Valuation of Goodwill

Goodwill means advantage which arise due to past efforts/ purchased efforts/ locational efforts. We will value goodwill due to past/ purchased efforts in this chapter.

Method:

(i) Avg. Profit Method = FMP * NYP
(ii) Super Profit Method = (FMP-NRR*CE) * NYP
(iii) Capitalization Method = Super Profit / NRR
    Use Closing Capital Employed
(iv) Capitalization Method = Super Profit / NRR
    Use Avg. Capital Employed
(v) Annuity Method = Super Profit or FMP * PV of Annuity Factor

Where,
FMP= Future Maintanable Profit
NYP = No. of Year Purchased
NRR = Normal Rate of Return
CE = Capital Employed

How to Calculate FMP?
FMP represent profit of future period based on certain assumption.
(i) Projection Method
(ii) Past Profit Method

(i) **Projection Method:** Sales, COGS and expenses are projected based upon expectation.

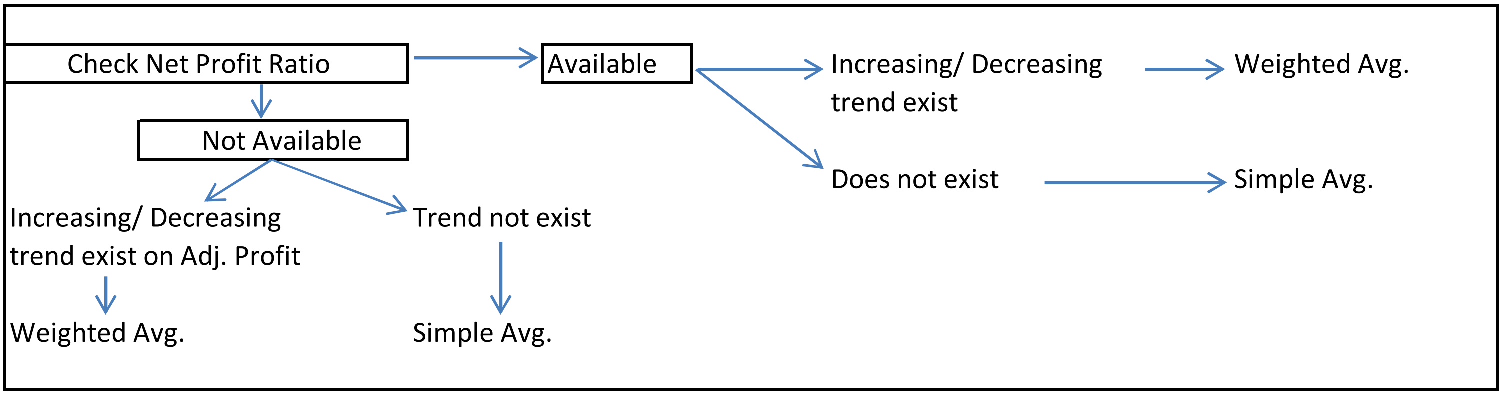
(ii) **Past Profit Method:**

Particulars	Year 1	Year 2	Year 3
PAT			
+ Tax Expense			
PBT			
± Abnormal Loss/ Gain			
± Non recurring items (Profit on sale of Machine)			
± Rectification of Errors			
± Effect of change in A/cing policy			
± Revaluation of CA/ CL			
+ Goodwill Amortisation			
- Non Operating Income			
Adjusted Profit			

Average

Average Adjusted Profit	
± Future Income/ Expenses	
FMPBT	
- Future Tax	
FMP	

Notes:
(1) Future Tax Rate will be either given or previous year rates or avg. of previous years.
(2) Whenever abnormal item exists, but can't be valued, ignore such year.
(3) All investment will be assumed as non trade if question is silent.
(4) Average can be:
    (i) Simple Average
    (ii) Weighted Average
    (iii) Trend line Average



Trend line Method to be applied if question specify:

Formula ======> $y = a+bx$

y = Income
a = Simple avg.
b = Growth = $\sum XY / \sum X^2$
x = Variable from median

How to Calculate CE?

Sundry Assets	
(-) Sundry Liablity	
Capital Employed (Share Holders Fund)	

Note:

1. All Assets & Liablitities should be after revaluation.
2. All Assets & Liablitities should be after rectification.
3. All Assets & Liablitities should be after chage in accounting policy.
4. Sundry Assets should not include Goodwill, Preliminary Expenses, Non Trade Investment
5. Sundry Liabity does not include proposed dividend (it is treated as part of Reserve & Surplus)
6. Tangible CE means Closing CE
7. Preference should be given to Average CE
8. a) Avg. CE = (Opeing CE + Closing CE)/ 2
   b) Avg. CE = Closing CE - 1/2 Rectified PAT
9. Whenever we use weighted average in FMP, use Closing CE
10. Whenever we use simple average in FMP, use average CE

Trend line:

Example: Calculate profit of 6th year

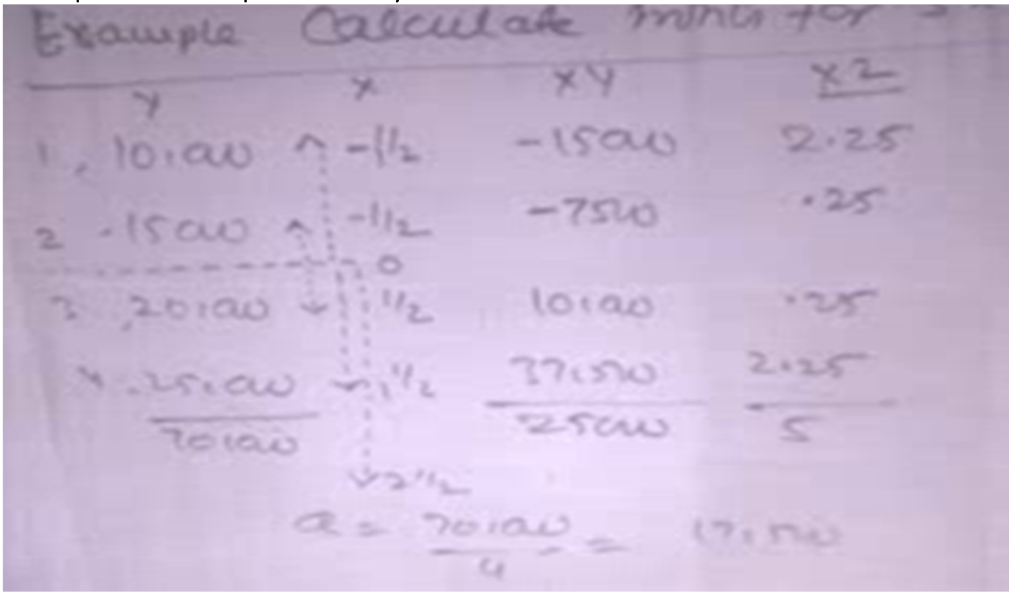
	Y	X	XY	X^2
1	10000	-2	-20000	4
2	15000	-1	-15000	1
3	20000	0	0	0
4	25000	1	25000	1
5	30000	2	60000	4
Total	**100000**		**50000**	**10**

a) 100000/5 = 20000

b) $\sum XY/\sum x^2$ = 50000/10 = 5000

6^{th} Year = 20000+5000*3
= 35000

Example: Calculate profit of 5th year



Projection Method:

Past Profit Today CE Future Profit

Goodwill = (FMP-NRR*CE)/ No. of year purchased

With growth Closing
Not With growth Avg.

* when to use Avg. CE/ Closing CE in valuation ?

Check instruction in Question

Question specify instruction → Use Avg. CE/ Closing CE

Question is Silent

- Check FMP Basis → Trandline → use Closing
- Check FMP Basis → Weig. Avg. → use Closing CE
- Check FMP Basis → Simp. Avg. → use Avg. CE
- Check FMP Basis → Projection → use Closing CE

How to Calculate NRR:

$$NRR = \frac{\text{Avg. Dividend Earnings}}{\text{Avg. Market Price}} * 100$$

NRR should be after tax

How to Calculate Number of Year Purchase:

i) If No. of year purchase is missing, use capitalization method and capitalization of super profit method.

ii) If No. of year purchase is missing and require no. of year purchase, then estimate no. of year purchase from 3-5 year by giving note.