Goodwill

CHAPTER 3

---

1. **Goodwill :** It is the good name or reputation of a business which helps it to earn more profits than others.

2. **Nature of goodwill**: Goodwill is an intangible asset (an asset not having physical existence) and not a fictitious asset, because it has a realizable value and fictitious assets don't a realizable value.

3. **Factors affecting goodwill**

   i. Nature of business
   ii. Efficiency of management
   iii. Location
   iv. Market situation
   v. Special advantages

4. Classification of goodwill it can be classified as

(i) **Purchased (acquired) goodwill** it is the goodwill that is acquired by a business after paying consideration in cash or in kind.

(ii) **Self-generated goodwill** it is the internally generated or hard earned goodwill which arises due to continued hard work of the organization, its better quality products, better customer service, etc.

5. **Methods of valuation of goodwill** following are the methods of valuation of goodwill

i. Average profit method

(a) Simple average profit method

Value of goodwill = average profit × number of years' purchase

$$\text{average profit} = \frac{\text{total actual profits of given number of years before abnormal and non-business items}}{\text{given number of years}}$$

(b) D average profit method

Value of goodwill = weighted average profit × number of years' purchase

$$\text{weighted average profit} = \frac{\text{total of products}}{\text{total of weights}}$$

ii. Super profit method

Value of goodwill = weighted average profit × number of years' purchase

$$\text{normal profits} = \text{average capital employed} \times \frac{\text{normal rate of return}}{100}$$

Capital employed (net assets) = total assets (excluding goodwill) – external liabilities

super profit = average (actual) profit – normal profits

iii. Capitalization method

(a) Capitalization of average profit (in sacrificing ratio)

Value of goodwill = capitalised of average profit – actual capital employed

$$\text{capitalized value of average profits} = \text{average profits} \times \frac{100}{\text{normal rate of return}}$$

Actual capital employed = total assets (excluding goodwill) – external liabilities

(b) Capitalization of super profit

$$\text{goodwill} = \text{super profits} \times \frac{100}{\text{Normal rate of return}}$$