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VALUATION OF GOODWILL

Goodwill

Meaning:

Goodwill is the extra value attached to the business over and above the intrinsic value of its net assets. In other words, it is the value of operations or good name of the business.

Super profit earning capacity due to wide connection & reputation.

Definition:

Prof. Dicsee, "when a man pays for Goodwill. He pays for something which puts him in a position of being able to earn more than he would be able to do by his own unaided efforts."

Spices and Pegler, " Goodwill may be said to be that elements arising from the reputation connection or other advantages possessed by a business which enables it to earn greater profits than the return normally to be expected on the capital represented by the net tangible assets employed in the business.

Types of Goodwill

P.D leake has classified Goodwill as under.

(I) Dog-Goodwill

Goodwill in which, it is attached to persons, i.e customers who are attached to particular person's, lead to person Goodwill which is not transferable.

(ii) Cat-Goodwill:

Cat-Goodwill is The Goodwill where it is attached to locality. Some customer prefer some shop a business Because it is in well established area which leads reputation is cats prefer the person/environment of old home.

(iii) Rat-Goodwill:

The other type of Goodwill is the where customer has attachment neither to the person nor to the place, which in other words is known as Rat-Goodwill.

Features of Goodwill:

(1) Intangible Assets:

Goodwill is an intangible asset that means it cannot be seen or touched but we can feel or find out the existence of Goodwill.

(2) Not a fictitious asses:-

Goodwill is the real asset which yields some benefits to the business and it is not a fictitious asset.

(3) It cannot be separated:-

Goodwill always exist with business but it cannot exist itself. I.e individually the goodwill cannot be purchased or sold.

(4) Goodwill is subject to fluctuations:-

Value of the goodwill depends upon the so many factors if any change in those factors leads to changes in value of goodwill which leads to fluctuations.

Factors determining the value of goodwill

Goodwill of a business represents it capacity to earn profit above the normal profit.

The factors which influence the value of goodwill are

(1) Location factors:

Favourable and we'll established location influence the earnings capacity of the business and enhance the value of goodwill and vice versa.

(2) Time factor:

A long established business enables better goodwill than the nearly established business

(3) Nature of Business

The nature of goods in which company of dealing, risk attached the competition involved are also the main factor which determining the goodwill if risk and competition is less goodwill will be high and visa versa.

(4) Efficiency of Management:

Efficient management of a firm contributes to higher profits and maintains goodwill of a firm & visa versa.

(5) Stability of business:

If business condition of the firm is stable the company will have more goodwill. If business unstable means goodwill be less.

(6) Past profits of Business:

If past profits of the business high means there is an expectation the future profits also high & value of goodwill also high & visa versa.

(7) Future Prospects of Business:

The better the future prospects of business the better will be the goodwill if future prospects not so good, Goodwill also be less.

(8) Other Factors:

The economic policies, political society government policies, money marked condition etc,, are the other factors influence the value of goodwill

(9) Risk involving

(10) Government

(11) Monopoly position enjoyed by the company

(12) Sources of capital

Circumstances when valuation of goodwill is required

(1) In the case of joint stock company.

(a) On the amalgamation of 2 or more companies
(b) On Observation of one company by another company
(c) On external reconstruction
(d) On acquisition of majority of shares by H. companies
(e) For the purpose of valuation of shares

(2) In the case of a Partnership

(a) On the admission of a partner
(b) On the retirement of a partner
(c) On the death of partner
(d) On the amalgamation of a firm
(e) On sale of firm to limited company

(3) In the case of sole trading company

(a) When a sole trading concern is sold
(b) When conversion of sole trading in to partnership Or JOC
(c) When there is a Amalgamation

Methods of Valuation of Goodwill

There are four methods

- ✓ **Average Profit methods**
  - ❖ Simple Average profit method
  - ❖ Weighted Average profit
- ✓ **Super profit method**
- ✓ **Capitalization method**
- ✓ **Annuity method**

(1) AVERAGE PROFIT METHOD:

STEP-01:- Calculation of adjusted profit (or) Adjusted future profits (or) Maintainable Profits:

While calculating the adjusted profit the profit of each year should be adjusted in the light of "future Possibilities"

Profits have to be adjusted for the actual expenses and losses and incomes and gains that are not likely to occur in the future and actual expenses and losses and income and gains which are likely to occur in future.

Detailed Performa of Computation of Adjusted profits

PARTICULARS	Rs	Rs
Profit		XXXX
Add:		
(1) Abnormal loss		
(a) Loss of stock	XXX	
(b) Specification loss	XXX	
c) Betting	XXX	XXXX
(2) Capital Expenditure		
a. Purchase of asset	XXX	
b. Installation charges of asset	XXX	
c. Major repairs	XXX	XXX
(3) Expenses not expected in future		XXX
(4) Income expected in the future		XXX
(5) Under valuation of closing stock		XXX
(6) Over valuation of opening stock		XXX
		XXXX
LESS:		
(1) Expenditure expected in future		
Insurance premium	XX	
Additional salary	XX	XXX
(2) Depreciation		XXX
(3) Income not recurring in nature		XXX
(4) Fair managerial remuneration		XXX
(5) Under valuation of opening stock		XXX
(6) Over valuation of closing stock		XXX
ADJUSTED/FUTURE PROFIT		**XXXX**

Note: When there is no anticipation about future possibilities the profit given itself is adjusted profit

STEP-02:- Calculation of Adjusted Average profits.

(a) Simple Average method

When there is fluctuation in the profits simple average method should be used.

$$\text{Adjusted Average Profit} = \frac{\text{Total Adjusted profit of all years}}{\text{Number of years}}$$

(b) Weighted average profit method

When the "weights for each year are given" in the problem (OR) When the profits are following an "increasing or decreasing trend" the weighted average method should be used.

$$\text{Weighted adjusted average profit} = \frac{\text{Total Product}}{\text{Total weights}}$$

STEP-03:- Computation of Goodwill

Value Of goodwill = Adjusted average profits * Number of years of purchase

Note: If number of years of purchase is not given then, the number of year for which profit or loss details given should be considered.

(2)SUPER PROFIT METHOD

Super Profit

Refers to the excess profit earned by the company over & above the normal profit based on normal rate of return.

Under this method goodwill is calculated in the following manner

Step-1:- Calculation of adjusted Profits.

It is computed as similar as in average profit method.

Step-2:- Calculation of average adjusted Profit

It is computed as similar as in average profit method.

Step-3:- Computation of Capital employed

PARTICULARS	Rs
All trading assets at their market value	XXX
(-) Outsider Liabilities	XX
Closing Capital Employed	**XXX**
(-) 1/2 * current adjusted profit	XX
Average Capital Employed	**XXX**

Note:1: Should not consider goodwill. Investment, preliminary expenses, under writing commissions, Discount on issue of shares debentures & debit balance of P&L A/C

Note-2: While taking the liabilities should not consider equity share capital, Preference share capital & Reserve & surplus.

Step-4:- Calculation of Normal Profit

$$\text{Normal Profit} = \text{Capital Employed} * \frac{\text{normal rate of return}}{100}$$

Step-5:- Calculation of Super Profit

Super profit = **Average adjusted profit – Normal profit**

Step-6:- Valuation of Goodwill

Goodwill = **Super profit * No's year of purchase**

(3)<u>CAPITALISATION METHOD</u>

(A) Capitalization method Average Profits

STEP-1: Computation of Adjusted Average Profit

As same as Super Profit method.

STEP-2: Capitalisation of Average Profit [Value of the Firm]

$$\text{Total value of Business} = \frac{\text{Average Adjusted annual profit}}{\text{Normal Rate of Return}} * 100$$

STEP-3: Computation of Capital Employed

As same as Super Profit method.

STEP-4: Computation of Goodwill

Goodwill = Total Value of business (-) Capital Employed

(B) Capitalization of Super Profits

$$\text{Goodwill} = \frac{Super\ Profit}{\text{NRR}} * 100$$

(4)<u>ANNUITY METHOD</u>

Goodwill = Super Profit X Present Value of Rupee