THIRUTHANGAL NADAR COLLEGE

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Selavayal, Chennai-51.

A Self-Financing Co-educational College of Arts & Science

Affiliated to the University of Madras

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An ISO 9001: 2015 Certified Institution

NAME OF THE DEPARMENT: B.Com (Computer Applications)

SUBJECT : Corporate Accounting

TOPIC : Valuation of Goodwill

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VALUATION OF GOODWILL

Concept of Goodwill.

Goodwill is the value of the reputation of the firm judged in respect of its capacity to bring in, unaided profits. Goodwill is an asset that cannot be seen but can be imagined. Hence it is known as an "intangible asset."

WHAT ARE THE BASES OF VALUATION OF GOODWILL? EXPLAIN

FOR THE VALUATION OF GOODWILL THE FOLLOWING PROFITS ARE CALCULATED

(1) ACTUAL AVERAGE PROFIT OR FUTURE MAINTAINABLE PROFIT

(2) SUPER PROFIT

Calculation of Actual Average Profit : It can be calculated by using the following three steps :

Step I :

Calculation of Adjusted Profit :		
Net Profit Before Tax		XXX
Add : Abnormal Expenses & Losses (If debited in P&L A/c)		XXX
Less : Abnormal Income and Profit (If credited in P&L A/c)	XXX	
Preference Share Dividend	XXX	
Provision for Taxation	XXX	
Provision for Bad and Doubtful Debt (Due to Accounting Error)	XXX	
Income from Non-Trade Investments (If Unequal Income in Every Year)	XXX	XXX
Adjusted Profit		XXX

STEP II : CALCULATION OF AVERAGE PROFIT :

- Simple Average Profit = Total adjusted profit / Number of years

If past adjusted profit show any trend of raising or falling then weighted average profit will be calculated.

- Weighted Average Profit = Total Product of Profits & Weights / Total of Weight

Average Profit		xxx
Add : Expenses that will not incur in future		xxx
Income and Profit that will arise in future		xxx
Savings in depreciation due to decrease in value of Fixed Assets		xxx
		xxx
Less : Expenses that will incur in future	xxx	
Income and profit that will not arise in future	xxx	
Fair remuneration of the owner	xxx	
Income from non-Trading Investment	xxx	
Additional depreciation on increased value of assets	xxx	
Provision for bad debts in future	xxx	xxx
Future Maintainable Profit or Actual Average Profit		xxx

(2) Super Profit :

- Super Profit = Actual Average Profit – Normal Profit
- To calculate normal profit - (a) Average capital employed, and (b) Normal rate of return is computed. These can be calculated as follows :-

(A) **Capital Employed :**

- Total of Assets – Outside Liabilities
- To calculate the total of assets the following points should be kept in mind :-
- (b) Fixed assets and intangible assets will be taken at their realizable value otherwise at book value.
- (c) Fictitious assets and goodwill given at cost will not be included.
- (d) Non-trade investments will not be taken.

Average Capital Employed :

- Average Capital Employed can be calculated by following three formulae:

(i) Opening Capital Employed + Closing Capital Employed / 2

(ii) Opening Capital Employed + ½ of current years profit after tax and preference dividend

(iii) Closing Capital Employed – ½ of current years profit after tax and preference dividend

(B) **Normal Rate of Return :** The rate of earnings which normally applies in similar concerns or which is expected by the investor to apply in similar concern is known as normal rate of return

EXPLAIN THE VARIOUS METHODS OF VALUATION OF GOODWILL.

There are three methods of valuation of goodwill, the selection of method will depend on the circumstance of a particular business.

- (1) **Year's Purchase Method :** This method is based on the assumption that the buyer of business will earn certain amount of profit or super profit during the life time of business. So he must pay some of the years profits as goodwill to the seller.

Goodwill = Future Maintainable Profit or Actual Average Profit

X Number of years (2 or 3)

Or Goodwill = Super Profit X Number of year (4 to 5)

Goodwill = Normal Capital Employed – Actual Capital Employed

(2) **Capitalization Method :**

(i) **Capitalization of Super Profit Method :** According to this method it is estimated that how much capital will be required to earn super profit at a normal rate of return or profit.

Value of Goodwill = Super Profit /Normal rate of return X 100

(ii) **Capitalization of Average Profit :** In this method first average profit is capitalized at normal rate of return. This is known as normal Capital Employed

- Normal Capital Employed = Actual Average Profit X 100

  Normal rate of return

- Then value of goodwill will be calculated as follows :-

- Value of Goodwill = Normal Capital Employed – Actual Capital employed

(3) **Annuity Method :** According to this method the goodwill will be equal to the amount of present value of future super profits because one has to pay goodwill today but the amount of super profit will be earned in future. In this way loss of interest can be compensated.

- Value of Goodwill = Super Profit X present value of Rs. 1
- Present value of Rs. 1 received annually for „n�" year = 1(1/1+r)n/r
- Here r = rate of interest, n = number of years.