ACCOUNTANCY
CHAPTER – 2
VALUATION OF GOODWILL

Goodwill is good name or the reputaion of the business, which is earned by a firm through the hardwork and honesty of its owners. If a firm renders good service to the customers, the customers who feel satisfied will come again and again and the firm will be able to earn more profits in future.

Thus, goodwill is the value of the reputaion of a firm which enables it to earn higher profits in comparison to the normal profits earned by other firms in the same trade.

Features of Goodwill

1. It is an intangible asset : Goodwill cannot be seen or touched, it does not have any physical existence, thus it belongs to the category of intangible assets such as patents, trade marks, copy rights, etc.

2. It is a valuable asset

3. It is helpful in earning excess profits.

4. Its value is liable to constant fluctuations : While goodwill does not depreciate, its value is liable to constant fluctuation, its vlaue is liable to constant fluctuations.It is always present as a silent asset in a business where there are super profits (i.e.more than the normal) but declines in value with the decline in earnings.

5. It is valuable only when entire business is sold : Goodwill cannot be sold in part. It can be sold with the entire business only. The only exception is at the time of admission or retirement of the partner.

It is difficult to place an exact value on goodwill : This is beecause its value may fluctuate from time to time due to changing circumsatnces which are internat and external to business.

Goodwill is divided into two categories.

I. Purchased Goodwill: Purchased goodwill means goodwill for which a consideration has been paid e.g. when business is purchased the excess of purchase consideration of its net assets i.e. (Assets – Liabilities) is the Purchased Goodwill. It is separately recorded in the books because as it is purchased by paying in form of cash or kind.

Characteristics

(i) It arises on purchase of a business or brand.

(ii) Consideration is paid for it so it is recorded in books.

(iii) Shown in balance sheet as on asset.

(iv) It is amortised (depreciated).

(v) Value is a subjective judgment & ascertained by agreement of seller & purchaser. It is approximate value and cannot be sold separately in the market or in parts.

II. Self-generated Goodwill also called as inherent goodwill. It is an internally generated goodwill which arises from a number of factors that a running business possesses due to which it is able to earn more profits in the future.

Features

(i) It is generated internally over the years.

(ii) A true cost cannot be placed on this type of goodwill.

(iii) Value depends on subjective judgment of the value.

(iv) As per Accounting Standard 26(Intangible Asset), it is not recorded in the books of accounts because consideration in money or money's worth has not be paid for it.

Factors Affecting the Value of Goodwill

Efficient management : If the business is run by experienced and efficient management, its profits will go on increasing, which results in increase in the value of goodwill.

1. Quality of products : If the firm is suppyong good quality of products, then the customer will come again and again for the same and thus will create the goodwill and brand name for the same.

2. Location of business : If the business is located at a convenient or prominent place, it will atract more customers and therefore will have more goodwill.

3. The Longevity of the business : An older business is better known to its customers, therefore it is likely to have more goodwill. When a business enterprise has built up good repuation over a period of time, the number of customers will be more in comparison to the customers of new entrants. Number of customers is an indicator of profit earning capacity of a business.

4. Monopolistic and other Rights : If a buiness enjoys monopoly market, it will have assured profits. Similarly, if it holds some special rights such as patents, trade marks, copyrights or concessions, etc, it will have more goodwill.

5. Other factors:

(i) Good industrial relations.

(ii) Favourable Government regulations

(iii) Stable political conditions

(iv) Research and development efforts

(v) Effective advertising to establish brand popularity

(vi) Popularity of product in terms of quality.

Need for Valuing Goodwill: Whenever the mutual rights of the partners changes the party which makes a sacrifice must be compensated. This basis of compensation is goodwill so we need to calculate goodwill.

Mutual rights change under following circumstances

1. When profit sharing ratio changes

2. On admission of a partner

3. On Retirement or death of a partner

4. When amalgamation of two firms taken place

5. when partnership firm is sold.

Method of valuation of goodwill :

It is very difficult to assess the value of goodwill, as it is an intangible asset. In case of sale of a business, its value depends on the mutual agreement between the seller and the purchaser of the business. Usually, there are three methods of valuing goodwill:

1. average profit method

2. Super profit method

3. Capitalization method

Average Profit Method

This is a very simple and widely followed method of valuation of goodwill. In this method, goodwill is calculated on the basis of the number of past years years. Average of such profits is multiplied by the agreed number of years (such as two or three) to find out the value of goodwill.

Formula for calculation of goodwill

Goodwill = Average Profits × Number of years of purchase

Number of years of purchase means for how many years the firm will earn the same amount of profits in future.

Average Profits = Total Profits/Number of years

A buyer always wants to estimate the future profits of a business. Future profits depend upon the average performance of the business in the past. Past profits indicate as to what profitsare likely to accrue in the future. Therefore the past profits are averaged. But before calculating the average profits, the profits earned in the past must be adjusted in the light of future expectations and the following factors should be taken into account while calculating the average profits:

Abnormal income of a year should be deducted out of the net profit of that year.

(i) Abnormal loss of a year should be added back to the net profit of that year.

(ii) Income from investments should be deducted out of the net profits of that year, because this income is received from outside the business.

Weighted Average Profit Method: This method is a modified version of average profit method.In this Method each year's profit is assigned a weight. The highest weight is attached to profit of most recent year.

Eg: 2011-1, 2012-2, 2013-3, 2014-4.

Each year profits are multiplied by assigned weights. Products are added & divided by total number of weights. Weighted average is multiplied by agreed Number of years of Purchase.

Weighted Average Profit: = $\frac{Total\ product\ of\ profits}{Total\ of\ weights}$

Goodwill = Weighted Average Profit $\times$ No. of years of purchase.

Weighted average profit method is considered better than the simple average profit method because it assigns more weightage to the profits of the latest year which is more likely to be earned in future. This method is preferred when profits over the past years have been continously rising or falling.

Super profit Method : In this method goodwill is calculated on the basis of surplus (excess) profits earned by a firm in comparison to average profits earned by other firms. If a business has no anticipated excess earnings, it will have no goodwill. Super Profit are the excess of actual profit over normal profits. Where Normal profits are profits earned by similar business.

If a firm earns higher profit in comparison to normal profit (generally earned by other firms of same industry) then the difference is called Super Profit. Goodwill is calculated on the basis of Super profit due to future expectations of earning capacity of the firm.

Goodwill is calculated by the formula

Goodwill = Super Profit $\times$ Number of years of purchase Super Profit = Average profit - Normal profits

Normal Profit = Investment (Capital Employed) $\times \frac{Normal\ Rate\ of\ \mathrm{Return}}{100}$

Capital Employed = Capital + Free Reserves – fictitious Assets (if any), or

All Assets – (Goodwill, fictitious assets and non-trade Investment) – Outsider's Liabilities

Capitalised Method Under this method, goodwill can be calculated in two ways:

(A) Capitalisation of Average Profit Method: Under this method first of all we calculate the average profits and then we assess the capital needed for eanring such average profits on the basis of normal rate of return. Such capital is also called capitalised value of average profits. It is calculated as under.

Capitalised value of the firm = $\frac{Average\ profits \times 100}{Normalrate\ of\ return}$

Goodwill is calculated by deducting the actual capital employed in business from the capitalised value of average profits.There will be no goodwill if the actual capital employed in the business exceeds or equals the capitalised value of the average profits.

Net Assets or Capital employed = Total assets – Outside liabilities

Goodwill = Capitalized value of average profits – Capital Employed

(B) Capitalisation of Super Profit Method: Underthis method first of all we calculate the super profits and then we assess the capital needed for earning such super profits on the basis of normal rate of return. Such capital is actually the amount of goodwill. Super profits are calculated in the same manner as calculated in super profits method.

Goodwill of the firm = Super Profits * 100 / Normal rate of return.