The Definition of Goodwill- a Chronological Overview

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Abstract

The purpose of this paper is to offer a full perspective on the evolution in time of goodwill definitions. This paper is part of the research conducted in the doctoral dissertation and we consider it is very important to have a full understanding of the concept studied in order to develop on this subject. We use a chronological analysis and review definitions from the late 1800s until today. The definitions are given by prominent scholars of the time, published in highly ranked journals and books or offered by international accounting boards. We approach the definition from an accounting and a legal perspective. Our findings are that, in time, the definitions offered either improve on an old definition or are completely original. Some elements used to describe goodwill remain the same throughout the whole period we studied. The conclusion of our study is that this type of in-time analysis is beneficial to the researcher in the way that it offers a complete picture of the concept and its history.

Key words: *goodwill, definition, chronological, accounting, scholar*

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1. Introduction

Goodwill is one of the intangibles which have always been a constant problem of accountants and accountancy ever since its existence was first acknowledged in the 1880s. Many authors have since then defined the concept of goodwill (Dicksee&Tillyard, 1906, Seed, 1937, Gynther, 1969, Fess and Niswonger, 1981). It is interesting to observe that the divergent opinions with regard to the definition of goodwill over time are also true about the accounting treatment of goodwill worldwide today.

Many questions which researchers raised about goodwill one hundred years ago are still being answered today, which represents a strong reason to study this topic, which is challenging, current, ambitious and also important both to stakeholders and to the field of research. This paper makes the first step in comprehending the meanings of goodwill as they were conveyed in the last hundred years by the most esteemed accounting professors or researchers of a certain time, and in the latest years by the international accounting boards which have a significant influence in accounting worldwide. Our study continues the study of Courtis(1983), but improves on that study by adding definitions from 1983 to the present time, by including international accounting boards' definitions alongside academic definitions alone, by linking the definitions to one another through the elements which we find similar. We consider our study to be important and useful to the field of research because it gathers only the best, carefully selected definitions of goodwill, which have taken the test of time, offered only by outstanding academics, published in highly ranked journals or famous books which have become part of the accounting history, or by influential accounting boards, namely the International Accounting Standards Board and Financial Accounting Standards Board.

2. Literature review

By the end of the 19th and beginning of the 20th century, business combinations were not very common, sole owners and family businesses were still the most spread types of businesses on the market. Meanwhile, the only form of existing goodwill referred to the quality of the services or products offered and the reputation of the business or the correctness of the owner. Before accounting institutions were formed, individual writers and researchers of the time based their writing on personal experience and referred to legal cases in common law. One of the first authors to give a definition for goodwill that is still popular today was Professor L.R. Dicksee in the first book dedicated entirely to goodwill, “Goodwill and Its Treatment in Accounts” (1906). Goodwill he says, “is the benefit arising from connection and reputation, the probability of old customers going to the new firm which has acquired the business” (cited by Courtis, 1973, p.3).

Although there is no internationally accepted definition of goodwill from a legal perspective, Courtis (1973) identifies numerous cases in common law where definitions were offered. One of the best legal perspectives was offered by Lord Macnaghten in 1901. He said goodwill “is the benefit and the advantage of the good name, reputation, and connection of a business. It is the attractive force which brings in the custom... Goodwill is composed of a variety of elements. It differs in its composition in different trades and in different businesses in the same trade”. Macnaghten’s view of goodwill is strongly related to the elements which comprise it. The comprising elements of goodwill have been subject to change over time, along with the creation of institutions or accounting bodies which regulated their valuation.

3. Research methodology

We approach a chronological, qualitative overview of the definitions and the conceptualization of goodwill starting from the late years of the nineteenth century to this day. By analyzing accounting writings and the legal encounters of the term goodwill we offer a clarification of this concept and its nature. The diversity of definitions explaining goodwill for more than a decade will inherently advance criticism about the substantiality, complexity or logic abiding when formulating these definitions. In order to prevent such criticism we only considered for this paper the definitions which were given by prominent scholars of the time, published in articles or books which proved their substantiality over time, appeared in legal cases which are considered precedents, especially in the common-law countries and in the international accounting standards worldwide.

In conducting this research, for the beginning of the period studied we used the first books which were published about goodwill. Dicksee published the first book on goodwill in 1897, but we used the later, third edition, which was published in coauthorship with Tillyard in 1906. P.D. Leake published his valuation theory of goodwill in 1914, but for our paper we used the later version republished in 1921. We also used journals which are ranked in the Thompson Reuters (ISI) Web of Knowledge, especially for the period after 1900, when accounting journals were first indexed in this database. The most cited papers were published in the following journals: The Accountant, which is the first journal of accountancy worldwide, ABACUS, Accounting Review and not least, The Accounting Historians Journal, which was the sine qua non journal for this type of research.

We consider the chronological content analysis conducted in the research of our topic to be important and adequate at the same time, because it is crucial to have a thorough understanding of the evolution of goodwill in order to properly work with the concept further along when demonstrating the importance of this intangible asset in investors' behavior on the market.

4. Research findings

Defining goodwill is a process which has spread over a long period of time, from the late 1800's until today, and has not yet found closure. The stretch over time and the continuity of this process was best explained by Hughes (1982), as cited by Bloom (2008): "...there was no one Truth and never will be. The origin of goodwill can be revealed through history, but its nature is a matter of personal interpretation."

The earliest reference to goodwill was cited by Leake (1921), "I gyue to John Stephen …. My whole interest and good will of my Quarelle" (i.e. quarry) and goes back to 1571. This citation does not give a definition of the term, but it proves it has been acknowledged more than four centuries ago and it seems to be the oldest, most famous quote about goodwill researchers ever found.

The oldest definition authors refer to appeared in Bithell's "A Counting House Dictionary" in 1882 as cited by Courtis (1983):

"The advantage connected with an established business of good repute. A well-established business presents an expectation of profits to any one entering upon it, and is worth paying for. Anyone having such a business and who is willing to relinquish the expectation of the business by transferring it for consideration to someone else can do so by what is technically called "selling the Goodwill of that business"".

There are two important aspects in this definition which perpetuated over time: first, goodwill is viewed as an "advantage" and to this day the international accounting boards refer to goodwill as such and the second aspect is goodwill's attribute of "expectation of profits" which is also part of its description today.

In the first book ever written on goodwill, "Goodwill and Its Treatment in Accounts" Dicksee and Tillyard (1906) revise the most important legal cases of that time, which give definitions of goodwill, and summarize them into a very suggestive paragraph: "...where the locality of the business makes the trade, Goodwill as a disposable asset represents the advantage derived from the chance that customers will continue to frequent the premises in which the business has been carried on; that where the business is one which depends upon the reputation of a firm, the Goodwill consists of the advantage which the owner (whether original or by assignment) derives from being allowed to represent himself as such; and that where the value of the business depends on its business connection, the Goodwill on sale consists of the right to be properly introduced to those connections."

Again we find an element in this definition which remained constant over time: the advantage associated to the concept of goodwill, derived from the location of the business, the reputation or brand significance, or the prior to the sale business connections.

In 1921 the illustrious chartered accountant P.D. Leake publishes the second book dedicated entirely to goodwill called "Commercial Goodwill. Its History, Value and Treatment in Accounts", where he elaborates the "Super-profit Valuation Theory of Goodwill". He defines goodwill as:
"...the right which grows out of all kinds of past effort in seeking profit, increase of value or other advantage... The exchangeable value of the right depends upon the probability of earning future super-profit- the term "super-profit" meaning the amount by which revenue, increase of value, or other advantage received exceeds any and all economic expenditure incidental to its production".

The main idea of Leake's theory is that the value of commercial goodwill is the current value of a super-profit which diminishes annually on a straight line pattern. He also identifies the "advantage" associated to goodwill which results from the difference between revenue and expenditure incurred in obtaining that revenue.

For the first time, in 1937, H.D. Seed relates goodwill to law associated with its components- namely trade names, trademarks, patents or copyrights. He develops the thesis that goodwill should only be valued in association to the valuation of the whole business. The influence of his predecessors is evident in the qualities Seed attributes to goodwill when defining it:

"The advantage which arises from the good name, reputation and connections of a business; alternatively, the benefit which accrues to the owner of a business from the likelihood that such business will earn, in the future, profits in excess of those required to provide an economic rate of remuneration for the capital and labor employed therein."

In 1946, in an attempt to probably express the frustration of some writers to find the best definition for goodwill, Harry Norris, in his book "Accounting Theory. An Outline of Its Structure", as cited by Courtis (1983), brings a little true humor into the definition of goodwill:

"If X is a live pedigree dog, and Y a dead one, then perhaps X-Y=Z. But Z doesn't mean anything in itself. The label 'goodwill' in business accounts closely resembles Z; its use is as sensible as trying to find what makes a dog tick by dissecting it."

What Norris probably means is that what gives value to goodwill are precisely its components, which cannot be valued separately, therefore are all included under the name of goodwill. Even though a funny definition, the truth behind it still emerges to the surface today, when accountants admit that the notion of goodwill contains elements which cannot be separately valued as assets.

In 1969, Gynther approaches the definition of goodwill in a way that is still valid today, and this validation in time of his definition makes it, in our opinion, one of the most convincing definitions we managed to find in our research. Gynther (1969) admits that goodwill has been a "thorny problem" of accountants over time and the motive for that may be the fact that the real definition has been replaced by just means of calculation for goodwill. He says:

"Goodwill exists because assets are presented, even though they are not lined with the tangible assets. For example "special skill and knowledge", "high managerial ability", "monopolistic situation", "social and business connections", "good name and reputation", "favorable situation", "excellent staff", "trade names", "established clientele" are assets in this category. The sum of the value of these assets...is the value of Goodwill".

The list of the elements which form goodwill that Gynther mentions is definitely not an exhaustive one, but our attention will be directed to those elements in another research paper. He draws attention to an aspect that is still troubling accountants today, what is the value of goodwill and what does components does it encompass?

In 1975, Gibson and Francis are among the first researchers to define goodwill with connection to consolidation:

"Goodwill on consolidation is the term used to describe the excess of the cost of investment in subsidiaries over the book value of the equity acquired."

In 1981, Fess and Niswonger, define goodwill with relation to the higher rate of return it can bring in a business combination:

"Its (goodwill's) existence is evidenced by the ability of the business to earn a rate of return on the investment that is in excess of the normal rate for other firms in the same line of business."

In 1981, when the International Accounting Standard Committee exposed its first draft for ED22 Accounting for Business Combinations, they defined goodwill as "the excess of the purchase price over the assigned values of the net identifiable assets acquired."

In 1983, the International Standard Committee issues IAS 22 Accounting for Business Combinations, where goodwill is defined as "the future benefits from unidentifiable assets".

In 2010, the International Accounting Standards Board issued the International Financial Reporting Standard 3 Business Combinations and replaced IAS 22. IFRS 3 defines goodwill as: "future economic benefits arising from assets that are not capable of being individually identified and separately recognized". The definition confirms that the value of the business as a whole is bigger than the sum of the accountable and identifiable net assets. More important however than this descriptive definition, the IFRS 3 defines goodwill by means of how it should be measured: "Consideration transferred to obtain control plus Amount of non-controlling interest (using either option) plus Fair value of previously-held equity interest less Fair value of the identifiable net assets of the acquiree (100%)" (Paragraph 32, under IFRS 3 Revised 2008 (IFRS 3R)).

The Financial Accounting Standards Board issued the Status of Statement No. 142, SFAS 142, Goodwill and Other Intangible Assets in 2001 and in 2007 SFAS 142 Revised where they define goodwill through how it is measured: "the aggregate fair value of purchase consideration, any non-controlling interests in the target company, and any equity interests in the target company already held by the acquirer on the transaction date less the net fair value of identifiable assets acquired and liabilities assumed in the business combination". The very similar definition of goodwill offered by the FASB to the one offered by the IASB is explained by the convergence process both institutions signed up for.

From a legal perspective, until today, no international legal or financial institution has published an act or another legal form of regulation with regard to goodwill. In many common-law countries, some trials have been considered important precedents to others and many accounting related trials mentioned goodwill. By large, over the last hundred years we studied, what most cases referred to in connection to goodwill, was in fact connected to its components. The location of the business, the social and business connections, trademarks, copyrights, patents, skilled workers, the quality of the services or products sold, the customer loyalty, the reputation of the business were all subject to trial. Legal opinions with regard to goodwill also highlight the importance of the element of advantage which we identified in almost every definition accountants give of this term.

Even if there is no Goodwill Law, to be sanctioned internationally, in 1967, the World Intellectual Property Organization is formed, who, in its own words "is dedicated to the use of intellectual property (patents, copyrights, trademarks, designs, etc.) as means of stimulating innovation and creativity", in a fair manner and with respect to the regulations of this worldwide organization. The importance of this institution to goodwill has proved to be crucial in time, because all the intellectual property elements mentioned above, which were prior to this included in goodwill, had now grounds to be valued on their own and not be considered goodwill components anymore.

Another milestone in close connection to the definition and components of goodwill happened in 1990, when the Swedish company Skandia, for the first time, gave meaning and draw a clear perspective of the concept of intellectual capital, which is a major component of goodwill. Until today, the intellectual capital is not accounted for separately, but there is an international interest, both in business and in academic research of how it could become an independent intangible asset. When this happens, goodwill will be short of one more important element, and its accounting value will drastically drop, meaning its value won't be as significant to the business as it is today.

5. Conclusions

The purpose of this paper is to offer an overview of goodwill definitions, going back for longer than a century and to understand how goodwill evolved, through the definitions given by academics, professional bodies of accountancy and courts of law. We have covered mostly accounting definitions and legal opinions.

Our findings indicate that goodwill has been defined over time in two different ways: by academics who indicated mostly the elements comprising goodwill and its characteristics and by the international accounting boards which define goodwill through the way it is measured. The most common characteristic which we encountered was the advantage brought by goodwill in a business combination, which is the only constant characteristic mentioned both by academics and institutions over time.

This study is the result of a chronological qualitative analysis of the concept of goodwill and it brings novelty to the literature by improving on existing studies dating in 1980s, and completing them to the day.

This study is extremely useful to both academics and professionals who want to use a brief but comprehensive analysis of goodwill definitions. The authors wish to continue this study with a similar chronological analysis of goodwill components and the accounting treatment of goodwill.

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