven per cent annual return. Goodwill should be written off the books during five subsequent years, by charging off one-fifth against each succeeding year."

As opposed to this view, which we have characterized as extreme, the following quotation from DICKSEE'S *Auditing*, American edition, may be of interest: "Goodwill does not depreciate. On the other hand, it will generally be conceded that it is liable to fluctuations both continual and extreme; * * * as a matter of fact goodwill is not written down because its value is sup-

* *Gage* v. *Canada Pub. Co.*, 11 Ont. App., 402; aff'g, 6 Ont. Rep., 68.

posed to have become reduced—such a course is all but unknown. The amount at which goodwill is stated in a balance sheet is never supposed to represent either its maximum or its minimum value; no one who thought of purchasing a business would be in the least influenced by the amount at which goodwill was stated in the accounts; in short, the amount is absolutely meaningless, except as an indication of what the goodwill may have cost in the first instance. Inasmuch, therefore, as nobody can be deceived by its retention, there is no necessity for the goodwill account to be written down. On the other hand, the practice is not unusual, where sufficient profits are being made. The question is not, however, one upon which the auditor is required to express an opinion."

It is generally recognized that the question of the value of goodwill does not arise until a sale is contemplated. Thus, it does not seem possible for a concern, which has organized otherwise than by purchase of an already established business, to create the asset goodwill during the course of its operations as a going concern. Still, if it is considered proper to set aside the expenses of organization in an account which will be reduced periodically during the years to which the benefit derived therefrom applies; if, further, it is agreed that corporations have the right to spread the loss incurred through discounts on bonds over the life of the bonds, 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.

We often hear of concerns which expect to lose money during the first five years of operation, owing to the heavy advertising which they will have to do in order to call the public's attention to the value of their goods. If the cost of such advertising is charged to expense, together with other lavish expenditures which a newly-established business is bound to make at the start, to win the favor of those whom curiosity alone attracts to the establishment, a considerable deficit may be shown. Would it not be better to raise an account with goodwill, which would be made to reflect the extraordinary cost of establishing the business, and to distribute that cost over the future periods which are to be benefited thereby?

PATENTS

BLACK'S *Law Dictionary* defines a patent: "A grant made by the government to an inventor, conveying and securing to him the exclusive right to make and sell his invention for a term of years."

Thus a patent is nothing short of a monopoly granted by the state, presumably as an inducement to the inventor to disclose the secret of his invention for the benefit of the public at large. The territory over which the monopoly extends is mentioned in both the letters patent issued to the inventor and in the statute authorizing the issue of patents. United States patents apply to all the states and organized territories, as well as to American vessels on the high seas. They do not, however, apply to foreign vessels in American ports. In certain foreign countries—England for instance—a patent which has not been operated for four years may be revoked, but in the United States the right of the patentee is not thus affected. In England, the crown reserves the right to use the patented invention in return for fair compensation. While the United States government does not reserve that right to itself, it is within its power to use the invention by paying therefor reasonable fees to the inventor. No injunction can be obtained against the government.

In the United States the term of a mechanical patent is seventeen years from the date of grant; the term of a design patent is three years and one-half, or seven years, or fourteen years, according to the application. In England, the patent expires with any foreign patent granted before the English patent; in Canada, it expires with any foreign patent granted during its life. In the United States a patent can be extended by special act of congress.

The value at which the asset "patents" is carried on the books depends upon whether the concern which owns it is at the same time the inventor, or has acquired it from the inventor. In the former case its value is the cost of conducting the experiments which have led to the invention, as well as the cost of the fees paid in connection with the search as to the validity of the claim for the patent, and with the filing of the said claim. In the latter case its value will of necessity be what the concern which acquired it paid for it.

Since patents grant what may be termed a legal monopoly, it is clear that they convey a sort of a title to the goodwill of the community in which the right to exclude everybody except the government from the use of the invention is exercised. This is why so many corporations which acquire the business of other concerns where a patent is included among the assets, carry the excess price paid over the intrinsic value of the property acquired under the term "patents and goodwill," or merely spread it over the value of the patents.

If the monopoly granted by the patents lasts only for a term of years, it would seem that the asset should be written off during the life of the grant. This can be done in two ways:

(*a*) Credit patents and debit profit and loss with equal installments corresponding in number to the number of years during which the patent is to be operative.

(*b*) Credit patents, or reserve amortization of patents, and debit one of the components of the cost of goods sold with periodical amounts representing the probable royalty which would have to be paid on the sales if the patents were leased instead of owned.

If the reserve account has been created, debit it and credit patents as soon as the two accounts are equal in amount.

It will be noticed that method (*b*) makes the cost of manufacture bear the loss sustained through the natural extinction of the very asset which made operations possible, and created a legal monopoly; and, further, that it leads to the peculiar conclusion that the income from sales becomes larger as soon as the asset patents has been eliminated.

It should be stated that, instead of being written off, patents have frequently been appraised on the basis of the saving in royalties which their possession affords, precisely as waterpower rights have been appraised on the basis of the saving in fuel and power producing machinery which the privilege to use natural forces guarantees.

There exists another theory, to the effect that while it is true that patents expire within a certain number of years, the benefit deprived from them by the business does not expire concurrently. It is pointed out that the species of monopoly granted by patents is bound to create a considerable amount of goodwill,

the existence of which is appreciated by would-be competitors, and deters them from engaging in a line of business which has been for so many years the exclusive domain of an established concern. Under this theory it would be possible to retain the asset patents long after its legal termination by transferring its value to the account goodwill.

TRADE-MARKS

A trade-mark is nothing more than a conventional sign which, for commercial purposes, has the same effect as the signature has upon a written document—both certify to the genuineness of the thing to which they are appended.

Trade-marks make it possible for their owners so to ear-mark their goods as to make them easily recognizable by buyers. In other words they guarantee that whatever goodwill attaches to the product will be certain to revert to the proper party. In the case of *Liedersdorf* v. *Flint,* 15 Fed. Cases No. 8,219, it was said: "The court proceeds upon the ground that the complainant has a valuable interest in the goodwill of his trade or business, and that having appropriated to himself a particular label or sign or trade-mark, indicating that the article is manufactured or sold by him or by his authority, or that he carries on his business at a particular place, he is entitled to protection against any other person who pirates upon the goodwill of his customers or of the patrons of his trade or business, by sailing under his flag without his authority or consent."

Since an unauthorized use of trade-marks constitutes an infringement of the owner's right to exclusiveness, it may be said of them that they confer a monopoly different from the one obtained under patents only in that its duration is not limited by statute, and can be exercised as long as one desires to use the marks for trade purposes. Thus, the main distinction between patents and trade-marks is that the former need not be used to remain in force, whereas the latter must be.

While the cost of trade-marks may be insignificant when acquired otherwise than by purchase from former owners their value may be considerable, because the very success of the goods which they protect means the acquisition of the goodwill of the trade, to which these goods are offered for sale. If trade-marks

have been acquired from another concern, their cost may be high, owing to the goodwill which they convey. No matter what their cost may be, their influence upon the prosperity of the business is so well defined that they are entitled to a place among the invested values of the enterprise. If kept in force their value should not be written off. If abandoned they may be closed by debit to profit and loss, precisely like all other assets which have outlived their usefulness; or they may be written off gradually during a period of years, upon the theory that, although given up, they have brought goodwill to the business of future years; or again their original cost may be transferred to goodwill, to be written down with that asset if such is the policy of the concern.

COPYRIGHTS

BOUVIER'S *Law Dictionary* defines copyrights as follows: "The exclusive privilege, secured according to certain legal forms, of printing, or otherwise multiplying, publishing, and vending, copies of certain literary or artistic productions."

Like trade-marks and patents, copyrights give a monopoly; but in this country the privilege is limited to a term of twenty-eight years from the time of recording. The term can be extended for a further term of twenty-eight years, upon request by the author, his widow, or his children, within six months of the termination of the original grant of twenty-eight years. This privilege of extension is not conveyed to the assignee, unless so provided in the contract of assignment.

Copyrights are personal property and as such, they may be willed. In the absence of a will they descend to the natural heirs.

The nature of the species of monopoly granted by copyrights consists in the privilege enjoyed by the owner or his assignees or full licensees to prevent any unauthorized sale of the copyrighted works, and the publication of mutilated parts thereof.

The question of the value of the asset copyrights is a complicated one. The original cost of obtaining the grant is insignificant, unless the value of the time consumed in the preparation of the work be capitalized, together with the expenses incident

thereto and the cost of such preliminary advertising as may have been deemed necessary.

In the case of copyrights which are valuable only to the original grantee—such, for instance, as catalogues, price lists and advertisements—the cost of plates, etchings, half-tones, etc., may be added to the value of the asset as stated above. But in the case of assignable copyrights, the plates, etchings and half tones are so independent of the right itself that they can be sold without giving the purchaser the slightest claim upon the copyright, unless the contract provides to the contrary.

The probable value of assignable or salable copyrights depends to a great extent upon an estimate of the vogue which they will enjoy; their real value depends upon past performances so far as public favor is concerned, as well as upon an estimate of the continuation of their vogue.

Copyrights, being a monopolistic grant, raise naturally the question of goodwill. A copyrighted work may have proven a financial failure, and yet have obtained an artistic success such as to lift its author and its publishers to a very high plane in the favor of a certain class of readers. If the defects which made it commercially unprofitable can be remedied in future works of the same author, the goodwill which the first production has acquired may enhance greatly the commercial success of subsequent copyrights. Hence, the losses sustained by the poor seller might be capitalized under the name of goodwill, or added to the value of the copyright, at least until such time as the retroactive effect of subsequent successful works upon the unsuccessful one has been ascertained.

FRANCHISES

Franchises have been defined thus: "A branch of the sovereign power of the state, subsisting in a person or in a corporation, by grant from the state." This definition has been assailed, upon the ground that it fails to establish a proper distinction between "primary franchises," and "secondary franchises."

Primary franchises are special privileges, not generally possessed by individuals, which are granted to them by the state in pursuance with a well-defined policy of government or of

business control. They include the right of perpetuity of purpose and of life, which corporations obtain by virtue of their charter; the privilege of limited liability which certain forms of organization receive from the state, as well as all the other special privileges which their legal status conveys and the rights and privileges which all citizens enjoy under existing statutes, or in accordance with the spirit of the common law.

Secondary franchises, at least under the American system of government, originate through a contract made, upon valuable consideration, between the sovereign power and individuals or corporations. The consideration for the contract may be monetary, or it may be only the public value of the services to be rendered by the party seeking the grant. They include in the language of the supreme court, "rights and privileges which are essential to the operations of the corporation, and without which its road and works should be of little value such as the franchise to run cars, to take tolls, to appropriate earth and gravel for the bed of its road, or water for its engines, and the like." *

The main distinction between the two classes of franchises, so far as organized business codes are concerned, is that the former (primary) cannot be alienated, assigned, mortgaged, or otherwise disposed of, while the latter (secondary) may be, if proper authorization is given by the sovereign power which made the grant.

Generally speaking, secondary franchises are monopolistic and permanent rights "to do an act, or a series of acts of public concern." † They constitute a contract between the grantor and the grantee, which cannot be revoked unless the grantor specifically reserves to himself the right of revocation.

The characteristic feature of franchises is that they must be granted by a sovereign power. Under this interpretation of the nature of the grant, it has been claimed that the privileges conferred by the municipalities are not franchises but merely licenses.‡ On the other hand, it has been held if the grantee of the municipal licenses has given adequate consideration, (such as a promise to pay to the municipality a certain proportion of its earnings or of its net profits), the grant ceases to be a license and

* *Morgan* v. *Louisiana*, 93 U. S., 217, 23 L. Ed., 860.
† *Southampton* v. *Jessup*, 162 N. Y., 122, 126, 56 N. E., 538.
‡ *Chicago City R. R.* v. *People*, 73 Ill., 541.

becomes a franchise which is in the nature of a binding contract, and cannot be revoked at the will of the grantor.*

The legal doctrine which attempts to establish a difference between franchises granted by the state and those granted by municipalities is generally thought to be unsound, upon the ground that municipalities, being state corporations and part of the body politic, are mere subdivisions of the sovereign power. The question as to whether or not the grant of a franchise by a city is an infringement of the right of the state appears to be one of legal proceedings, and not a question of facts.†

In connection with the components of the book value of the asset franchises, when possessed by public service corporations, the public service commission of the first district of the state of New York has ruled:

"To this account shall be charged the amount (exclusive of any tax or annual charge) actually paid to the state or to a political subdivision thereof, as the consideration for the grant of such franchise or right which is necessary to the conduct of the corporations. If any such franchise is acquired by mesne assignment, the charge to this account in respect thereof must not exceed the amount actually paid therefor by the corporation to its assignor, nor shall it exceed the amount specified in the statute above quoted. Any excess of the amount actually paid by the corporation over the amount specified in the statute shall be charged to the account 'other intangible street railway capital.' If any such franchise has a life of not more than one year after the date when it is placed in service, it shall not be charged to this account but to the appropriate accounts in 'operating expenses,' and in 'prepayments' if extending beyond the fiscal year.

"Payments made to the state or to some political subdivision thereof as a consideration for granting an extension for more than one year of the life period of a franchise shall be classed as renewals. Those made as a consideration for franchises or extensions thereof covering additional territory to be operated as a part of an existing system shall be classified as betterments. If the franchises cover separate and distinct new enterprises, the payments therefor shall be classed as original. *Note*: Annual or more frequent payments in respect of franchise, must not be

* *Chicago Municipal Gas Light, etc., Co.* v. *Lake*, 130 Ill., 42, 22 N. E., 616.
† *East Cleveland R. Co.*, 6 Ohio Cir. Ct., 318.

charged to this account, but to the appropriate tax or operating expense account." *

This debars a public service corporation, which falls under the commission's supervision, from charging to the account "franchises" the cost of obtaining the consent of the property owners, and the cost of the legal expenses incurred in connection with obtaining the grant. Generally speaking, however, such expenses are thought to be properly capitalized under the heading "franchises" by companies not controlled by the commission, together with the consideration for the contract between the grantor and the grantee, i. *e.*, the amount paid to the state or political subdivision thereof. As to the propriety of capitalizing legal expenses, the question remains an open one; some accountants claim that such capitalization is faulty whenever the company which is the beneficiary of a franchise has a permanent legal department as part of its administrative organization.

Any other cost incident to or necessary for the enjoyment of the franchise, such for instance as the cost of paving between tracks, may be capitalized in some other property account, such as paving, track and roadway, etc.

The payment to a municipality of a portion of the earnings from operations, in accordance with the terms of a franchise grant, is considered as a burden of the asset, and cannot enter into its valuation.

* § 55 of the Public Service Commission Law.