CHAPTER 2

Goodwill : Nature and Valuation

Meaning of Goodwill:

Goodwill places the organization at a good position due to which the organization is able to earn higher profits without any extra efforts. Goodwill cannot be seen but felt.

Therefore goodwill is called an Intangible asset.

Factors affecting the value of Goodwill :

1. Efficient management
2. Quality of products
3. Location of business
4. Availability of raw material
5. Favorable contracts

Need for valuing goodwill : Whenever the mutual rights of the partners changes then party which makes a sacrifice must be compensated. This basis of compensation is goodwill so we need to calculate goodwill.

Mutual rights change under following circumstances

1) When profit sharing ratio changes

2) On admission of a partner

3) On Retirement or death of a partner

4) When amalganation of two firms taken place.

5) When partnership firm is sold.

Methods of valuation of goodwill :

1. Average profit method
2. Super profit method
3. Capitalization method

Average Profit Method

The profit earned by a Firm during previous accounting periods on an average basis is called average profit. Goodwill is calculated on the basis of average profit due to future expectations of earning capacity of the firm.

Illustration 1. (Average Profit Method)

Akanksha,Chetna and Dipanshu are partners in a firm sharing profits and losses in the ratio of 3:2:1. They decide to take Jatin into partnership from January 1,2012 for 1/5 share in the future profits. For this purpose , goodwill is to be valued at 2 times the average annual profits of the previous four years. The average profits for the past four years were:

Formula

Average Profit = Total Profits/No. of Years

Goodwill = Average Profit x Number of years of purchase.

Year	₹
2008	96,000
2009	60,600
2010	62,400
2011	84,400

Calculate the value of goodwill.

Solution:

Year	₹
2008	96,000
2009	60,600
2010	62,400
2011	84,400
Total	3,03,400

Average Profit = Total Profit/No. of Years

Average profit = 3,03,400/4=75,850

Goodwill = Average Profit x Number of Years of Purchase

Goodwill = 75,850x2=1,51,700

Super Profit Method

If a firm earns higher profit in comparison to normal profit (generally earned by other firms of same industry) then the difference is called Super Profit. Goodwill is calculated on the basis of Super profit due to future expectations of learning capacity of the firm.

Super profit = Average profit - Normal profit

Normal Profit = Investment (Capital Employed) x Normal Rate of Return/100

Illustration 2. (Super Profit Method)

A firm earned net profits during the last three years as :

Year	2008-09	2009-10	2010-11
Profit (₹)	36,000	40,000	44,000

The capital investment of the firm is ₹ 1,20,000. A fair return on the capital having regard to the risk involved is 10%. Calculate the value of goodwill on the basis of three years purchase of the average profit for the last three years.

Solution :

Average profit : 36000+40000+44000/3=40000

Normal Profit = Capital Employed x Normal Rate of Return/100

Normal Profit : 120000x10/100 = 12,000

Super profit = Average profit - Normal profit

= 40,000-12,000=28,000

Goodwill = Super profit x number of years purchased

= 28,000 x 3 = 84,000

Capitalisation Method

In this method capitalized value of the firm is calculated on the basis of normal rate of return. Difference between teh capitalized value and actual capital employed is called goodwill.

Illustration 3 (Capitalisation Method)

A earns ₹ 1,20,000 as its annual profits, the rates of normal profit being 10% The assets of teh firm amounted to ₹ 14,40,000 and liabilities to ₹ 4,80,000. Find out the value of goodwill by capitalization method.

Solution :

Capitalized value of the firm = Average profit x 1000/ Rate of normal profit

= 1,20,000x10/100 = 12,00,0005

Capital employed = Total assets - liabilities

= 14,40,000 - 4,80,000 = 9,60,000

Goodwill = capitalized value - capital employeed

= 12,00,000-9,60,000=2,40,000

Illustration 4 . (Average profit method)

A and B are partners in a firm. They admit C into the firm. The goodwill for the purpose is to be calculated at 2 year's purchase of the average normal profits of the last three years which were ₹ 10,000, ₹ 15,000 and ₹ 30,000 respectively. Second years profit included profit on sale of Machinery ₹ 10,000. Find the value of goodwill of the firm on C's Admission.

Solution

(1) Calculation of Average Profit :

Year ended	₹
Ist Year	10,000
2nd Year (₹15,000-₹10,000)	5,000
3rd Year	30,000
Total Profits	45,000

Average profit = Total profit/No. of years

= ₹ 45,000/3=15,000

Illustration 5 (Super profit method)

The average net profits expected of a firm in future are ₹ 68,000 per year 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 remuneration of the partners is estimated to be ₹ 8,000 for the year. You are required to find out the value of goodwill on the basis of two years' purchase of super profits.

Solution

Average Profit = Average Net Profit - Partner's remuneration

(1) Average profit = ₹ 68,000-₹ 8,000 = ₹60,000

(ii) Normal profit= Capital employed x Normal rate of return/100

= ₹ 3,50,000x12/100= ₹ 42,000

(iii) Super Profit = Average profit - Normal profit

= ₹ 60,000- ₹ 42,000 = ₹ 18,000

(iv) Value of goodwill = Super profit x No. of years ' purchase

= ₹ 18,000x2 = ₹ 36,000

Illustration 6. (Super profit method)

On April 1st, 1998 an existing firm had assets of ₹ 75,000 including cash of ₹ 5,000. The partners' capital accounts showed a balance of ₹ 60,000 and reserves constituted the rest. If the normal rate of return is 20% and the goodwill of the firm is valued at ₹ 24,000 at 4 years purchase of super profits, find the averages profits of the firm

Solution :

(1) Calculation of Normal Profit :

Capital employed x normal rate/100

=75,000x20/100 = ₹ 15,000

(2) Calculation of Super Profit :

Goodwill = Super profit x No. of years' purchase

₹ 24,000 = Super Profit x4

Super Profit = ₹ 24,000 = ₹6,000

(3) Calculating of Average Profit :

Super Profit = Average Profit - Normal Profit

₹ 6,000 = Average Profit - ₹ 15,000

Average Profit = ₹ 6,000+ ₹ 15,000 = ₹ 21,000