B.COM 2^{nd} Semester (FYUGP)

Subject: Corporate Accounting

Unit 2 Topic - Valuation of Goodwill

Q.1 What is Goodwill?

Answer - Goodwill, in accounting, represents the value of a company's reputation, customer base, brand, and other intangible assets. It arises when one company acquires another for more than the fair market value of its net assets.

Q.2 What are the distinguishing features of Goodwill ?

Answer - Goodwill has several distinguishing features:

1. Intangible Nature- Goodwill is intangible and non-physical, unlike tangible assets such as machinery or inventory.
2. Generated from Business Operations- It arises from factors such as customer loyalty, brand recognition, reputation, and strategic location, which are built through the company's ongoing business activities.
3. Not Separately Identifiable- Goodwill cannot be separated or sold independently from the business. It represents the overall value of the business beyond its individual tangible assets.
4. Subjective Valuation- Determining the value of goodwill involves subjective judgment and estimation, as it depends on factors like market conditions, brand strength, and future earning potential.
5. Recorded in Business Combinations- Goodwill is recognized only when one company acquires another for a price higher than the fair market value of its identifiable net assets.
6. Subject to Impairment- Goodwill is tested for impairment annually or whenever there are indications that its value may have decreased. If impaired, it is written down to reflect its reduced value.

7. Disclosure Requirements- Companies must disclose information about their goodwill in their financial statements, including the amount, any impairment losses, and the methods used to assess its value.

Q.3 Distinguish between Purchased and Not Purchased Goodwill.

Answer - Purchased goodwill refers to the excess amount paid for an acquired business over its fair market value. Not purchased goodwill, on the other hand, arises internally and isn't acquired through a business transaction; it includes factors like reputation, brand value, and employee expertise.

Q.4 List out the contributing factors for the creation of Goodwill of a business house.

Answer - Here are the contributing factors for the creation of goodwill of a business house

1. Reputation: Positive perception and trustworthiness in the market.
2. Brand Value: Strong brand recognition and loyalty among customers.
3. Customer Base: Large and loyal customer base.
4. Quality of Products/Services: Consistently high-quality offerings.
5. Innovation: Ability to innovate and stay ahead of competitors.
6. Customer Service: Excellent customer service and support.
7. Location: Prime location or accessibility.
8. Employee Expertise: Skilled and knowledgeable workforce.
9. Supplier Relationships: Good relationships with suppliers.
10. Financial Stability: Strong financial performance and stability.
11. Market Position: Leading or prominent position within the industry.
12. Ethical Practices: Adherence to ethical business practices.
13. Longevity: Established track record and longevity in the market.
14. Intellectual Property: Patents, trademarks, or proprietary technology.
15. Management: Competent and visionary leadership.

Q.5 State the circumstances in which there may be need for valuation of Goodwill.

Answer - Valuation of goodwill may be necessary in the following circumstances:

1. Business Sale or Acquisition: When buying or selling a business, determining the fair value of goodwill is essential.
2. Merger: Valuing goodwill in mergers to assess the combined entity's worth.
3. Partnership Dissolution: When a partner leaves or joins a partnership, goodwill needs to be valued.
4. Financial Reporting: Goodwill valuation is required for financial statements, especially after acquisitions, to comply with accounting standards.
5. Shareholder Disputes: Valuation may be necessary to settle disputes among shareholders or partners.
6. Tax Purposes: For taxation reasons, such as capital gains tax or inheritance tax.
7. Bankruptcy or Liquidation: In case of bankruptcy or liquidation, goodwill needs to be assessed for distribution of assets.
8. Intangible Asset Recognition: Goodwill valuation is needed for proper recognition and reporting of intangible assets.
9. Insurance: For insurance purposes, especially to determine the replacement value of intangible assets.
10. Regulatory Compliance: Regulatory bodies may require goodwill valuation for compliance with reporting standards.

Q.6 What is Super Profit? What are the steps to be followed for valuation of Goodwill under Super Profit Method?

Answer - Super profit refers to the excess earnings generated by a business over and above the normal return on its tangible assets. It represents the earning capacity of the business attributable to factors like goodwill, brand value, customer loyalty, etc.

Here are the steps to be followed for the valuation of goodwill under the Super Profit Met

1. Calculate Normal Profit: Determine the normal rate of return expected on the tangible assets of the business. This can be calculated by multiplying the total tangible assets by the normal rate of return (e.g., prevailing interest rate, industry average return on assets).

2. Determine Super Profit: Subtract the normal profit (step 1) from the total profits of the business. The resulting excess represents the super profit attributable to factors like goodwill.

3. Identify Average Super Profit Period: Determine the period over which the super profit is expected to continue. This period is typically based on the life of the goodwill, which could be influenced by factors such as industry trends, brand strength, and market conditions.

4. Calculate Goodwill: Multiply the average super profit (step 2) by the number of years of the average super profit period (step 3). This gives the total goodwill attributable to the business.

5. Adjustments: Make adjustments as necessary for factors such as abnormal earnings, non-recurring profits or losses, and changes in market conditions.

6. Consideration of Other Factors: Take into account other relevant factors such as market conditions, industry trends, and the business's competitive position.

7. Final Valuation: The final valuation of goodwill is the sum of the tangible assets and the calculated goodwill. This represents the total value of the business.

It's worth noting that the Super Profit Method is a subjective approach and relies heavily on estimations and assumptions, so it's important to carefully consider all factors and use sound judgment during the valuation process.