GOODWILL METHODS OF VALUATION OF

1. Goodwill	A Goodwill IS the value of Reputation, Good name and wide business connections of a firm which enables it to earn higher profits in compare to the normal profit earned by the other firms in the same trade.
2. Features of Goodwill	Features of Goodwill are as under:- 1. It is valuable, Intangible Asset. 2. It helps in earning, excess profit. 3. It is valuable only when entire business is sold
3. Factors affecting the value of Goodwill	The main factors affecting the value of goodwill are as follows: 1. Nature of business 2. Location 3. Efficiency of Management 4. Market Situations 5. Special advantages like low rate and assured supply of electricity, long term contracts for supply of materials, well known collaborators, patents, trademarks, import, licences, etc,. enjoy higher value of goodwill.
4. Categories of Goodwill	1. Purchased Goodwill 2. Self Generated Goodwill
5. Meaning of Features or Purchased Goodwill	Goodwill for which a consideration in money or money's worth has been paid in cash is called Purchased Goodwill. Features - 1 It arises on purchase of business or brand. 2. Shown in Balance Sheet as asset. 3. It is amortised (depreciated)

6. Meaning of Features or Purchased Goodwill	It is an internally generated Goodwill which arises from a number of factors that a running business possess. Features 1. It is generated over the years. 2. According to AS-26, it is not recorded in books of accounts. 3. It is also known as "INHERENT GOODWILL"
7. Meaning of Features of Self Generated Goodwill	GOODWILL needs to be valued in the following circumstances. 1. Change in Profit Sharing ratio among the existing partners 2. Admission of a New Partner 3. Retirement of a Partner 4. Death of a Partner 5. Dissolution of a firm involving Sale of business as a going Concern. 6. Amalgamation of a Partnership Firm

GOODWILL METHODS OF VALUATION OF GOODWILL

SIMPLE AVERAGE PROFIT METHOD	Under this method, the goodwill is valued at the agreed numbers of years of purchase of the average profits of the past years. STEPS OF CALCULATE GOODWILL 1. Calculate Adjusted Profits/Normal Business Profit: Profit or Loss of the past year ADD : Abnormal losses Loss on Sale of Fixed Assets Overvaluation of opening stock Undervaluation of closing stock Non-recurring Expenses Capital Expenditure charged as Revenue Expenditure LESS : Abnormal gains Profit on sale of Fixed Assets Overvaluation of closing stock Undervaluation of opening stock Non-recurring incomes Partner's remuneration, if it is not deducted Income from Non-trade Investments Any future Expense

	ADJUSTED/FUTURE MAINTAINABLE PROFIT
	2. AVERAGE PROFIT = $\frac{\text{TOTAL OF ADJUSTED PROFIT}}{\text{No. of YEARS}}$ 3. GOODWILL = AVERAGE PROFIT X NO. OF YEAR'S OF PURCHASE
SUPER PROFIT METHOD	Under this method, the goodwill is valued at the agreed number of year's of purchase of the super profits of the firm STEPS TO CALCULATE GOODWILL 1) Average Capital = $\frac{\text{Opening capital employed} + \text{closing capital employed}}{2}$ 2) Calculate average maintainable profit (as above) 3) Normal of profit = Average Capital Employed $\times \frac{\text{Normal rate of return}}{100}$ 4) Super Profit = Average maintainable profits - Normal Profits 5) GOODWILL = SUPER PROFIT × NO. OF YEAR'S OF PURCHASE <u>Calculation of capital employed</u> • Assets side Approach • Capital Employed = All Assets (except goodwill, non-trade investments and ficitious assets) - Outside liabilities • Liabilities side Approach

	Capital Employed = Capital + Reserves - Goodwill (if exists in books)- Ficitious Asset - Non- trade investments
CAPITALISATION OF AVERAGE PROFITS	Under this method, the value of goodwill is calculated by deducting the actual capital employed from the capitalization value of the average profits on the basis of the normal rate of return **STEPS TO CALCULATE GOODWILL** 1. Calculate Average Normal Profit 2. Capitalised value of the Business = $\frac{\text{Average profit} \times 100}{\text{Normal rate of return}}$ 3. Capital Emloyed = All Assets (except goodwill, non-trade investment and ficitious assets) - Outside liabilities 4. GOODWILL = Capitalised value of the Business - Net Assets
CAPITALISATION OF SUPER PROFITS	Under this method, Goodwill is calculated by capitalizing the super profits **STEPS TO CALCULATE GOODWILL** 1. Capital Employed = All Assets (except goodwill, non-trade investments and ficitious assets) - Outside Liabilities 2. Normal Profit = Capital Employed × $\frac{\text{Normal rate of return}}{100}$ 3. Capital average maintainable profit (as above) 4. Super Profit = Average maintainable profits - Normal Profits 5. GOODWILL = $\frac{\text{Super Profit}}{\text{Normal rate of return}} \times 100$

Simple Average Profit Method

Illustration 1.

Shweta purchased a business on 1st April 2019. It was agreed to value goodwill at three years purchase of average normal profits of last 4 years. The Profits are as follows.

Year Ended	Profit (₹)
31st March 2016	(₹) 90,000
31st March 2017	(₹)1,60,000
31st March 2018	(₹)1,80,000
31st March 20169	(₹)2 20,000

Following facts are noticed–

1. During the year. ended 31/march/2016, an asset was sold at a profit of ₹ 10,000

2. During the year ended 31/March/2017, firm had incurred a abnormal loss of ₹ 20,000

3. Repairs to car amounting to ₹ 50,000 was wrongly debited to vehicles on 1st May 2017. Depreciation charged on vehicles @ 10 % on straight line Method

4. Firm had abnormal gain of ` 10,000 during the year. ended 31 March 2019

5. During the year ended 31 March 2019, a machine got destroyed in accident & ₹ 30,000 was written off as loss in Profit & Loss Account.

Calculate the value of goodwill

Solution

CALCULATION OF NORMAL PROFIT

Yr Ended	PROFIT	ADJUSTMENT (`)	NORMAL PROFIT (`)
31/Mar/2016	90,000	(10000) Profit on sale of Asset	80,000
31/Mar/2017	1,60,000	(20,000) Abnormal loss	1, 80,000
31/Mar/2018	1,80,000	(45,000) In note (i) & (ii)	1, 35,000
31/Mar/2019	2,20,000	(5000) Depreciation (10,000) Abnormal loss 30,000 Loss on sale of asset	245,000 `
			6, 40,000

$$\text{Average Profit} = \frac{\text{Total Normal Profit}}{\text{No. of years}} = ₹\ \frac{640\,000}{4} = ₹\ 1{,}60{,}000$$

Goodwill = Average Profit x No. of years Purchase

$= 1{,}60{,}000 \times 3 = ₹\ 4{,}80{,}000$

W. NO

i). Repaie Exp. tha should have been debited to P & L A/c as expense but accounted as capital expenditure ₹ (50,000)

Hence, Loss rises by ₹ 50,000

(ii) Depreciation wrongly debited to P & L A/c for the year ended 31/Mar/2018 ₹ (5,000)

Adjustment for year ended 31/march/2018 ₹ (45,000)

(iii) Adjutstment of depreciation for year ended 31/March/2019 (10 % 50,000) = ` (5,000)

Weightened Averarge Profit Mehtod

Illustration 2. Sunil & Anil are partners sharing profit in the ratio 3:2. They admit Deepak into partnership. It was agreed to value goodwill at three years purchase on the basis of average profit of the past five years.

The Profits for these 5 years were-

Year Ended	Profit (₹)
31st March 2015	1,80,000
31st March 2016	1,60,000
31st March 2017	2, 50,000
31st March 2018	3,00,000
31st March 2019	3,50,000

Following additional Information is given

(i) An abnormal gain of ₹ 20,000 was earned in the year eded 31st March 2016

(ii) Expenses of ₹ 50,000 incurred to overhaul a machine on 1st, April 2017 was debited to P&L A/ instead of being debited to Machinery Account. Depreciation is charged on machinery @ 20 % on written Down value Method.

(iii) The closing stock for the year ended 31st March, 2018 was under valued by ₹ 20,000

(iv) To Cover management cost an annual charge of ` 9600 should be made for the purpose of goodwill valuation.

Calculate the value of goodwill

Solution

CALCULATION OF ADJUSTED PROFIT

Particulars	31st March 2015 (₹)	31st March 2016 ((₹)	31st March 2017 (₹)	31st March 2018 (₹)	31st March 2019 (₹)
Given Profits Less Abnormal Gain	1,80,000	1,60,000 (20,000) 1,40,000	2,50,000	3,00,000	3,50,000
Add Capital Expenditure on Machinery	-----------	-----------	-----------	50,000	3,50,000
Less Depreciation on Machinery @ 20 % W.D.V	-----------	-----------	-----------	(10,000)	(8,000)
	1,80,000	1,40,000	2,50,000	3,40,000	3,42,000

Particulars	31 March 2015 (₹)	31 March 2016 (₹)	31 March 2017 (₹)	31 March 2018 (₹)	31 March 2019 (₹)
Add Underavaluation of closing stock	1,80,000 -	1,40,000 -	2,50,000 -	3,40,000 20, 000	3.42,000 -
Less undervaluation of opening stock	1,80,000	1,40,000	2,50,000	3,60,000	3.42,000 (20,000)
	1,80,000	1,40,000	2,50,000	3, 60,000	3.22,000

Calculation of Goodwill

Average Profit = $\frac{\text{Total Normal Profit}}{\text{No. of years}}$

$$= \frac{180,000 + 1,40000 + 250,000 + 3,60,000 + 3,22,000}{5}$$

$= \frac{12,52,000}{5}$ ₹. 2,50, 400/-

Value of Goodwill = Average Profit x No. of years Purchase

= ₹ 250.400 X 3

= ₹ 7,51,200

Super Profit Method

Illustration (3) The average net profits expected of a firm is future are ₹ 68000 per years and capital invested in the business by the firm is ` 3,50,000. The rate of interest expected from capital invested in this class of business is 12%. The renumeration of the partners is estimated to be ₹ 8000 for the year. Calculate the value of goodwill on the basis of two years purchase of super profits.

Solution

Average Profit (Adjusted) = Average net Profit - Partner's Remuneration

₹ 68000 - ₹ 8000

= ₹ 60,000

Normal Profit = $\frac{\text{Capital Employed} \times \text{Normal Rate of Return}}{100}$

₹ 3,50,000 * ₹ $\frac{12}{100}$

= ₹ 42,000

Super Profit = Average Profit - Normal Profit

₹ 60,000- ₹ 42000 = 18000

Goodwill = Super Profit x No. of years purchase

= ₹ 18000 X 2 = ₹ 36,000

Illustration 4. Average profit earned by a firm is ₹ 75,000 which includes undervaluation of stock of ₹ 5000 on average basis. The capital invested in the business is ₹ 8,00,000 & the normal rate of return is 8 %. Calculate goodwill of the firm on the basis of 5 times the Super Profit.

Solution

Adj. Average Profit = Average Profit + Undervaluation of stock

₹ 75000 + ₹ 5000

= ₹ 80,000

Normal Profit = Capital Employed x $\frac{\text{Normal Rate of Return}}{100}$

₹ 800,000 × $\frac{8}{100}$

= 64,000

Super Profit = Adjusted Average Profit - Normal Profit

= ₹ 80,000 × 2 = ₹ 80,000 – ₹ 64,000

= ₹ 16000

Goodwill = ₹ 16000 × 5 = ₹ 80,000

Capitalisation of Average Profit Method

Illustration 5.

Bharat and Bhusan are partners in a retail business. Balances in Capital & Current Accounts as on 31st March 2019 were

	Capital Account	Current Account
Bharat	₹ 400 000	₹ 1000 000
Bhusan	₹ 480 000	₹ 20, 000 (Dr)

The firm earned an average profit of ₹ 97000. If the normal rate of return is 8%, find the value of goodwill

Solution

Capital Employed = ₹ 400,000 + ₹ 4,80, 000 + ₹ 10,00,00 - ₹ 20,000

= ₹ 9,60,000

Capitalised value of the Business = $\frac{\text{Average Profit}}{\text{Normal Rate of Return}} \times 100$

₹ 97,000 × $\frac{100}{8}$ = ₹ 12, 12, 500

Goodwill = ₹ 12, 12, 500 - ₹ 960000

₹ 2, 52, 500

Capitalisation of Super Profit Method

Illustration 6. Average Profit of the firm is ₹ 1, 50, 000. Total tangible assets in the firm are ₹ 12,00,000 & outside liabilities are ₹ 7,00,000. In the same type of business, the normal rate of return is 20 %. Calculate the value of goodwill of the firm by Capitalisation of Super Profit method if the goodwill is valued at 2 years. Purchase of Super Profit.

Solution

Normal Profit = Capita; Employed × $\frac{\text{Normal Rate of Return}}{100}$

= ₹ 5,00,000 × $\frac{20}{100}$

= ₹ 1,00,000

Capital Employed = Total tangible Assets - Outside liabilities

= ₹ 12, 00, 000 - ₹ 7,00,000

= ₹ 5,00,000

Average Profit = ₹ 1, 50,000 (given)

Super Profit = Average Profit - Normal Profit

= = ₹ 1, 50, 000 - ₹ 1,00, 000

= = ₹ 50,000

$$\text{Super Profit} = \frac{\text{Super Profit}}{\text{Normal rate of return}} \times 100$$

$$= ₹ \frac{50,000}{20} \times 100$$

= = ₹ 2, 50, 000

Practice Exercise

Ques.1. On Ist April 2018, a firm had assets of ₹ 3,00,000 including Cash of ₹ 5,000. The Partner's Capital A/c showed a balance of ₹ 2, 00, 000 & the Reserve Constituted the rest. If the normal rate of return of is 10 % & the goodwill of the firm is valued at ₹ 200,000 at four years purchase of Super Profit. Find the average Profit of the firm.

[Hint:- Average Profit = Super Profit + Normal Profit]

Ques.2. Balance Sheet of M/s Laxmi Stores as at 31/3/2019 was as follows.

Liabilities	₹	Assets	₹
Capital A/cs		Land & Building	400,000
A 1,50,000		Computers	70,000
B 1,50,000		Furniture	30,000
C 1,50,000	4,50,000	Investments	1,00,000
Reseves	2,50,000	Stock	2,00,000
		Sundry Debitors	1,50,000
Sundry Creditors	3,00,000	Bill Receivable	50,000
Outstanding Expenses	10,000	Cash in Hand	50,000
bank Overdraft	90,000	Advertisement Suspense	50,000
	11,00,000		11,00,000

Average Profit was ₹ 125000. Calculate goodwill at 3 year's puchase of Super Profit given NRR = 15 % if ---

(a) Investment is treated as Trade Investment

(b) Investment is taken as Non- Trade Investment

[Hint;- Non Trade Investment are deducted to calculate Capital Employed]

Ques.3. Calculate value of goodwill of the firm -

(a) At 3 years purchase of Average Profit

(b) At 3 year's purchase of Super Profit

(c) On the basis of Capitalisation of Super Profit

(d) On the basis of Capitalisation of Average Profit

Following Information is given -

(i) Average capital Employed is ₹ 6,00,000

(ii) Net Profit/(Loss) of the firm for the last 3 years ender are

31st March 2019	₹ 2,00,000
31st March 2018	₹ 1, 80, 000
31st March 2017	₹ 1,60,000

iii) Normal Rate of return in similar business is 10 %

(iv) Remuneration of ₹ 1,00,000 to partners is to be taken as charge against profit

(v) Assets of the firm (excluding goodwill) fictitious assets and Non-trade investments) is ₹ 7,00,000 whereas Partner's Capital is ₹ 6,00,000 & outside liabilities ₹ 1,00,000.

Ques.4. The Capital Employed in a firm is ₹ 10,00,000 & the market rate of interest is 15 %. Annual Salary of the partners is ₹ 80,000. the profit of the last 3 years were ₹ 3,00,000. ₹ 4,00,000 & ₹ 5,00,000 respectively. Calculate value of goodwill on the basis of 2 years purchase of average super profit of last 3 years.

Ques.5. Average profit earned be a firm is ₹ 2,50,00 which includes overvaluation of stock of ₹ 10,000 on an average basis. Capital invested in the business is ₹ 14,00,000 & the normal rate of return is 15 %. Calculate goodwill of the firm on the basis of 4 times the Super Profit.

Ques.6. On April 1, 2018, a firm has assets of ₹ 1,00,000 excluding stock of ₹ 20,000 . The current liabilities were ₹ 10,000 and the balance constituted partner's capital Accounts. If the normal rate of return is 8 %, the Goodwill of the firm is valued at ₹ 60.000 at four years purchase of super profit, find the actual profits of the firm.

Sol. Total Assets = ₹ 1,20,000

Capital Employed = Total Assets - Current Liabilities

= 1, 20,000- 10,000

= ₹ 1,10,000

Normal Profits = 8 % of 1, 10,000

= ₹ 8.800

Goodwill = Super Profits X No. of Years Purchase

Super Profits = Actual Average Profits - Normal Profits

Given Goodwill = ₹ 60, 000

60,000 = 4 (Average Actual Profits - Normal Profits)

15000 = Average Actual Profits - 8,000

Average Actual Profits = 15, 000 + 8,800 = ₹ 23, 800

MCQs

Que. 1) Gaining Ratio : \

a) New Ratio- Sacrificing Ratio

b) Old Ratio- Sacrificing Ratio

c) New Ratio- Old Ratio

d) Old Ratio - New Ratio

Que, 2) A and B were partners in a firm sharing profit ration or losses equally with effect from 1st April, 2019 they agreed to share profits in the ratio of 4: 3 . Due to change in the profit sharing ratio, B's gain or sacrifice will be:

a) Gain 1/14

b) Sacrifice 1/14

c) Gain 4/7

d) Sacrifice 3/7

Que. 3). The excess amount which the firm can get on selling its assets over and a above the saleable value ot its assets is called.

a) Surplus

b) Reserve

c) Super Profits

d) Goodwill

Que. 4). When goodwill is not purchase, goodwill account can:

a) Never be raised in the books

b) Be raised in the books

c) Be partially raised in the books.

d) Be raised as per partnership deed

Que. 5). Weighted average method of calculating goodwill be used. When goodwill be used

a) When profits are fluctuating

b) When profits show a trend

c) When Profits are not equal

d) None of the above

Que. 6). The Formula for Capitalisation of Super Profit Method is

a) Super Profit x No. of years Purchase

b) Super Profit x /100/Normal rate of Return

c) (Super Profit - Normal Profit) x 100 / Normal Rate of Return

d) None of the above

Que. 7). Which of the following is not true in relation to Goodwill

a) It is an Intangible Asset

b) It is a Factious Asset

c) It has a realisable value

d) All of these

Que. 8). A, B & C are partners sharing profits in the ratio of 4:3:2 decided to share profit equally. Goodwill of the firm is valued at ₹ 10, 800. Adjusting entry will be -

a) A' Capital A/c Cr. by ₹ 4, 800; . B's Capital A/c CR. by ₹ 3, 600;

C's Capital A/c Cr. by ₹ 2400

b) A' Capital A/c Cr. by ₹ 3600; B's Capital A/c CR. by ₹ 3, 600;

C' Capital A/c Cr. by ₹ 3600

c) A' Capital A/c Dr. by ₹ 1200; C's Capital A/c Cr. by ₹ 1200

d) A's Capital A/c Cr. by ₹ 1200; C's Capital A/c Dr. by 1200

Que.9 A, B & C are partners sharing profitls in the ration of 1:2:3 on 1st April 2019 they decided to share profits equally. On the date there was credit bal ance of ₹ 1, 20,00; in their P & L A/c & L A/c & a balance of ₹ 1, 80,000 in General Reserve Ac. It is decided to record an adjustment entry, instead of closing the General Reserve & P & L A/c, it will be

a) Dr. A by ₹ 50,000; Cr B by ₹ 50,000

b) Cr. A by ₹ 50,000; Dr. B by ₹ 50,000;

c) Dr. A by ₹ 50,000; Cr. C by ₹ 50,000;

d) Cr. A by ₹ 50,000;; Dr. C by ₹ 50,000;

Que. 10 M, N & P Are partners sharing profit and losses in the ratio of 5: 3: 2 . They decided to share the future profit in the ration of #:3: 2:1 . Workmen Compensation reserve appearing in the balance sheet on the date if no information is available for the same will be"

a) Distributed to the partners in old profit sharing ratio

b) Distributed to the partners in new profit sharing ratio

c) Distributed to the partners in Capital ratio

d) Carried forward to new balance sheet without any adjustment.

Que. 11 A firm earns ₹ 1,10,000,. The Normal rate of return is 10% . Value of goodwill by capitalization of average profit will be.

a) ₹ 2,00,000

b) ₹ 10,000;

c) ₹ 5,000;

d) ₹ 1,00, 000

Que. 12. State whether the following statement are True or False

a) Efficiency of management does not effect the goodwill of business.

b) Goodwill can be defined as the present value of anticipated profits.

c) Self Generated Goodwill is recorded in the books of account as some consideration is paid for it.

Que. 13. Fill in the blanks

a) Goodwill is a capitalized value of ....

b) .... is the excess of actual profit over the normal profit

c) Average profit equals to .....

d) When the business is taken over by another business, the excess of purchase consideration over its net asset value is referred to as ......

e) The value of Goodwill is based on .... judgement of the value.

GOODWILL

ANSWERS

MCQS

1. C	2. B	3. D	4. A
5. B	t6. B	7. B	8. D
9. C	10 A	11. D	

TRUE OR FALSE

12. A . False. B. True. C. False

Fill up

13. 1. Super Profit

2. Super Profit

3. $\dfrac{\text{Total Profit}}{\text{No. of relevant years}}$

4. Purchase Goodwill

5. Subjective

Practice Questions

Q. 1. Average Proft = 80,000

Q. 2. a) Capital Employee = ₹ 6, 50, 000 Goodwill = ₹ 82, 500

b) Capital Employee = ₹ 5, 50, 000 Goodwill = ₹ 1,27,500

Q, 3. a) ₹ 2, 40, 000 b) ₹ 60,000

c) ₹ 200,000 d) ₹ 200,000

Q. 4 ₹ 3,40, 000

Q. 5 ₹ 1,20, 000