13
VALUATION OF GOODWILL & SHARES

QUESTIONS & ANSWERS

VALUATION OF GOODWILL

Que. No. 1] What do you understand by goodwill? Describe the various methods for calculation of goodwill.

Write a short note on: Super profit method of valuation of goodwill

CS (Executive) – Dec 2013 (5 Marks)

Ans.: Goodwill may be described as the aggregate of those intangible attributes of a business which contribute to its superior earning capacity over a normal return on investment. It may arise from such attributes of a business as good reception, a favourable location, the ability and skill of its employees and management, nature of its products, etc.

Goodwill is an intangible asset. The real value is indeterminable for a non-purchased goodwill and based on arbitrary measurement. The valuation of goodwill is often based on the customs of the trade and generally calculated as number of year's purchase of average profits or super-profits.

Valuation of purchased goodwill:

(1) Average profit method : Under this method average profit is calculated on the basis of the past few year's profits. At the time of calculating average profit abnormal profit or loss will be ignored. After calculating average profit, it is multiplied by a number (3 or 4 years), as agreed. The product will be the value of the goodwill.

Goodwill = Average Profit × No. of year purchase

(2) Weighted average profit method : To obtain the average profit, the profit of the year must be multiplied by its weightage and the grand total should be divided by the aggregate number of weights. After calculating average profit, it is multiplied by a number (3 or 5), as agreed. The product will be the value of the goodwill.

Goodwill = Weighted average Profit × No. of year purchase

(3) Super-profit method : Super profit is the excess of actual profit over the normal profit. Under this method, super profits are taken as the basis for calculating goodwill in place of average profit. Goodwill is calculated as follows:

Step 1	*Calculate capital employed*
Step 2	*Calculate normal return* Normal Return = Capital employed × Rate of normal return
Step 3	*Calculate future maintainable profit*

Step 4	*Calculate super profit*	
	Future Maintainable Profit	xxxx
	Less: Normal Return	(xxx)
	Super Profit	xxxx
Step 5	Goodwill = Super profit × No. of years purchases	

(4) Annuity method : Under this method super profits should be discounted using appropriate discount factor. When uniform annual super profit is expected, annuity factor can be used for discounting the future values for converting into the present value.

Goodwill = Super Profit × Annuity factor

(5) Capitalization of future maintainable method : Under this method, the firm is valued by applying the following formula:

$$\text{Goodwill} = \left[\frac{\text{Future maintainable profit}}{\text{Normal rate return}} \times 100\right] - \text{Capital employed}$$

(6) Capitalization of super profits method : Under this method, goodwill is calculated by capitalizing super-profits at agreed rate. The goodwill is calculated directly by applying the following formula:

$$\text{Goodwill} = \frac{\text{Super profit}}{\text{Capitalization rate}} \times 100$$

Que. No. 2] How you will calculate 'Capital Employed' for the purpose of valuation of goodwill under "Shareholders Funds Approach" & "Long Term Funds Approach"?

Ans.: Calculation of capital employed:

Particulars		₹
Plant & machinery	(at current cost)	xxxx
Building	(at current cost)	xxxx
Land	(at current cost)	xxxx
Furniture	(at current cost)	xxxx
Patents	(at current cost)	xxxx
Know-how	(at current cost)	xxxx
Trading investments	(at market price)	xxxx
Other investments	(at book value)	xxxx
Finished goods stock	(at market price)	xxxx
Raw material stock	(at cost)	xxxx
Work-in-progress	(at cost)	xxxx
Sundry debtors	(at realizable value)	xxxx
Less:		
… % Debentures		(xxx)
Creditors		(xxx)
Bills payable		(xxx)
Outstanding expenses		(xxx)
Outstanding & accrued interest		(xxx)
Tax provisions		(xxx)
Liabilities not provided in account		(xxx)
Prior period adjustments (that reduces profit of the earlier years)		(xxx)
Capital employed *(Shareholders Funds Approach)*		xxxx

Important notes:

(1) **'Debentures'** will not be deducted while following **'Long Term Funds Approach'**.

(2) **Non-trading investment & fictitious assets** like preliminary expenses, issue of shares & discount should not be taken into consideration while calculating Capital employed.

Que. No. 3] Write a short note on: Characteristics of goodwill

Ans.: Characteristics of goodwill are as follows:

(1) It belongs to the category of **intangible assets** which includes other items such as patents, trademarks and copyrights. Goodwill along with these other *intangibles* are non-physical, fixed assets and are included on the balance sheet.

(2) It is a **valuable asset**.

(3) It contributes to the **earning of excess profits**. The existence of goodwill is often key to a business earning profits over and above the levels for similar businesses in the same industry.

(4) Its value is liable to **constant fluctuations**.

(5) Its value is only realised when a business is sold or transferred.

(6) It is difficult to place an exact value on goodwill and it will always involve **expert judgment**.

Que. No. 4] Enumerate the factors affecting goodwill of joint stock company.
CS (Inter) – Dec 2000 (5 Marks)

Ans.: The key factors affecting goodwill are:

➢ The **nature** of the business.

➢ Favourable **location**. If a business is situated in a good location it will generally have a positive effect on the value of goodwill.

➢ **Longevity** of the business. If a business has been trading for a long period it may have had more time to develop a good solid reputation, and more goodwill.

➢ Possession of **licenses** or **technical know-how**.

➢ **After sales services** and general customer care.

➢ Business **risk** involved.

➢ Future **competition** and new entrants into a specific business marketplace.

➢ **Management's attitude** towards the fulfilment of commitments.

VALUATION OF SHARES

Que. No. 5] Write a short note on: Valuation of shares

What are the different circumstances under which valuation of shares become necessary?
CS (Executive) – June 2014 (5 Marks), June 2015 (5 Marks)

Ans.: The valuation of the shares of a company involves use of judgment, experience and knowledge. The accountant undertaking this work should possess knowledge of the analysis and interpretation of financial statements backed by a practical appreciation of business affairs and investments. A valuation based on quantitative information alone will not be adequate for a real valuation. It should also be recognised that the method of valuation of shares would vary, depending on the purpose for which it is to be used.

The following is an illustrative list of the circumstances which call for a value to be placed upon shares in companies:

Purposes of share valuation:

(1) Assessments under the **Wealth Tax Law**.

(2) Purchase of a block of **shares for acquiring a controlling interest** in the company.

(3) **Purchase of shares by employees** of the company where the retention of such shares is limited to the period of their employment.

(4) Formulation of schemes of **amalgamation**, **absorption**, etc.

(5) Acquisition of **interest of dissenting shareholders** under a scheme of reconstruction.

(6) **Compensating shareholders**, on the acquisition of their shares, by the Government under a scheme of nationalization.

(7) **Conversion** of preference into equity shares.

(8) **Advancing a loan** on the security of shares.

Que. No. 6] Write a short note on: Intrinsic value of shares/Net asset value of shares

CS (Inter) – Dec 1997 (5 Marks)

Ans.: According to this method, value of equity share is determined as follows:

Value per share (Fully paid up share) =	$\frac{\text{Net assets available for equity shareholder}}{\text{No. of shares}}$
Value per share (Partly paid up share) =	Value of fully paid up share – Unpaid call per share

Calculation of Net Asset Value per share:

Particulars	₹
Capital employed (as per shareholders funds approach)	xxxx
Less:	
Preference share capital	(xxx)
Arrear of dividends	(xxx)
Proposed preference dividend	(xxx)
Add:	
Notional call on partly paid up equity shares	xxxx
Goodwill	xxxx
Share suspense account	xxxx
Non-trading investment	xxxx
Net assets available to equity shareholders	xxxx

Important notes : If the objective is to determine **ex-dividend value** of equity shares, **proposed dividend** on equity shares is also to be **deducted**.

Que. No. 7] Write a short note on: Yield based valuation of shares

Ans.: Yield based valuation may take the form of valuation based on rate of return. The rate of return may imply rate of earning or rate of dividend.

When only a few shares are sold : The rate of dividend basis will be appropriate.

When controlling shares are to be sold : The rate of earning should be the basis