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Topic – Valuation of Goodwill

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Valuation of Goodwill

Introduction

The name and fame of an organisation can be term as goodwill. Goodwill is the benefit and merit of a good name, reputation and connection of a business. Goodwill refers to a measure of the capacity of a business to earn excess profit. It is an intangible but an invisible fixed asset. It is not a physical asset like building equipment. Thus Goodwill is the present value of a firm anticipated excess earning or as the capitalised value attached to the differential profit capacity of a business.

Meaning of Goodwill

Goodwill is a monetary value of reputation of a business, however, goodwill gets value only if the business is profitable and has a capacity to get more profit in future. In other words, goodwill means the popularity or reputation of a business enterprise resulting from quality production, punctuality, social responsibility, harmonious relationship, employees, dealers and customers integrity and honesty and proprietary technology. These things are, in fact, valuable assets of a company, however they are not tangible assets.

Thus goodwill is the reputation possessed by a business enterprise which enable it to earn higher profits than the normal return on the investment. Itexists only when the firm earns super profit. Any business enterprise that earns normal profit or is incurring losses has no goodwill.

Definitions of Goodwill

It is very difficult to define goodwill. Some important definitions are given below.

1. According to **Lard Lindley,** " The term goodwill is generally used to denote benefit arising from connections and reputation."

2. According to **J.O.Magee** 'the capacity of a business to earn profits in future is basically what is meant by the term goodwill.'

3. According to **Lord Macnagloten** 'Goodwill is the benefit and advantages of good name reputation and connection of a business, it is the attractive force which brings in customers.

   After studing the above definitions, it can be says that goodwill is an intangible fixed assets and belongs to its owner at a point of time. It may be defined as the value of reputation of a business enterprise in respect of profits expected in future over and above thenormal lend of profits earned by undertakings belonging to the same class of business. It is capitalised value attached to the differential profit capacity of a business.

   Characteristics of Goodwill

   Above definitions reveal the following feature/characteristics pf goodwill emerge

   1. Goodwill is an intangible fixed assets such as patent, trade marks, etc.
   2. Goodwill is non-visible, it cannot be seen or touch but present as a silent asset in a business and can be felt.
   3. It is difficult to place a cost of goodwill as the value may fluctuate from day to day as a result of internal and external circumstances, i.e. changing fortunes of the business enterprise
   4. Its value and existence is dependent on the subjective judgement of the values
   5. It cannot be separated from the business and therefore can not be solt like other identifiable and separable assets, without disposing off the business as a whole.
   6. It represent a non-physical value over and over the physical assets.

7. It has the extra earning capacity i.e. higher profits
8. Goodwill is not a fictitious asset as it can be purchased or sold with any other assets.
9. Goodwill does not depreciated
10. It comes into existence and depend upon several features viz. location of business, reputation of owner, popularity of product, favourable position of market, efficiency of employees or management etc.

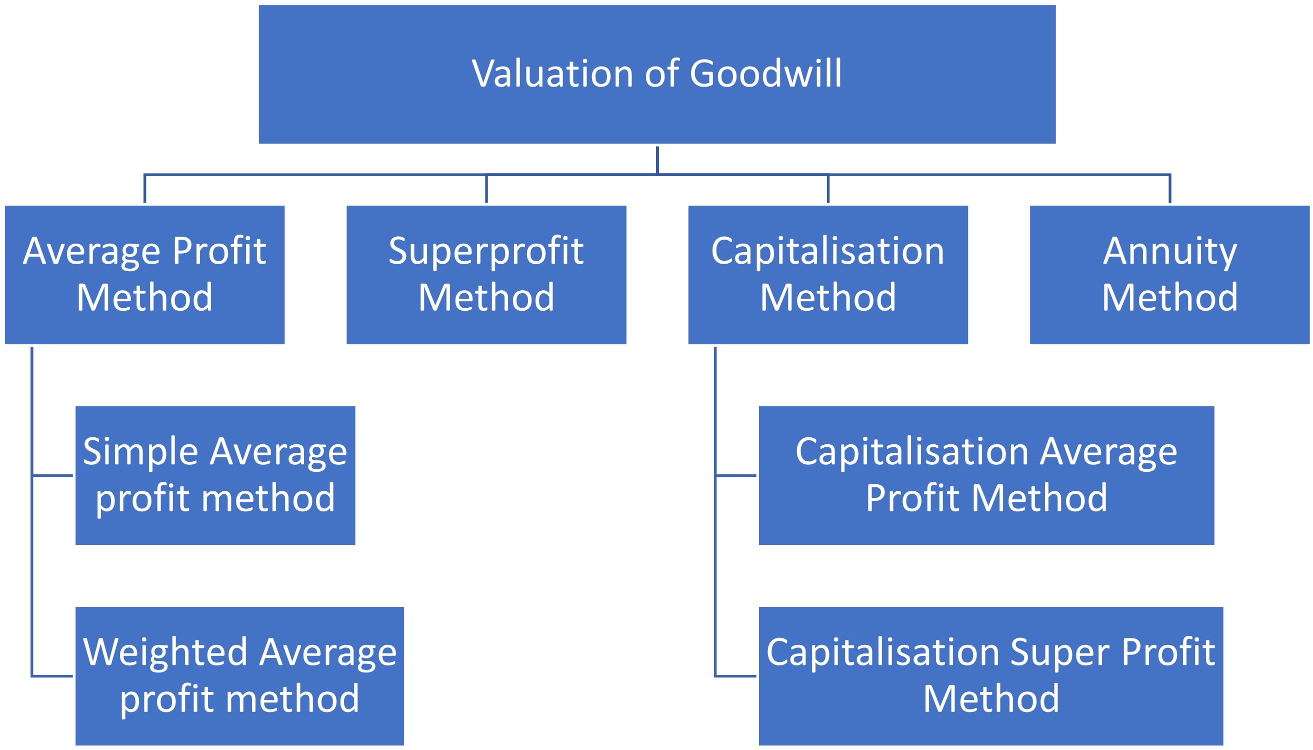
Factors affecting the value of Goodwill

Goodwill is the monetary value of the reputation of a business. The important factors that give rise to goodwill are as follows.

1. Place of business
2. Nature of business
3. Risk and uncertainty of business
4. Monopolistic business
5. Management of business
6. Personality of business
7. Value of capital
8. Popularity of trademark
9. Volume of profit
10. i. Possibility of corruption
    ii. Effective advertising policy
    iii. Quality of product
    iv. Customers service
    v. Government policy
    vi. Good industrial relation
    vii. Stable political environment
    viii. well-known collaboration

Methods of valuation of goodwill

Goodwill is the reputation, attraction, connection and that force which helps in maintaining relationship with customers which in turn helps to earn future profits. It is an intangible assets having a definite value. It is very difficult to calculate its value accurately. Various methods have been advocated for the valuation of goodwill which are as follows.



- **Average Profit Method**

In average profit method, goodwill can be calculated by two ways

1. Simple Average Profit Method
   Under this method, goodwill is ascertained at agreed number of 'years' purchased of the average profits of the past few years. Here average profit is the total profit divided by the total number of years for which profit and loss is given.
   Number of years purchase means for how many years in the future, a business will earn the same amount of profits due to its past efforts.

   Steps for calculation –

   a. Calculate normal profit (maintainable profit) of each year after adding abnormal losses and deducting abnormal gains.

   Calculation of normal profit (maintainable profit)
   Net profit during the year

   Add Abnormal losses
   Less Abnormal gains
   Add Normal Income
   Less Normal expenses

   b. Calculate the total of normal profit required number of year
   c. Divide the total normal profit by specified no. of years purchased and get goodwill

$$\text{Average Profit} = \frac{\text{Total Normal Profit}}{\text{Number of years}}$$

d. Multiply the average profit by specified no. of years purchased and get goodwill

$$\text{Goodwill} = \frac{\text{Total Normal Profit X No. of years purchase}}{\text{Number of years}}$$

2. Weight Average Profit Method

This method is modified version of the simple average profit method. In this method each year's profit is multiplied by the respective number of weights i.e. 1,2,3,4,5, etc in order to find out value of product and after that total of products is divided by the total of weights in order to ascertain the weighted average profit. Thereafter the weighted average profit is multiplied by the agreed number of years purchase to findut the value of goodwill.

Steps for calculation –

a. Calculate profit for each of the given years
b. Give weights i.e. 1,2,3,4,5 to the profit of the given years
c. Multiply each year's profit by the weight
d. Find out the total of weight and total of weighted profit like product
e. Calculate weighted average profit like

$$\text{Weighted Average Profit} = \frac{\text{Total of product of profits}}{\text{Total of weight}}$$

f. Multiply weighted average profit with agreed number of years to find out goodwill.

$$\text{Goodwill} = \frac{\text{Total of product of profits X No. of year purchase}}{\text{Total of weight}}$$

$$\text{Goodwill} = \text{Weighted Average Profit X Required No. of year purchase}$$

- **Super Profit Method**

  The super profit method of valuation of goodwill cover the excess actual profit over the normal profit is termed as Super profit. Such super profit is multiplied by the agreed number of years purchase to find out the value of goodwill.

Steps for calculation –

a. Calculate the actual/average profits.

b. Calculate the normal profit on the capital employed by multiplying capital employed with normal rate of return liability from real assets. Real assets means all assets other than goodwill and fictitious assets.
c. Calculate the super profit by deducting normal profit from the actual profit
d. Calculate goodwill by multiplying super profit with no. of years purchase.

$$\text{Normal profit} = \frac{\text{Capital employed X Normal rate of return}}{100}$$

Super profit = Actual profit - Normal profit
Goodwill = Super profit X No. of years purchase

For calculation of capital employed, you will not consider the goodwill, non-trading or external investments and preliminary expenses etc.

Sometime average capital employed is calculated for normal profit, in this regards average capital employed is calculated in following ways.

1. Average Capital Employed = Capital employed – ½ of current year profit
2. Average Capital Employed = Capital employed at the beginning of the year + ½ of current year profit
3. Average Capital Employed $= \dfrac{\text{Capital employed at the beginning of the year + Capital employed at the end of the year}}{\mathbf{2}}$
4. Super profit = $\dfrac{\text{Actual profit - Average Capital Employed X NRR}}{100}$

5. Goodwill = Super profit X No. of years purchase

3. <u>Capitalisation method</u>
Goodwill ubder this method can be calculated in following two ways

a. Capitalisation of Average Profit Method
b. Capitalisation of Super Profit Method

a. <u>Capitalisation of Average Profit Method</u>

In this method
. Goodwill = Capitalised value of Average Profit - Capital employed

Where as –
Capitalised value of Average Profit = $\dfrac{\text{Average Profit X 100}}{\text{Normal rate of return}}$

Capital employed = Total assets at market value (excluding Goodwil) – outside liabilities

b. Capitalisation of Super Profit Method

Calculate goodwill by capitalising the Super profit
So,

$$\text{Goodwill} = \frac{\text{Super profit X 100}}{\text{Normal rate of return}}$$

4. **Annuity Method**

Under this method the present value of annuity is found out by – a. Annuity table or b. Formula the amount of annuity may be calculated by the following formula –

$$\text{Present value} = \frac{1 - [100 / 100 + r]^{n}}{r/100}$$

Here n = number of years
r = Rate of interest

so for, calculation of goodwill can be done in two ways-

1. If the present value of annuity is less than rs. 1 then the amount of goodwill is calculated by –

$$\text{Goodwill} = \frac{\text{Super profit}}{\text{present value of annuity}}$$

2. If the present value of annuity is more than rs. 1 then the amount of goodwill can be found by

$$\text{Goodwill} = \text{Super profit X present value of annuity}$$

Hence the value of goodwill of a business can be find out after using the above mentioned methods.

short answer type Questions.

1. What is goodwill?
2. What do you profit know about capital employed ?
3. What is Super profit?

Long Answer type Question.

1.Describe the concept of goodwill and Explain different methods of valuation of goodwill.

2. Define goodwill and Explain the factors affecting it.

End

References.

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