

VALUATION OF GOODWILL

Dr. G. Bright Jowerts,
Assistant Professor in commerce,
St. Xavier's College (Autonomous),
Palayamkottai.

What is Goodwill?

Goodwill is excess of

purchase price over share of Net Assets (Fair Value)

- ✓ Goodwill is Intangible Asset
- ✓ Goodwill is Reputation , higher earning of income , etc

Goodwill = Purchase price – FV of Net Assets acquired as on date of purchase

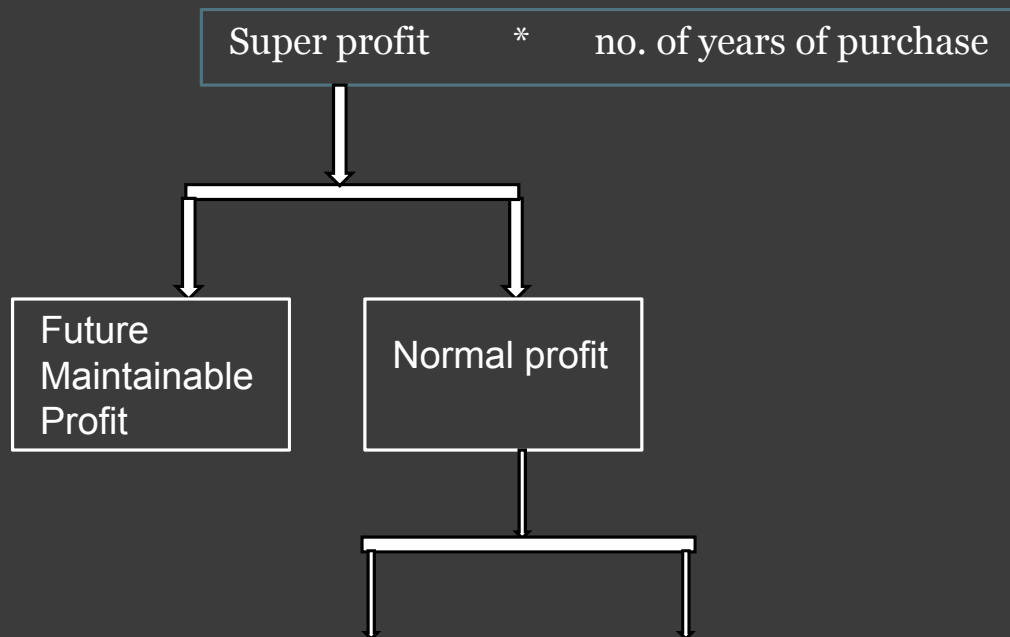
Methods of valuing Goodwill :

Super profits method

Capitalization method

Annuity method

Super profits method :



Super profits method

Normal profit = capital employed * Normal Rate of Return

Super Profit = FMP – Normal Profit

Goodwill = Super Profit * no. of years of purchase

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

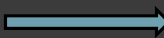
Considers Long Term
Debt as Capital
Employed

LONG TERM FUND APPROACH

Asset Side Rule:

Fixed Assets	XXX
Trading Investments	XXX
Current Assets	<u>XXX</u>
	XXXX
LESS: Current Liabilities	<u>XXX</u>
CAPITAL EMPLOYED →	<u>XXXX</u>

Liabilities Side Rule :

Equity Share Capital	XXX
Preference Share Capital	XXX
Reserves & Surplus	XXX
<i>LONG TERM DEBT</i>	<u>XXX</u>
	XXXX
LESS: NON TRADE INVESTMENTS	XXX
Miscellaneous exp not written off	<u>XXX</u>
<i>CAPITAL EMPLOYED</i> 	<u>XXXX</u>

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)

Capital Employed Represents the fair value of net assets invested in the business for earning profits

Investment in Associate , Subsidiary or Joint venture is considered as "Trade investments."

Share Holders Fund approach:

Asset Side Rule:

Fixed Assets	XXX
Trading Investments	XXX
Current Assets	<u>XXX</u>
	XXXX
LESS: Current Liabilities	XXX
*LONG TERM DEBT	<u>XXX</u>
CAPITAL EMPLOYED	<u>XXXX</u>

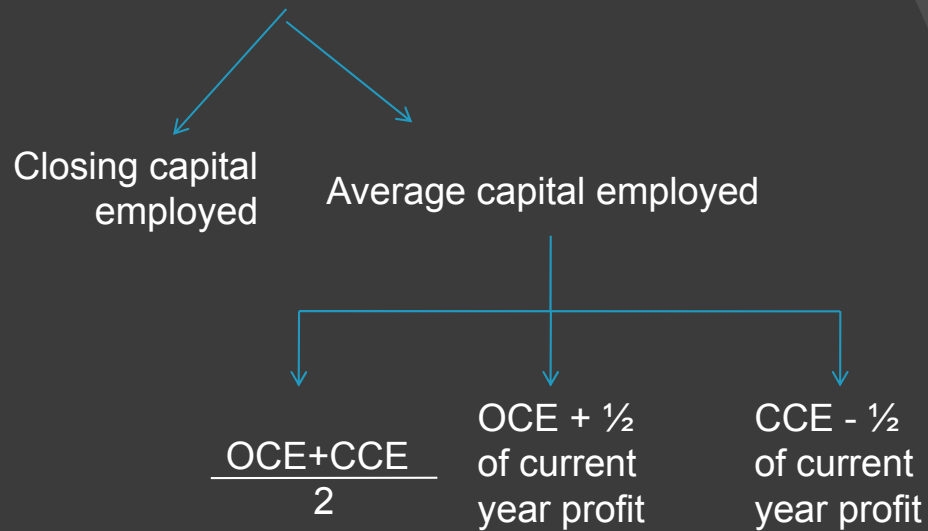
Liabilities Side Rule :

Equity Share Capital	XXX
Preference Share Capital	XXX
Reserves & Surplus	XXX
	<hr/>
	XXXX
LESS: NON TRADE INVESTMENTS	XXX
Miscellaneous exp not written off	XXX
	<hr/>
<i>CAPITAL EMPLOYED</i>	XXXX
	<hr/>

ASSET SIDE APPROACH IS PREFERD

CAPITAL EMPLOYED IT TO BE CALCULATED ON

CAPITAL EMPLOYED



OCE = Opening Capital Employed
CCE = Closing Capital Employed

Treatment of proposed dividend :

- *proposed dividend is employed in the business through out the year*
- *proposed dividend is current liability but it is apportioned from P&L A/c*
- *therefore treat proposed dividend as Capital Employed*

Treatment of Provision for Tax:

- *We pay Tax in form of Advance Tax*
- *It appears to be apportionment from P&L A/c*
- *Actually this is not employed in the business as money already gone in form of Advance Tax*
- *Not considered as Capital Employed*

FUTURE MAINTAINABLE PROFIT (FMP)

- Trend Method
- Average Method
- Weighted Average Method

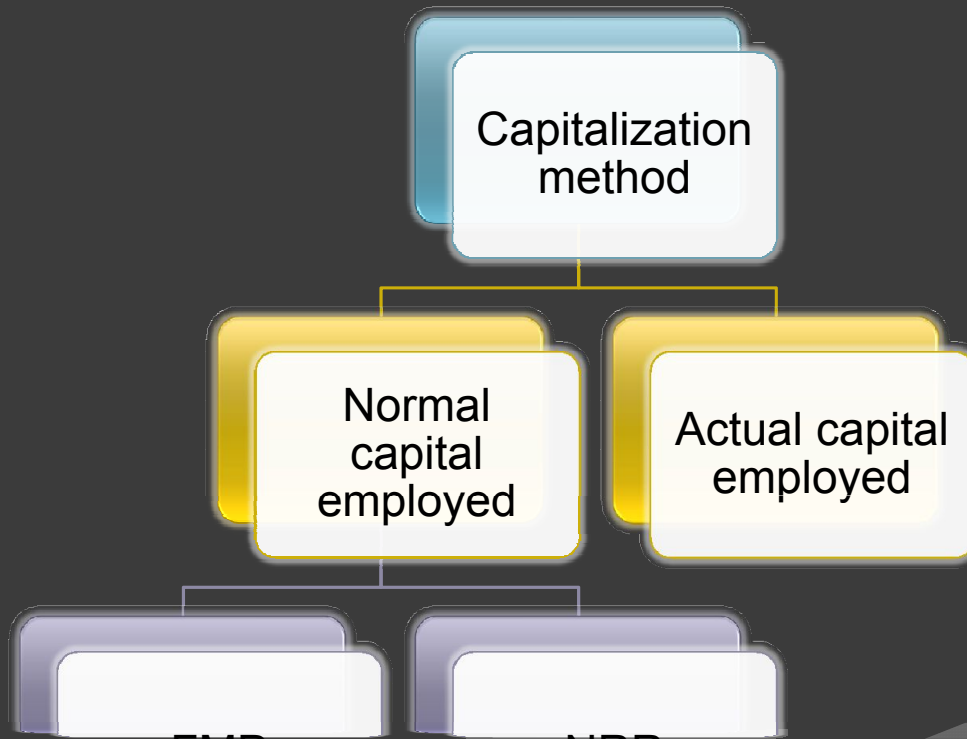
By taking past years profits apply any one of the above tools then we can find FMP

Weighted average method is used when there is up or down trend

Adjustments to be made to profits while calculating FMP:

- ❖ *Extra ordinary items and non recurring items should not be considered.*
- ❖ *Abnormal items should be eliminated*
- ❖ *Income from non trade investments should be eliminated*
- ❖ *Adjust for any change in Accounting Policy*
- ❖ *Incase of change in tax rate*
 - add back – already paid tax*
 - reduce – Tax payable in future*

CAPITALIZATION METHOD



CAPITALIZATION METHOD

Goodwill = Normal Capital Employed –
Actual Capital Employed

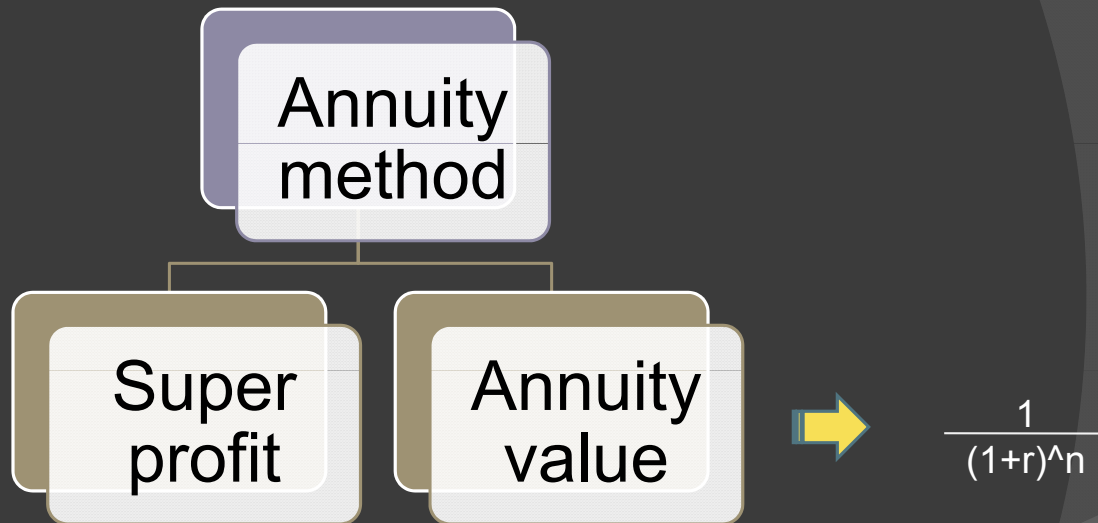
NCE – ACE

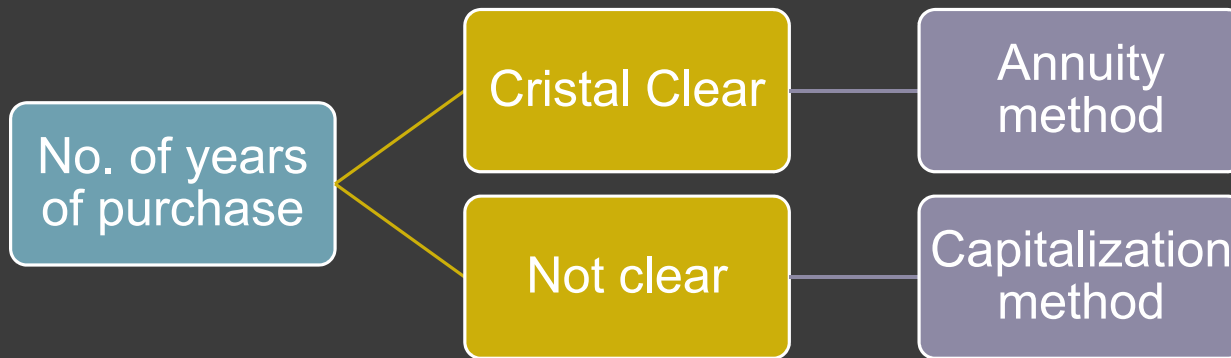
NCE = FMP / NRR

OR

GOODWILL = Super profit / NRR

ANNUITY METHOD :





NRR can be calculated as under also if not directly given in the problem

✓ $NRR = 1/PE \text{ Ratio}$

Closing Capital Employed Vs Avg Capital Employed

Capitalization method :

Under this method closing capital employed should be taken for calculation of GOODWILL unless the problem specifically requires application of Avg Capital employed

Super Profits Method :

Under this method closing capital employed should be generally applied except in following situations

- Specifically asked in the problem
- Information about opening capital is given in problem
- No changes prescribed in problem for closing capital employed & FMP is calculated purely based on past profits without adjusting for future

