HOLY CROSS HOME SCIENCE COLLEGE, THOOTHUKUDI

CORPORATE ACCOUNTING - I

CLASS: III B.COM **SUBJECT CODE: SMCO51**

UNIT –V

Valuation of Goodwill and Shares –Various Methods of Valuation of Goodwill and Shares.

GOODWILL

INTRODUCTION

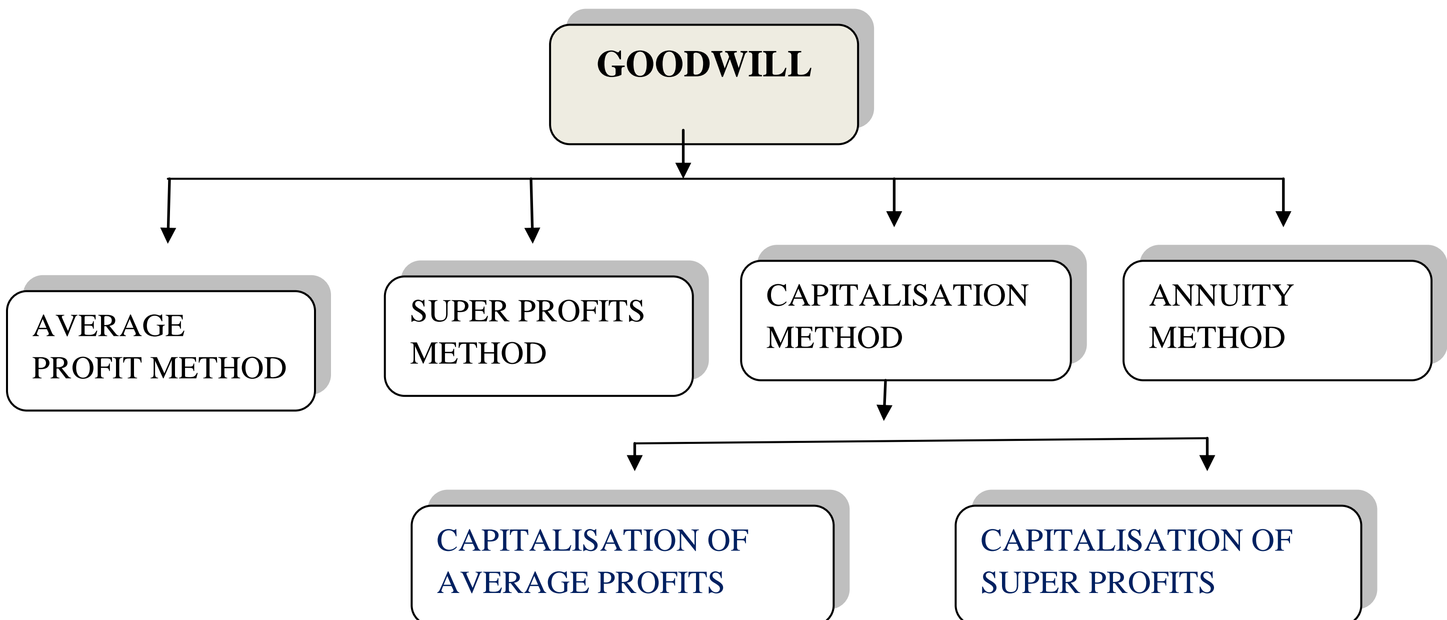
Goodwill is an intangible asset that arises as a result of the acquisition of one company by another for a premium value. The value of a company's brand name, solid customer base, good customer relations, good employee relations and any patents or proprietary technology represent goodwill. Goodwill is considered an intangible asset because it is not a physical asset like buildings or equipment.

DEFINITION

According to Kohler "Goodwill is the Current Value of Expected Future Income in Excess of Normal Return on Investment in Net Tangible Assets"

DIFFERENT METHODS OF VALUATION OF GOODWILL

Goodwill is the benefit and advantage of good name, reputation and popularity or image of the business in the market. Four methods of valuation of goodwill:



1. AVERAGE PROFITS METHOD

Goodwill is calculated on the basis of some agreed number of past years. The average is then multiplied by the agreed number of years. This is the simplest and the most commonly used method of the valuation of good will.

Average profit=Total profit/No. of years

Goodwill=Average profits x Number of years of purchase.

Before calculating the average profits the following adjustments should be made in the profits of the firm:

- Any abnormal profits Eg. high sales due to problems of competitors should be deducted from the net profits of that year.
- Any abnormal loss Eg. loss due to strikes, fires, theft, damage, should be added back to the net profits of that year.
- Non operating incomes Eg. Income from investments etc should be deducted from the net profits of that year.
- Non operating expenses Eg. interest on loan, loss on sale of asset should be added from the net profits of that year.

2. SUPER PROFITS METHOD

Super profits are the profits earned above the normal profits. Under this method Goodwill is calculated on the basis of Super Profits i.e the excess of actual profits over the normal profits. For calculating goodwill, super profits are multiplied by the agreed number of years of purchase.

Steps for calculating goodwill under this method are given below:

1. Normal profits= capital invested x Normal rate of return/100
2. Super profits=Actual profits – Normal profits
3. Goodwill=Super profits x No.of years purchased

3. CAPITALISATION METHOD

There are two ways of calculating goodwill under this method:

a) CAPITALISATION OF AVERAGE PROFITS METHOD

Under this method the average profits is calculated as usual and then assess the capital needed for earning such average profits on the basis of normal rate of return. Such capital is called capitalized value of average profits.

The formula is:-

- **Capitalised Value of Average Profits = Average profits x [100/Normal Rate of Return]**
- **Capital Employed = Assets - Liabilities**
- **Goodwill = Capitalised Value of Average Profits - Capital Employed**

b) **CAPITALISATION OF SUPER PROFITS**

Under this method goodwill is valued by capitalizing the super profit. To ascertain Goodwill under this method super profit of the concern and normal rate of return are required. The following formula is used

Goodwill = Super Profits x 100/Normal Rate of Return

4. **ANNUITY METHOD**

Under this method goodwill is calculated by multiplying super profit with annuity value.

Goodwill = Super Profit x Annuity Table Value

FACTORS DETERMINING THE VALUATION OF GOODWILL

1. **Location Factor**

If the firm is centrally located or located in a very prominent place, it can attract, more customs resulting in an increase in turnover. Therefore, locational factor should always be considered while ascertaining the value of goodwill.

2. **Time Factor**

Time dimension is another factor which influences the value of goodwill. The comparatively old firm will enjoy more commercial reputation than the other one since the old one is better known to its customers although both of them may have the same locational advantages.

3. **Nature of Business**

This is another factor which also influences the value of goodwill which includes: the nature of goods; risk involved; monopolistic nature of business, benefits of patents and trademarks; and easy access of raw materials, etc.

4. **Capital Required**

If two business concerns earns the same profits with different amounts of capital, the business concern with lesser amount of capital requirement will enjoy more goodwill.

5. **Trend of Profit**

Value of goodwill may also be affected due to the fluctuation in the amount of profit [i.e. on the basis of rate of return]. If the trend of Profit is always rising, no doubt value of goodwill will be high, and vice versa

6. **Efficiency of Management**

The efficient management may also help to increase the value of goodwill by increasing profits through proper planned production, distribution and services.

7. **Long term contracts**

If a business unit has favorable long term contracts for the supply of raw materials or distribution of finished goods or raising funds, these will help in raising the value of goodwill.

8. **Political Protection**

If a particular concern is protected or not against the provision of political background, it has the highest value of goodwill.

9. **Advantage of Patents**

Possession of good trade marks, patents or copy rights will increase the value of goodwill of the company.

10. **Customers' Attitude**

The type of customers which a company has is important. If the company has more customers, the value of goodwill will be high.

NEED FOR VALUATION OF GOOD WILL:

The need for valuation of goodwill depends on the form of business organisation. In case of one man business, goodwill is valued at the time of selling the business. In case of partnership, goodwill is valued at the time of admission, retirement, death or amalgamation. In case of limited companies, goodwill is valued under the following occasions.

- When two or more companies Amalgamate - Amalgamation.
- When a company takes over another company - Absorption.

- When a company wants to acquire controlling interests of another company - Holding Company
- When the government takes over the business of the company - Acquisition of business by govt.
- When one class of shares is converted into another - Conversion of Preference Shares into Equity.
- When valuation of shares for tax purposes - Estate Duty, Gift tax etc.

SHARES CIRCUMSTANCES UNDER WHICH SHARES OF A COMPANY ARE VALUED

A share is a single unit which the entire capital of a company is divided. A share is a fractional part of the share capital. The owners of shares are called “shareholders”.

1.At the time of purchase and sale of shares in private companies.

2. When a block of shares is to be purchased to acquiring interest of another company.

3.To determine the amount payable to dissenting shareholders.

4. To assess estate duty, wealth tax and gift tax by authorities.

5. When shares are pledged as a security against a loan.

6. When shares of one class are converted into another class.

7. At the time of the paying court fee.

8. At the time of the valuing the assets of the company.

FACTORS TO BE CONSIDERED AT THE TIME OF VALUATION OF SHARES

1. Demand and supply of shares

2. Nature of business

3. Availability of ready market for future sale and

4. Other factors like political influence, peace in the country etc.

TWO METHODS OF VALUATION OF SHARES

1. Net Asset Method

This method is also known as intrinsic value method or break up value method. This method aims at finding out the possible value of shares in the event the company goes into liquidation. If liquidation takes place, the assets will be sold at and liabilities will be paid. After playing all liabilities, when preference shareholders have priority over the ordinary shares, they must be paid. The remaining amount will be divided among ordinary shareholders. When Preference shareholders have no priority, net assets will be shared among both Preference and ordinary shareholders.This is shown as under

Net Asset Method of valuation of shares;

Assets at market value

Good will		xxx
Land and buildings		xxx
Plant		xxx
Stock		xxx
Debtors		xxx
Cash		xxx
Assets at market value		xxx
Less: Liabilities:		
Creditors	xxx	
Bills payable	xxx	
Bank draft	xxx	
Debentures	xxx	
Interest on debentures	xxx	xxx
Net assets		xxx
Less: Preference capital		xxx
Less: Dividend on preference shares		xxx

Amount available to equity share holders	xxx

Value per equity share = Amount available to equity shares / No. equity shares

$$\text{Value per equity share} = \frac{\text{Amount available to equity shares}}{\text{No. equity shares}}$$

2. Yield Method

Under this method, the valuation of share is calculated by obtaining the expected rate of return with normal rate of return. If the expected rate of return is higher than the value of shares increases proportionately. In order to calculate expected rate of return, the profits available to ordinary shareholders after paying taxes, reasonable transfers to reserves and dividend to preference shareholders will be deducted.With the help of expected rate, normal rate of return and paid up value of an ordinary share, value of share can be calculated. The following are the important steps to be followed.

Calculation of value of shares under Yield Method

Average profits	xxx
Less: Tax	xxx
Profit after tax	xxx
Less: Transfer to reserve	xxx
Profit after tax and reserve	xxx
Less: Dividend to preference shareholders	xxx
Amount available to equity shareholders	xxx

Expected rate of return [ERR] = Profits available to equity share holders / Paid up capital x 100

$$\text{Expected rate of return [ERR]} = \frac{\text{Profits available to equity share holders}}{\text{Paid up capital}} \times 100$$

Value per share = Expected rate of return x Paid up value per share / Normal rate of return

$$\text{Value per share} = \frac{\text{Expected rate of return} \times \text{Paid up value per share}}{\text{Normal rate of return}}$$

Key to remember: $VPS = \frac{ERR \times PVPS}{NRR}$

4. Fair Value Method

Under this method, the share value is calculated by the average value of share under net asset method and value of shares under yield method.

$$VPS = \frac{\text{Value as Per Net Asset Method} + \text{Value as Per Yield Method}}{2}$$

FORMULAS

VALUATION OF GOODWILL

1. **Average Profit Method**
   G/W = Average profit × No. of years of purchase
   Average profit = Total Profit / No. of years

2. **Super Profit Method**
   G/W = Super profit × No. of years of purchase
   Super profit = Average profit – Normal profit
   Normal profit = Capital employed × Normal rate of return
   Capital employed = Assets (excluding investments) – Outsiders liability

3. **Weighted Profit Method**
   G/W = Weighted average profit × No. of years of purchase
   Weighted average profit = Weighted profits / Total weights

4. **Capitalisation of Super Profit Method**
   G/W = Super profit / Normal rate of return * 100

5. **Annuity Method**
   G/W = Super profit × Annuity table value

6. **Capitalisation Method**
   G/W = Total value of business – Net Assets
   Total value of business = Average profit / Normal rate of return * 100
   Net Assets = Total assets (excluding goodwill) – Outsiders liability

VALUATION OF SHARES

1**. Net Asset Method or Intrinsic Value Method**
Value of Equity share = Assets available to equity share holders /No. of equity shares

Assets available to equity share holders

Assets at Book value or Market value (except Miscellaneous expenses and P&L a/c debit balance)

Fixed assets	***
Current assets	***
	____

	***
Less: Outside liabilities	***
	***
Less: Preference share capital	***
Assets available to eq share holders	***

2. **Income or Yield Method**

Value per share = Expected rate of return / Normal rate of return * Paid up value per eq share
Expected rate of return = Profits available to equity share holders / Paid up eq cap * 100
Profits available to equity share holders:

	Average profit	***
Less:	Tax	***
	Profit after tax	***
Less:	Transfer to reserve	***
		***
Less: Preference dividend		***
Profits available to eq sh holders		***

3. Fair Value Method

Value per share = Value as per Net asset method + Value as per yield method / 2