Goodwill: Nature and Valuation

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Example:

Net Value OF BUSINESS IS 70 LAKHS

MARKET VALUE OF BUSINESS IS 75 LAKHS

Rs. 5 lakhs extra is for what reason?

Brand Name

+

Customers size

+

Suppliers

+

Its workforce

Goodwill

Goodwill…

"Goodwill is an intangible asset linked to an established business built over time, as a business gains favorable reputation for maintaining good customers-suppliers relationship and effective branding as it is expected to make profit year after year."

Factors of Existence of Goodwill

1. Good Public Relation
2. Regular Customers
3. Quality Maintenance
4. Management Skills
5. Location
6. Good Relation with Suppliers
7. Employees

Types of Goodwill

Purchased Goodwill

Self-Generated Goodwill

Methods of Valuation of Goodwill

Average profits method

Super profit method

Capitalization method

Average Profit Method

Simple Average Profit Method

Weighted Average Profit Method

NOTE:-

- Before calculating the average profits the following adjustments should be made in the profits of the firm:
  a) Any abnormal profits should be deducted from the net profits of that year.
  b) Any abnormal loss should be added back to the net profits of that year.
  c) Non-operating incomes e.g. income from investments etc should be deducted from the net profits of that year.

Simple Average Profit Method

Goodwill = Average Profits X Number of years of Purchase

Average profit = Total Profit/ Number Of Years

Number of years of Purchase means the no of years for which the firm is likely to earn the same amount of profit.

Weighted Average Profit Method

Goodwill = Weighted Average Profit x Number of Years Of Purchase

Weighted Average Profit = Average Profit x Given Weights

Super Profits Method

- **Goodwill** is calculated on the basis of Super Profits i.e. the excess of actual profits over the average profits.
- For calculating Goodwill
  - Super Profits are multiplied by the number of year of purchase.

  i. Goodwill = Super Profits × No. of years purchased

  ii. Super Profits = Actual profits – Normal Profits

  iii. Normal profits = Capital Invested × Normal rate of return/100

Capital Employed :

Share Holders Fund Approach

⇨ Asset Side Approach

⇨ Liabilities side Approach

Considers Long Term Debt as LIABILITY

Long Term Fund Approach

⇨ Asset Side Approach

⇨ Liabilities side Approach

Considers Long Term Debt as Capital Employed

Long Term Fund Approach

Asset Side Rule:

Fixed Assets
XXX
Trading Investments XXX
Current Assets
XXX
→
XXXX
LESS: Current Liabilities
XXX
CAPITAL EMPLOYED
XXXX

Liabilities Side Rule :

Equity Share Capital XXX
Preference Share Capital XXX
Reserves & Surplus XXX
Long Term Debt XXX

XXXX
Less: Non Trade Investments XXX
Miscellaneous Exp. Not Written Off XX

Capital Employed XXXX

X NOTE: Non Trade Investments should not form part of Capital Employed (NON OPERATING ASSETS)

EX: Fixed Deposit
Land (which is not used for business & do not yield any income)

For example

If the normal rate of return in a particular type of business is 20% and your investment in the business is Rs10,00,000 then your normal profits should be Rs 2,00,000 . But if you earned a net profit of Rs 2,30,000 then Rs 2,30,000 – Rs 2,00,000 = Rs 30,000 are your super profit.

Capitalization Method

1. Capitalization of Average Profits Method
2. Capitalization of Super Profits Method

Capitalization Method

1. Capitalization of Average Profits Method

- Under this method we calculate the average profits and then assess the capital needed for earning such average profits on basis of normal rate of return. such capital is called capitalization value of average profit.

Capitalization Method

1. Capitalization of Average Profits Method

- Goodwill = capitalized value of the firm - net assets
- Capitalized value = average profit/normal rate of return*100
- Net assets = total assets-external liabilities

Capitalization Method

1. Capitalization of Average Profits Method

Example:

- A firm earns Rs.65000 as its average profits. The usual rate of earnings is 10%.the total assets of the firm amounted to Rs.680000 and liabilities are Rs.180000.

Capitalization Method

1. Capitalization of Average Profits Method

Calculation:

- Total Capitalization Value = 65000/10*100 = 650000
- Net Assets = 680000-180000 = 500000
- Goodwill = Total Capitalization Value – Net Assets

  = 650000 – 500000

  = 150000

Capitalization Method

2. Capitalization of Super Profits Method
   - we calculate the Super Profits and then calculate the capital needed for earning such super profits on the basis of normal rate of return
   - Goodwill = Super Profits X (100/ Normal Rate of Return)

Capitalization Method

2. Capitalization of Super Profits Method

Example:

- Verma Brothers earn a profit of Rs. 90,000 with a capital of Rs. 4, 00,000. The normal rate of return in the business is 15%.

Capitalization Method

2. Capitalization of Super Profits Method

Calculation

- Normal Profit = Rs. 4, 00,000 x 15/100 = Rs. 60,000
- Super Profit = Rs. 90,000 – Rs. 60,000 = Rs. 30,000
- Goodwill = Super Profit x 100/Normal Rate of Return = Rs. 30,000 x 100/15 = Rs. 2, 00,000

Conclusion

"Just as cement binds together the bricks and other building material into walls, similarly goodwill binds together or unites the other assets and aspects of the business into cohesive whole."

THANK YOU