Valuation of Goodwill (for B.Com II Year) 1

Methods of Valuation of Goodwill

1. Average Profit method
2. Super Profit method
3. Capitalisation method
4. Purchase Consideration method
5. Annuity method.

(1) Average Profit method

- Simple A.P method
- Weighted A.P method

1. Simple Average Profit method :-

$$\text{Goodwill} = \text{Avg Profits} \times \text{No of years Purchased.}$$

$$\text{Avg Profits} = \frac{\text{Total of Profits}}{\text{No of years.}}$$

★ Precautions :-

1. Abnormal loss / Non Recurring Exp is to be added like loss by fire, loss by earthquake, loss by theft etc.
2. Abnormal gain & Non Recurring Income like lottery income, Speculative gains should be deducted.
3. Income from investment Should be deducted.
4. Such type of income which a firm was not receiving earlier, but is to be received in future will be added.
5. Such type of Expenses which were not Previously happened in past, but in future it is likely to happened in future will be deducted.

2. Weighted A.P method :-

Goodwill = Weighted A.P × No of years Purchased.

$$\text{Weighted A.P} = \frac{\text{Total of Products of Profits}}{\text{Total of weights}}.$$

* weighted Avg Profits methods is used when Profits shows a trend, i.e Profit are increasing continuously. OR. weights are given in the Question.

* Super Profits method :-

Goodwill = Super Profits × No of year Purchased.

Super Profits = Average Profits − Normal Profits

Normal Profits = Capital employed × $\frac{NRR}{100}$

* Capital employed = Assets − outside liabilities.

Note :- In questions we have to Calculate Average Capital employed. for this firstly calculate Net Cap employed.

Avg Capital employed = Net Cap employed − 1/2 of current year Profits after adjustments & taxes.

while Calculating Avg Cap employed :-

1. All the fixed assets and current assets are to be taken at Market Value. If market value is not given then Book value is taken. fictitious assets, share

issue expenses, Preliminary expenses etc are not taken.

2. All the liabilities which are related to outside parties like debentures, creditors, loans etc are to taken into A/c.

★ Capitalisation Method :-

1. Capitalisation of Average Profit method.
2. Capitalisation of Super Profits method.

1. Capitalisation of A.P method :-

Goodwill = Capitalised value of AP − Average Capital employed

$$\text{Capitalised value of AP} = \text{Avg Profits} \times \frac{100}{NRR}$$

2. Capitalisation of Super Profits method :-

$$\text{Goodwill} = \text{Super Profits} \times \frac{100}{NRR}$$

★ Purchase Consideration method :-

Goodwill = Assets - liabilities.

★ Annuity method :-

In this method annuity rate is given. firstly we have to calculate the super profits.

★ If Annuity rate is less than 1 then

$$\text{Goodwill} = \text{Super Profits} \times \frac{1}{\text{Annuity rate}}$$

★ If Annuity rate is more than 1 then

$$\text{Goodwill} = \text{Super Profits} \times \text{Annuity Rate}.$$