Meaning

Goodwill means the ‘Good name’ or the ‘reputation’ of the business which attracts more customers and therefore, it helps to earn more profits in future. It is an intangible real asset and not a fictitious asset.

In other words, Goodwill refers to a measure of the capacity of a business to earn above normal profits. It is the benefit and advantage of a good name and reputation in connection with business

Definition

According to J.O. Magee, "The capacity of a business to earn profits in future is basically what is meant by the term goodwill".

According to the Institute of Chartered Accountants of India, Goodwill is "an intangible asset arising from business connections or trade name or reputation of an enterprise".

Valuation of Goodwill

The following circumstances, we need to calculate the value of goodwill

- In the case of Partnership, When there is admission, retirement, death or amalgamation or a change in the profit sharing ratio take place
- In the case of a company, When two or more companies amalgamate or one company absorbs another or one company wants to acquire controlling interest in another company

- In the case of sole trader concern, Goodwill is valued at the time of selling the business to decide the purchase consideration
- In the case of Individuals, goodwill is valued for the purpose of Estate duty, death duty, etc. On the death of a person

Factors determining the value of Goodwill

- ✓Location Factors
- ✓Time Factor
- ✓Nature of business
- ✓Efficiency of the management
- ✓Other factors – General economic conditions, Political stability, Money market conditions, trade cycles, etc

Methods of valuing Goodwill

1. Average Profit Method (or) Simple Profit Method

Goodwill = Average Profit X No. of years Purchase

2. Capitalisation of Average Profit Method

Goodwill = Capitalised value of business – Net tangible Assets

3. Super Profit Method

Goodwill = Super profit X No. of years purchase

Super profit = Average Profit – Normal Profit

Normal Profit = Capital Employed X Normal rate of return

4. Capitalisation of Super Profit Method

Goodwill = Super profit X100/ Normal rate of return

5. Annuity Method

Goodwill = Super profit X Annuity value

Valuation of shares

Reasons for valuation

1. Where there is no market price as in the case of private company or proprietary company
2. When the market price is not reflect the true or intrinsic value of the share

Need for valuation in the following circumstances

1. For formulating amalgamation or absorption schemes
2. For purchase or sale of controlling shares
3. For reconstruction schemes
4. For Estate Duty purposes
5. When shares are acquired by the Government
6. For pledging shares as a security against loan

Methods of valuing shares

1. Net Asset Method (or) Intrinsic Value Method

Value of share = Net Assets Available to Equity Shareholder/ No. of Equity shares

2. Yield Method (or) Earning Capacity Method

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

Expected rate of return = Profit available to equity dividend X100/Paid up equity capital

3. Fair value Method

Value of share = Intrinsic value +Yield value/2