Semester – V

Corporate Accounting – I

Valuation of Goodwill and Shares

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PART - A

Valuation of Goodwill:

Goodwill: Goodwill may be described as the aggregate of those intangible attributes of a business which contribute to its superior earning capacity over a normal return on investment. It may arise from such attributes of a business as good reception, a favourable location, the ability and skill of its employees and management, nature of its products, etc.

From the different angle, "The term goodwill can hardly be said to have any precise significance. It is generally used to denote the benefit arising from connection and reputation and its value is what can be got for the change of being able to keep that connection and improve it. Upon the sale of an established business its goodwill has a marketable value, whether the business is that of a professional man or of any other person. But it is plain that goodwill has no meaning except in connection with a continuing business, and the value of the goodwill of any business to a purchaser depends in some cases entirely, and in all very much, on the absence of competition on the part of those by whom the business has been previously carried on".

Types of Goodwill:

Goodwill is generally of two types: a) Purchased Goodwill; and b) Non – purchased or Inherent Goodwill.

a) Purchased goodwill: It arises when one business buys another and the purchase consideration paid is more than the value of the net tangible assets received. It can be exist in a new business except by purchase. It is the accepted practice to recognise only the purchased goodwill in the accounting system. Therefore, goodwill should enter into the books of account of a business only in connection with a valuation ascribed to it in the acquisition price of a business.
b) Non – purchased or Inherent Goodwill: It is referred to as internally generated goodwill and it arises when a business may over the years generate its own goodwill.

Valuation of Non – purchased Goodwill

This method takes into account the average profits for the last few years and fixes the value of the goodwill as to many years' purchase of this account. Under this method, at first, average profit is calculated on the basis of the past few years' profits. At the time of calculating average profit, precaution must be taken in respect of any abnormal items of profit or loss which may affect future profit. It should be mentioned that average profit may be used on **simple average** or **weighted average**.

1. **Average profit method:**

Value of Goodwill = Agreed numbers of years purchased x Average maintainable profits.

Average maintainable profits:

Average annual profits (simple or weighted average)	x
Less: Depreciation (over/under)	x
Less: Under/over valuation of stock	x
Less: Casual income (Non-recurring income)	x
Add: Abnormal Loss	x
Add: Capital expenditure wrongly charged against profit	x
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	x
Less: Provision for taxation	x
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	x
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2. **Super profit method:**

Super profit = Average future maintainable profits – Normal return on capital employed.

Value of goodwill = Super profit x No. of years purchased.

Steps to be followed:

a) Calculation of Capital employed or Average capital employed

Total sundry assets (Excluding goodwill but including goodwill at cost paid for And Non trading assets & fictitious assets)	x
Less: Current Liabilities & Provisions	x
Less: Contingent & Probable Liabilities	x

Trading Capital Employed	x
Less: ½ of Current years trading profits after tax (If the profits remain undistributed)	x
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Average Capital Employed	x
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b) Calculate Average Annual Adjusted Maintainable Profits as shown above.

c) Calculate Normal Return on Capital Employed OR Average Capital Employed. (i.e Normal Rate of Return x Average capital employed)

d) Calculate Super Profits (i.e. Average Annual Adjusted Profits – Normal Profits)

e) Value of Goodwill = Super Profits x No. of years purchased

3. **Capitalization of Average profit method:**

Steps to be followed:

a) Calculate Annual Adjusted Maintainable Profits as shown above

b) Calculate Normal Capital Employed
i.e Normal Capital Employed = Average Maintainable Profits / Normal Rate of Return x 100

c) Calculate Actual capital Employed

d) Value of Goodwill = Normal Capital Employed – Actual Capital Employed.

4. **Capitalization of Super Profits Method:**
   Steps to be followed:
   a) Calculate Super Profits Method as said under **Method 2**
   b) Value of Goodwill = Super Profits / Normal Rate of Return x 100
5. **Annuity Method:**

$$V = a / i [1 - (1 + i)^{-n}]$$

V = value of goodwill
n = number of years
a = annual super profits
I = rate of return

Practical Problems & Solutions:

1. The following particulars are available in respect of the business carried on by Bankey Ltd. :
   a) Profits earned: 2016-17 Rs.50000
      2017-18 Rs.48000
      2018-19 Rs.62000
   b) Profits for 2017-18 is reduced by Rs.5000 due to stock destroyed by fire and profits of 2016-17 included a non-recurring income of Rs.4000.
   c) Profits for 2018-19 includes Rs.2000 income from investments.
   d) The stock is not insured and it is though the prudent to insure the stock in future. The insurance premium is estimated at Rs.500 p.a.
   e) Fair remuneration to the proprietor (not taken in the calculation of profits) is Rs.10000 p.a.
   You are required to compute the value of goodwill on the basis of 2 years' purchase of the average profits of the last three years.

Solutions.1.

Calculation of Annual profits after tax:

	2016-17	2017-18	2018-19
Profits Earned	Rs.50000	Rs.48000	Rs.62000
Add: Stock destroyed by fire	-----------	Rs.5000	-----------
Less: Non-recurring income	(Rs.4000)	----------	-----------
Less: Income from investment	-----------	----------	(Rs.2000)
Less: Insurance premium	(Rs.500)	(Rs.500)	(Rs.500)
Less: Fair remuneration	(Rs.10000)	(Rs.10000)	(Rs.10000)
Adjusted Annual Profits	Rs.35500	Rs.42500	Rs.49500

Average Adjusted Annual Profits = $\frac{Rs.35500+Rs.42500+Rs.49500}{3}$

= Rs.42500

Value of Goodwill = Average adjusted annual profits x No. of years purchased

= Rs.42500 x 2

= Rs.85000

2. The average net profits before adjustment(s) is Rs.514000. The profit includes interest at 8% on non-trading investments. The cost of these investments is Rs.198200 while the face value at Rs.200000. Expenses amounting to Rs.7000 per annum are likely to be discontinued in future. The provision for income tax be made at 30%. The normal rate of return may be taken at 10%. The average capital employed in the business (including investments) is Rs.1898200.
   Assuming four years' purchase of super profits, compute the value of goodwill.

Solutions.2.

Under super profits method:

Steps to be followed:

a) Calculation of Adjusted Average capital employed:

Average capital employed	Rs.1898200
Less: Investments	Rs. 198200

Adjusted Average Capital Employed	Rs.1700000
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b) Adjusted annual profits after tax

Average profits before tax	Rs.514000
Less: Non-trading Income (200000*8%)	Rs.16000
Less: Expenses	Rs.7000

Adjusted profits before tax	Rs.491000
Less: provision for tax @30%	Rs.147300

Adjusted annual profits after tax	Rs.343700
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c) Normal profits = Average Capital Employed x Normal rate of return

= Rs.1700000 x 10%

= Rs.170000

d) Super profit = Adjusted profit after tax – Normal profits.
   = Rs.343700 – Rs.170000

= Rs.173700

e) Value of Goodwill = Super profits x No. of years purchased

= Rs.173700 x 4 = Rs.694800

3. The following information relates to a company as on 31st March, 2020:

Equity share capital (Rs.10)	Rs.500000
10% preference share capital	Rs.200000
Reserves and surplus	Rs.70000
9% debentures	Rs.100000
Depreciation fund	Rs.60000
Trade payables	Rs.50000
Unamortised preliminary expenses	Rs.20000

Market value of assets is Rs.70000 more than the book value.

Profits for last three years after 40% tax were Rs.75000, Rs.84000 and Rs.114000 respectively.

Fair return on capital employed in this type of business is estimated at 10%.

You are required to calculate the value of goodwill by capitalisation of super profits (Take weighted average profit.)

Solutions.3.

Under capitalisation of super profits method:

Calculation of super profit:

a) Calculation of capital employed / average capital employed

Equity share capital	Rs.500000
10% preference share capital	Rs.200000
Reserve & surplus	Rs.70000
9% debenture	Rs.100000

	Rs.870000
Add: Increased value of assets	Rs.70000

	Rs.940000
Less: Unamortised Preliminary Expenses	Rs.20000

Average Capital Employed	Rs.920000
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b) Average maintainable profit after tax (under weighted average method)

Year	Profits	Weights	Weighted profits
1	Rs.75000	1	Rs.75000
2	Rs.84000	2	Rs.168000
3	Rs.114000	3	Rs.342000
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		6	Rs.585000
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Weighted average profit after tax = Rs.585000 / 6 = Rs.97500
Add: Interest on debenture (100000 x 9%) x 60% = Rs.5400

Rs.102900
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c) Normal profit = Average Capital employed x Normal rate of return
= Rs.920000 x 10%
= Rs.92000

d) Super profit = Average profit after tax – Normal profit
= Rs.102900 – Rs.92000
= Rs.10900

e) Value of goodwill = Super profit / Normal rate of return x 100
= Rs.10900 / 10 x100
= Rs.109000.

Continued to be Part B (Valuation of shares)…………