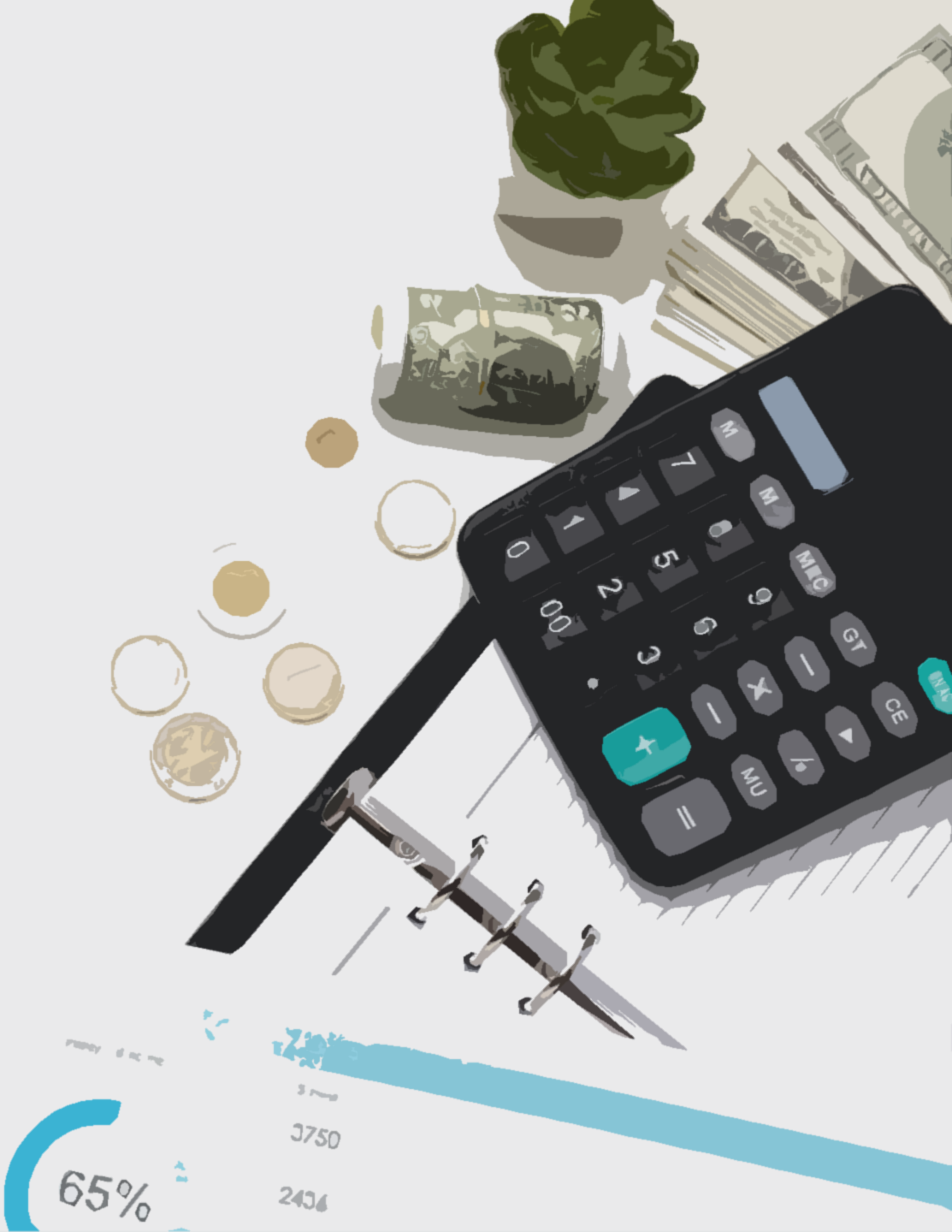
Art'o'val Advisors

True Art of Valuation

Valuation Series

8 – Valuation of Goodwill

August 2023



What is Goodwill?

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Goodwill Overview

- Goodwill is good name or the reputation of the business, which is earned by a firm through the hard work and honesty of its owners
- Built by offering good service that satisfies customers and encourages repeat business
- Value of the reputation of a firm which enables it to earn higher profits in comparison to the normal profits earned by other firms in the same trade
- Value of a firm's reputation, leading to increased future earnings, can't be self-generated; it's acquired and recognized when selling the business
- Examples include brand value, customer loyalty, employee relationships, and patents
- Established companies benefit from brand value and customer trust, buyers pay extra for these advantages, which is termed goodwill
- Buyers expect future super profits and pay for goodwill accordingly, Valuation of goodwill involves assessing its value for the firm's intrinsic worth

When is Goodwill Calculated?

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The valuation of Goodwill occurs in the following scenarios

Partnership

- The firm needs goodwill valuation at the time of admission, retirement, or death of a Partner.
- The need for goodwill valuation also arises at the time of dissolution or amalgamation of the firm.
- A firm also needs to value goodwill at the time of change in the profit-sharing ratio of the old partners.

Company

- Goodwill valuation takes place during Acquisitions and Mergers.

Sole Proprietorship

- Goodwill valuation occurs while calculating purchase considerations related to the sale or acquisition of the Business.

Features of Goodwill

Intangible Asset

Separation from Business - Not Possible

Value Not Relative to any Investment Amount or Cost

Subjective Value it Depends on Individual's Judgement

Subject to Wild & Unpredictable Fluctuation in Response to Externalities

Types of Goodwill

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Purchased Goodwill

- Arises from acquiring a business for an amount exceeding the fair value of its separately identifiable net assets
- Reflected as an asset on the balance sheet
- Represents the only form of goodwill eligible for recognition in a company's financial accounts

Self-Generated Goodwill

- Self-generated goodwill or inherent goodwill is the value of the business over the fair value of its net assets
- It is referred to as internally generated goodwill and it occurs over some time due to the good status of a business
- The value of goodwill may be positive or adverse
- Positive goodwill occurs when the value of the business as a total is higher than the fair value of its net assets taken over
- It is adverse when the value of the business is lower than the value of its net assets taken over

Factors Affecting Goodwill

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Location of the business	A business which is in a suitable location will have a more favorable chance of higher goodwill than a business located in a remote location
Quality of goods and services	A business which is providing a higher quality of goods and services stands a great chance of earning more goodwill than competitors who provide inferior goods and services
Efficiency of management	Efficient management results in an increase in profit of the business which enhances the goodwill of the business
Business Risk	A business having less risk has a better chance of creating goodwill than a high-risk business
Nature of business	It means the type of products that business deals with, the level of competition in the market, demand for the products and the regulations impacting the business. A business having a favorable outcome in all these areas will have a greater goodwill
Favourable Contracts	A firm will enjoy a higher goodwill if it has access to favorable contracts for sale of products
Possession of trademark & patents	Firms that have patents and trademarks will enjoy a monopoly in the market, which will contribute to the increase in the goodwill of the firm
Capital	A firm with a higher return on investment along with lesser capital investment will be considered by buyers as more profitable and having more goodwill

Valuation Methodologies

The methods of valuation of goodwill should be consistent with the market practices of the Business

Methods of Goodwill Valuation

- **Few Years' Purchase of Average Profit Method**
  - Simple Average Profit Method
  - Weighted Average Profit Method
- **Super Profits Method**
  - Annuity Method
  - The Purchase Method by No. of Years
- **Capitalization Method**
  - Capitalization of Average Profit Method
  - Capitalization of Super Profit Method

Few Years' Purchase of Average Profits Method

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Few Years' Purchase of Average Profit Method

- It is the simplest method of valuation of goodwill
- The firm Values the goodwill based on an agreed number of years' purchase of the average maintainable Profit
- **Factors considered during valuation:**
  - ✓ Subtracting the year's abnormal gains from that year's net profit
  - ✓ Adding the abnormal loss of the year to the net profit of that year
  - ✓ Deducting income not earned from operations from the Net Profit of that year
  - ✓ For example, income from investments

Method 1 — **Simple Average Profit Method**

- The firm values the Goodwill based on the Numbers of past years' profits
- It then computes the average of such gains, and it does this by dividing the total of such Profits by the Number of years
- For calculating the value of Goodwill, the firm multiplies the average of the profits with the agreed number of years of purchase

1. **Average Profit** = **Total Profit** ÷ **No. of Years**
2. **Goodwill** = **Average Profit** × **No. of Years of Purchase**

Few Years' Purchase of Average Profits Method

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Method 2 | **Weighted Average Profit Method**

- Allot weights to the Profit of the latest year
- Compute the Product of profits by multiplying the weight with the gain of that particular year
- Calculate the weighted average Profit by dividing the total products of profits by the Total Weights
- Calculate the value of the goodwill by multiplying the Weighted Average Profit and the Number of years of purchase

1. **Weighted Average Profit** = **Total Product of Profit** ÷ **Total Weight**
2. **Goodwill** = **Average Profit** × **No. of Years of Purchase**

Super Profits Method

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Super Profit Method

- The firm calculates goodwill based on the Super profit
- Super Profit means the excess of actual profit earned over the normal yield
- The actual profit is the profit that an organization makes with or without making the adjustment
- If there is no anticipated super profit, there is no goodwill for the firm
- The Number of years of purchase a firm takes into consideration depends on many factors

Steps to Compute Goodwill

1. Actual Average Profit = Total Profit ÷ No. of Years
2. Capital Employed = Total Asset − Current Liabilities
3. The Normal Profit = Capital Employed × Normal Rate of Return ÷ 100
4. Super Profit = Actual Average Profit − Normal Profit
5. Goodwill = Super Profit × No. of Years of Purchase

Super Profit Method

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Annuity Method

- The basis is the average Super Profit.
- The value of goodwill is the current value of an annuity of the average Super Profit discounted at a given Rate of Interest

Goodwill = Super Profit × Discounting Factor

Purchase Method by No. of Years

- The firm evaluates the super profits in a definite number of purchase years for calculating the value of goodwill

Super Profit = Actual Profit − Normal Profit

Capitalization Method

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Capitalization Method

- The organization, determines the capitalized value of its profits
- It helps to find the amount of capital the firm needs to make the desired profit

Method 1 — **Capitalization of Average Profit Method**

- The firm estimates the capitalized value of the average profit based on the standard rate of return
- The following steps are involved in calculating the value of goodwill under the Capitalization Method:

Step 1 — Compute the Average Profit by dividing the total profits by the Number of Years.

Step 2 — Compute the Capitalized Value of the Average profit.

Capitalized Value of Average Profit = **Average Profit** × **100** ÷ **Normal Rate of Return**

Step 3 — Find the Goodwill of the Firm by deducting the Capital invested from the Capitalized Value of the Average Profit.

Goodwill = **Capitalized Value of the Average Profit** − **Capital Invested**

Capital invested is the difference between Assets and Liabilities as on the date of valuation of Goodwill.

Capitalization Method

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Method 2 | **Capitalization of Super Profit Method**

The firm determines the capitalized value of the Super Profit based on the Normal Rate of return

It enables the firm to assess the amount of Capital it requires to earn the Super Profit

In this method, the value of Goodwill and the capitalized value of the Super Profit are equal

Step 1 Calculate the Super Profit by finding the excess of the Actual Average Profit over the Normal Profit

Step 2 Find out the Goodwill of the firm

Goodwill = **Super Profit** × **100** ÷ **Normal Rate of Return**

Impairment of Goodwill

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Overview of Goodwill Impairment

- Impairment is an accounting charge that companies record when goodwill's carrying value on financial statements exceeds its fair value.
- Goodwill is recorded after a company acquires assets and liabilities and pays a price in excess of their identifiable net value.
- The impairment expense is calculated as the difference between the current market value and the purchase price of the intangible asset.
- The impairment results in a decrease in the goodwill account on the balance sheet.
- An impairment charge is a process used by businesses to write off worthless goodwill.
- We will cover the impairment of goodwill in more details in our next valuation series in Volume 9. Stay tuned for more updates on impairment of goodwill.

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Thank You

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