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GOODWILL AND ITS VALUATION

Rahul Kumar Das

Guest Faculty, Department of Commerce, Dibru College, Dibrugarh, Assam, India

Vivek Jain

Guest Faculty, Department of Commerce, Dibru College, Dibrugarh, Assam, India

ABSTRACT

It is generally observed that a company, which has been in existence for a number of years, is in a position to earn a higher amount of profits year after year in comparison to a new company in spite of all other things such as location, investment, quality of goods etc. remaining the same. This is because over a period of time a firm establishes its reputation on account of which not only the old customers continue to patronize the firm but they also bring new customers. This results in enabling an old established company to earn excess profits as compared to a new company. This excess profit is termed as "Goodwill". Goodwill has, therefore, been defined as "The present value of firm's anticipated excess earnings". The term "excess earning" is an indicator of this fact that goodwill is there when a business is earning over and above the normal earnings made by other similar firms in the same business or industry.

The present paper is designed to understand the concept of "Goodwill" and different methods of valuing goodwill.

KEYWORDS: *Goodwill, profits, judgement, intangible in nature, valuer.*

CONCEPT OF GOODWILL

Goodwill may be said to be that element arising from the reputation, connection, or other advantages possessed by a business which enables it to earn greater profits than the return normally to be expected on the capital represented by the net tangible assets employed in the business. It is generally observed that a company, which has been in existence for a number of years, is in a position to earn a higher amount of profits year after year in comparison to a new company in spite of all other things such as location, investment, quality of goods etc. remaining the same. This is because over a period of time a firm establishes its reputation on account of which not only the old customers continue to patronize the firm but they also bring new customers. This results in enabling an old established company to earn excess profits as compared to a new company. Goodwill has, therefore, been defined as "The present value of firm's anticipated excess earnings". The term "excess earning" is an indicator of this fact that goodwill is there when a business is earning over and above the normal earnings made by other similar firms in the same business or industry. Thus, Goodwill is viewed in accounting as the combination of those attributes of a company or business which permit it to earn above average profit.

NATURE OF GOODWILL

Following are some of the essential characteristics of goodwill:

1. **Intangible asset**: It represents a non-physical value, intangible in nature, goodwill does not depreciate by wear and tear. However, the goodwill becomes a fictitious asset if it appears in the books of a losing concern
2. **No separate existence**: Goodwill has no existence separate from business, i.e. goodwill cannot exist independently of business. It is attached to the business.
3. **Subjective judgement**: The value of goodwill and the assessment of its existence are based upon subjective judgement of the person judging it, inspite of different methods of its valuation.
4. **No partial trading**: Goodwill can be sold or purchased with entire business. It is valuable only when entire business is sold or purchased.
5. **Fluctuations in value**: It is difficult to place an exact value to goodwill since its value fluctuates from time due to changing circumstances of business

TYPES OF GOODWILL

Goodwill is generally classified into two categories i.e. Purchased Goodwill and Inherent Goodwill.

1. Purchased Goodwill: When a company decides to purchase another company or enterprise, the consideration paid will, in many cases, exceed the total of the separate valuation of each of the assets and liabilities of the company or enterprise being purchased. The excess amount so paid as premium is called goodwill. In other words, Purchased goodwill arises when a business concern is purchased and the amount paid as purchase consideration exceeds the fair value of the separable net assets acquired. The purchased goodwill is shown on the assets side of the Balance sheet. Para 36 of AS-10 'Accounting for fixed assets' states that only purchased goodwill should be recognized in the books of accounts.

The following are the important features of purchased goodwill

i. It arises on the purchase of a business
ii. It is recorded in the books of account
iii. It is depreciated over its useful economic life.
iv. It is shown in the Balance Sheet as an asset.

2. Non-Purchased or Inherent goodwill: Inherent goodwill is the opposite of purchased goodwill and represents the value of a business more than the fair value of its separable net assets. It is referred to as internally generated goodwill and it arises over a period of time due to good reputation of a business. The value of goodwill may be positive or negative. Positive goodwill arises when the value of business as a whole is more than the fair value of its net assets. It is negative when the value of the business is less than the value of its net assets.

The following are the important features of purchased goodwill

i. Unlike purchased goodwill, non-purchased goodwill generated internally over years.
ii. It is recorded in the books of account
iii. A cost cannot be placed on this type of goodwill.
iv. Its valuation depends on the judgement of the valuer.
v. It is generally not shown in the books of account.

NEED FOR VALUATION OF GOODWILL

The need for valuation of goodwill arises in various circumstances. Some of the circumstances are as follow:

1. In the case of a Sole-Proprietorship business: In the case of sole trading concern, valuation of goodwill is required to be done:

a. When the firm is sold to another person.
b. When the firm takes any person as a partner.
c. When the firm is converted into a company.

2. In the case of a Partnership firm: In the case of a partnership firm, valuation of goodwill is required to be done:

a. When a new partner is admitted.
b. When an existing partner retires.
c. When an existing partner dies.
d. When there is any change in profit sharing ratio among the partners.
e. When the firm is sold.
f. When the firm is converted into a company.

3. In the case of a Company: In the case of a company, valuation of goodwill is required to be done:

a. When the goodwill has already been written-off in the past but value of the same is to be recorded further in the books of accounts.
b. When there is amalgamation of two or more companies.
c. If the Stock Exchange Quotation of the value of shares of the company is not available in order to compute gift tax, wealth tax etc.
d. If the shares are valued on the basis of intrinsic values, market value or fair value methods.

FACTORS AFFECTING THE VALUE OF GOODWILL

The following factors affect the value of goodwill:

1. Location of the business: Location of the business is one of the most important factors for creation of goodwill for the business. If the business is located at a very prominent place, it can attract more customers resulting in an increase in turnover.

2. Nature of the business: Nature of the business is also one of the important factors which influence the value of goodwill. If the business fulfills the most demanded need of the customers in best possible way, it will help to generate more customers and hence its goodwill will increase.

3. The Longevity of the business: An older business is better known to its customers; therefore it is likely to have more goodwill. When a business enterprise has built up good reputation over a period of time, the number of customers will be more in comparison to the customers of new business having the same locational advantages.

4. Capital Required: If two businesses have same rate of profit, the business which requires lesser amount of capital tends to enjoy more goodwill.

5. Efficient Management: A good management brings more profits to the business. Increase in the value of goodwill is the result of efficient management.

6. Quality of Products: A firm producing qualitative products can easily have name and fame in the market. This lead to increase in value of goodwill.

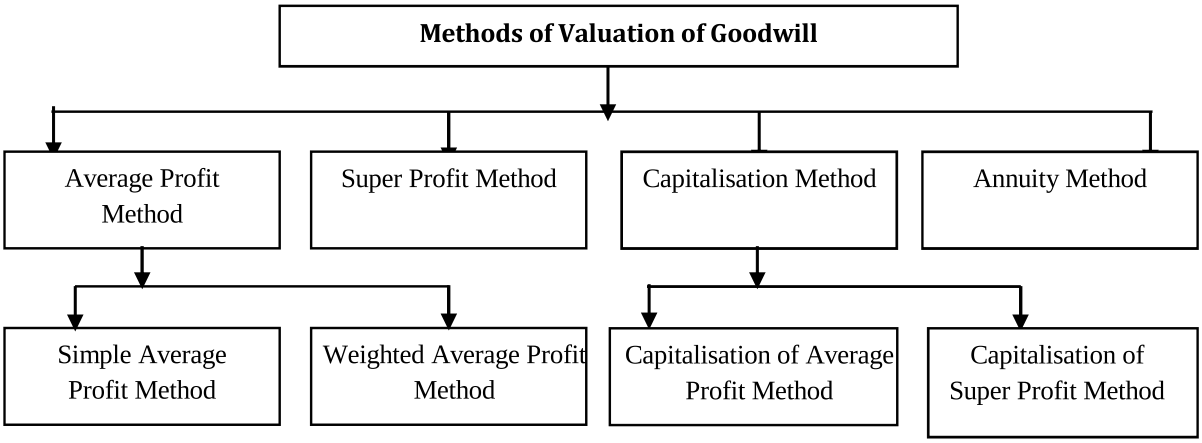
7. Trend of Profit: If the Profits of a Business are Increasing Continuously, the Value of its Goodwill will be more. If the Profits are Declining or if the Profits are Uncertain , the Value of Goodwill will be Less

8. Market Situation: The monopoly condition leads to earn high profit which leads to higher value of goodwill.

9. Special Advantages: The firms which have special advantages like importing licenses, long term contracts for supply of material, patents, trademark etc. enjoy higher value of goodwill.

METHODS OF VALUATION OF GOODWILL

The various methods of valuing goodwill is shown below



Methods of valuing goodwill

1. Average profit method: Average profit method is very simple method of valuing goodwill. Under this method, goodwill is valued by multiplying the average profit by agreed number of years of purchase. Here, average profit is calculated by adding the profits of certain number of years and dividing the same by the number of years. While calculating average profit precaution must be taken in respect of any abnormal items of losses and gains which may affect future profit. In other words, to calculate average profit we must deduct the items of abnormal losses and add the items relating to abnormal gains.

Under average profit method, goodwill may be valued by using *"Simple Average Method"* or by using *"Weighted Average Method"*.

a.Simple Average Profit Method: If simple average profit method is used, i.e. each year's profit is given the equal weight and no discrimination is made between the profits of different years. Under this method, average profit is calculated by adding the profits of agreed number of years and dividing the sum total of profits by agreed number of years.

$$\text{Average Profit} = \frac{\text{Sum total of profits of number of years}}{\text{Number of years}}$$

After calculating the average profit, we determine the value of goodwill by multiplying the average profit with agreed number of years of purchase.

Goodwill= Average Profit × Agreed number of years of purchase

b. Weighted Average Profit Method: If weighted average profit method is used then each year's profits are given different weights. In other words, if profits of last four years such as 2018, 2017, 2016 and 2015 are given then weights should be given as 4, 3, 2 and 1 respectively. The weightage average is used when there is an increasing or decreasing trend in the profits. It is calculated by multiplying the profits of different years with their relative weightage and dividing the grand total by the aggregate number of weights. Symbolically it can be written as

$$\text{Weightage Average Profit} = \frac{\sum WE}{\sum W}$$

Where,

W = Weights,

P = Profits

After calculating the weightage average profit, value of goodwill is determined by multiplying the weightage average profit by the agreed number of years of purchase.

Goodwill = Weightage Average Profit × Number of years of purchase

2.Super Profit Method: Super profit method is a common method of valuing goodwill. Super profit arises when actual profit exceeds the normal profit of an enterprise. Super profit is the result of some special advantages possessed by a business unit which makes it possible to earn profits over and above the normal profit. These extra profits, generally expressed as super profit. The procedure for calculating super profit and goodwill is given below:

i.Calculation of Capital Employed: Capital employed is the sum total of shareholders' equity and long term debts. It is also calculated by adding the amount of fixed assets and working capital.

Capital employed = Shareholders' Equity + Long Tern Debts

Or

Capital employed = Fixed Assets + Working capital

Or

= Fixed Assets + Current Assets – Current Liabilities

(*Working Capital = Current Assets – Current Liabilities*)

ii. Calculation of Normal Rate of Return: Normal rate of return is the minimum expected rate of return which is generally earned by businesses of the same line during a period of time. In most of the cases it is given in the questions but if it is not given in the question then we determine the normal rate of return on the basis of 'normal profit of the business' and 'total capital employed in the business with the help of the following formula:

$$\text{Normal Rate of Return} = \frac{\text{Normal Profit}}{\text{Capital Employed}} \times 100$$

iii.Calculate Average Maintainable Profit: As we discussed earlier, average maintainable profit is 'the sum total of profits (or loss) of certain number of years' of the business divided by 'the number of years' and adjustment(s) is required to be made (if any).

$$\text{Average Maintainable Profit} = \frac{\text{Sum total of profits of number of years}}{\text{Number of years}}$$

iv. Determine the Super Profit of the Firm: Super profit is the excess of average maintainable profit over the normal profit of the firm. It is calculated by deducting the amount of normal profit from the amount of average profit.

Super Profit of the Firm = Average Maintainable Profit – Normal Profit

v.Compute the Value of Goodwill: After calculating the super profit, value of goodwill is calculated by multiplying the super profit with agreed number of years of purchase.

Goodwill= Super profit × No. of years of purchase

3. Capitalisation Method: Capitalisation method is considered as very genuine method of valuing goodwill. Under this method goodwill can be valued either by using "average profit" or "super profit". The result obtained will be the same either we use "capitalization of average profit method" or "capitalization of super profit method". Let we discuss these two methods in detail.

a. Capitalisation of average profit method: Under this method goodwill is valued on the basis of 'Market Value of the Firm' and 'Net Tangible Assets of the business. To determine the value of goodwill we need to go through the following steps:

i.Calculate Average Maintainable Profit: As we discussed earlier, average maintainable profit is 'the sum total of profits (or loss) of certain number of years' of the business divided by 'the number of years' and adjustment(s) is required to be made (if any).

ii.Compute the Normal Rate of Return: Normal rate of return is the minimum expected rate of return which is generally earned by businesses of the same line during a period of time. In most of the cases it is given in the questions but if it is not given in the question then we determine the normal rate of return on the basis of 'normal profit of the business' and 'total capital employed in the business with the help of the following formula:

$$\text{Normal Rate of Return} = \frac{\text{Normal Profit}}{\text{Capital Employed}} \times 100$$

iii. Compute the Market Value of the Firm: The market value of the firm represents the total saleable value of the business. This market value of the firm or total value of the business is determined with the help of the following formula:

$$\text{Market value of the firm} = \frac{\text{Average Maintainable Profit}}{\text{Normal Rate of Return}} \times 100$$

iv. Compute Net Tangible Assets of the business: Net Tangible Assets (NTA) is the value of all physical or tangible assets minus all liabilities in a business. In other words, NTA are the total assets of a company minus intangible assets and total liabilities.

Net Tangible Assets = Total Assets – Intangible Assets – Total Liabilities

v. Compute the Value of Goodwill: After computing the market or total value of the firm, goodwill is calculated by deducting the net tangible assets of the business from total value of the firm.

Goodwill = Total (Market) value of the firm – Net Tangible Assets

b.Capitalisation of Super Profit Method: Under this method valuation of goodwill is done on the basis of super profit of the firm. To determine the value of goodwill we need to go through the following steps:

i. Calculate Average Maintainable Profit: As we discussed earlier, average maintainable profit is 'the sum total of profits (or loss) of certain number of years' of the business divided by 'the number of years' and adjustment(s) is required to be made (if any).

$$\text{Average Maintainable Profit} = \frac{\text{Sum total of profits of number of years}}{\text{Number of years}}$$

ii. Determine Normal Profit of the Firm: Normal profit of the firm is calculated by multiplying the capital employed in business with the normal rate of return.

$$\text{Normal Profit} = \text{Capital employed} \times \frac{\text{Rate}}{100}$$

iii. Determine the Super Profit of the Firm: Super profit is the excess of average maintainable profit over the normal profit of the firm. It is calculated by deducting the amount of normal profit from the amount of average profit.

Super Profit of the Firm = Average Maintainable Profit – Normal Profit

iv. Compute the Value of Goodwill: Lastly, the value of Goodwill is computed by applying the following formula:

$$\text{Goodwill} = \text{Super Profit} \times \frac{100}{\text{Rate}}$$

4. Annuity Method: An annuity is a series of equal periodic payments occurring at equal intervals of time. Under this method, valuation of goodwill is done taking into consideration the average super profit and value of an annuity over a certain number of years. Thus, to calculate the value of goodwill under this method the following steps are followed.

i. Calculate Average Maintainable Profit: As we discussed earlier, average maintainable profit is 'the sum total of profits (or loss) of certain number of years' of the business divided by 'the number of years' and adjustment(s) is required to be made (if any).

$$\text{Average Maintainable Profit} = \frac{\text{Sum total of profits of number of years}}{\text{Number of years}}$$

ii. Determine Normal Profit of the Firm: Normal profit of the firm is calculated by multiplying the capital employed or net tangible assets in business with the normal rate of return.

Normal Profit = Capital employed

Or

Normal Profit = Net Tangible Assets

Net tangible assets is calculated by deducting the current liabilities from total tangible assets.

iii. Determine the Super Profit of the Firm: Super profit is the excess of average maintainable profit over the normal profit of the firm. It is calculated by deducting the amount of normal profit from the amount of average profit.

Super Profit of the Firm = Average Maintainable Profit – Normal Profit

iv. Compute the Value of Goodwill:

a. If the value of annuity is given: Lastly, the value of Goodwill is computed by multiplying the average super profit with the value of annuity over a certain number of years.

Goodwill = Average Super Profit × Value of an annuity

b.If value of annuity is not given: If the value of annuity is not is not given, the following formula can be applied for valuing goodwill:

$$\text{Value of Goodwill} = \frac{a}{i}\left[1 - \frac{1}{(1+i)^n}\right]$$

Where,

a = Average super profit.

i = Rate of interest.

n = Number of years.

CONCLUSION

Goodwill is an intangible asset which means we cannot see or touch it but it helps the business to earn profit over and above the normal profit. Thus, even if we cannot see it, it comprises the same value as other assets in the balance sheet have. It is very easy to generate tangible assets but it takes long time with some special features of the business to generate goodwill. There are various methods of valuing goodwill as we discussed above, one has to choose the appropriate method to value goodwill based on time period and situation.

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