UNIT -3
Valuation of Goodwill

Meaning of Goodwill:

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 reputation or good name of the business.

Definition of Goodwill:

Goodwill is defined as "the present value of a firm's anticipated excess earnings"

According to Prof. Dicksee, "when a man pays for goodwill, he pays for something which put him in a position of being able to earn more than he would be able to do by his own unaided efforts".

Types of Goodwill:

1. Purchased goodwill
2. Non – Purchase goodwill

1**. Purchased goodwill:**

Purchased goodwill is the goodwill which arises when a business enterprise is acquired or purchased by another business enterprise, and the purchase price paid is more than the net assets acquired.

2. Non – Purchased Goodwill:

Non-Purchase goodwill, inherent goodwill or raised goodwill is the goodwill which arises when a business generates its own goodwill over a period of time due to various factors, such as good location, efficient management, good quality products, good sales policies, good public image, etc.

Features of Goodwill:

- Goodwill is an intangible asset
- Goodwill is a real asset but not a fictitious asset

- Goodwill always exist with business but it cannot exist by itself.
- Goodwill is subject to fluctuations.

Factors determining the value of Goodwill:

- Location factors
- Time factor
- Nature of business
- Efficiency of management
- Past profits of a business
- Stability of a business
- Future prospects of a business
- Other factors (General economic conditions, Political stability, Government polices, money market conditions, trade cycles etc)

Various Circumstances when valuation of Goodwill is necessary:

1. In the case of a Sole – Trading Concern

- When a Sole-trading concern is sold
- When a Sole-trading concern is converted into a partnership firm/Joint stock Co
- When a sole-trading concern is amalgamated with another sole-trading concern

2. In the case of a Partnership Firm:

- On the admission, retirement, death of a partner

- On the amalgamation of partnership firms
- On the sale of partnership firm to a Limited Co

3. In the case of Joint Stock Company

- On the amalgamation of two or more companies
- On the absorption of one company by another company
- On the external reconstruction of a company
- On the acquisition of majority of shares by a holding company

For the purpose of valuation of shares

Index:

1. Problems on Average Profits Method
2. Problems on Capitalisation Method
3. Problems on Super profit Method
4. Problems on Annuity Method
5. Problems including Average profit method, Capitalization method and Annuity method
6. 5- Marks Problems

Methods of Valuation of Goodwill

1. Average Profits Method
2. Capitalization Method
3. Super Profits Method
4. Annuity Method

I. Average Profits Method:

Steps to be followed under Average Profits Method

1. Calculation of Adjusted Profits, Adjusted future Profits, Maintainable Profits
2. Calculation of Adjusted Average Profits:

- Simple Average Profit Method

- Weighted Average Profit Method

3. Calculation of Good will.

Step-1: Calculation of Adjusted Profits or Adjusted future profits or Maintainable profits:

Proforma of Calculation of Adjusted Profits

Particulars	**Rs**
Add. All Expenses and losses not likely to occur or incur in future (Extraordinary Salary of a person, loss from fire or theft i,e abnormal losses) Capital Expenses etc	XXX
Add All Profits likely to come in future (Profit due to new line of business)	XXX
Less All expenses and losses expected to occur in future (Salary of directors and staff to be appointed, insurance on stock in future, depreciation in future, cost of management or any expenses not provided earlier but to be incurred in future)	XXX
Less Profit no likely to recur	XXX
Adjusted Profit or Future Profits	XXX

Note: When the future possibilities are not given in the problem than Average profit should be calculated directly (Step-2)

Step-2: Calculated of Adjusted Average Profits:

Adjusted Average Profit can be calculated by using any one of the method

Simple Average Method:

When there is fluctuation in the profits, simple average profit method should be followed. This can be calculated by using the following formula.

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;

Note: when there is an increasing trend in profits it is advisable to follow this method.

Step-3 Calculation of Goodwill:

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

I.Problems on Average Profits Method

1. Mr. Dhruva has been doing business, intends to sell his business on 1-12-2010, From the following particulars ascertain the amount of Goodwill based on 3 years purchase of average profits of last 4 years,
The profits during 4 years are as follows:
2007 – Rs.500,000, 2008 – 5,60,000, 2009 – Rs. 6,00,000, 2010 – Rs. 7,00,000
At the time of acquisition of business, the buyer was employed as a manager of similar business on a salary of Rs.6,000 per month. The profits of 2010 include income from investment of Rs. 1,00,000. The profit of 2007 were reduced by Rs. 2,50,000 being loss on speculation, Similarly in 2009 profits were reduced by Rs. 50,000 due to loss from betting.

2.The following particulars are available in respect of the business carried on by Mr. Vinod

a. Profits Earned – 2008 – Rs.65,000, 2009 – Rs. 78,000, 2010 – Rs. 82000
b. Profits in 2009 reduced by Rs. 10,000 due to stock destroyed by fire and profit of 2008 included non-recurring income of Rs. 8000.
c. Profit of 2010 include Rs.5,000 income on investment

d. The stock in not insured and it is thought prudent to insure the stock in future. The insurance premium is estimated at Rs.1,500 p.a.
e. Fair remuneration to the proprietor (Not taken in the calculation of profits) is Rs. 10,000 p.a. you are required to compute the value of goodwill on the basis of 2 years purchase of average profits of the last 3 years.

3. Deepak purchased a business from suresh from 1-4-2001. Profit earned by Suresh for the preceding years were 1999 – Rs. 5,00,000, 2000- Rs.6,00,000, 2001 – 5,40,000. It was found that the profits for the year 1999 included a non-recuring income of Rs.20,000 and profits for the year 2001 was reduced by 30,000 due to an abnormal loss on account of a small fire in the shop. The properties of the business were not insured in the past, but it was thought prudent to insure the property in future at premium of Rs. 5,000 p.a. Deepak at the time of purchase of business was employee as manager of an identical business concern at a monthly salary of Rs.10,000. He intends to replace the manager of business who is drawing a salary of Rs. 7,500 p.m. The goodwill is estimated at 2 years purchase of average profits. Calculate Goodwill.

B. Weighted Average method:

4. Kavya Ltd proposed to purchase the business carried on by Lakshmi. Goodwill for this purpose is agreed to be valued at 3 years purchase of the weighted average profits of the past 4 years, the appropriate weights to be used are:

1998 – 1

1999 – 2

2000 – 3

2001 – 4

The profits for these years are:

1998 – Rs. 1,01,000, 1999 – Rs. 1,24,000, 2000-Rs. 1,00,000. 2001 – Rs. 1,50,000

On a scrutiny of the accounts the following matters are revealed

a. On 1st January, 2000 a major repair was made in respect of the plant incurring Rs. 30,000 which amount was charged to revenue. The said sum is agreed to be capitalized for goodwill calculation subject to adjustment of depreciation of 10% p.a on reducing balance method.
b. The closing stock for the year 1999 was over valued by Rs. 12,000
c. To cover management cost an annual charge of Rs. 24,000 should be made for the purpose of goodwill valuation.

Compute the value of goodwill of the firm.

5. Aruna Mills proposed to purchase the business carried on by Mr. Bhaskar. Goodwill for this purpose is agreed to valued at three years purchase of the weighted average profits of the past four years. The appropriate weights to be used are:

2001 – 1

2002 – 2

2003 – 3

2004 – 4

The profits for these year are

2001 – Rs. 30,300, 2002-31,200, 2003 – 36,000, 2004 – 45,000

On a scrutiny of the accounts, the following matters are revealed:

a. on 1st September. 2002, major repair was made in respect of the plant incurring Rs.9,000, which amount was charged to revenue. The said sum is agreed to be capitalized for goodwill calculation subject to adjustment of depreciation of 10% on diminishing balance method.
b. The closing stock of 2002 was over-valued by Rs. 3,600
c. To cover management cost, an annual charge of Rs. 7,200 should be made for the purpose of goodwill valuation.

Compute the value of the goodwill of the firm.

<u>II Problems on Capitalizations Method</u>:

The Capitalisation method can be subdivided into two types:

<u>A. Capitalisation of Average profits</u>:

Step -1 Calculation of Adjusted average profits – Same as above

Step -2 Calculation of Total value of business:

Step -3 Calculation of Goodwill:

Total value business – Net assets (Assets – Liabilities) or Capital employed

B. Capitalisation of Super Profits:

Under this method, the value of goodwill can be ascertained directly by capitalizing its super profits on the basis of Normal rate of return with the help of the following formula.

6.The net profits of a company for the past 5 years are 2006-Rs. 50,000, 2007-Rs.60,000, 2008-Rs.70,000, 2009-Rs.80,000, 2010 – 85,000

The capital employed in the business is Rs.4,00,000. On which a reasonable rate of return of 10% is expected. Calculate the goodwill of the company under the capitalization of the average profits method.

7. A company desirous of selling its business to another company has earned an average past profit of Rs. 2,00,000 P.a and the same amount of profit is likely to be earned in the future also, except that:
    a. Directors fees of Rs.15,000 P.a charged against such profits will not be payable by the purchasing company whose existing Board can manage the new business also.
    b. Rent of Rs. 35,000 p.a which had been paid by the vendor company will not be incurred in the future since the purchasing company owns its own premises and the necessary accommodation can be provided.

    The net assets, other than good will, were Rs. 22,00,000 and it was considered that a reasonable return on investment in this type of business would be 10%

III.Problems on Super profit Method

Step 1: Calculation of Adjusted average profit as above

Step-2 Calculation of average capital employed

a. Asset based approach:

Assets (other than non trading assets, goodwill and past deffered expenses and losses I,e preliminary expense, discount on issue of share and debentures etc)at market value on the Balance sheet date	XXX
Less Liabilities to outsiders at revised value if any	XXX
Capital employed at the end f the year	XXX
Less Half of the profit earned during the year	XXX
Average capital employed for the year	XXX

b. Liabilities Base Approach:

Add Equity Share Capital Preference Share Capital Reserves and profits Profit on revaluation of assets and liabilities	XXX XXX
Less: Good will (Book value) Losses & past expenses not yet written off Loss on revaluation Capital employed at the end	XXX XXX XXX XXX
Less; Half of the profit	XXX
Average Capital employed	XXX

Note: i. When capital employed is given in the problem, there is no need to calculate average capital employed.

ii. Non-trading assets, means assets acquired because of spare funds such as investment in Government Securities are excluded.

Step – 3: Calculation of Normal Profits:

Normal Profit = Average capital employed X Normal rate of return

Step-4: Calculation of Super Profits:

Adjusted average Profits	XXX
Less Normal Profits	XXX
Super profits	XXX

Step – 5: Calculation of Goodwill

Super profit X No of year's of purchase

Problems:

8. From the following particulars relating to the business of Ashwini, Compute the value of Goodwill on the basis of three years purchase of super profits taking average of last four years.

Fixed assets Rs. 8,00,000

Current assets Rs. 80,000

Current liabilities Rs. 1,60,000

Normal rate of return 15%

Managerial remuneration if employed elsewhere Rs. 10,000 p.a

Profits for the last four years were Rs. 1,20,000. Rs. 1,40,000, Rs.1,30,000, and Rs. 1,50,000 respectively.

9. The Balance Sheet of Madhav is as follows on 31-12-2010

Liabilities	Rs	Assets	Rs
Equity Share of Rs 10 each	2,50,000	Fixed asset less depreciation	2,00,000
General Reserve	1,00,000	Investments	50,000
Profit & Loss A,c	50,000	(face value Rs. 1,00,000)	
Current Liabilities	50,000	6% Government promissory Notes	
		Current Assets	2,00,000
Total	4,50,000	Total	4,50,000

Net profit after taxation:

2008-Rs.65,000, 2009 – Rs. 62,500, 2010 – Rs. 75000

Goodwill may be taken as 4 year's Purchased of average super profits trading on the basis of 15% normal profit on closing capital invested. The current assets are to be taken as Rs. 2,10,000. Ascertain Goodwill.

10.. The following is the Balance sheet of Belgium Ltd a concern owned by Sarathy as at 31-4-2010

Liabilities	Rs	Assets	Rs
Creditors Capital Reserve	76,080 3,28,000 80,000	Fixed Assets Current Assets Investment in Shares	1,80,000 2,44,080 60,000
Total	4,84,080	Total	4,84,080

The following net profits were earned which included a fixed income from investment of Rs. 4,000 p.a

2007 – Rs. 64,000 - 1

2008 – Rs, 72,000 - 2

2009 – Rs. 86,000 - 3

2010 – Rs. 90,000 - 4

Standard rate of return on capital employed in such type of business is 8%

Compute the amount of Goodwill of the above business at three year's purchase of the average super profits for 4 years assuming that each year's profit was immediately with drawn in fully by the proprietor.

<u>IV Problems including Annuity method, Capitalization methods and Super profit method</u>:

In this method the super profit of the business is multiplied by the present value of the Rupee ascertained of the business can be calculated as follows:

Goodwill of the firm = Super profit X Annuity value

8. The net profits of a company after providing for taxation, for the past 5 years are; Rs. 20,000, Rs.21,000, Rs.22,500, Rs. 23,000, Rs. 23,500

The capital employed in the business is Rs. 2,00,000 on which a reasonable rate of return of 10% is expected

It is expected that the company will be able to maintain its super profits for the next five year, hence there is an increasing trend in pofits (weighted average method)

Calculate the value of goodwill of business on the basis of

i. Annuity of super profits taking the present value of an annuity of one rupee for five years at 10% interest is Rs. 3.78.
ii. Capitalization method
iii. 5 years purchase of Super-profit method

9. The net profit of a business, after providing for taxation, for the past five years are Rs. 80,000, Rs. 85,000, Rs. 92,000 Rs. 105,000, and Rs. 1.18.000. The capital employed in the business is Rs. 8,00,000. The normal rate of return expected in this type of business is 10% it is expected that the company will be able to maintain its super profits for the next 5 years. Calculate the value of goodwill on the basis of:

   a. 5 years purchase of super-profit method
   b. Annuity method, taking the present valued of annuity of Rs. 1 for five years at 10% as 3.78 and
   c. Capitalization of super-profit method

10. The following is the Balance Sheet of X Ltd on 31st Dec 2001

Liabilities	RS	Assets	Rs
Equity Share Capital of Rs 10 each	5,00,000	Buildings	1,65,000
		Machinery	85,000
General Reserve	2,00,000	Furniture	50,000
Profit and Loss A/c	1,00,000	Motor Vans	1,00,000
Sundry Creditors	60,000	Investments	1,00,000
Bills Payable	20,000	(Market Price 1,20,000)	

Provision for Tax	20,000	Stock	1,50,000
		Debtors	80,000
		Bank	1,70,000
Total	9,00,000	Total	9,00,000

Net profit before tax:

1999 – Rs. 2,10,000, 2000 – Rs. 2,20,000, 2001 – Rs. 2,50,000. Rate of taxation 40%. Income from Investments may be taken at 6%, Normal rate of return on average capital employed is 15%. Building is valued at Rs. 1,80,000 and Machinery at Rs. 90,000. Taking weighted average of profits after tax as basis, Calculate the value of Good will based on

- 5 Years Purchased of Super profits
- Capitalisation of Super Profits
- Annuity of super profits taking annuity rate at 2.97 (Ignore additional depreciation on Building and Machinery)

13. Balance Sheet of Standard Ltd . as 31/3/2006 is as under

Liabilities	Rs	Assets	Rs
10,000 Equity shares of Rs.100 each	10,00,000	Fixed Assets	10,00,000
		Stock	3,50,000
6000 15% preference Shares of		Debtors	4,50,000
Rs. 100 each	6,00,000	Cash andBank	2,00,000
General Reserve	80,000		
P&L A/c	1,60,000		
Sundry creditors	1,60,000		
Total	20,00,000	Total	20,00,000

The profits of the company (before providing for taxation at 38.5%) and the rate of dividend declared in respect of the past 5 financial years are as under

Financial year	Profits in Rs.	Rate of dividend
2001-2002	2,70,000	8%
2002-2003	3,10,000	10%
2003-2004	3,40,000	12%
2004-2005	3,30,000	15%
2005-2006	3,60,000	15%

You are required to find out the value of goodwill at 5 years purchase of the super profits of the company

14. The following particulars are available in respect of the business carried on by Indira Ltd;

1. Profits earned for the years

2005-Rs. 50,000, 2006 – Rs.60,000. 2007 – 55,000

2. Profit of 2005 included a non-recurring income of Rs.5,000

3. During the year 2006 Closing stock was under valued by Rs.1000

4. Normal rate of return 10%

5. Average capital employed Rs.3,00,000

6. Present value of an annuity of one rupee for 5 years at 10% is Rs. 3.78.

You are required to calculate the value of goodwill.

a. As per five years purchase of super profits
b. As per capitalization of super profit
c. As per annuity method

15. The following particulars are available in respect of the business carried on by Nischal Ltd.

1. Profits earned: 2006- Rs. 1,00,000, 2007- Rs. 96,000, 2008- Rs. 1,04,000

2. Profit of 2007 is reduced by Rs. 10,000 due to stock destroyed by fire and profit of 2006 included a non recurring income of Rs. 6,000.

3. Profit of 2008 include Rs. 4000 income from investment

4. The stock is not insured and it is thought prudent to insure the stock in future. The insurance premium is estimated at Rs. 1000 p.a

5. Normal rate of return 10%

6. Average capital employed Rs. 8,00,000

7. Present value of an annuity of one rupee for 5 years at 10% is Rs. 3.78

You are required to calculate the value of good will

a. As per 5 years purchase of super-profits
b. As per capitalization of super-profits and
c. As per annuity method
d.

5- Marks Problems

16. From the following information, calculate the value of goodwill under:

a. Three years purchases of super profits method

b. Capitalisation of Super profits method

i. Average Capital employed: Rs/ 8,70,000

ii. Net profits of the firms for the past 3 years were:

Rs. 1,22,000, Rs. 98,500. Rs. 1,75,000

iii. Managerial remuneration of employed elsewhere Rs. 18,000 per annum

iv. Normal rate of return 8%

17. Following is the Balance sheet of Chandana Ltd as on 31-3-2006

Liabilities	Rs	Assets	Rs
Share Capital	30,00,000	Fixed Assets	20,00,000
Reserves & Surplus	7,50,000	Current Assets	25,00,000
Creditors	12,50,000	Investments	5,00,000
Total	50,00,000	Total	50,00,000

The investments are 8% Government Bonds. The net profit after taxation for the past 4 years were Rs. 7,85,000, Rs. 8,45,000, Rs. 8,50,000 and Rs. 8,60,000 respectively, Normal rate of return on average capital employed is 20% Calculate goodwill at 3years purchase of super profits.

18. The net profit of Karthik Ltd. After providing for taxation, for the past five years were. Rs. 80,000. Rs.85,000, Rs/ 92,000, Rs, 1,13,000 and Rs. 1,10,000. The capital employed in the business is Rs. 8,00,000. The normal rate or return expected in this type of business is 10%

Calculate the value of Goodwill on the basis of :

a. 5 years purchase of Super profits method

b. Annuity method, taking the present value of annuity of Rs. 1 for five years at 10% as 3.78.

19. Briefly explain various methods of valuing good will

20. State any five circumstances necessitating valuation of goodwill

2-Marks Questions:

1. Define Goodwill
2. State the features of Goodwill
3. What are the various methods of valuing goodwill?
4. Mention the factors determining the value of goodwill
5. What is average capital employed
6. What is meant by normal rate of return?
7. What is Super Profit?
8. State any four circumstances necessitating valuation of goodwill
9. What is Non-Purchased goodwill

Valuation of good will

Average profit method	Capitalization Method	Super profit Method	Annuity Method
Step-1 Adjusted profit Profit-xxx Add Capital Exp xx Xx			

Add Future profit xx			