ADVANCED ACCOUNTING

5th Semester

TOPIC :

VALUATION OF GOODWILL

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Meaning of Goodwill :

Goodwill is an intangible but not fictitious assets which means it has some realizable value. From the accountants' point of view goodwill, in the sense of attracting custom, has little significance unless it has a saleable value. To the accountant, therefore, goodwill may be said to be that element 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.

In considering the return normally to be expected, regard must be had to the nature of the business, the risks involved, fair management remuneration and any other relevant circumstances. The goodwill

DEFINITION:

A business builds up some reputation after it has continued for some time. If the reputation is good, the firm will come to acquire a fixed clientele in the sense that a number of customers will automatically make their purchases from the firm.

This is a very valuable asset even if one cannot touch or see it The asset is intangible but not fictitious. This asset is known as goodwill and may be defined as the value of the reputation of a firm. Its tangible effect is extra profit which firms not possessing equal reputation do not earn.

The goodwill possessed by a firm may be due, inter alia, to the following:

1. The location of the business premises, the nature of the firm's products or the reputation of its service.

2. The possession of favorable contracts, complete or partial monopoly, etc.

3. The personal reputation of the promoters.

4. The possession of efficient and contented employees.

5. The possession of trade marks, patents or a well-known business name.

6. The continuance of advertising campaigns.

7. The maintenance of the quality of the firm's product and development of the business with changing conditions

The need for evaluating goodwill may arise in the following cases:

1. When the business or when the company is to be sold to another company or when the company is to be amalgamated with another company;

2. When, stock exchange quotations not being available, shares have to be valued for taxation purposes, gift tax, etc.;

3. When a large block of shares, so as to enable the holder to exercise control over the company concerned, has to be bought or sold; and

4. When the company has previously written off goodwill and wants its write back.

In valuation of goodwill, consideration of the following factors will have a bearing:

(a)Nature of the industry, its history and the risks to which it is subject to.

(b) Prospects of the industry in the future.

(c) The company's history — its past performance and its record of past profits and dividends.

(d) The basis of valuation of asset of the company and their value.

(e) The ratio of liabilities to capital.

(f) The nature of management and the chance for its continuation.

(g) Capital structure or gearing.

(h) Size, location and reputation of the company's products.

(i) The incidence of taxation.

(j) The number of shareholders.

(k) Yield on shares of companies engaged in the same industry, which are listed in the Stock Exchanges.

(l) Composition of purchasers of the products of the company.

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(m) Size of block of shares offered for sale since large blocks very few buyers would be available and that has a depressing effect on the valuation. Question of control, however, may become important, when large blocks of shares are involved

(n) The major factor of valuation of goodwill is the profits of the company. One who pays for goodwill looks to the future profit.

The profits that are expected to be earned in future are extremely important for valuation of goodwill. The following are the important factors that have a bearing on future profits:

(i) Personal skill in management

(ii) Nature of business

(iii) Favorable location

(iv) Access to supplies

(v) Patents and trade marks protection

(vi) Exceptionally favorable contracts.

(vii) Capital requirements and arrangement of capital.

(o) Estimation of the profits expected to be earned by the firm and the amount of capital employed to earn such profits, are to be computed carefully.

(p) Market reputation which the company and its management enjoys.

(q) Returns expected by investors in the industry to which the firm or company belongs.

Concept of Goodwill:

When one company buys another company, the purchasing company may pay more for the acquired company than the fair market value of its net identifiable assets (tangible assets plus identifiable intangibles, net of any liabilities assumed by the purchaser). The amount by which the purchase price exceeds the fair value of the net identifiable assets is recorded as an asset of the acquiring company. Although sometimes reported on the balance sheet with a descriptive title such as “excess of acquisition cost over net assets acquired”, the amount is customarily called goodwill. Goodwill arises only part of a purchase transaction. In most cases, this is a transaction in which one company acquires all the assets of another company for some consideration other than an exchange of common stock.

The buying company is willing to pay more than the fair value of the identifiable assets because the acquired company has a strong management team, a favourable reputation in the marketplace, superior production methods, or other unidentifiable intangibles.

The acquisition cost of the identifiable assets acquired is their fair market value at the time of acquisition. Usually, these values are determined by appraisal, but in some cases, the net book value of these assets is accepted as being their fair value. If there is evidence that the fair market value differs from net book value, either higher or lower, the market value governs.

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, trademarks, copyrights, 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 value 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.

6. It is difficult to place an exact value on goodwill: This is because its value may fluctuate from time to time due to changing circumstances which are internet 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.

THANK YOU