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Research Paper Accountancy

Accounting for Intengible Assets : With a Special Reference to Valuation of Goodwil

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ABSTRACT

Goodwill is an intangible real asset and not a fictitious one; it is perhaps the most intangible of intangibles. Goodwill may be defined as the value of the reputation of a business house in respect of profit expected in future in over and above the normal level of profit earned by undertakings belonging to the game class of business. In a different case a company need for evaluating goodwill there are some important components of goodwill likely, know-how, patents, location, managerial superiority, special commercial advantages etc.

There are many general factors also affecting the value of goodwill these are profitability, nature of business, capital employed, patent and trademark protection etc. in valuation of goodwill, the expectation of investors plays in an important role since it is this expectation that determines the normal level of profit. It is also called the average rate of return. It means that return which will satisfy an ordinary investor in the industry concerned.

1. INTRODUCTION

Goodwill is an intangible asset but not fictitious. Sometimes a tangible asset is less valuable than goodwill. A tramway company may have spent lakhs of rupees on laying the track and is justified in treating the expenditure as an asset. Yet, the realizable value of the track will only be a small fraction of the amounts spent unless the tram ways are profitable and unless the track is being sold as part of a going concern. It is so also with goodwill. Goodwill is a valuable asset if the concern is profitable; it is a valueless if the concern is a losing concern. Goodwill is the value of the reputation of the firm judged in respect of its capacity to bring in, unaided, profits. Prof. Dicksee says, When a man pays for goodwill he pays for goodwill he pays for something which places him in the position of authority says, “Thus given a business, the goodwill of which is for disposal, there would be no valuable goodwill if anyone could do just as well by establishing a business de novo.” Goodwill may be defined as the value of the reputation of a business house in respect of profits expected in future over and above the normal level of profits earned by undertaking belonging to the same class of business.

A firm may enjoy better profits of even profitability than other firms in the industry because of numerous factors, some of which are stated below:

(i) Favourable location in respect of source of raw materials or of markets or of both, enabling the firm to enjoy substantial economies through saving in freight or through facility in sales.

(ii) Favourable long-term contracts as regards supply of raw materials or components or as regards

(iii) Exclusive use of patents or trade marks on the basis of which competition from similar products is avoided.

(iv) Know-how, i. e., knowledge about the peculiar problems facing the industry (both in respect of production and marketing) and about how to overcome them. Often this knowledge is acquired through collaboration with foreign firms but it is also acquired through experience, well pondered, and through systematic research.

(v) Active, intelligent, dynamic and forward looking management.

Factors (i) to (iii) are rather temporary ; factors (iv) and (v) are enduring in nature.

Strictly speaking, enduring goodwill should be in respect of know-how and management only-it come about through the quality and caliber of the human resources at the disposal of the undertaking.

Here goodwill will be used in its wide meaning as including the value of future profits arising from whatever source of reason such as technical knowledge and experience (know-how), near-monopoly position, etc. it is, of course, possible to put a value on each major factor separately. In that case, the term goodwill will have a narrow meaning-value of the reputation only of the firm including that of its management.

2. NED FOR EVALUATING GOODWILL

Goodwill is realizable only if the business is disposed of No one would consider selling the goodwill, i. e., the firm’s name and its special advantages while still trying to run the old business and on one will probably buy goodwill on the condition that the previous firm will continue to exist. Therefore, a question may arise as to the necessity of valuation of goodwill. In case of a joint stock company, the need for evaluating goodwill may arise in the following cases :-

(a) When the company has previously written off goodwill and Wants to write it back in order to wipe off or reduce the debit balance in the profit and loss Account.

(b) When the business of the company is to be sold to another company or when the company is to be amalgamated with another company.

(c) When, stock exchange quotations not being available, shares Have to be valued for taxation purposes.

(d) When a large block of shares, such as to enable the holder to exercise control over the company concerned, has to be bought or sold.

(d) When one class of shares is to be converted into another.

3. COMPONENTS OF GOODWILL

Conceptually, it is possible to analyses the super profits earned by a firm by the factors involved (see the previous page). Goodwill may therefore be broken up into various parts, related to:

(i) Know-how possessed by the firm;
(ii) Advantage enjoyed by it because of certain patents available to it;
(iii) Special locational advantage;
(iv) Special commercial advantages such as a long-term contract for supply of raw materials at a low price or for sale of finished goods at remunerative prices;
(v) Advantage because of prior entry specially if later entry is made difficult through a system of licensing that may be in force of some such other factor; and
(vi) Managerial superiority.

If it is possible to analyse profits in the manner mentioned above, the goodwill attaching each of the factore can be separately calculated. However, generally such an attempt is not made since it difficult to disentangtle the various forces leading to business results. Sometimes, however such calculation becomes unavoidable-for example when compensation has to be paid for forcing a business firm to give up its present location.

4. GENERAL FACTORS AFFECTING THE VALUE OF GOODWILL

The main factors affecting goodwill are the following :-

(a) Profits expected to be earned by the firm of company including those arising from its special advantages. One must realize at the very outset that when one acquires a firm and its goodwill, one is hopping to earn good profits in the future. If for any reason, it is evident that profits in the future will be low, one will not pay much for goodwill-perhaps one will decline to acquire the firm itself. Good past profits are not relevant except to the extent they point to the possibility of earning good profits in the future also.
(b) The yield expected by investors in the industry to which the firm or the company belongs.
(c) The amount of capital employed to earn the profit mentioned in (a) above.
(d) Special factors relevant to a particular situation, for instance those to be considered when the government acquires control over a company by executive order.

5. PROFITABILITY

It is not well recognized that profitability of a concern is the chief factor in the valuation of goodwill. Investors invest money only to earn an income and the size of the income determines what they will pay for the asset concerned. The cost of the asset to the previous proprietor does not matter at all. The market value of a house does not depend on its cost but on the rent fetched by it. Suppose a business is for sale and proprietor demands Rs. 10,00,000 for the tangible assets and another Rs. 4,00,000 for goodwill, the profit earned in that business being Rs. 1,00,000 per year; on one will pay anything for goodwill if a new, similar, business started with Rs. 10,00,000 will also yield Rs. 1,00,000 profit. Goodwill is paid only for the extra profits. If, in the above example, the actual profits were Rs. 1,40,000 whereas a new business would earn with the same capital only Rs. 1,00,000 goodwill will arise in respect of the extra Rs. 40,000 profit.

One who pays for goodwill can look only to the future profits. Hence, the business will be thoroughly examined to see what special advantages it is in possession of and which of them are likely to continue with the change in ownership and passage of time. The attempt is to establish the future maintainable profits.