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A NEW THEORY OF GOODWILL

BY

H. KANER, B.Sc., A.S.A.A.

INCORPORATED ACCOUNTANT



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PREFACE

It is customary for an author to apologize for the appearance of a new book and, in seeking to excuse himself, to explain the reason for it and the manner of its inception.

This book was commenced with the intention merely of crystallizing into solid form the nebulous impressions of what was vaguely understood by Goodwill.

From experience the author discovered that not only different people but different classes of people, business men, solicitors and accountants, differed in their ideas as to what Goodwill meant and how to arrive at its worth.

Nor was that all. Textbooks on the subject were consulted, legal decisions and *obiter dicta* sought out, and the various modes of computation examined; yet without satisfaction. Actually, the deeper one probed into the subject, the more was the confusion and the less the satisfaction.

There seemed to be lacking a scientific basis. Although a common generalization could be discerned, the existing theory, or rather theories, suggested an edifice built up mainly of guess-work.

So the book came to be written, and moreover written in a manner deliberately provocative in order to arouse professional interest in a subject which every day is becoming continuously more important.

It was felt that a scientific examination of the

subject had now become necessary on lines far from the existing rule-of-thumb hotch-potch.

It was considered that the present theories should be thrown over and an effort made to replace them by one built up on sound logical premises. No more guesswork but scientific knowledge obtained from analysis, research, and classification.

This book is intended only as a beginning, as an urge to Accountants generally to co-operate in establishing facts within the separate knowledge of each, and to combine in producing not only a scientific theory of Goodwill, but also to evolve therefrom a practical and generally accepted formula, or formulae, for valuing it.

But, as indicated in the final chapter, a large amount of statistical work, for the purpose of classification and analysis, will first have to be done.

The author ventures to suggest that this work could best be performed by the encouragement, or under the auspices, of the leading bodies of professional Accountants.

The first part of this book, after defining Goodwill, explains, it is hoped clearly, existing theories and methods of computation. Next, it is sought to demonstrate how untenable these theories are. Later, Goodwill is analysed and at the end an attempt is made to indicate upon what lines, in the author's opinion, the subject should be pursued.

H. KANER

July, 1937

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A NEW THEORY OF GOODWILL

CHAPTER I

WHAT IS GOODWILL?

GOODWILL is an example of what F. W. Maitland in his *Lectures on Equity* calls "thing-making." He says, in discussing Uses, ". . . we get a conversion of the Use into an incorporeal thing—in which estates and interests exist—a sort of immaterialized piece of land. This is a perfectly legitimate process of 'thing-making' and one that is always going on. For an old example you may take the advowson; new examples are patent right, copyright: goodwill is now in the very process."

Goodwill has assumed such importance in modern finance and commerce that the time is ripe for an attempt at greater definition and scientific computation than exists at the present time.

The rule-of-thumb calculations based on some "think-of-a-number" years' purchase of those mysterious "super profits" invented for the confusion of laymen by Accountants, is about on a par with the famous formula used by nurse for ascertaining the temperature of baby's bathwater, "blue baby, cold; red baby, hot."

Let us first of all see what we mean and understand by Goodwill. What is Goodwill?

There are at least four quite different views of

the term Goodwill: the ordinary intelligent man's idea of it, the legal definition, the Accountants' conception, and the Inland Revenue's notion.

Can these views be reconciled? Are they only superficially different? Do they severally relate to the identical thing?

An idea arises in the world of commerce. Although the idea is centuries old, it is only comparatively recently that it attains any importance. People begin to talk about the Goodwill of a business, or a practice, or a firm. They not only talk about it, they are prepared to buy it, to pay for it in hard cash.

So it has to be valued. By whom better than by Accountants? The Accountants duly evolve a formula or several formulae for its computation.

Soon there is a dispute. The Courts have to define Goodwill. Lawyers are called in to help the Court or perhaps their clients. A definition is enunciated—several definitions. And, as usual, some definitions are too narrow, some too wide.

And then comes the Revenue. The State wants a "rake-off." The term "Goodwill" finds itself in a Finance Act, in several Finance Acts. Their Lords of the Treasury take cognizance of it in Regulations and Orders to their myrmidons.

Let us, however, start with the average layman's view. Let us shed all thoughts of Balance Sheets, intangible assets, amalgamations, partnership premiums, super profits, open markets, years' purchase, and all those technicalities that so cloak the primary idea.

What, then, to the non-expert, is Goodwill? All he knows is that from experience he finds he

prefers to buy one particular brand of cigarettes, or he prefers to buy his clothes at one particular shop, or he prefers to consult one particular firm of Solicitors. He has more confidence in them or they suit his taste or his pocket or his convenience better. Then he discovers that many other people share some of his preferences. Finally, he wakes up to the value of such preferences. Thus is born the idea of Goodwill.

To the layman, therefore, Goodwill represents the sum total of such preferences which a business commands.

The legal definitions of Goodwill follow more or less the layman's general conception of it as stated above. In endeavouring, however, to give a finite clearness to what is after all an elusive, although very real, idea, the Courts, that is to say eminent and learned judges, influenced by the arguments and the ingenuity of only slightly less eminent and learned lawyers pleading with the primary object of stating to the best advantage their respective clients' cases, have sometimes aimed too low and sometimes overshot the mark, depending as a rule, on the nature of the particular dispute under consideration.

Thus, Lord Eldon's dictum in *Crutwell v. Lye* that "Goodwill . . . is nothing more than the probability that old customers will resort to the old place," although bearing a resemblance to the average person's idea of Goodwill, clearly does not go far enough.

Vice-Chancellor Wood in *Churton v. Douglas* went beyond what is generally understood by Goodwill.

Many other definitions were enunciated in the Courts and a good average example of all such definitions is undoubtedly Lord Macnaghten's in *Inland Revenue v. Muller & Co. Ltd.* In his judgment ". . . It (Goodwill) is the benefit and advantage of the good name, reputation and connection of a business. It is the attractive force which brings in custom . . ."

The legal definition of Goodwill is thus of the same species and on the same lines as the loosely thought and vague generalization of the ordinary man-in-the-street.

Before we inquire into the Accountants' attempt at greater precision in determining the nature of Goodwill, let us ascertain what the Revenue Authorities consider Goodwill to be. It is of small importance in Income Tax matters, but may loom large in determining the value for Death Duties of a deceased's business, or practice, or his share in a partnership or his holdings in private limited companies, or in public limited companies which are not quoted on any Stock Exchange.

The clue to the official attitude is given by the combined operation of Section 7 (5) of the Finance Act, 1894, Section 60 (2) of the Finance (1909-10) Act, 1910, and Section 38 of the Finance Act, 1930.

The net result of all these statutory provisions is that, to the Revenue, Goodwill is simply gauged by what price it is estimated to fetch in the open market. What is meant by the open market has been clarified by a number of judicial decisions; *At.-Gen. v. Jameson*; *Salvesen's Trustees v. Inland Revenue*; *Earl Ellesmere v. Inland Revenue*; *In re*

Crossman, deceased, re Paulin, deceased. It is now generally accepted that the official open market comprises all possible and willing purchasers wherever located. It is necessarily the widest possible market and, moreover, is essentially hypothetical.

The definition of Goodwill by the Revenue Authorities, it is suggested, is something like this: The estimated price obtainable in the open market of a business in excess of the value of its surplus tangible assets.

The official view is thus unfortunately not very helpful in arriving at any clear perception of what Goodwill is, except that it does suggest a practical means of, if not computing it, at least testing the accuracy of any calculation of its value arrived at on any particular theoretical basis.

To the Accountants, however, falls the most difficult task, namely, that of valuing Goodwill in terms of £ s. d. on the innumerable and diverse occasions for which this has now become necessary in modern finance and commerce; amalgamations, liquidations, reorganizations, dissolutions, etc.

And for them there are no statutory hypothetical conditions. They have to deal with hard facts, practical details, and finite consequences.

In self defence they invented the theory of super profits. Thus, P. D. Leake defines Goodwill as "the present value of expected future super profits . . ."

L. R. Dicksee states ". . . when a man pays for Goodwill, he pays for something that places him in the position of being able to earn more money than he would be able to earn by his own unaided exertions."

A. E. Cutforth describes Goodwill as "the capitalized value of the actual or prospective super-earnings of a business."

E. Miles Taylor and V. H. M. Bayley come to the conclusion that ". . . financially, the Goodwill of a business is the capital value (i.e. Present Worth) of an annuity of (estimated) future net premium profits . . ."

Thus it will be seen that Accountants generally view Goodwill from quite a novel angle. They appear to keep their eyes on the "profits," or more usually, the "super profits."

And it is quite easy to understand why they do so. They are the experts to whom business men naturally turn for advice when valuations of commercial assets are required, or when anything affecting Accounts is under consideration.

The quotation from L. R. Dicksee, given above, is a good indication of the circumstances which more or less forced Accountants to adopt their peculiar (and somewhat unique) view of Goodwill.

Let us repeat the quotation, ". . . when a man pays for Goodwill, he pays for something that places him in the position of being able to earn more money than he would be able to earn by his own unaided exertions."

The sequence of events is somewhat as follows. A man is impressed with another man's business, with those preferences, referred to earlier on in this chapter, which in his mind he identifies with Goodwill. He is prepared to pay for this ephemeral commodity. But how much should he pay? He turns to his Accountant for advice. More, he

requires his Accountant to assess a value. The Accountant naturally assumes (and, of course, justifiably) that the business man wishes to buy the Goodwill in order to derive some benefit therefrom, that is, to obtain profits. Hence Dicksee's definition.

But most Accountants (again justifiably) make a further assumption. They assume that the business man wishes to derive extra profits. Not merely such an annual return as he could obtain by investing his money almost anywhere, in gilt-edged securities for example, but greater profits after taking into account the extra hazards of commercial enterprise.

And so Accountants evolved their "super profits."

But where the Accountants generally have erred is in confusing a formula for valuing Goodwill, with Goodwill itself. It is like confusing the term πr^2 with area itself. The idea of super profits may be extremely valuable in arriving at some sort of valuation of Goodwill, but it is emphatically not Goodwill itself. Moreover, it is not admitted that the theory of super profits is sound, that it does in fact give the value of Goodwill accurately, that it is even precise or scientific. It may be useful as a rough and ready method of comparing two similar businesses, or as a means of arriving at a compromise as between businesses in amalgamations. But the valuation of Goodwill by means of super profits arrived at on very arbitrary and generally doubtful assumptions, and then moreover multiplied by a completely artificial number supposed to represent

some unidentifiable period of years, must essentially be incorrect.

When Accountants complicate the computation still further by splitting up the super profits, and multiplying each fragment by a different number of years' purchase, one is irresistibly reminded of the ingenious calculations of medieval astronomers in reconciling the intricate eccentricities of the apparent movements of the stars with the then current fundamental (and, of course, fallacious) assumption that the whole Universe revolved round the Earth as centre.

Let us now recapitulate the various definitions of Goodwill—

(i) *The General Public*. The sum total of preferences that a business commands.

(ii) *The Law*. The benefit and advantage of the good name, reputation and connection of a business. The attractive force which brings in custom.

(iii) *The Revenue*. The estimated price obtainable in the open market of a business in excess of the value of its tangible surplus assets.

(iv) *The Accountants*. The present value of expected future super profits.

Definitions (i) and (ii), although different, are clearly closely related. They both identify Goodwill with what a tradesman would call "regular" customers. The two definitions show another similarity in that they are very general in their tenor and lack precision. While definition (i) is obviously much too narrow—for Commercial Goodwill depends on more than only the recurring

preferences of a proportion of the general public—definition (ii) is perhaps too wide—there are other factors besides Goodwill that go to the production of that reputation and attractive force referred to in the definition.

Nevertheless, these two definitions are sufficiently alike to make it apparent that they relate to the identical idea designated by the term "Goodwill."

The suggested Revenue definition is undoubtedly too wide, and, though it has the air of definiteness and practicability, it is in reality, as already indicated, only hypothetical in several respects.

Yet, being based on values and valuations, it has more than a superficial relationship to the definition adopted by Accountants.

This last definition, however, it is submitted, is quite beside the mark. It does not define Goodwill at all, but merely states an arbitrary and entirely empirical method of valuing Goodwill. Moreover, it is considered that the result obtained by this method of computation is incorrect, and bears no relation to the true values as obtained in practice when businesses are bought and sold by actual negotiation in the business world.

Leaving out definition (iv), therefore, a composite definition of Goodwill which might be most generally acceptable may be stated thus: Goodwill is that asset possessed by a commercial undertaking which, by enhancing that undertaking's reputation, attracts from a portion of the public special preferences, and results in an added value in excess of the surplus tangible assets of the undertaking.

CHAPTER II

THE THEORY OF SUPER PROFITS

IN most cases where businesses are sold, a rough and ready estimate of the value of Goodwill is based simply on the average net profits of the past three years.

This has always been recognized as a most unreliable and unsatisfactory method because it leaves out of consideration many other factors besides Goodwill which go to the making of those profits, such as the amount of capital employed, and the skill of the proprietors, to name but two of the most important.

Accountants have been the first to recognize this, and in attempting to arrive at a more scientific and reliable valuation of Goodwill they evolved the theory of super profits.

A. E. Cutforth in his *Methods of Amalgamation* puts the matter very clearly. He states, "The expression 'super earnings' means the balance of the net profits after providing adequately for the remuneration of those managing the business and after deducting a sum equal to a fair return or yield upon the capital employed, the rate of such return being dependent upon the nature of the Capital employed and the class of business."

P. D. Leake takes the matter a little further. He says, "The vendor of Goodwill is entitled only to the present value of an annuity equal to an annual share of future super profits"; and,

moreover, he continues later on, "Super profits can never exist permanently."

Now, let us take the theory step by step, and in order to fix ideas let us take a concrete example.

Suppose a retail business, say a drapery store, in an undistinguished locality where there is the usual competition of other similar stores in the neighbourhood. The Balance Sheet shows total tangible assets valued at £17,000, liabilities of £7000, and a capital of £10,000. The profits for the past three years have been £500, £900, and £1600 respectively, i.e. an average of £1000 per annum. The proprietor renders full-time services to the business.

What is the value of the Goodwill in this case?

First of all, let us assume the rough and ready method based simply on average net profits. At, say, two years' purchase the value of the Goodwill is £2000. Why two years' purchase is taken and not fifty-two or a hundred and two is never quite certain. There is some talk of the custom of the trade, but as a fuller criticism of years' purchase is given later on, we shall leave this question for the present. Our main concern at the moment is to afford a definite illustration of this particular method of computing the value of Goodwill.

Now let us take the next system of valuation. Here allowance is made both for the Capital employed and for the proprietor's skill.

Let us still consider the same example. Again the average annual net profit, viz. £1000, is utilized as the keystone.

But from this is deducted in the first place that yield from the Capital employed in the

business which could have been obtained if invested in any other business of the same nature.

Incidentally, there is sometimes a variation of this deduction. Only that yield is sometimes deducted which could be obtained by investing the Capital in perfect safety in gilt-edged securities. The necessary adjustment is then made by multiplying by a smaller number of years' purchase.

Let us assume the former method. Suppose that generally speaking a return of, say, 6 per cent can be obtained by investing in this class of securities. This figure of 6 per cent can be fixed with a fair degree of accuracy by referring to general yields on Stock Exchange quotations of shares in public companies engaged in this trade.

Thus, from the average annual profits of £1000 is to be deducted 6 per cent on £10,000, i.e. £600, leaving a balance of £400.

Now for the next deduction. Suppose the proprietor's services can be rendered equally well by a manager who would have to be paid a wage of, say, £250 per annum. That is to say, the proprietor's services are estimated to be worth £250 per annum. Deducting this £250 from the above balance of £400, we are left with £150.

This £150 represents the annual super profits. In order to arrive at the value of the Goodwill the super profits are capitalized at so many years' purchase.

How this figure of years' purchase is arrived at or what it represents is never made clear.

When the annual profits or turnover show an upward trend the figure is higher than when they are stationary, and higher still than when the

trend is downward. The reason for this is, of course, obvious.

In our particular case, suppose the figure agreed upon is 5. The value of the Goodwill is thus computed to be $5 \times \text{£}150 = \text{£}750$.

Another method of arriving at Goodwill is favoured by some Accountants, who hold that the super profits themselves should be split up on the assumption that each little packet of super profits is worth more than the one after it, and is accordingly weighted by being multiplied by a higher number of years' purchase.

Thus, adhering to our example, the $\text{£}150$ is split up into three parts of $\text{£}50$ each. The first $\text{£}50$, being the most likely to be maintained, is multiplied by, say, 5 years' purchase, the middle $\text{£}50$ by, say, 3 years' purchase, and the last $\text{£}50$ by one year's purchase. Thus we get—

$$\begin{array}{r} \text{£}50 \times 5 = \text{£}250 \\ \text{£}50 \times 3 = \text{£}150 \\ \text{£}50 \times 1 = \text{£}50 \\ \hline \text{Total} = \text{value of} \\ \text{Goodwill} = \underline{\underline{\text{£}450}} \end{array}$$

Consider, however, what happens if the two deductions for Capital and Management together exceed the average profits.

Suppose in the above example the value of the proprietor's services is to be assessed at $\text{£}500$ per annum. Then the total deductions amount to $\text{£}600 + \text{£}500 = \text{£}1100$, i.e. $\text{£}100$ more than the average net profits. The super profits thus amount to, mathematically, minus $\text{£}100$.

Then, say some Accountants, their perspective

curtailed by the walls of figures of the groove in which they are entrenched, there must be a *negative* Goodwill. They have even named this negative Goodwill "Badwill." How Goodwill can ever be negative is beyond comprehension. Either a business possesses Goodwill or it does not. It is possible even to go categorically further. Every business does inevitably possess some modicum of Goodwill, however negligible.

But negative Goodwill! Impossible!

It is true that mathematicians make use of the expression $\sqrt{-1}$ and have even given it a symbol, viz. *i*. But this is recognized as a convention only. Every mathematician knows that $\sqrt{-1}$ is unreal, that it is entirely imaginary and exists only as a mathematical term.

Similarly in co-ordinate geometry, mathematicians talk about minus areas, but they know it is only a convention to describe the position of the area in relation to the co-ordinates. They do not for a moment deduce from their symbolism that an area can be negative.

So it is also with negative Goodwill or "Badwill." "Badwill" has and can have no real existence.

Let us now examine the further hypothesis with regard to the super profits basis of valuation of Goodwill, namely, that which regards Goodwill as the present value of an annuity consisting of the super profits over a term of years.

It is held by a number of eminent Accountants that the simple number of years' purchase of the super profits is too crude a method of valuing Goodwill. They postulate that, owing to economic causes, such as increased competition or other

factors such as the death or retirement of a skilled proprietor or manager, or a change of fashion or of premises, super profits must inevitably diminish continuously until they disappear altogether.

Still retaining our example showing super profits of £150 per annum, and assuming that these will entirely disappear at a uniform rate within five years, and that a reasonable rate of discount would be 10 per cent per annum, a mathematical formula gives £355 as the value of the Goodwill. The formula is the summation of the series

$$\begin{aligned} \frac{n}{n}x(1-r) + \frac{n-1}{n}x(1-r)^2 + \frac{n-2}{n}x(1-r)^3 \\ + \frac{n-3}{n}x(1-r)^4 + \dots + \frac{1}{n}x(1-r)^n \end{aligned}$$

where n represents the number of years after which the super profits disappear, x the estimated first year's super profits, and r the discount rate.

Reviewing all the results obtained from the various computations, we observe that the Goodwill of one and the same drapery store can be valued at £2000, £750, £450, or £355, depending only on the method of valuation adopted.

What, however, is the true value of the Goodwill? Does the buyer shut his eyes and pick one of these four values out of a hat? Or does the vendor (or his Accountant) insist on one method and the purchaser (or his Accountant) choose another?

The probability is that all four values are wrong, and that the value actually agreed upon by the parties is none of them at all and different from any.

CHAPTER III

YEARS' PURCHASE

IN arriving at the value of Goodwill, whether on the basis of average net profits or of super profits, the capitalization is effected by means of multiplying by some number which is termed the number of years' purchase.

This expression is of very ancient usage, and probably came into existence in feudal times in connection with socage tenure of land, and later on with the granting of leases proper.

It may even have been known to the Romans when an *Emphyteusis* or a *Superficies* was sold, the agreed price being stated in the *Stipulatio* which probably accompanied it.

Similarly at the present time the capital value of Ground Rents is computed at so many years' purchase. Or if a leaseholder wishes to acquire the freehold of his property the price is negotiated on the same basis.

There are other forms of property also valued on the basis of a number of years' purchase, such as Annuities in certain public utility companies. In all these cases, however, computation at so many years' purchase rests on the solid foundation of the current rate of interest.

This needs more explicit explanation.

In 1929, for example, the average yield from Trustee securities in England was in the neighbourhood of 5 per cent. Gilt-edged securities yielded less and industrials more. But generally

speaking the rate of interest then current was 5 per cent. In 1936, however, the current rate of interest gauged in the same manner was roughly 3 per cent.

Now in 1929, it will be found, Ground Rents and Annuities generally fetched in the open market, prices of 20 years' purchase of their annual value, i.e. on a 5 per cent basis. In 1936 they fetched as much as 33 years' purchase, i.e. on a 3 per cent basis.

Turning to the valuation of Goodwill, it will unfortunately be found that there is no such logical or relevant basis for the number of years' purchase adopted whether in capitalizing average net profits or super profits.

What, then, does the figure for years' purchase represent in Goodwill? Is there any correspondence with any definite and ascertainable fact or condition or circumstance capable of being determined arithmetically with a practical degree of accuracy?

Before we can express any opinion we must, to be scientific, examine, with a view to analysis, such data as are available.

Table A, placed at the end of this chapter, is a compilation showing the basis of valuation of Goodwill agreed upon in actual cases where average annual profits were utilized.

Table B shows other cases where super profits were taken. In both Tables it will be obvious what little consistency there exists in the number of years' purchase adopted, either during the same period or for businesses of the same type.

Thus it is observed in Table A that the number of years' purchase used in the cases of Chemists were $\frac{1}{4}$, $1\frac{1}{2}$, 2, $2\frac{1}{2}$, and 3. For a Baker and Confectioner it was anything from 1 to 3. While during any year, say 1932, it ranged from nil to $2\frac{1}{2}$.

Table B shows even greater divergencies, the figures ranging from 1 to $6\frac{1}{2}$; for a Corn Merchant for example, being 5, 1, 2, and for a Butcher $1\frac{1}{2}$, 2, and 3.

On the whole the figures in Table B are higher than in Table A which, of course, is understandable, but what is unexpected is that they are only so slightly higher.

This affords, in the writer's opinion, additional evidence of the incorrectness of computing Goodwill on the basis of super profits.

There is, as was mentioned in Chapter II, some talk of the "custom of the trade," but Table A and Table B tend to explode this theory, and it is almost certain that on a more searching investigation it will be found to be mythical, and that there is no such custom for the fixing of the number of years' purchase to be adopted in valuing Goodwill.

The Goodwill of each business is valued not according to some general formula but apparently haphazardly, depending on the personalities and the relative forcefulness of the respective parties to the deal.

It would seem that each valuation of Goodwill is separate and distinct from all other valuations based on no general principles, but only on the merits of its own particular case.

And there are very good reasons why this

should be so, as is demonstrated in a later chapter, but, before we reach that, there is still another source of data to be examined, which is usually overlooked when dealing with the question of Goodwill.

TABLE A
VALUATION OF GOODWILL BASED ON AVERAGE PROFITS

<i>Nature of Business</i>	<i>Date</i>	<i>Number of Years' Purchase</i>
Baker and Confectioner	1932	2½
do.	1932	2
do.	1933	1½
do.	1934	1
do.	1934	3
do.	1935	1½
do.	1936	2
Boarding House	1934	2
Book Binder	1932	10 ³ / ₁₀
Bookmaker	1934	1
Book Seller	1933	1½
Boot Dealer	1934	1
do.	1934	2 ² / ₃
do.	1933	1 ¹ / ₃
Boot Manufacturer	1935	1
do.	1933	nil
Builder	1934	1½
do.	1936	2
Butcher	1935	1½
do.	1933	3
Chemist	1936	2½
do.	1933	1½
do.	1933	2
do.	1932	¼
do.	1934	3
Confectioner	1932	1 ³ / ₄
Corn Merchant	1932	1
Decorator	1932	1
Dentist	1935	1½
do.	1932	nil

TABLE B
VALUATION OF GOODWILL BASED ON SUPER PROFITS

<i>Nature of Business</i>	<i>Date</i>	<i>Number of Years' Purchase</i>
Baker and Confectioner	1936	1
Boat Builder	1935	2
Book Binder	1934	1½
Book Seller	1933	3
Boot Dealer	1933	2
Brush Manufacturer	1933	2
Builder and Contractor	1933	2½
Butcher	1933	2
do.	1934	1½
do.	1934	3
Chemist	1934	2
do.	1936	1½
do.	1935	2½
Confectioner	1933	2
Corn Merchant	1933	5
do.	1934	1
do.	1934	2
Credit Trader	1932	2
Dentist	1933	2
Draper	1934	3
do.	1933	2
Electrical Engineer	1936	2
Fishmonger	1936	2
Fruiterer	1934	2½
do.	1933	3
do.	1934	2
Furrier	1935	1
Furnisher	1936	3
do.	1930	1
Wholesale Newsagent	1934	6½

CHAPTER IV

GOODWILL AND STOCK EXCHANGE QUOTATIONS

LET us now view the subject of Goodwill from an entirely novel angle.

As a general rule the prices obtained for shares in transactions on the Stock Exchange depend primarily on dividends which have been paid, or which are about to be paid, or which it is anticipated will be paid.

There are, of course, several other factors which influence the value of shares, such as general monetary conditions, the stability of the Company (or its reputed stability), industrial, economic and political considerations, interest rates, public confidence, Government activities, etc.

On the whole, however, the shares of a company are valued according to the amount of its distributed profits (i.e. the dividends), or the prospect of future distributable profits.

We perceive here a possible correspondence between Stock Exchange quotations and Goodwill. Both are apparently related to profits, both have apparently some affinity with super profits, and future prospects.

Let us examine this possibility. Let us determine how the Stock Exchange quotation compares with the value of the shares computed on the basis of the surplus tangible assets as disclosed by the Balance Sheet. Let us see whether the difference between this value and the quoted price

corresponds in any way with the value of Goodwill calculated on the basis of net profits, or super profits.

An objection might be raised by reason of the fact that the price of shares fluctuates on the Stock Exchange. But a moment's thought will bring the realization that Goodwill itself is essentially a fluctuating asset.

We have taken below ten quotations, more or less at random, from the London Stock Exchange List on dates about one month after the presentation of the Balance Sheet in each case. These dates have been chosen deliberately in order to exclude the temporary artificial fluctuation caused by the declaration of dividends or the immediate anticipation thereof.

(I) AERATED BREAD CO. LTD.

The following Balance Sheet as at the 3rd October, 1936, was presented on the 28th November, 1936. The ordinary £1 shares were quoted on the London Stock Exchange on the 28th December, 1936 (i.e. one month later), at 25s. 6d. to 27s. per £1 Ordinary Share, actual dealings on that date being recorded at 26s. per share.

The Directors' Report stated that the net profit made after providing for all expenses and contingencies, depreciation, Directors' fees, and Income Tax was £114,213. The net profit after payment of the net Preference dividends was £77,609, which was available for distribution among the ordinary shareholders.

The Balance Sheet discloses surplus tangible

BALANCE SHEET

<i>Liabilities</i>	£	<i>Assets</i>	£
Capital	2,014,542	Freehold and Leasehold Properties,	1,894,650
Mortgages	424,014	<i>less</i> Depreciation	749,429
Provision for Taxation	142,888	Plant, Machinery, etc., <i>less</i> Deprecia- tion	83,542
Creditors	168,742	Stocks	45,550
Due to Subsidiary Companies	3,442	Debtors, etc.	37,000
Unclaimed Dividends	586	Pension Fund Investments	133,501
Obsolescence Reserve	110,000	Investments	79,755
Staff Pension Fund	37,000	Cash	£3,023,427
Profit and Loss Account	122,213		£3,023,427
	<hr style="border: none; border-top: 1px solid black; margin: 5px 0;"/> £3,023,427		<hr style="border: none; border-top: 1px solid black; margin: 5px 0;"/> <u>£3,023,427</u>

assets of £2,136,755, assuming that the Obsolescence Reserve of £110,000 and the Provision for Taxation of £142,888 were fully warranted.

The Capital of £2,014,542 consists of £732,542 6½% Preference Shares and £1,282,000 Ordinary Shares.

Valuing the Preference Shares, which are not participating, at par, we are left with £2,136,755 less £732,542 = £1,404,213 for the 1,282,000 Ordinary Shares.

Now, the Stock Exchange quotation of 25s. 6d. to 27s., and the actual dealings, suggest a valuation of 26s. per share. This gives a value of the total Ordinary Share Capital of £1,666,600, while the Balance Sheet shows a value based on tangible assets of only £1,404,213 as indicated above.

The difference, viz. £262,387, is assumed on our hypothesis to represent the open market value of the Goodwill of the Company.

Now, the net profits available for Ordinary shareholders amounted to £77,609. The corresponding profits for the previous two years were £75,884 and £86,733 respectively. The average is thus £80,075.

The value of Goodwill as computed above, viz. £262,387, thus represents about 3¼ years' purchase of the average profits.

(2) CEREBOS LTD.

The following Balance Sheet as at 31st December, 1935, was issued on 1st May, 1936. The Stock Exchange quotation for the shares on the 2nd June, 1936, was £9½ to £9¾, although actual transactions were recorded at £9⅞.

BALANCE SHEET

AS AT 31ST DECEMBER, 1935

<i>Liabilities</i>	<i>£</i>	<i>Assets</i>	<i>£</i>
Capital	750,000	Property, Plant, Machinery, Fittings	272,180
Reserves	350,000	Goodwill, Patents, etc.	158,078
Creditors, etc.	264,296	Shares in Subsidiary Company	54,784
Profit and Loss Account	305,410	Shares in Associated Companies	23,864
		Stocks	91,917
		Debtors	77,404
		Due from Subsidiary Company	2,186
		British Government and other Investments	901,867
		Cash	87,426
	<u>£1,669,706</u>		<u>£1,669,706</u>

The surplus tangible assets are shown at £1,247,332 to which must be added £94,404 which is the amount by which the market value of the British Government and other Investments exceeds the Balance Sheet figure. This gives a total surplus of £1,341,736.

The Stock Exchange quotation suggests an open market value of the shares of, say, £9½ each, giving a value for the total Capital of £7,218,750.

The value of the Goodwill would thus appear to be £7,218,750 less £1,341,736 = £5,877,014.

The profits for 1933, 1934, and 1935, were £226,976, £283,514, and £353,724 respectively. The 1933 and 1934 financial year terminated on the 30th November, while that for 1935 terminated on the 31st December and contained 13 months.

Moreover, the figures for 1934 and 1935 included £14,733 and £35,990 respectively, profit on sale of investments.

Making the necessary adjustments we find that the average net trading profits amounted to £262,094.

Goodwill at £5,877,014 thus gives almost exactly 22½ years' purchase of the average profits.

It will be observed that the Balance Sheet includes an item of £158,078 for Goodwill, Patents, etc. But this is obviously merely a book figure, having no true relationship with true Goodwill.

(3) J. & J. COLMAN LTD.

The Balance Sheet given on page 36 was presented at the Annual General Meeting held on the 29th April, 1936. A month later the Ordinary Shares were quoted at 79s. to 81s. with bargains at 80s.

BALANCE SHEET

AS AT 31ST DECEMBER, 1935

<i>Liabilities</i>	<i>£</i>	<i>Assets</i>	<i>£</i>
Capital	3,502,632	Goodwill	350,000
Creditors, etc.	429,549	Land and Buildings	577,039
Owing to Subsidiary Companies	275,035	Machinery, Fittings, Rolling Stock, etc.	261,373
Contingencies, Development and other Reserves	210,000	Holdings in Subsidiary Companies	1,148,134
General Reserve	371,740	Owing by Subsidiary Companies	286,638
Profit and Loss Account	405,954	Government and other Marketable Securities	1,441,046
		Trade and other Investments	58,777
		Stock	512,112
		Debtors, etc.	209,650
		Cash	350,141
	<u>£5,194,910</u>		<u>£5,194,910</u>

The Capital consists of £1,495,620 5% Preference Shares and £2,007,012, Ordinary £1 Shares.

The total surplus tangible assets amount to £3,734,372.

Deducting the Preference Shares at par we have £2,238,752 available for the Ordinary shareholders.

The market value of the Ordinary Share Capital at £4 per share (according to the Stock Exchange quotation) gives £8,028,048.

Goodwill would thus appear to be worth £8,028,048 less £2,238,752 = £5,789,296.

The net profit for 1935 after deduction of Income Tax and the Preference Dividend, amounted to £429,859, which makes the Goodwill worth about 13½ years' purchase of the net profits.

(4) JOHN DELANEY LTD.

The Balance Sheet shown on page 38 was published on the 19th November, 1936. A month later, the 5s. Ordinary Shares appeared in the London Stock Exchange Supplementary List as having changed hands at 3s. 6d. and 4s. per share.

Let us now examine the Balance Sheet.

The book value of the surplus assets amounts to £142,187. The Capital consists of £129,950 in 5s. Ordinary Shares and 1000 1s. Deferred Shares.

Ignoring the Deferred Shares, the Ordinary Shares are worth on the Balance Sheet figures about 5s. 6d. per share.

But the open market price is at the most only 4s. per share.

What about Goodwill now? A minus quantity!

The net profits in 1933-4 were £5378, in 1934-5

BALANCE SHEET

AS AT 31ST JULY, 1936

	<i>£</i>	<i>Assets</i>	<i>£</i>
<i>Liabilities</i>			
Capital	130,000	Land and Quarries, Buildings, Kilns,	
5½% Debenture Stock	94,000	Plant, Machinery, etc.	127,135
Creditors	11,564	Railway Wagons	17,565
Bankers (Secured)	11,278	Quarries, Development Account	23,890
General Reserve	10,000	Stocks	8,418
Profit and Loss Account	7,350	Debtors	20,654
		Investments at Cost	61,112
		Cash	255
		Debenture Issue Expenses	5,163
	<u>£264,192</u>		<u>£264,192</u>

were £8493, and in 1935-6 were £5276, the net average being £6382.

The market value of the total Share Capital amounts to $519,800 \times 4s. = \text{£}103,960$, which is £38,227 less than the value of the surplus assets as shown in the Balance Sheet.

Goodwill is thus apparently minus 6 years' purchase of the average profits (i.e. minus $\text{£}38,227 \div \text{£}6382$).

Let us see what correspondence there is between the Stock Exchange quotation and Goodwill computed on the super profits basis.

The average net profits amount to £6382. The Capital is £130,000. Deducting 10 per cent on this Capital, viz. £13,000, we see that the super profits are minus £6618. The value of Goodwill computed with reference to the Stock Exchange quotation is minus £38,227, which gives plus 6 years' purchase of the (negative) super profits.

(5) ARTHUR GUINNESS SON & CO. LTD.

The Ordinary Stock, of which the total issued is £7,500,000, was quoted on the London Stock Exchange at about £7 10s. per £1 unit, one month after the following Balance Sheet (page 40) was published.

The apparent surplus assets are valued at £14,328,181. The Government Securities, etc., are shown at cost but, on the other hand, the first item on the Assets side includes Goodwill, Trade-marks, and possibly other intangible assets.

The market value of the total Ordinary Stock at £7 10s. is $56\frac{1}{4}$ million pounds sterling. The excess over the surplus assets representing Goodwill is thus about 42 million pounds.

BALANCE SHEET

AS AT 30TH JUNE, 1936

<i>Liabilities</i>	£	<i>Assets</i>	£
Capital	9,500,000	Premises, Machinery, etc., less Depreciation	7,111,709
Deposits	341,073	Moveable Plant and Machinery	142,039
Creditors	2,693,580	Casks	492,160
Dividends Unclaimed	13,761	Debtors	1,740,974
Reserve	2,900,000	Stocks	1,704,088
Profit and Loss Account	1,928,181	Government Securities, etc.	4,931,634
		Shares in Subsidiary Companies	63,747
		Due from Subsidiary Companies	107,976
		Cash	1,082,268
	<u>£17,376,595</u>		<u>£17,376,595</u>

The profits after deduction of tax and preference dividend were practically two million pounds per annum during 1935 and 1936, so that the Goodwill on this basis represents 21 years' purchase of the average profits.

This is perhaps too high, as the profits made by Subsidiary Companies are not included in the accounts, but it is sufficient as an index of the degree of the figure for years' purchase.

(6) HEPWORTH & GRANDAGE LTD.

In this case the Balance Sheet as at 30th September, 1936, was issued on 27th November, 1936. On the 28th December, 1936, the shares (which are 10s. Ordinary Shares) were quoted in the Supplementary Stock Exchange List at $\pounds 1\frac{3}{8}$ to $\pounds 1\frac{1}{2}$, actual transactions having taken place at 28s. and 28s. 3d. per share.

The Balance Sheet discloses surplus tangible assets amounting to $\pounds 276,083$ giving a value of roughly 16s. per share. But as stated above the open market value was about 28s. per share, thus indicating a value for the Goodwill of 12s. per share, i.e. $\pounds 210,000$.

Now let us examine the profits earned during the past three years.

In the year 1933-4 the net profits after deduction of Income Tax amounted to $\pounds 28,373$; in 1934-5 $\pounds 28,742$; and in 1935-6 $\pounds 34,110$. But to the 1934-5 figure must be added back $\pounds 2310$ and to the 1935-6 figure $\pounds 2000$, which had been charged in writing off instalments of Reorganization Expenses. The average annual profits for the three years are thus $\pounds 31,800$.

BALANCE SHEET

<i>Liabilities</i>	<i>£</i>	<i>Assets</i>	<i>£</i>
Capital	175,000	Freehold Land and Roads	9,288
Capital Reserve	5,000	Buildings	52,504
Creditors	41,633	Plant and Machinery	110,105
General and Special Reserve	41,000	Motors	2,316
Profit and Loss Account	56,083	Furniture and Fittings	6,791
		Stock and Work	55,513
		Debtors	55,350
		Advance Payments	401
		Cash	24,948
		Investments	500
		Reorganization Expenses Account	1,000
	<u>£318,716</u>		<u>£318,716</u>

The Goodwill as computed above would appear to be worth £210,000, i.e. roughly 7 years' purchase of the average profits.

(7) MEUX'S BREWERY CO. LTD.

On 3rd February, 1937, a final dividend of $7\frac{1}{2}$ per cent on the Ordinary Stock was declared, making 11 per cent for the year, an interim dividend of $3\frac{1}{2}$ per cent having been declared in September, 1936.

On the 3rd March, 1937, these shares were quoted in the London Stock Exchange List at 45s. 6d. to 47s. 6d. *ex* dividend (the final dividend, though declared, not yet having been paid). Actual transactions took place on that date at 46s. 6d.

The Balance Sheet as at the 31st December, 1936, is shown on page 44.

The Capital consists of £540,540 in 5% Preference Stock and £1,037,760 in Ordinary Shares and Stock (£1 units).

The Balance Sheet discloses surplus tangible assets of £1,802,016. Deducting the Preference Stock at par, viz. £540,540, we are left with £1,261,476 for the Ordinary Shares and Stock.

The market value, however, at 46s. 6d. of the Ordinary Capital comes to £2,412,782.

Goodwill is thus represented by the difference, viz. £2,412,782 less £1,261,476 = £1,151,306.

The net profits after deduction of the preference dividends amounted in 1934 to £122,497; in 1935 to £124,442; and in 1936 to £125,154, giving an average of £124,031 for the annual profits.

The value of the Goodwill, £1,151,306, thus

BALANCE SHEET

<i>Liabilities</i>	<i>Assets</i>
<i>£</i>	<i>£</i>
Capital	Freehold and Leasehold Properties ¹
Debiture Stocks and Interest accrued	Fixed Brewing, Maltings, etc., Plant ¹
Deposits and Interest accrued	Casks and Movable Plant ¹
Creditors, etc., including Beer Duty and Tax	Investments at Cost—
Due to Subsidiary Companies	British Government Securities
Preference Dividend accrued	Trade
Reserve for Contingencies, etc.	Subsidiary Companies—
Reserve Account	Shares at Cost, less Reserves
Profit and Loss Account	Interest in Thorne Bros. Ltd., as valued, 1928
	Interest in Burge & Co. Ltd. at Cost
	Current Accounts
	Debtors, etc.
	Stock
	Cash
£3,533,920	£3,533,920

¹ Less Depreciation.

works out at $9\frac{1}{3}$ years' purchase of the average profits.

(8) S.G.B. (DUDLEY) LTD.

The Directors' Report on this Company was issued on the 29th September, 1936. On the 29th October, 1936, the 5s. Ordinary Shares were quoted in the London Stock Exchange Supplementary List at 5s. 3d. to 6s. 3d. An average open market valuation would thus be 5s. 9d. per share.

The Balance Sheet as at the 30th June, 1936, is appended on page 46.

The surplus assets would appear to be £368,447.

There were 600,000 Ordinary Shares of 5s. each.

Deducting the Preference Shares at par from the surplus assets figure of £368,447 we have £218,447 remaining for the 600,000 Ordinary Shares.

The Stock Exchange Quotation, however, gives at 5s. 9d. per share, a value of £162,500, which is less, thus indicating a negative Goodwill as in example No. (4) on page 37.

The net profit after deducting the preference dividend on the 6% Preference Shares and deducting also £971 profit on sale of War Loans, amounted to £13,890. (The Company was incorporated in 1934 so that the first year's results must be ignored.)

Let us deduct 10 per cent of the Ordinary Share Capital to arrive at the super profits, i.e. £15,000 giving super profits of minus £1110.

The market value of the shares is £162,500 while the Balance Sheet value is £218,447, so that the Goodwill works out at minus £55,947, which is thus over 50 years' purchase of the super profits.

BALANCE SHEET

<i>Liabilities</i>	<i>£</i>	<i>Assets</i>	<i>£</i>
Capital	300,000	Freehold and Leasehold Properties,	220,900
Capital Reserve	48,677	Buildings, Kilns, etc.	48,871
Depreciation Account	2,250	Plant, Machinery, etc.	1,719
Creditors, etc.	19,266	Motor Vehicles, etc.	29,160
Profit and Loss Account	19,770	Stocks	5,010
		3½% War Stock	49,238
		Debtors	35,065
		Cash	—
	<u>£389,963</u>		<u>£389,963</u>

(9) VENESTA LTD.

On the 26th October, 1936, the Balance Sheet on page 48 was submitted to the shareholders.

The surplus assets at Balance Sheet values amounted to £1,351,424. This, however, includes a reserve for contingent losses and depreciation of £265,102. Assuming that 50 per cent of this is justified and will in due course have to be met, we are left with £1,218,873.

The Ordinary £1 Shares (of which 439,417 are issued) were quoted on the 27th November, 1936, at about £2 per share, giving a total market value of £878,834.

The issued Capital of the Company includes also 400,000 £1 Preference Shares. Taking these at par the surplus assets representing the Ordinary Shares are worth thus £1,218,877 less £400,000 = £818,877.

The net profits available to Ordinary shareholders were £67,121 in 1933-4, £54,245 in 1934-5, and £78,808 in 1935-6, giving an average of £66,725.

Now the open market value of the Goodwill, based on our hypothesis, is £878,834 less £818,877 = £59,957, which is roughly one year's purchase of the average net profits.

(10) WATERLOW & SONS LTD.

This Balance Sheet (page 49) was issued on the 11th December, 1936.

It will be observed that the surplus tangible assets amount to £1,300,755. The Deferred Ordinary Share Capital issued was £690,000 out of a

BALANCE SHEET

AS AT 30TH JUNE, 1936

<i>Liabilities</i>	£	<i>Assets</i>	£
Capital	839,417	Freehold Land, Buildings, Plant, Ma-	
Notes and Interest	204,500	chinery, etc.	397,708
General Reserve	73,163	Stock	297,288
Reserve for Depreciation and Loss on		Investments in Subsidiary Companies	259,752
Continental Assets	265,102	Other Investments	19,896
Creditors, etc.	188,246	Loans to Continental Companies	131,938
Due to Subsidiary Company	4,824	Furniture	2,133
Profit and Loss Account	173,742	Motor Vehicles	3,082
		Advances	260,828
		Debtors	357,413
		Bills Receivable	2,512
		Cash	16,444
			<hr/>
	<hr/>		<hr/>
	£1,748,994		£1,748,994
	<hr/>		<hr/>

BALANCE SHEET

AS AT 30TH SEPTEMBER, 1936

<i>Liabilities</i>	£	<i>Assets</i>	£
Capital	1,770,000	Freehold Properties	551,376
General Reserve	305,000	Leasehold Premises	28,996
Creditors	193,181	Plant and Machinery (<i>less</i> Depreciation)	419,675
Bank (Secured)	151,479	Fixtures and Fittings, etc. (<i>less</i> Depre-	
Overdraft (Secured)	36,882	ciation)	6,195
Unclaimed Dividends	225	Investments	30,953
Profit and Loss Account	87,015	Debtors	317,416
		Stock, Work in Progress, etc.	310,453
		Cash	18,358
		Copyrights, etc.	1,320
		Goodwill	859,940
	<u>£2,543,782</u>		
			<u>£2,543,782</u>

total capital of £1,770,000, the balance consisting of £540,000 in 4% Preference Shares and £540,000 in 6½% Preferred Ordinary Shares.

Deducting the two latter at par from the surplus assets we get £220,755 as available for the Deferred Ordinary Shares.

The last-named were quoted in January, 1937, at 30s. per share, giving a market value for the total Deferred Shares of £1,035,000, and a Goodwill of £814,245.

The net profits after deduction of the Preference and the Preferred Ordinary dividends were in 1933-4 £44,261, in 1934-5 £46,350, and in 1935-6 £58,154, giving an average of £49,922.

The Goodwill thus appears to be worth about 16 years' purchase of the average profits.

In order to obtain a comprehensive view it would be as well to collate the results of our investigation.

Table C at the end of this chapter shows our computation of years' purchase based on the open market value of Goodwill and the average net profits.

Table D shows the computation of years' purchase based on super profits, the allowance for Capital being made at a uniform interest of 10 per cent in all the examples taken.

The gross inconsistency is apparent at the most cursory glance.

Table C shows the figure for years' purchase ranging from minus 6 to 22½, and no two examples give the same result.

Table D shows even greater divergence from any common level.

It will be observed that only in the case of Waterlow & Sons Ltd. does the figure shown in the Balance Sheet for Goodwill approximate the open market value as determined on the basis of the Stock Exchange quotation.

TABLE C
YEARS' PURCHASE BASED ON AVERAGE NET PROFITS

	<i>Company</i>	<i>Average Net Profits</i>	<i>Open Market Value of Goodwill</i>	<i>Number of Years' Purchase</i>
1	Aerated Bread Co. Ltd.	£80,075	£262,387	3½
2	Cerebos Ltd.	£262,094	£5,877,014	22½
3	J. & J. Colman Ltd.	£429,859	£5,789,296	13½
4	John Delaney Ltd.	£6,382	Minus £38,227	Minus 6
5	Arthur Guinness Son & Co. Ltd.	£2,000,000	£42,000,000	21
6	Hepworth & Grandage Ltd.	£31,800	£210,000	7
7	Meux's Brewery Co. Ltd.	£124,031	£1,151,306	9½
8	S.G.B. (Dudley) Ltd.	£13,890	Minus £55,947	Minus 4
9	Venesta Ltd.	£66,725	£59,957	1
10	Waterlow & Sons Ltd.	£49,922	£814,245	16

TABLE D
YEARS' PURCHASE BASED ON SUPER PROFITS

	<i>Company</i>	<i>Value of Goodwill</i>	<i>Average Annual Profits</i>	<i>Allowance for Capital (10%)</i>	<i>Surplus Profits</i>	<i>Years' Purchase</i>
1	Aerated Bread Co. Ltd. .	£262,387	£80,075	£128,200	Negative	—
2	Cerebos Ltd.	£5,877,014	£262,094	£75,000	£187,094	31½
3	J. & J. Colman Ltd. . .	£5,789,296	£429,859	£200,701	£229,158	25
4	John Delaney Ltd. . . .	Minus £38,227	£6,382	£13,000	Minus £6,618	6
5	Arthur Guinness Son & Co. Ltd.	£42,000,000	£2,000,000	£750,000	£1,250,000	32½
6	Hepworth & Grandage Ltd.	£210,000	£31,800	£17,500	£14,300	14½
7	Meux's Brewery Co. Ltd. .	£1,151,306	£124,031	£103,776	£20,255	56½
8	S.G.B. (Dudley) Ltd. . .	Minus £55,947	£13,890	£15,000	Minus £1,110	50
9	Venesta Ltd.	£59,957	£66,725	£43,942	£22,783	2½
10	Waterlow & Sons Ltd. . .	£814,245	£49,922	£69,000	Negative	—

CHAPTER V

THE FALLACY OF YEARS' PURCHASE

WE have seen that however we attempt to vindicate the application of years' purchase to the computation of Goodwill, the results are entirely negative.

Does it mean that the practical examples we have considered are not true tests? Or is the correct inference that the whole theory of the present-day methods of computing Goodwill by means of years' purchase is fallacious?

It is submitted that whatever practical test could be devised, it would inevitably show that the theory of computing Goodwill on the basis of years' purchase gave inconsistent results.

And when we take another look at Goodwill and consider anew its nature with minds disburdened from preconceived ideas on the subject, we begin to understand why this must be so.

The fact is, it is attempted to make the figure for years' purchase, superimposed on the sadly unsound foundation of super profits or average net profits, counterbalance their deficiencies. An impossible task.

Too great a load is placed on years' purchase and the consequence naturally is unsoundness. The whole edifice of the theory of Goodwill is out of perpendicular. It is not true. It does not and cannot represent Goodwill.

The errors intrinsically incorporated in the theory, and the even more important omissions,

are sought to be remedied by varying the number of years' purchase.

Thus, when the annual net profits have an upward trend, the number of years' purchase adopted is higher than when the profits are diminishing.

Or when a half partnership is bought, a higher figure for years' purchase is taken than when the whole of the business is bought outright.

Or when a partner has retired altogether from business or has died, a higher figure is used than if he has merely withdrawn from the partnership and is likely to set up in competition.

Or when the services of a particularly valuable Manager are retained, years' purchase stands at a higher figure than otherwise, or if the vendor himself is that Manager and does not intend to assist the purchaser.

And so on *ad infinitum*.

Nor have we any real quarrel with this practice except that it is done not scientifically but arbitrarily and by rule of thumb.

What has been readily appreciated and recognized, yet not taken into account in computing the value of Goodwill, is that Goodwill consists of any or all of at least seven different varieties. Goodwill may be—

1. Locality Goodwill.
2. Efficiency Goodwill.
3. Organization Goodwill.
4. Advertisement Goodwill.
5. Personal Goodwill.
6. Established Goodwill.
7. Monopoly Goodwill.

To try to make a single digit in a simple formula cover all these diverse and in some cases complicated elements, is like attempting the integration of an exponential series by means of simple multiplication.

Locality Goodwill, for example, is essentially different from Efficiency Goodwill; its effect is of a different nature and its value must, therefore, be estimated on a different basis.

So, if the Goodwill of a business is the result both of locality and of efficiency, a single arithmetic factor or a simple formula cannot possibly represent the combined effect of both species of Goodwill. Only a more comprehensive and probably more complicated formula will serve.

How much more must this be so in the case of a business where the Goodwill is comprised possibly of all seven elements.

And with most businesses, Goodwill results not from only one factor but from several.

It is clear, therefore, that the super profits theory of Goodwill must be specious, and that the years' purchase method of computation must fail to give either accuracy or even, it is urged, an indication which is not misleading.

CHAPTER VI

GOODWILL ANALYSED

It is an age-long axiom that to destroy is far easier than to construct. The reformer is usually merely an iconoclast, and it is rarely, and then only generally after a long struggle for existence, that any new constructive idea achieves recognition.

So it is with Goodwill. It is generally admitted now that the present basis of computation involving profits and years' purchase is unsatisfactory and unscientific, but to essay its replacement by a more satisfactory mode is no easy task.

The suggested method referred to in Chapter II, of the present value of an annuity which continuously diminishes to nil during a fixed period certainly has something to commend it, but the almost insuperable difficulty of gauging the period and rate of diminution by any means short of pure guesswork must be a shattering criticism.

Various different methods are also occasionally met with in a few trades of valuing Goodwill, on a basis other than years' purchase of profits.

For example, in some professions, e.g. Accountancy and Medicine, Goodwill is usually valued at so many years' purchase of the gross fees.

Again, Bakeries sometimes value Goodwill on the basis of the number of sacks of flour consumed, Butchers at so many weeks of the average takings, Cinemas on their seating capacity, Credit Drapers at a percentage of their Book Debts, Dairies on the number of gallons of milk sold *per diem*.

But in none of these cases can any consistent principle or any scientific formula be detected.

In every case the final figure adopted for Goodwill has been a compromise after negotiation, a compromise, however, not on any recognized basis but more or less haphazard. Thus, for example, a Dairyman's business is variously valued at from anything between £4 to £24 per daily gallon.

To invent a simple yet efficient system is impossible. There is no short cut. Goodwill, by its very nature, is intangible and fluctuating; it is influenced easily by many factors both internal and extraneous, and it is composed of diverse elements.

Its value can be computed therefore by no simple device, but by some formula which must take into account all these different factors, which operate, moreover, in their number and effect differently in each separate business.

Before, however, we venture to suggest what lines our quest for a method of valuation should follow, we must first examine more closely the different kinds of Goodwill enumerated in the previous chapter, viz.—

1. Locality Goodwill.
2. Efficiency Goodwill.
3. Organization Goodwill.
4. Advertisement Goodwill.
5. Personal Goodwill.
6. Established Goodwill.
7. Monopoly Goodwill.

In addition there may be in certain cases special factors of Goodwill relative only to particular businesses.

For example, the Goodwill of an industrial concern may rest not on its locality, nor its organization, nor on any one of these other forms of Goodwill stated above, but almost entirely on the size of its Capital. For a large undertaking with Capital running into several million pounds acquires publicity and a reputed stability which is not strictly what is meant by Advertisement Goodwill, as will be seen later, and which, nevertheless, brings in custom and at the same time causes the shares to be priced in the open market, e.g. on the Stock Exchange, well in excess of their intrinsic value.

No doubt every Accountant knows some isolated case where a peculiar type of Goodwill prevails, but we are prepared to assert that only in one case out of 10,000 would Goodwill be traceable to a cause outside the seven enumerated above.

To estimate the value of the Goodwill of a particular business it is first of all necessary to resolve the resultant total effect into its component elements and to study each element separately.

Is the Goodwill of the business a composite of Locality Goodwill, and Efficiency Goodwill and Organization Goodwill and the other forms, or of only some of them?

The answer to this will become apparent only after the circumstances of the particular business have been investigated. Each business has its own peculiar attendant circumstances, which the Accountant must ascertain from the facts and conditions surrounding and governing the business.

Having dissected the whole resultant Goodwill

into its separate sources, each must be examined separately, carefully weighed up and valued generally by a separate method.

It will be found that each type of Goodwill has to be valued on a distinctly different basis.

Thus, Locality Goodwill cannot be assessed merely on profits, but clearly must bear some relation to the rent or the cost of the lease or the freehold of the premises.

Similarly, Advertisement Goodwill can be gauged chiefly by reference to fluctuations in the turnover, Monopoly Goodwill by the unexpired period of the Patent or whatever right is creating the monopoly. And so on.

Each particular type of Goodwill, therefore, must be dealt with separately, and then, in order to obtain the total value of the composite Goodwill, the separate entities must be welded together to furnish the value of the whole.

There is bound to be some overlapping in the results produced by the separate Goodwills, but in the hands of a competent investigator this would receive due allowance.

In the next chapter a brief outline is given of the nature of each type of Goodwill, with a tentative suggestion of the manner in which its value may be determined.

It is by no means sought to exclude any other method which may suggest itself to an investigator in any particular case, because it is readily appreciated and is emphasized that each business must be dealt with on its own merits as, in fact, it is dealt with in practice when negotiations take place at arm's length.

But an effort is here made, however, to inaugurate a process of valuation of Goodwill on practical and scientific lines in substitution for the present crude and thoroughly unsatisfactory basis of years' purchase of average net profits or super profits.

CHAPTER VII

TYPES OF GOODWILL

1. Locality Goodwill

IT is self-evident that a shop in Bond Street is likely to do much more business than a similar shop in Potters Bar. Not, be it observed, that the Bond Street shop would necessarily make more *profits* (although that is hoped), but it would certainly do a bigger trade, attract more customers, have a greater Goodwill.

This Goodwill is what we call Locality Goodwill. It depends entirely on the advantage of Bond Street for trading purposes by reason of its position in the centre of London.

And for this advantage traders are quite naturally prepared to pay.

How do they pay for it? By rent, or the equivalent of rent, a lease or the cost of the premises.

Now, the most generally accepted economic theory of rent is based primarily on the conception illustrated above. Rent is not, as it would at first sight appear to be, what the landlord charges for the loan of his premises. It is, on the contrary, the amount which a tenant is prepared to pay for them.

There seems to be no difference between the two, but in fact the difference is fundamental.

The landlord cannot get what he would like to charge, but only what a tenant would be willing to pay.

And as the trading position of Bond Street is better than Potters Bar, there is more competition among traders for the former, which thus can command a higher rental.

Thus, it is clear that there is a close relationship between Locality Goodwill and rent. It may safely be presumed, therefore, that the value of Locality Goodwill can only be determined by basing it on the rent (or its equivalent).

Now, if the amount of the rent exactly counterbalances the advantages of the Locality Goodwill, no tenant would take the premises, for he would gain nothing thereby.

Hence, there must be some lag between Locality Goodwill and the rent, the difference representing the excess value of Locality Goodwill over the rent.

How can the value of this excess be determined?—for this would be the value of effective Locality Goodwill.

Each particular business, and each particular district, must be dealt with on its own merits. And generally speaking the investigator must choose the method he considers most suited to the special case or which in the circumstances, commends itself.

Merely as a suggestion we venture to put forward the following possible method.

Take a thoroughfare like the Strand. The majority of businesses situated there rely primarily for trade on Locality Goodwill.

Some, of course, which have acquired a "name" of almost world repute—the examples readily come to mind—by reason of sentiment or efficiency

or through some particular product or circumstance, also possess some other type of Goodwill.

But, generally speaking, the trading depends entirely in the Strand on Locality Goodwill, on the advantage of position, and the never-ending stream of visitors from the four corners of the Kingdom and from all ends of the Earth.

It is reasonable to presume that the rentals are, roughly speaking, equal per frontage along the whole thoroughfare, and moreover, in all probability the rent bears a more or less fixed ratio to turnover or perhaps to the gross profits.

Here is clearly an indication of a scientific assessment of the value of Locality Goodwill, and it is tentatively suggested that this might be accurately determined by taking a certain percentage (the exact figure could with a little inquiry easily be ascertained) of the rent as representing the annual value of Locality Goodwill. This could be capitalized at so many years' purchase on the same lines as Ground Rents or an annuity, as explained at the beginning of Chapter III.

There is a good deal of room on this subject of Goodwill for inquiry and research. For that matter, the whole theory and practice of Accountancy suffers from lack of research work, and the collation and tabulation of statistics which could be of vital importance not only to Accountants, but to the whole of the industrial and commercial world.

For example, a knowledge of the value of Locality Goodwill could easily be determined for a thoroughfare like the Strand, and the results so obtained could then be applied to other businesses in other districts where Locality Goodwill

is not the primary cause of trade, but is perhaps only one of several types of Goodwill.

With regard to Locality Goodwill, moreover, it must be appreciated that this occurs only in certain types of commercial enterprise such as retail shops, occasionally wholesalers, and in some few cases, professions (e.g. Lincoln's Inn Fields for Solicitors, Harley Street for Doctors).

Locality Goodwill is not to be confused with Site Value such as a factory might possess if near a canal or a railway or in a certain district where specialized labour is available (e.g. hats at Luton, gloves at Yeovil, lace at Leicester).

2. Efficiency Goodwill

Under this heading we include all that Goodwill which is the result of some peculiarity of skill inherent in or specialized by a particular firm.

It may be due to some "flair" or skill or knowledge possessed by the proprietor or a director or a manager, it may be due to some unique machinery or process of manufacture, or it may be due to expert craftsmanship or system.

Whatever it may be due to, it results in the production of an article perhaps superior in quality or cheaper in price, and thus commanding a preference for it among consumers.

But how are we to assess the value of this type of Goodwill?

Partly, of course, it is usually counterbalanced by increased cost of production, such as higher wages for better craftsmen, or expense of specialized plant, and these naturally themselves form a basis for measuring the resultant Goodwill.

But as with Locality Goodwill, so with Efficiency Goodwill, it is the object of the investigator first of all to discern the existence of this type of Goodwill and then to devise some means, depending primarily on the peculiar nature of each case, of determining its value according to whatever circumstances or facts may commend themselves as suitable material.

3. Organization Goodwill

This resembles Efficiency Goodwill but applies generally to the distribution side of a business as opposed to the production side.

Thus a remarkably efficient body of travellers or a good system of supplying consumers with regularity and certainty, or a reliable service may create an excellent reputation and so a valuable Goodwill.

And here again the method of estimating the value of this Organization Goodwill depends primarily on its cause.

If it is the result of carefully picked and capable salesmen, then the extra salaries or commission payable to them must be the basis for computing the resultant Goodwill.

If it springs from special services rendered to consumers, then obviously the cost of such services must form the basis of our estimate.

Sometimes it may be possible to value this type of Goodwill by reference to the turnover, noting the fluctuation of trading consequent on the adoption or relinquishment of any particular measure promoting this type of Goodwill.

4. Advertisement Goodwill

This denotes the Goodwill created by means of advertising.

There are some commodities which depend for their sale almost entirely on the extensiveness with which they are advertised.

On the other hand there are cases where advertising does not create any Goodwill at all.

Care must be taken to distinguish between those cases where sales cease almost immediately on the cessation of advertising, and those cases where the Goodwill is established primarily by the initial advertising campaign and sales do not seriously diminish when the advertising is stopped or, at any rate, not continued on the same scale.

In the former case it can hardly be stated that there is any Advertisement Goodwill at all—there might perhaps be a residuum—but in the latter undoubtedly Goodwill has been created by the advertising.

At first sight it might be considered that the cost of advertising is inevitably a direct measure of the Goodwill created, but a little reflection will soon modify that impression.

The safest method of tackling the problem of estimating the value of Advertisement Goodwill is by establishing the relationship of turnover to the annual cost of advertising subsequent to the initial campaign.

If there is a direct ratio, then it is doubtful whether much (if any) Advertisement Goodwill exists.

Thus, for example, if expenditure of £2000 on

advertising results in roughly an increase in sales of twice as much as when only £1000 is spent, there may be no Advertisement Goodwill.

If, however, only a comparatively small annual outlay is necessary in order to keep up sales, then there is undoubtedly Advertisement Goodwill which may be measured more or less accurately on the basis of the non-recurring proportion of the original outlay.

5. Personal Goodwill

The statement is frequently met with that the Goodwill of a business is personal to the proprietor himself, in the sense that, on his death or retirement, the business automatically loses the whole of its pristine Goodwill.

Occasionally it is even asserted, in the case of a limited liability company, that the Goodwill attaches not to the Company but to, perhaps, the Managing Director or the Secretary or to a particular agent or other official.

From practical experience it is well known that, in nearly every case where the collapse of a business is feared by reason of the removal or death of any particular individual, those fears are not in fact realized to any appreciable extent.

Turnover generally is not affected, or if at all, not seriously, even when it is a "key man," perhaps the founder himself, who drops out of the business.

Contrary to general expectations, we have from personal experience found that no matter how vitally important a certain person appears to be in the conduct or prosperity of a business, he can

always be replaced by somebody else of similar attainments. Sometimes it is not necessary even to bring in anybody from outside to replace him, there being generally somebody already in the business with sufficient ability or who develops the required ability or acumen to carry on.

There are, however, undoubtedly cases where some special knowledge or "flair" or skill on the part of the proprietor makes the business and gains for it that peculiar Goodwill known as Personal Goodwill. On the whole, however, it is far less important and far less common than is generally realized.

Not so much in commercial enterprise as in the professions does this type of Goodwill exist. Sometimes, also, it is found in industrial concerns; for example, a brilliant chemist or engineer or an inventor.

How is this Personal Goodwill to be valued?

It is suggested that unless its existence is patently and indisputably clear—and the investigator will in every case soon be sure of this—it should be entirely ignored and assumed to be non-existent, even though the proprietor himself (or the founder) claims special ability.

Where Personal Goodwill does exist, the method of valuation must depend on the circumstances of each particular case.

Where a brilliant chemist or metallurgist is its fount, the salary or fees he commands may be taken as the basis. Perhaps he has replaced some previous less famous chemist. Then the advantage of his advent to the business must be gauged by reference to turnover or gross profits or output

or whatever other factor may commend itself to the investigator.

Where the Personal Goodwill depends on skill pure and simple as, for example, in a member of a firm of Solicitors or Accountants, similar factors may be looked to for guidance, such as the fluctuation in gross fees or number of clients since his entry into or departure from the firm.

6. Established Goodwill

This may be termed the Goodwill of Inertia.

Most people, when they form habits of going to any particular place for their purchases or of buying a particular brand of article, are too conservative to make a change unless there is a definite and decided advantage in doing so, and even then sometimes cannot bring themselves to alter their customary preferences.

And the longer the habit, the more reluctant is the change.

So, people dealing for any considerable period with one firm continue to do so from mere inertia and conservatism, notwithstanding that by making a change they might derive some benefit.

This tendency gives rise to what we have called Established Goodwill.

It is the Goodwill which comes from the very fact of having been long established and in due course having retained a certain number of what might be termed true "regular" customers. It is the combined result merely of the firm having been long in existence and of the human element of inertia resisting change.

It is safe to say that every old established

concern possesses this most valuable type of Goodwill to a larger or smaller degree.

To suggest a method of valuing it is not easy. Perhaps a view of the list of customers, showing what proportion is retained year after year for, say, a decade, might afford a clue as to what basis an investigator might adopt. Perhaps graphs relating turnover with the number of sales effected over a period might give a hint.

7. Monopoly Goodwill

This is hardly Goodwill at all, although it is generally accepted as such.

It depends, of course, on possession of those particular rights, such as Copyrights, Patents, Designs, etc., which confer upon a firm the monopoly.

Its value may be assessed simply on the turnover or gross profits which the monopoly produces, or is estimated to produce, for the period during which the monopoly will continue. Or it may be calculated on the basis of the present value of the net profits for which the monopoly is responsible.

CHAPTER VIII

CONCLUSION

IN the preceding chapters an attempt has been made to place the whole subject of Goodwill on a footing not only novel but also, it is hoped, more scientific.

The subject has been approached with as open a mind as possible, and from an angle at which the fundamental first principles would not be obscured by the unsatisfactory and surely outworn shibboleths of "average profits" and "super profits" and "years' purchase."

Chapter I attempts a definition which confines itself to Goodwill, and does not involve conceptions and ideas really outside its scope, even although these extraneous notions might be useful in arriving at some empirical formula for valuing Goodwill.

Chapter II briefly explains the present-day theories underlying the usual bases of estimating Goodwill, while Chapters III, IV, and V endeavour to expose the fallacy of the present-day methods.

It is in Chapter VI that we venture to give an outline of the new theory as it commends itself to us, while Chapter VII is an effort to give clearness to the expressions we have used, to elaborate a little the theory we desire to expound, and to offer suggestions as to the practical application of our theory.

It is appreciated that this is only a beginning, and that a great deal more has still to be said on

the subject, and a tremendous amount of research is necessary before the final word is written.

The ancient Greeks propounded on practically every subject open to human thought some very fine and remarkably prophetic theories, some of which were adopted only within the last half century, and some in all probability are yet to be accepted. The ancient Greeks, however, were unfortunately merely theorists, and it was not until the results of the practical research work performed since the seventeenth century, laborious observations, tedious classifications, collation and tabulation of statistics, that any real progress was made and any particular theory could be accepted as corresponding with the facts.

Similarly now with Goodwill. No attempt has been or can be made at this stage to lay down dogmatically any particular theory, nor can one investigation alone deal with this subject exhaustively.

We shall be supremely satisfied, however, if this little book has the effect of inaugurating a system of inter-communication among Accountants and the correlation and tabulation of observations made by them separately, much as is at present done among astronomical observers throughout the world.

What we venture to assert as definite is that the time is overripe for a more scientific view to be adopted by Accountants of this subject of Goodwill, and that the present system of valuation is unsatisfactory, inaccurate, and tends to lower the prestige of the profession.

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