Goodwill and Methods of its valuation

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'Goodwill'

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

•The value of a company's brand name, solid customer base, good customer relations, good employee relations and any patents or proprietary technology represent goodwill.

•Goodwill is considered an intangible asset because it is not a physical asset like buildings or equipment. The goodwill account can be found in the assets portion of a company's balance sheet.

•Its value arises when one company purchases another for a premium value.

Factors Affecting the Value of Goodwill

- Good Public Relations
- Quality Maintenance
- Management Skills
- Location
- Good Relation with Suppliers
- Employees

Need for valuation arises under the following circumstances

- Change in profit sharing ratio
- Admission of a partner
- Retirement of a partner
- Death of a partner
- Dissolution of a firm
- Amalgamation of firm

Methods of Valuation of Goodwill

- Average Profit Method
- Super Profit Method
- Capitalisation Method
  - a) Capitalization of average profit
  - b) Capitalization of super profit
- Annuity Method

Average Profits Method

- Average profit – Total profit / No. of years

- Goodwill- Average profit x Number of years of purchase

- The value of goodwill depends upon the past performance.
- The buyer compensate the seller for few years profits which buyer will get because of seller’s efforts.

Calculation of Average Profits Method

Profit of the year

Add:

- Abnormal loss
- Income that will arise in future
- Expenses that will not occur in future

Less:

- Abnormal Gain
- Non-operating income
- Remuneration to the proprietors
- Income that will not arise in future
- Expenses that will occur in future
- Income tax

Weighted Average Profits Method

- Weighted average profit= Total of Product/Total of weights

- Goodwill= Weighted average profit x No. of years of purchase

- ❑It gives weightage to latest profit which is likely to be maintained in the future.
- ❑This method is used when profits show either rising or falling trend.

Super Profits Method

In this method goodwill is calculated on the basis of super profits i.e. the excess of actual profits over the average profits.

It assumes that a business has a goodwill if it earns super profit, otherwise not.

Super Profit method

- Super profits= Actual average profit- Normal Profit

Where,

- Normal profit= Capital employed x Normal rate of return
- Normal rate of return= Current interest rate+ Risk factor rate
- Goodwill= Super profit x No. of Years purchased

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 the basis of normal rate of return. Such capital is called capitalized value of average profit.

- Goodwill= Capitalized value of the firm-Net assets
- Capitalized value= average profit/Normal rate of return x 100
- Net assets= Total assets- external liabilities

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 profit x (100/ Normal rate of return)

Annuity Method

Under this method goodwill is calculated by finding the present worth of annual super profits to be earned over an estimated period by discounting at a given rate of interest.

Goodwill= Super profit x Annuity factor

Thank you