VALUATION OF GOODWILL

From the accounting point of view, goodwill is divided into two categories:
(i) Purchased goodwill; and
(ii) Non-purchased goodwill.

Purchased goodwill arises when the purchase consideration for an acquired entity exceeds the value of net assets taken over. Purchase consideration represents the cost of the acquired business entity while net assets mean the difference between the aggregate value of identifiable assets and liabilities of the acquired entity.

Non-purchased goodwill arises when a business raises its goodwill over a period of time on account of favourable location, efficient management, brand loyalty, good public image, good quality product, assured sources of supply and so on. Non-purchased goodwill is therefore also known as inherent goodwill or internally generated goodwill.

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Future Maintainable Profits :- (2)

It must be noted that goodwill will be paid for with a view to earning more profits in future. Therefore, the future maintainable profit is taken as a basis for calculating the value of goodwill. It is generally based upon the average profit of the last few years after making certain adjustments regarding non-operating incomes and expenses. It may be noted that such average profit may be simple average profit or weighted average profit as mentioned below:

(i) Simple average profit $= \frac{\text{Total Profits}}{\text{No of year}}$

OR

(ii) Weighted average profit $= \frac{\text{Total weighted profits}}{\text{Total of weights}}$

The average profit as calculated above must be adjusted to eliminate abnormal losses or expenses, capital profit or loss, profit or loss from investment etc. Similarly, necessary adjustments are to be made regarding adequate depreciation, provision for bad and doubtful debts, tax to be deducted at current (3) rates, etc.

The above points regarding the computation of future maintainable profit may be summarised as follows:

(a) All actual expenses and losses not likely to occur in the future are added back to profits of the relevant years;

(b) Expenses and losses expected to arise in future are deducted from the past profits;

(c) All profits likely to arise in future are added; and

(d) All profits not likely to occur in future are deducted.

Methods of Valuation of Goodwill

The following methods of valuation of goodwill are often used in practice:

(1) Number of years' purchase of simple average profit

(2) Number of years' purchase of weighted average profit

(3) Super profits method:

(i) No. of years purchase of super profit

(ii) Annuity method of super profit

(iii) Capitalisation of super profit

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Illustration 2 (Simple Profit Method)

A Ltd. agreed to purchase business of a sole trader. For that purpose, goodwill is to be valued at three years' purchase of the average of previous 4 year's adjusted profits. The profits for the years ending 31.12.2010 to 31. 12.2013 were as follows: ₹ 20,200, ₹ 24,800, ₹ 25,000, ₹ 30,000. Following additional information is available as under:

(i) On 01.09.2012 a major repair expenditure to plant and machinery for ₹ 6,000 was charged to revenue. This was agreed to be capitalised for goodwill subject to 10% p.a. depreciation on diminishing balance method.

(ii) The closing stock for the year ending 31.12.2011 was over-valued by ₹ 2,400.

(iii) In order to cover cost of management, an annual charge of ₹ 4,800 should be made for valuation of goodwill.

Compute value of Goodwill.

Solution

Calculation of Adjusted Profits

			₹
Total profits for past four years (20,200 + 24,800 + 25,000 + 30,000)			1,00,000
Add:	Expenditure on machinery wrongly debited to profit & loss account in 2012		6,000
Add:	Overvaluing of opening stock in 2012		2,400
			1,08,400
Less:	Depreciation on machinery 2012 : 10% on ₹ 6,000 for 4 months 2013 : 10% on ₹ 5,800 (6,000 - 200) for one year	580 200	780
			1,07,620
Less:	Overvaluing of closing stock in 2011		2,400
			1,05,220
Less:	Cost of management (₹ 4,800 × 4)		19,200
			86,020

Adjusted Profits

Total adjusted profits for four years	86,020
Average Adjusted Profit = 86,020 ÷ 4	21,505

Goodwill: Number of years' purchase × Adjusted Profit

= 3 × 21,505 = ₹ 64,515

// **If weighted average is to be used, then various adjustments will be made on yearly basis.**

Evaluation: This method has nothing to recommend itself since goodwill is attached to profits over and above what one can earn by starting a new business or by a normal business engaged in the same line of activity and not to total profits. It ignores the amount of capital employed for earning the profit. However this method is usually adopted for valuing the goodwill of the **professional persons or firms** such as chartered accountants or doctors.

Illustration 3 (Purchase of Weighted Average Profits Method)

The following information is available about Big B Ltd.:

Profits for the last four years are:

respective allotted weights, say 1,2,3,4 and so on in order to find out the product. This product is then divided by the total number of weights for calculating the Weighted Average Profit.

Thus the Weighted Average Profit is multiplied by number of years' purchase in order to ascertain the value or amount of goodwill.

Suitability: This method is preferred when there is rising trend of profits. The method is summarised as :

$$\text{Weighted Average Profits} = \frac{\textbf{Total Product of Profits or Total Weighted Profits}}{\textbf{Total Number of Weights}}$$

$$\text{Value of Goodwill} = \text{Weighted Average Profit} \times \text{No. of years' Purchase}$$

2nd method

Illustration 4 (Purchase of Weighted Average Profit Method)

A Ltd. proposed to purchase the business carried on by M/s X and Co. Goodwill for this purpose is agreed to be valued at three years' purchase of the weighted average profits of the past four years. The appropriate weights to be used are:

Year	Weight	Profit
2010-11	I	1,01,000
2011-12	2	1,24,000
2012-13	3	1,00,000
2013-14	4	1,40,000

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

(i) On 1 December 2012 a major repair was made in respect of the plant incurring ₹ 30,000 which was charged to revenue. The said sum is agreed to be capitalised for goodwill calculation subject to adjustment of depreciation of 10% p.a. on reducing balance method.

(ii) The closing stock for the year 2011-12 was overvalued by ₹ 12,000.

(iii) To cover management cost, an annual charge of ₹ 24,000 should be made for the purpose of valuation of goodwill.

Compute the value of goodwill of the firm. **[B.Com. (Hons.) Delhi]**

Solution

1. Calculation of Adjusted Profit

(a)	Profits for 2010-11	1,01,000
	Less: Management Expenses	24,000
	Adjusted Profits for 2010-11	77,000
(b)	Profit for 2011-12	1,24,000
	Less: Management Expenses	24,000
		1,00,000
	Less: Overvaluation of Closing Stock	12,000
	Adjusted Profit for 2011-12	88,000
(c)	Profits for 2012-13	1,00,000
	Less: Management Expenses	24,000
		76,000

years' purchase is considered proper, then at 10%, goodwill should be ₹ 2,48,685 (and not ₹ 3,00,000 as under the 3 years' purchase of Super Profit method). In the absence of reference to annuity tables the formula for calculating goodwill as per annuity method is as under:

$$A = \frac{1 - \left(1 + \frac{r}{100}\right)^{-n}}{\frac{r}{100}}$$

Where A = the present value of annuity for ₹ 1; r = normal rate of return per cent; n = the number of years

(ii) CAPITALISATION OF SUPER PROFIT METHOD

Under this method, the value of goodwill is arrived at by capitalising the super profit at the normal rate of return. In other words, this method attempts to determine the amount of capital needed for earning super profit. The formula is :

$$\text{Goodwill} = \frac{\text{Average Annual Superprofit}}{\text{Normal Rate of Returns}}$$

Suppose the super profit is ₹ 2,50,000, the normal rate of profit is 10%, the goodwill as per capitalisation of super profit method is :

$$\frac{2,50,000 \times 100}{10} = ₹\ 25,00,000$$

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Illustration 6 (Number of Years' Purchases of Super Profit)

The following account balances have been extracted from the books of X Ltd as at 31 March 2013 :

Credit	₹	Debit	₹
8% 5,000 Preference Shares of ₹ 10 each	50,000	Goodwill	10,000
10,000 Equity Shares of ₹ 10 each	1,00,000	Fixed Assets	1,80,000
Reserves (including provision for taxation ₹ 10,000)	1,00,000	Investments (5% Government Loan)	20,000
8% Debentures	50,000	Current Assets	1,00,000
Creditors	25,000	Preliminary Expenses	10,000
		Discount on Debentures	5,000
	3,25,000		3,25,000

The average profit of the company (after deducting interest on debentures and taxes) is ₹ 31,000. The market value of the machinery included in the assets is ₹ 5,000 more. Expected rate of return is 10%. Calculate the value of goodwill at three times of the super profits. [B. Com. (Hons.)]

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