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Theory Of Goodwill Accounting

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THEORY OF GOODWILL ACCOUNTING

A Thesis
Presented to
the Faculty of the Department of Business Administration
Carroll College

In Partial Fulfillment
of the Requirements for the Degree
Bachelor of Arts in Business Administration

by
Eddy Birrer

May 1966
The undersigned, appointed by the Dean of Studies, have examined a thesis entitled THEORY OF GOODWILL ACCOUNTING presented by Edward Birrer, a candidate for the degree of Bachelor of Arts in Business Administration and hereby certify that in their opinion it is worthy of acceptance.

John M. [signature]
The purpose of this thesis is to acquaint non-accountants with the theory of goodwill as it is related to accounting, in order that they might envision the value or lack of value of such an intangible asset, and so that they might recognize the problems, both tax and otherwise, which go with the usage of the goodwill item. An accounting student will benefit in that he will have a keener insight and a better overall picture of the structure of the goodwill account.

As presented, the subject matter is in a great deal repetitive, but only to expose that several accountants hold to a few general positions—each view being slightly different and worthy of mention.

Chronologically, the theory of goodwill is related from 1908 through the present day and will thus evidence a gradual change in the trend of thought. For this reason, the reader is asked to pay particular attention to footnote dates.

My own ideas are inserted at various intervals, but for the most part are contained in the epilogue following the exposition of the theory. The thesis is presented in such a way that each reader might derive his own ideas on the subject goodwill and be able to express his views in a concrete fashion with proper supporting evidence.

Ed Birrer
<table>
<thead>
<tr>
<th>CHAPTER</th>
<th>PAGE</th>
</tr>
</thead>
<tbody>
<tr>
<td>INTRODUCTION</td>
<td>1</td>
</tr>
<tr>
<td>I. EXPLANATION AND DEFINITION OF GOODWILL</td>
<td>3</td>
</tr>
<tr>
<td>II. ACQUISITION AND BASIS FOR RECORDING GOODWILL</td>
<td>9</td>
</tr>
<tr>
<td>III. SUPER-PROFIT METHOD OF COMPUTING GOODWILL</td>
<td>19</td>
</tr>
<tr>
<td>IV. AMORTIZATION OF GOODWILL IN RELATION WITH INTERNAL REVENUE RULINGS</td>
<td>23</td>
</tr>
<tr>
<td>V. PROLOGUE</td>
<td>33</td>
</tr>
<tr>
<td>BIBLIOGRAPHY</td>
<td>36</td>
</tr>
</tbody>
</table>
INTRODUCTION

Thomas Sanders lays out for us the following general principles of accounting:

A. Accounting should make available all material information of a financial nature relating to (a) the financial condition or status of the business, and (b) its progress in earning income.

B. Transactions which add to or subtract from capital must be distinguished from those which add to or subtract from revenue, and, where both kinds of change occur in one transaction, the extent of each must be shown.

C. A reliable historical record must be made of all transactions of the business; but this record must also be analytical, or susceptible to subsequent analysis, to preserve the necessary distinction between capital and income.

D. The use of long-term assets involves the apportionment of capital and income over the several accounting periods; the accuracy of the accounts depends in large measure upon the exercise of competent judgment in making these apportionments.

E. The basis of the treatment applied to the several items should be adhered to consistently from period to period; when any change of treatment becomes necessary, due attention should be drawn to the change.

F. The possible extent of unforeseen contingencies
of adverse character calls for a generally conservative treatment of items to which judgment must be applied.¹

The American Accounting Association’s 1957 revision of the "Accounting and Reporting Standards for Corporate Financial Statements" stated that the discipline of accounting is concerned with "information essential to an understanding of the activities"² of this creature called an enterprise. It will accumulate and communicate information, of which goodwill is a part.


"Intangible assets are defined as meaning patents, copyrights, secret processes and formulas, goodwill, trade-marks, trade-brands, franchises, and other like property." While the term intangible assets is without etymological significance (accounts receivable is tangible, but not in the physical sense of the word), it is still of use as a collective term, in general embracing the items given in the definition just quoted.

When a business changes hands, the purchaser or his advisers try to estimate future receipt which it will yield and future payments which will be necessary to produce those receipts.

The buyer then decides what sum he is willing to give for this stream of future receipts less payments, having regard to the risks. The balance of the purchase price over asset values must be debited to something and this is called goodwill.

As an accounting text reads: Goodwill is an example of an advantage which is an asset. Goodwill has no physical form of expression, but it may be real enough.

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2 Here we see the speculative nature of goodwill, and why it should be recorded only at purchase acquisition.
If a particular enterprise enjoys an excellent business because the public holds the company in high esteem, it has an asset which may be just as important as its building or its modern and attractive furnishings and fixtures. Goodwill is, therefore, an asset and although experience has taught accountants generally to be wary in recognizing it in the books, goodwill may be recorded and reported at its purchase price when one business buys out another. In this latter case the purchase and sale of goodwill gives the accountant objective evidence that the asset exists and has value and he may, therefore, recognize it formally.

Goodwill in the economic sense is another for organization. Baxter finds goodwill value derived from the economic benefits that a going concern may enjoy, as compared with a new one, from (a) established relations in all the markets in which it is accustomed to deal—not only in its sales markets, but also in the markets for all the goods and services it buys, including the labor market, the markets in which it buys its new materials, the market for finance, and so on; (b) established relations with government departments and other non-commercial bodies with which it has negotiations; and (c) the personal relationships that grow up among

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3 However, keep in mind that without a plant there will be no business.

people working together in a business, and the fund of knowledge and the habits that are built up, all of which will in favorable circumstances make for smoother and more effective working than could be expected in a new business.⁵ These things cannot be separated from the business and sold as can such assets as plant and machinery.

The value of a going partnership concern may exceed the book value of the proprietorship.⁶ Under such conditions a new partner would need to invest more than the amount of the partnership interest he is to receive. The surplus investment may be credited to the old partners or it may cause the recording of goodwill.

In order to have this added value the firm must possess certain rights, privileges or advantages that are of great value. Such rights, privileges, or advantages are assets; but they are different from other assets in that they are not tangible and ordinarily have value to the business only as a going concern. The most common in this classification is goodwill. Goodwill has been defined by the Treasury Department of the United States Government as "the value attached to a business over and above the value of the physical property."⁷,⁸ Goodwill arises when a business wins the favor of its

⁵Baxter, loc. cit.
⁷Ibid., p. 355.
⁸This definition seems to make such intangibles as patents a part of goodwill.
customers to such an extent that the customers will probably return to trade in the future.

Baxter's book on theory states that goodwill then is merely the difference between the value of a business at a moment of time, and the valuations, however made, of certain of the assets which are separately stated in the balance sheet.⁹ Thereafter these separate assets will be subject to adjustments which will be reflected in the income account, while the balance or goodwill is subject to an upper limit, but may be reduced according to the way the accountant or his employer feels about it.

Goodwill is variously defined as follows:

(1) A legal definition is "the probability that the old customers will resort to the old place."

(2) An accounting definition is, "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 the future revenue, increase, or advantage to be received is expected to exceed all economic expenditure incidental to its production, plus a normal profit."

(3) It is sometimes defined in a more general way as the excess of the total value of the assets of a going concern over that part of the value which can be

⁹Baxter, op. cit., p. 104.
allocated to specific assets.  

In practical translations the value of goodwill is based upon a more or less accurate estimate of prospective net earnings in excess of some assumed norm.

Commons (Legal Foundations of Capitalism) recognizes three main classes or kinds of goodwill: commercial goodwill, industrial goodwill, and financial goodwill. Each of these kinds of goodwill is undoubtedly important under present business conditions. To these one might add general reputation or public goodwill, and there is also the possibility of having political goodwill.

The mere presence of favorable attitudes and relationships does not imply the existence of goodwill as an asset. Every business involves such attitudes and relationships in some degree. It is only when these factors are somewhat persistent and unusual that they come to have an economic significance. It should also be remembered that goodwill as a recognizable asset arises only when there is a possibility of transfer. Further, personal skill, integrity, etc. cannot be sold, and hence can have no exchange value. On the other hand value arising from the customers' habit of resorting to the "old place," although originally based on more or less personal factors, may, within limits, be subject to

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10 Sanders, *op. cit.*, p. 67.


transfer. The possibilities of transfer vary with the type of goodwill, the manner in which it was built up, and the degree to which it has become solidly established.

In conclusion then we might define goodwill as that asset which generates profits over and above a normal rate of return.
CHAPTER II

ACQUISITION AND BASIS FOR RECORDING GOODWILL

In dealing with intangible assets herein considered, important questions arise as to the initial carrying amount of such assets, the amortization of such amount where their term of existence is definitely limited or problematical, and their write-down or write-off at some later time where there is a substantial and permanent decline in the value of such assets. Those intangibles having no limited term of existence and as to which there is, at the time of acquisition, no indication of limited life include goodwill.

The A.I.C.P.A. states that the initial amount assigned to all types of intangibles should be cost, in accordance with the generally accepted accounting principle that assets should be stated at cost when they are acquired. In the case of non-cash acquisitions, cost may be considered as being either the fair value of the consideration given or the fair value of the property or right acquired, whichever is the more clearly evident.

It is not considered desirable to record goodwill

1 All else aside, we have a problem with goodwill in that it is an intangible asset.

as an asset unless it has been purchased or sold. Further, there should be recognized procedure for determining its amount. Various ways of measuring this amount of goodwill exist; as Howard S. Noble points out, two common ways are: (1) value of goodwill may be estimated by the capitalization of the excess profits (2) may be estimated to be equal to the excess profit of several years.

Note: 4 Some accountants choose to debit the asset goodwill with an offsetting entry to some reserve account, justifying such action by stating that goodwill is a very contingent item. Therefore, if goodwill fails to materialize or fails to meet up to its past valuation at the time of purchase acquisition, it may be written off, and the firm returned to its original position. The fallacies of such action are obvious in that improper accounting methods are followed.

General contingency reserves, state the Committee (Bulletin recommendation of the Committee on Accounting Procedure of the American Institute of Accountants, 1939)5 should not be created or added to by charges to expense but by the appropriation of surplus, and on the balance

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3Noble, op. cit., p. 356.

4Writer's note.

sheet such reserves should be classified as a part of stockholders' equity. Costs or losses relating to the reserve should not be charged to the reserve but should be regarded as an expense of the period in which they are incurred. When the reserve or any part of it is no longer found to be necessary it should be returned to (earned) surplus. The Committee made no reference to contingency reserves other than "general."

The preceding statement further points out the fallacy of those who attempt to set up a reserve for goodwill—it is written off in a lump sum rather than periodically as recommended. William Cole, a former assistant professor of accounting at Harvard University says that it is common to read that balance sheets are of little use in judging the value of a going concern, for earning capacity is what really counts and that is shown only by the income sheet. He goes on to say that this is true to a great extent, but in a merger a disregard of balance sheets could easily lead to absurdity. Though earning capacity is dependent quite as much on intangible things, like personality and goodwill, as upon physical property, these intangible things can produce no results in business without the physical property to work upon. More concretely, the combination desires to secure not only the good reputation,

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the good trade, and good management of the separate concerns, but also goods, facilities, and equipment.

Cole further states that it is doubtless no two persons would offer quite the same plan for any consolidation; for no two would put quite the same valuation on assets or estimate future earnings in quite the same way. If an increase is to come from the application of the reputation and the executive organization and the personnel of the better concerns to the assets of the poorer, earning capacity chiefly should govern; but the measure of earning capacity for this purpose is really goodwill, i.e., the capacity to earn greater than ordinary profits. If we assume the increase to be due to the new management of the better concerns extending over the poorer, we distribute stock, above the requirement to cover assets, on the basis of the measure of that good management, namely, the excess profit or goodwill of those concerns.

Even this item goodwill might be eliminated by closing it out into the other accounts, writing them up. This goodwill, though not tangible, inheres in tangible things, for the goodwill without the property is of no value. Only because the goodwill enables the plant, goods, etc. to produce more than otherwise does anyone pay for it; and so property with goodwill attached is more than without it.

Theoretically Cole emphasizes neither goodwill nor the increased value due to combination of industry on a
large scale should be hidden by guesswork distribution among other accounts. It would be better to open an account—called, perhaps, appreciation to show the difference between par value of stock and paid-in. The aim of many accountants has been to conceal the facts where only experienced observers can find them.

It is generally accepted that a value should be placed on goodwill in the books only when goodwill has been purchased. The corollary is that goodwill should not be entered in the books of the business which builds it up.

Two modifications of this general rule have appeared: (a) the cost of extensive advertising, expected to yield benefits for a long period, is sometimes considered an indirect purchase of goodwill; (b) the operating deficits of the early years of a business have at times (public utilities for example) been regarded as a necessary expense of creating a going concern and, therefore, an indirect cost of goodwill.

It has been a not uncommon practice to value goodwill on such bases as the excess paid in cash for a group of assets above the net value of the tangible items upon the books of the vendor, or the same amount, paid in stock issued. It is desirable that, instead,

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7 Ibid., p. 310.
8 Sanders, op. cit., p. 68.
the buyer place specific values on goodwill and the other assets at the time of the transaction.

One C.P.A. points out that there is a tendency for the buyer to wish to "soak up" as much as possible of the total amount invested as physical property, and one can sympathize with this attitude, as a practical matter, in view of the unwillingness of the government to permit amortization of goodwill to be treated as an allowable deduction for income tax purposes. Ideally, on the other hand, he says that the fraction of the total investment which can fairly be said to represent the cost of goodwill should be segregated in the goodwill account. Bad classification with respect to tangible and intangible divisions may lead to questionable accounting for operating charges, both departmentally and for the business as a whole.

Some accountants hold that in view of the difficulty of valuing goodwill, at date of purchase and at later points, it is advisable to charge the cost of goodwill directly to capital surplus, assuming that such surplus is available. This position, however, does not accord with the view that it is the function of accounting—at the outset—to show the entire investment of the stockholders, and to follow the investment as it takes shape in various resources.

In general such assets as advertising, creation of

\[\text{Paton, op. cit., p. 347.}\]
facilities for the physical care, technical training, general education, and entertainment of employees, publicity, research should not be capitalized as deferred charges or goodwill value. To trace the specific effect of such costs is usually inexpedient or impossible. They must be taken on faith; and it is dangerous to assume completely favorable results. As Hatfield (Accounting) said: "Like the expense of experimentation, advertising may fail to bring forth fruit and instead of creating goodwill it may cause only a deficit." Further, many such costs are more or less regularly recurring, and to adopt a policy of capitalization would require the development of a concurrent policy of amortization if inflation were to be avoided. It is also to be doubted if it is sound accounting to attempt to restore such costs to asset values, once a superior earning power has been clearly established. As Yung (Goodwill and Other Intangibles) writes: "To test the value of investment on the basis of net earnings involves, fundamentally, an illogical procedure, and if carried too far may destroy the primary usefulness of accounting." The higher earning power of later years, further, may be due in considerable measure to factors which do not represent actual out-

10 Ibid.
11 Ibid.
12 Ibid., p. 848.
lays, such, for example, as the foresight and energy of the owners themselves.

Conservatively calculated "excess expenditures" for advertising should be capitalized but that instead of recording them as goodwill--they should be carried as prepaid advertising and written off rapidly over the next two or three years.

In some cases the capital account of a new partner may be credited with an amount in excess of his investment; this may be reflected as a bonus, or as goodwill. In the latter instance the partners may not wish to have their capital reduced. Assume that Zebbedy Clyde were to invest $5000 in a business, and that his investment will cause an increase in surplus value of $3000.

Entries:

\[
\begin{align*}
\text{Cash} & \quad 5,000 \\
Zebbedy Clyde, Capital & \quad 5,000 \\
& \quad \text{To record investment}
\end{align*}
\]

\[
\begin{align*}
\text{Goodwill} & \quad 3,000 \\
Zebbedy Clyde, Capital & \quad 3,000 \\
& \quad \text{To record asset goodwill and Clyde's capital increase.}^{13}
\end{align*}
\]

When a partnership is converted into a corporation, the amount of stock issued to the partners may be greater than the net assets acquired by the corporation. This difference is a charge to goodwill. For example, assume that Net Assets Acquired equals $50,000--Goodwill is then computed as $5,000.

\[^{13}\text{Noble, \textit{op. cit.}, p. 393.}\]
Since goodwill is associated with profits, a logical basis for valuation of goodwill is the amount of earnings. If earnings are sufficient to pay a modest return on the proprietorship value, there is no justification for attributing much, if any, value to the goodwill; but if the net profit consistently runs higher than a normal return—say, for example, it regularly runs around 20 percent of the proprietorship—then there is reason to believe that the business enjoys a healthy goodwill, and it may appear entirely reasonable to value that goodwill at an appreciable figure, and to increase the proprietorship to a value consistent with its earning power.

The rule has been not to enter a value for goodwill unless cost is incurred in its acquisition, as when a business is bought outright by a corporation at a price in excess of the value of the assets. The entry for such a purchase might be:

<table>
<thead>
<tr>
<th>Account</th>
<th>Value</th>
</tr>
</thead>
<tbody>
<tr>
<td>Accounts Receivable</td>
<td>50,000-</td>
</tr>
<tr>
<td>Inventory</td>
<td>27,000-</td>
</tr>
<tr>
<td>Plant</td>
<td>200,000-</td>
</tr>
<tr>
<td>Land</td>
<td>100,000-</td>
</tr>
<tr>
<td>Goodwill</td>
<td>125,000-</td>
</tr>
<tr>
<td>Allowance for Bad Debt</td>
<td>2,000-</td>
</tr>
<tr>
<td>Cash</td>
<td>500,000-</td>
</tr>
</tbody>
</table>

Purchase the business of Mike Boyle for $500,000 asset values shown above, excepting Accounts Receivable and Goodwill, are net values as determined by Zeke's Appraisal Company.\(^{14}\)

The corporation actually paid $500,000 cash for

\(^{14}\)Ascher, *op. cit.*, p. 431.
the business in question, yet its tangible assets are worth only $375,000. The extra $125,000 has to be accounted for because it was paid out. Assuming that the business acquired is a very prosperous one, the reasonable interpretation is that the extra sum was paid for the goodwill.

In summary then, we see that goodwill is to be recorded at cost as an intangible asset and placed in the balance sheet as such in order to reflect the true position of the business at any given time. And goodwill can be recorded only at the time of its purchase.

15 Ibid., pp. 432-33.
CHAPTER III

SUPER-PROFIT METHOD OF COMPUTING GOODWILL

The following formula and its explanation are the result of a study made by Professor W.C. Edey of the London School of Economics:

\[ V = \frac{A + P-rA}{j} \]

where:

- \( V \) is the value to be found;
- \( A \) is the value of the net tangible assets;
- \( P \) is the expected annual return;
- \( r \) is the normal annual rate of return appropriate to the business, expressed as a fraction;
- \( P-rA \) is the super-profit;
- \( j \) is the appropriate rate for capitalization of the super-profit, also expressed as a fraction;
- \( \frac{P-rA}{j} \) is the value of the goodwill, which we may write as \( G \).

We shall assume that the value of the tangible assets is defined as their estimated saleable value as individual assets in the best market available. To arrive at the net value, the amount of the current liabilities is deducted, so that \( A \) is an estimate of the break-up value of the business.

The future level of dividends will depend partly upon whether new capital is paid into the business at a later date. This possibility must be taken into account in any valuation.

Another determinant of the level of dividends after

\[ ^1 \text{Baxter, op. cit., pp. 202-06} \]
any given point of time is the level of dividends before that time. The lower, for example, earlier dividends are in the period after the valuation, the higher should later dividends be, for the lower level of earlier dividends will leave more resources in the business and these should add to earnings—restricting dividends has the same effect as paying additional capital into the business.

Some idea of current rates of return in different kinds of business can be obtained from published financial data, the rate in each case being expressed as the ratio of the current dividend to the market value of the relevant security. However, a rate of return that an investor would think appropriate for one business may well be inappropriate for another. Secondly, the observed ratio between a current dividend and the market value of the share does not tell us the relation that is generally expected by the market to exist between future dividends and that price. Finally, there is the problem that the market prices of investment cannot be identified with the net tangible assets of the super-profit method.

The product $rA$ is, by definition, the annual dividend which would satisfy the investor on the assumption that he invested a sum $A$ in the purchase of the business.

It is only possible to calculate the value if $rA$ is for a similar business opportunity. It seems that all
we can say of \( j \) is that it is assessed by the potential investor as some figure higher than \( r \) and higher than the average minimum rate of return he would accept on the total investment.

Edey feels that the super-profit formula represents a brave but unsuccessful attempt to apply certain concepts of abstract economic theory to an important business problem. He states that significance can be given to it in the following way: assume a world with conditions approaching those of perfect competition. Assume that resources have little specificity, and that there is little technical change. The saleable value of an asset approximates closely its replacement value. Rates of return on investment and interest rates tend to a standard level.

We can then define \( A \) as the market value of the business assets and as the standard rate of return. In such conditions, profits will deviate little from the standard rate of return on the market value of the assets; that is, \( P \) will usually approximate to \( rA \). The existence of super-profit will be exceptional. Should \( P \) be found to except \( rA \), this will imply a disequilibrium that is unlikely to persist. The present value of the super-profit will therefore be that of a short series of receipts capitalized at rate \( r \).\(^2\) If we set \( j \) equal to \( \frac{1}{a_n} \), this valuation of the super-profit can be repre-

\(^2\text{Ibid.}, \text{ p. 215.}\)
sented by the simple capitalization formula \( \frac{P-rA}{j} \)
inInstead of the more usual form \((P-rA)a_n\), \(a_n\) being the
present value of an annuity of 1 for \(n\) years at 100\(r\)
percent).

This is not an unreasonable approach to professional
practice valuation, provided that the full significance
of each term in the formula is borne in mind in assessing
the value to be assigned to it.

There is then, as evidenced by the basics of the
super-profit method, a recognized need for theoretical
determination of the goodwill amount.
CHAPTER IV

AMORTIZATION OF GOODWILL
IN RELATION WITH INTERNAL REVENUE RULINGS

There is marked difference of opinion and practice as to whether or not goodwill should be written off, and if so, by what steps. It is clear that goodwill itself suffers no actual decline as long as the earning power of the company remains unimpaired, but the persuasive feeling that the showing of goodwill does not add to the strength of the balance sheet has led to much writing off, usually in a few large amounts rather than by systematic amortization. As a result, a considerable number of important companies now show goodwill at $1, and others at no value. Distrust of the goodwill item, so far as it exists, probably arose more from excessive valuations in the past than from question as to the reality of the item. A smaller number of companies show goodwill reduced by a reserve or allowance, but still at substantial amounts.

How shall the balance in the Goodwill account be treated, as a permanent asset which will be kept on the books indefinitely or as a sum to be written off?

The proper way to write it off the record as soon as possible is to use the Surplus account to carry the burden, as follows:

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1 Sanders, op. cit., p. 69.
Allowance for Amortization of Goodwill is a contra account which modifies the goodwill account. Each year it is increased by a constant sum, with the necessary debit being made against Surplus, as shown above.

Eventually, the goodwill account will be completely written off against surplus, in which case the balance sheet of the corporation might look as follows:

| Miscellaneous Tangible Assets | 925,000- |
| Goodwill | 125,000- |
| Less: Allowance for amortization of goodwill | 125,000 |
| Liabilities | 25,000- |
| Capital Stock | 800,000- |
| Surplus | 100,000- |
| 925,000- | 25,000- |

From W.T. Baxter's book of Accounting Theory, we might add here: (One of the things on which nearly all accountants agree is that this sum must not be written up—even if it is clear beyond all reasonable doubt that the value of the business has risen. But what do accountants say about depreciating this figure? Even among those advocating writing off goodwill, there is a strange difference as to the circumstances in which this should be done. The more general opinion is that, if done at all, it should be done when the company has

2 The following method of writing goodwill off the books is not a theoretically sound accounting procedure.

3 Ascher, op. cit., p. 433.

4 Baxter, op. cit., p. 104.
enjoyed unusual profits which can be appropriated for that purpose. But some, on the contrary say that it is when profits are below the expected amount that goodwill has declined, and hence it is then that it should be marked down. As one fellow cleverly expressed it, "To put it briefly, if you can write it down, you need not; if you cannot, you should!"

The A.I.C.P.A. states that when a corporation decides that such an intangible asset may not continue to have value during the entire life of the enterprise it may amortize the cost of such intangible by systematic charges against income despite the fact that there are no present indications of limited existence or loss of value which would indicate that it has acquired a term of limited existence, and despite the fact that expenditures are being made to maintain its value. Such amortization is within the discretion of the company and is not to be regarded as obligatory. The plan of amortization should be reasonable. The procedure should be formally approved and the reason for amortization, the rate used, and the shareholders or directors' approval thereof should be disclosed in the financial statements.

The Institute goes on to say that the cost of non-limited term intangibles should be written off when it becomes reasonably evident that they have been worthless.

5American Institute of Certified Public Accountants, op. cit., p. 40.
Under such circumstances the amount at which they are carried on the books should be charged off in the income statement or, if the amount is so large that its effect on income may give rise to misleading inferences, it should be charged to earned surplus. In determining whether an investment in this type of intangibles has become or is likely to become worthless, consideration should be given to the fact that in some cases intangibles acquired by purchase may merge with, or be replaced by, intangibles acquired or developed with respect to other products or lines of business and that in such circumstances the discontinuance of a product or line of business may not in fact indicate loss of value.

In some instances, a corporation may in effect place a valuation greater than their carrying amount on some of the assets of the subsidiary in arriving at the price it was willing to pay for its investment therein. The corporation may have paid amounts in excess of carrying amounts for specific assets of the subsidiary or paid for the general goodwill of the subsidiary. In these cases, if practicable, the Institute insists that there should be an allocation as between tangible and intangible property, of the cost of the mixed aggregate of property or of the excess of a parent's investment over its share of the amount at which the subsidiary carried its net assets on its

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6 Thus showing that not all costs over book value are assignable to goodwill.
books at the date of acquisition. The amounts so allocated to intangibles should thereafter be dealt with in accordance with outlined procedures.

The writing off of such intangible assets as goodwill evokes scarcely any protest, even when it is recognized that substantial goodwill exists. The general distrust of goodwill and the knowledge that it has been widely used to capitalize exaggerated expectations of future earnings leave an almost universal feeling that the balance sheet looks stronger without it. When actual consideration has been paid for goodwill, it should appear on the company's balance sheet long enough to create a record of that fact in the history of the company as presented in the series of its annual reports. After that, nobody seems to regret its disappearance when accomplished by methods which fully disclose the circumstances.

Note: Such a procedure, however, might in effect cause the company to be writing off an asset which it still maintains.

According to one view the cost of the goodwill may be maintained on the books as a good asset as long as the earnings are maintained at or above the level implicit in the original value placed upon the intangible. The objection to this treatment lies in the fact that

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8 Writer's note.
in general the conditions which give rise to excess earnings cannot be assumed to be permanent, and hence that the value of such earnings as of any particular point of time is subject to amortization. As Hatfield (Accounting) says: "This doctrine of the permanence of goodwill seems inconsistent with the theory of valuing it as the purchase of a temporary, terminating annuity." If earnings are maintained at a rate as high or higher than that in effect at date of purchase, it may be argued, it does not follow that such earnings for an indefinite period are the earnings in which the investment was made. It is virtually impossible to impute on an objective basis an element in earnings to an investment in goodwill, at least for a period beyond that implied in the valuation of the intangible. After such period has elapsed, therefore, it is reasonable to answer that superior earnings are the result of new factors and conditions rather than of those present at the date of valuation and purchase, and that under the orthodox rule the value of such factors should not be explicitly recognized in the accounts.

A case where amortization is clearly required is found in the purchase of a personal service or professional business such as that of a law firm. It is clear that the goodwill of the business can hardly be

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9Paton, op. cit., p. 849.
10Ibid., p. 850.
retained unless satisfactory conditions are maintained, and that the maintenance of such conditions depends largely upon the personalities and abilities of the new members of the firm.  

Many accountants hold that goodwill should be amortized as rapidly as revenues will permit (and still yield a fair showing of net), basing the recommendation on the view that goodwill is at best a doubtful asset, a necessary evil, to be tolerated only for as short a period as possible.  

As suggested earlier it is small wonder that the intangibles are in bad odor among conservative accountants in view of the tendency on the part of enthusiastic financiers to use goodwill and similar headings to support nominal security values in excess of genuine assets. In fact there is much truth in the saying that "those who have goodwill don't recognize it and those who don't do."  

But although this policy tends to operate in the right direction, it is unduly arbitrary. Further, it does not insist on the elimination of the value of goodwill where the expected excess earnings fail to materialize, although all can agree that such a condition demonstrates the loss of the investment in goodwill.

11 But is this uncertainty a justification for the write-off of goodwill?

12 Paton, op. cit., p. 850.

13 Ibid.
The regulations issued by the Bureau of Internal Revenue state: "No deduction for depreciation, including obsolescence, is allowable in respect of goodwill." This rule is seriously objectionable, for in many cases it is possible to present a strong case for amortization or loss in value. Thus far, however, the courts seem to have supported the Bureau's attitude. 

There is no practical justification for the appreciation of goodwill. The factors and conditions in effect at the date of valuation and purchase may become more productive than was anticipated, but it is scarcely possible to demonstrate that an increase in the level of earnings is due to conditions present at date of purchase, and it is very probable, in general, that the increase is due to new conditions. To appreciate the valuation of goodwill, therefore, in the presence of increasing earning power, is likely to be equivalent to the recognition of intangibles developed within the business and having no explicit and assignable cost, and is objectionable for the same reasons.

The regulations of the Bureau of Internal Revenue state substantially as follows:

Gain or loss from a sale of goodwill results only when the business, or a part of it, to which the goodwill attaches is sold, in which case the gain or loss will be determined by comparing the sale price with the cost or other basis of the assets, including goodwill. If specific payment was not made for goodwill

\(^{14}\)Ibid., p. 851.
acquired after February 28, 1913, there can be no deductible loss with respect thereto, but gain may be realized from the sale of goodwill built up through expenditures which have been currently deducted. It is immaterial that goodwill may never have been carried on the books as an asset, but the burden of proof is on the taxpayer to establish the cost or Fair Market Value as of March 1, 1913, of the goodwill sold.\textsuperscript{15}

In an early memorandum the Committee on Appeals and Review of the Income Tax Unit recommended a method of determining the value of the goodwill of a business as of March 1, 1913, which consisted of capitalizing percentage of the excess of the \textit{average earnings} for a period of not less than five years prior to the basic date over 10\% of the investment in tangible assets, due allowance being made for the liabilities.\textsuperscript{16} It was emphasized in this memorandum that the value of intangibles is largely a matter of judgment and opinion, in view of the circumstances of the individual case.

On the other hand, if the purchase of the business was an arm's length transaction at a fair market price, and if the increase in corporation earnings after the acquisition seems to justify the full price paid for the business, there is good reason to believe that the goodwill was worth all that was paid for it. It is a true benefit to the corporation, an asset, and should be reported as such. With good fortune it may even increase! So why not report it as an asset of value?

\textsuperscript{15}\textit{Ibid.}, p. 849.
\textsuperscript{16}\textit{Ibid.}
Why write it off?

Corporate practice varies considerably. Coca-Cola Company reports goodwill, trademark, and formula at cost to the corporation of $37 million. U.S. Steel, on the other hand, lists its goodwill at the nominal value of $1. Graham and Meredith state:

When Woolworth Common Stock first sold, the balance sheet value of goodwill was $50 million. The market price indicated that goodwill was worth $20 million. Many years later (in several installments) Woolworth wrote down goodwill to $1 charging this $50 million of write-offs against accumulated surplus. But at the time of the last write-off, the publicly-valued goodwill was over $300 million.\(^1\)

The preceding indicates that there are several accountants who feel that goodwill should be written off in some way or another. However, none of their suggestions comply with theoretical accounting structure (for they are inconsistent in their methods) and none seem to answer why goodwill should not be correspondingly appreciated.

\(^1\)Ascher, op. cit., p. 434.
CHAPTER V

EPILOGUE

As can be seen by the pages of accounting theory related to goodwill, one might take rare instance to give into the amortization of goodwill and feel justified in so doing. Yet I feel that goodwill is built around "latent potentialities," and that these potentialities may be assimilated or developed by the parent company after acquisition.

For the first part, if goodwill is centered upon tangible assets, there is no reason that a competent businessman cannot maintain it. To use an extreme example: a small boy and an adult man could each have a candy store centrally located in a thriving consumer district. Both have the same tangible to begin with, yet the adult will be the only one of the two to truly develop the business. Further, if the adult were to see out to yet another child, the profits should normally drop (for the child would not be cogniscent of the value of proper inventories and the like), whereas if the adult sold out to another adult there should be a much greater possibility of goodwill retention.

On a more practical scale, therefore, if a man were unable to procure these advantages he should not pay for the added goodwill, but rather make an investment solely in tangibles and generate normal profits.

In another sense, the purchaser of a goodwill
created by another intangible (the former owner's personality, for example) has generally at least a complete business cycle in which to assimilate the goodwill of his predecessor. If unable to acquire the "super-profits," he too should have made an investment in tangibles only, without regard to the intangible goodwill. For to desire a write-off of goodwill is to say, in effect, that goodwill is virtually non-existent—but we can see that goodwill is evidenced in "latent potentialities" or it would not have been purchased. Further, subsidiary entrepreneurs are stopped by law from setting up a similar-nature business in the same area of economic distribution.

If goodwill can be legitimately traced to a particular asset, why not increase that particular asset's valuation and write it off over its usual life if it can be shown that any goodwill will terminate with the life of the asset.

Also consider that stockholders have the right to know the position of the firm in which they invest. For this reason alone goodwill should be left on the books so that stockholders will know the situation of the business, and so that they might have a basis for demanding business improvements which will generate a greater-than-normal profit.

Therefore, we see that goodwill is in fact an asset which generates profits in excess of a normal
return, and that it should be recorded only at a time of purchase, and only at an amount equal to cost or fair market value. Further, in view of its "latent poten­ti­alities," it should not be written off. Only with this notion can goodwill be judged in accordance with general accounting principles as outlined in the introduction of this thesis.
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