

Goodwill : Nature and Valuation

* Goodwill is an intangible asset which places an enterprise at an advantage due to which the enterprise is able to earn higher profits without extra efforts.

➤ Characteristics of Goodwill :-

1. It is an intangible asset and is not a fictitious asset.
2. It does not have an existence separate from that of enterprise.
3. It helps in earning higher profits.
4. It is an attractive force which brings in customers regularly to the place of business.
5. Value of goodwill is subjective, as it depends on the assessment of the valuer.
6. In the context of partnership, it is value of share of profit sacrificed by the sacrificing partner.

➤ Need for Valuing goodwill :-

The need for valuing of goodwill arises -

1. When there is a change in the profit-sharing ratio.
2. When a new partner is admitted.
3. When a partner retires or dies.
4. When partnership firm is sold as a going concern.
5. When two or more firms amalgamate.
6. When a partnership firm is converted into a company.

➤ Factors affecting the value of Goodwill :- गुणवत्ता के मान को प्रभावित करने वाले कारक :-

- ⊙ Efficient Management
- ⊙ Favourable Location
- ⊙ Favourable contracts
- ⊙ Longer Establishments of Business
- ⊙ Advantage of Patents
- ⊙ Access to supplies
- ⊙ Quality of the products
- ⊙ Market Situation
- ⊙ Risk associated with Business
- ⊙ Nature of Business
- ⊙ Past performances
- ⊙ Other factors: (a) After sale services (b) Good customer relations (c) Good labour relations, etc.

➤ Classification of Goodwill :-

Goodwill is of two types -

1. Purchased Goodwill
2. Self-generated or Non-purchased Goodwill

* Purchased Goodwill -

Purchased goodwill is that goodwill for which the firm has paid consideration in cash or kind.

⊙ Features of purchased Goodwill -

- (i) It normally arises on the purchase of a business.
- (ii) Since, the consideration is paid for it, it may be recognised in the books of Account.

- (iii) It is shown in Balance sheet as an Asset.
- (iv) Value of Goodwill is a subjective assessment but it is ascertained when both purchaser and seller agrees to its valuation.
- (v) It is amortised at the earliest but not later than its estimated useful life.
- (vi) Value of goodwill depends^{up} on the purchaser's expectation of future profits.

* Self Generated Goodwill or Non-purchased Goodwill:
 Self generated goodwill is the goodwill which is not purchased for a consideration but is earned by the efforts of the management (or partners). It is an internally generated goodwill which arises from a no. of factors that a running business possesses due to which it is able to earn higher profits.

● Features of self-generated goodwill —

- (i) It is generated internally, generally over the years.
- (ii) Its valuation is subjective assessment of the valuer, being not based on an evidence.
- (iii) AS-26 prescribes that self-generated goodwill is not recognised as an asset.

* Methods of Valuation of Goodwill:

1. Average profit Method

(i) Simple average profit Method

$$\text{Value of Goodwill} = \text{Average profit} \times \text{No. of years' purchase}$$

(ii) Weighted Average profit Method

$$\text{Weighted Average profit} = \frac{\text{Total weighted profit}}{\text{Total of weights}}$$

$$\text{Goodwill} = \text{Weighted Average Profit} \times \text{No. of years' purchase.}$$

2. Super profit Method

The excess of actual/average profit over normal profit is known as super profit.

$$\text{Super profit} = \text{Average profit} - \text{Normal profit}$$

$$\text{Goodwill} = \text{Super profit} \times \text{No. of years' purchase}$$

$$\text{Normal profit} = \text{Capital employed} \times \text{Rate of investment}$$

Capital employed :-

$$\text{Liabilities side approach} \Rightarrow \text{Capital} + \text{Reserve} - \text{Goodwill} - \text{Fictitious assets} \\ - \text{Non trade Investment}$$

$$\text{Assets side approach} \Rightarrow \text{All assets (except goodwill, fictitious asset - non trade)} \\ - \text{Outside liabilities.}$$