Goodwill: A Present Property Right or Only An Anticipated Future Right?

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The root of the controversy about "goodwill" is this basic distinction between present property rights and possible future rights (presently not owned) resulting from a contractual position. Unfortunately the confusion has been "canonized" into the basic capitalization formulas of finance theory. The standard formulas for the capitalized value of a capital asset routinely capitalize into the value of the asset the possible future profits that depend on a "non-owned" contractual position. Hence our task to tease apart the two parts of the so-called "capitalized value" into the part that does represent present property rights and the part representing anticipated but not presently owned future profits. It is this latter part, the capitalized value of anticipated future profits, that is called goodwill.

Introduction
The notion of "goodwill" is controversial for good reason. The usual treatment of goodwill as a present property right, e.g., in the accounting treatment of "purchased goodwill" as an asset, is based on a rather fundamental confusion. Unfortunately, the confusion extends to some of the basic ideas and formulas of finance theory so the matter has long resisted clarification. My purpose here is to present the argument why goodwill is not a present property right in a brief and simple manner.

―The business operator has no property right to force customers and suppliers to continually renew the past contracts.‖

Property rights versus going-concern contractual roles
A basic characteristic of a property right is that it may not rightfully be taken away from a person without the person's consent. A going-concern business is typically at the center of a nexus of market contracts which have a rather limited duration. When a current contract expires, then a customer or supplier may decide for whatever reason to terminate the contract and...

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take their business elsewhere. This does not require the consent of the business operator. The business operator has no property right to force customers and suppliers to continuously renew past contracts. Future profits may have been anticipated from the continuation of the old contracts, but no rights were violated if the customers or suppliers decided not to renew the contracts. The anticipated future property rights that would result from the continued contracts, e.g., future profits, might not materialize but that is quite different from some present property right of the business operator being violated.

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The capitalized value of an asset
Consider a simple example of a capital asset, e.g., a widget-maker machine, providing capital services K per period with which the labor services L will produce Q units of the product per period. Assume the asset provides these services for n periods with no maintenance required and then is finished with no salvage value. Let r be the competitive rental rate per unit of capital service so K would be the competitive rental for the asset's services per period. Anyone desiring to use the asset's stream of capital services, K, K\(_1\), ... K\(_n\), for n periods would have the market choice to rent or buy. Competitive arbitrage would equate the present value of the rentals and the market cost C of the asset. If p is the interest or discount rate per period, then the equation of the market cost and the discount present value of the rentals is:

\[
C = \frac{rK}{1 + p} + \frac{rK}{(1 + p)^2} + \ldots + \frac{rK}{(1 + p)^n}
\]

Market cost of the asset = Present value of rentals (no salvage value)

What is the "value" of such a machine to the its owner? If no other contracts were available, then the owner might have to rent out the machine at its rental rate and then the value C would accrue to the owner.

But suppose the machine owner, for whatever reason, is able to make another set of market contracts, namely to hire all part of the property rights of the asset owner. The standard formulas for capitalized asset values and business valuation are all more complex versions of this simple formula. To make the point explicit, one has to parse the formula into two parts: the present value representing the (future recovery of the value of) present property rights plus the present value of future profits resulting from the assumed "going concern" continuation of beneficial supplier and customer contracts, i.e., the goodwill.

In our simple example, the profit each period is:

\[
\pi = pQ - rK - wL
\]

Anticipated profit per period
so the discounted present value of the profit, namely the goodwill, is:

\[
GW = \frac{\pi}{1 + p} + \frac{\pi}{(1 + p)^2} + \ldots + \frac{\pi}{(1 + p)^n}
\]

Goodwill = Present value of future anticipated profits

Then since pQ - wL = rK + \pi, the capitalized value V is easily parsed into the sum of the asset's market value C plus the goodwill GW:

\[
V = \frac{pQ - wL}{1 + p} + \frac{pQ - wL}{(1 + p)^2} + \ldots + \frac{pQ - wL}{(1 + p)^n} = \frac{rK + \pi}{1 + p} + \frac{rK + \pi}{(1 + p)^2} + \ldots + \frac{rK + \pi}{(1 + p)^n} - C - GW
\]

"Capitalized value of asset" = market value of asset + goodwill.

Thus the standard capitalized value formulas for business assets or businesses are not just the value of present property rights but include the value of certain anticipated but presently not owned future profits.

The confusions about capitalized value are also expressed in the rather muddled idea that these anticipated future profits are somehow "attached" to the physical assets or the "business." "When a man buys an investment or capital-asset, he purchases the right to the series of prospective returns, which he expects to obtain from selling its output, after deducting the running expenses of obtaining that output, during the life of the asset." [Keynes 1936, 135]
But the buyer of the asset buys no such right against the customers and suppliers who may freely decide not to continue the past contracts and thus to change the "series of prospective returns" which the asset owner "expects to obtain".

Unfortunately these confusions about the property rights involved in owning a capital asset are carried over in modern finance theory to the valuation of an entire going-concern business as an "asset".

Hence "purchased goodwill" is no more a present property right than unpurchased goodwill since the seller had no such property right to sell.

Capital expended to "purchase" such a non-right should not be recorded as an owned asset but as a debit to equity.

Some accountants have courageously argued for this correct procedure, e.g., George Catlett and Norman Olson in Accounting for Goodwill.

"The amount assigned to purchased goodwill represents a disbursement of existing resources, or of proceeds of stock issued to effect the business combination, in anticipation of future earnings. The expenditure should be accounted for as a reduction of stockholders' equity."

[Catlett and Olson 1968, 106]

The debit to equity would then be replenished if and when the anticipated future profits were earned, i.e., were realized as present property rights.

However, one should not expect conceptual clarity in the standard literature on this issue anytime soon. It is not just an issue about accounting for goodwill. As we have noted, the issue involves very basic ideas about just what is owned in the ownership of an asset or a corporation, and the confusion is embedded in the standard asset capitalization formulas of finance theory.

References

