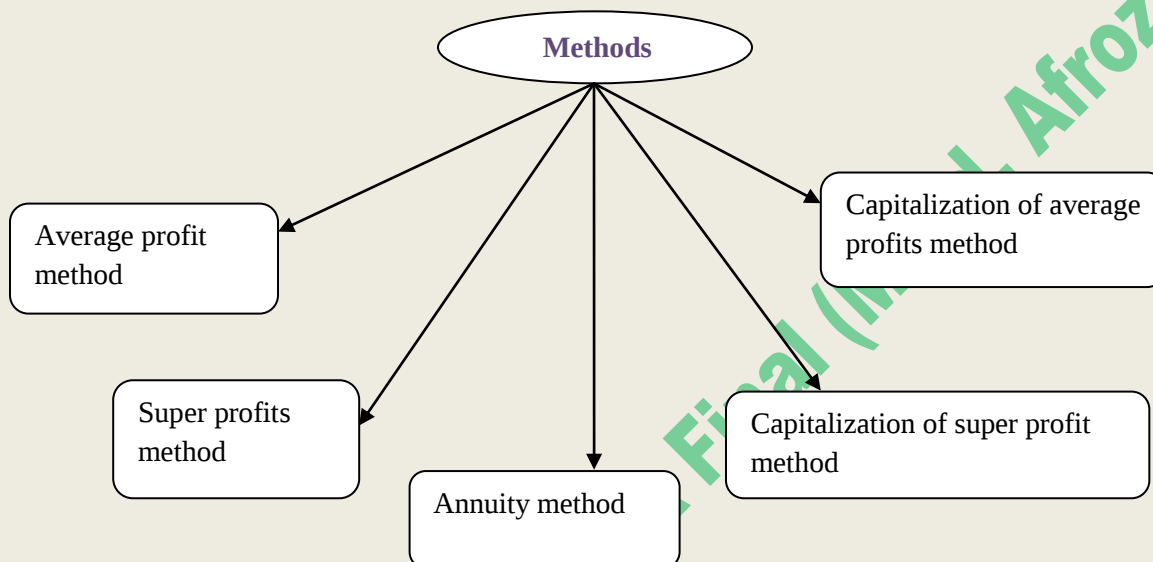


Valuation of Goodwill

Goodwill is an important part of the business. It creates worth of the business. It is an intangible asset of the business. It creates from profit of the business. When we sale our business, amalgamation, merger, acquisition and in case of reconstruction of business etc. need arise of valuation of goodwill. It cannot directly calculated therefore, we may use following methods to find out the value of Goodwill.



Average profit method

We can find out valuation of goodwill by average profit method. This method is widely used for the valuation of Goodwill. It has four steps. Each step is important. Therefore, we have to calculate very carefully.

Step – 1 –Computation of past profit before tax (PPBT)

S.No.	Particular	Amount
A	Closing balance of P/L account	XXXXXX
B	Add	
	1) Goodwill w/o.....XXX	
	2) Interim dividend.....XXX	
	3) Proposed .Preference .dividend.....XXX	
	4) Proposed Equity dividend.....XXX	
	5) Dividend distribution tax.....XXX	
	6) Transfer to Reserve.....XXX	XXXXXX
C	Less : Opening balance of P/L account	XXXXXX
D	PAT (A+B-C)	XXXXXX
E	Add : Tax at actual rate $(PAT/T*(1-T))$	XXXXXX
F	Profit before Tax (D+E)	XXXXXX

Step – 2 –Computation of past adjusted profit before tax (PAPBT)

S. No.	Particular	Amount
A	Profit before Tax from step – 1	XXXXX
B	Add: i. Abnormal lossXXXX ii. Capital expenditure charged on Revenue account.....XXXX iii. Over valuation of opening stock.....XXXX iv. Income of previous year not credited.....XXXX	XXXXX
C	Less: i. Abnormal profit.....XXXX ii. Income from non trade investment.....XXXX iii. Depreciation charged on above assets.....XXXX iv. Capital receipts charged on Revenue account.....XXXX v. Over valuation of Closing stock.....XXXX vi. Revenue expenditure of previous year not charged.....XXXX	XXXXX
D	PAPBT(A+B-C)	XXXXX

Step – 3 –Computation of future maintainable profit (FMP)

S. No.	Particular	Amount
A	Past adjusted profit before tax (PAPBT) calculated in step - 2	XXXXX
B	Add : 1. Income not earned in the past but likely to be earn in future 2. Expenditure incurred in the past but not likely to be incurred in future	XXXXX
C	Less : 1. Income earned in the past but not likely to be earn in future 2. Expenditure not incurred in the past but likely to be incurred in future	XXXXX
D	Future maintainable profit before tax (A+B-C)	XXXXX
E	Tax likely at future rate	XXXXX
F	Future maintainable profit after tax (D-E)	XXXXX

Step – 4 –Valuation of Goodwill

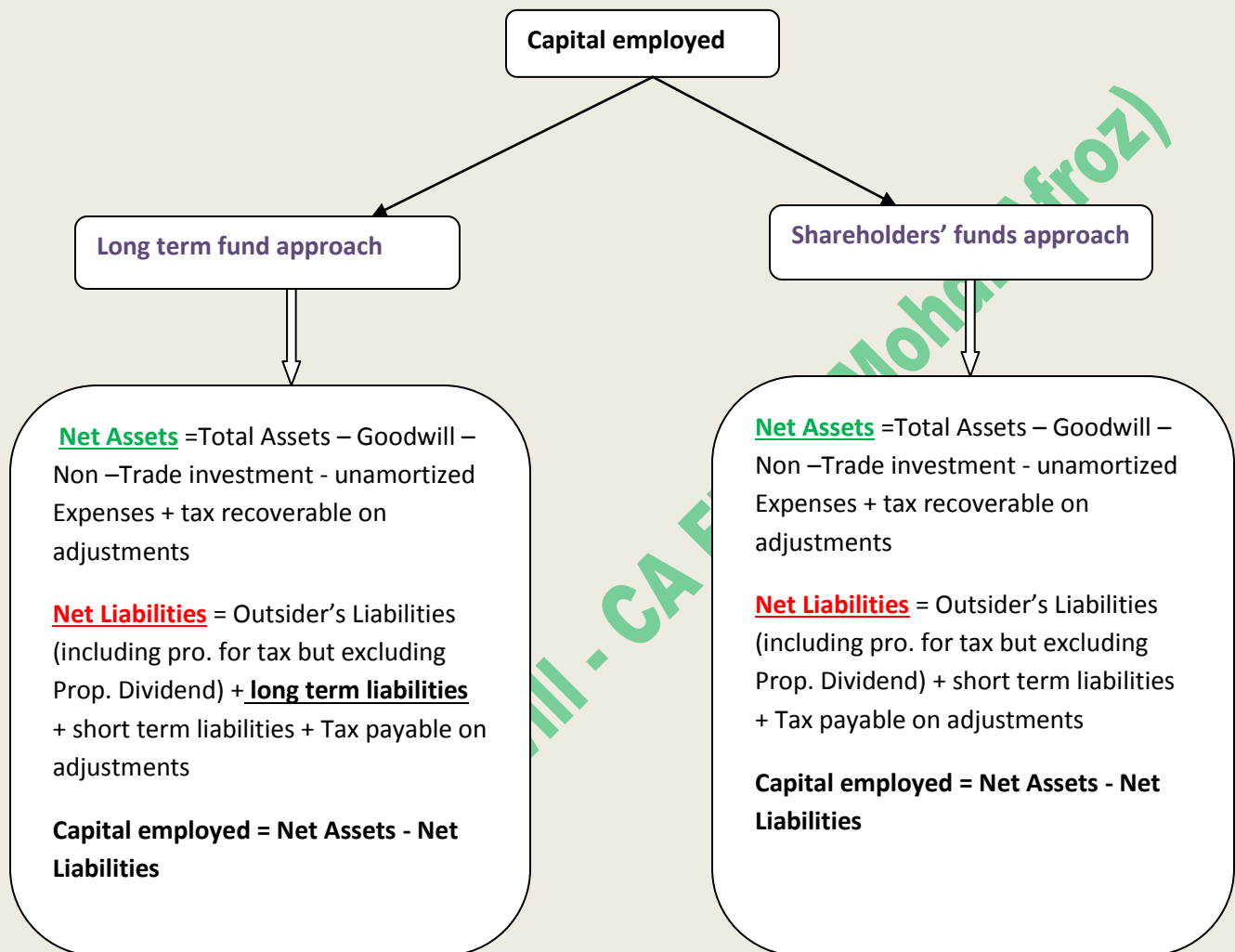
Goodwill = Future maintainable profit X number of year of purchase

Super profits method

Super profit method also used in the valuation of Goodwill. This method used when the business man assumed that a new business will not able to generate excess profit during the first few years of its operations. It has five steps. Each have been mentioned below :

Step – 1 –Computation of average capital employed

Average capital employed cannot find out without capital employed. Therefore, first we have to calculate capital employed. It may be calculated by long term fund approach and shareholder's fund approach.



Average capital employed

Where only one year's Assets and Liabilities are given:

S. No.	Particulars	Amount
A	Closing capital employed calculated above	XXXXXX
B	Dividend & Dividend tax paid at the end of current year	XXXXXX
C	Adjusted closing capital employed (A+B)	XXXXXX
D	Half of {current year adjusted profit before tax + income from non trade investments – tax}	XXXXXX
E	Average capital employed (C – D)	XXXXXX

Where more one year Assets and Liabilities is are given:

S.No.	Particulars	Amount
A	Closing capital employed calculated above	XXXXXX
B	Dividend & Dividend tax paid at the end of current year	XXXXXX
C	Adjusted closing capital employed (A+B)	XXXXXX
D	Opening capital employed	XXXXXX
E	Average capital employed (C +D/2)	XXXXXX

Step – 2 –Computation of normal profit

Normal profit = Avg. capital employed (calculated in step -1) X normal rate of return

Step – 3 –Computation of future maintainable profit (FMP)

Computation of future maintainable profit will remain same as calculated in average profit method.

Step – 4 –Computation of Super profit

Super profit = Normal profit – future maintainable profit

Step – 5 –Computation of Goodwill

Goodwill = Super profit X number of year purchase

Leverage effect: Normally shareholder's fund approach used for the leverage effect. Leverage effect arises due to use of borrowed fund carrying rate of interest lower than the rate of return on investment.

Leverage effect = value of Goodwill on the basis of Shareholder's approach – value of Goodwill on the basis of long term fund approach.

Annuity method

Under annuity method time value of money considered. Following steps used for the calculation of Goodwill under annuity method:

Step – 1: Future super profit = Avg. profit – normal profit

Step – 2: compute present value of all super profits.

Step – 3: Goodwill = sum of all present value of super profit calculated in step -2.

Capitalization of super profit method

Goodwill under this method is ascertained by capitalizing the super profit profits on the basis of normal rate of return. Following steps uses to find out the value of Goodwill.

Step – 1: Compute Super profits (according to steps given under super profits method)

Step – 2: Goodwill = Super profits x 100/ Normal rate of return.

Capitalization of super profit method is used if in the no. of years purchase of profits is not given.

Capitalization of average profits method

Step –1: Compute average Future Maintainable Profits (according to steps given under average Profits Method).

Step – 2: Compute the capitalized Value of Average profits as under:

Capitalized Value = Average Future Maintainable Profits x 100/ Normal Rate of Return

Step – 3: Compute the value of Net Assets as on the date of valuation of goodwill as under: Net Assets = all assets (other than goodwill, fictitious assets and non- trade investments) at their current values less Outsiders Liabilities.

Step – 4: Goodwill = Capitalized Value – Net Assets

Capitalization of average profits method is used if in the no. of year's purchase of profits is not given.