CHAPTER 2

Goodwill: Concept and Mode of Valuation

MEANING OF KEY TERMS USED IN THE CHAPTER

1. Goodwill

Goodwill is the value of benefit or advantage that a business has because of the factors that help in increasing its profitability. It may be because of its location, favourable contracts, access to supplies and customer loyalty, etc.
Goodwill is an intangible asset.

2. Purchased Goodwill

Purchased Goodwill means the goodwill for which a consideration has been paid.

3. Self-generated Goodwill

Self-generated Goodwill is the goodwill that has been generated by the business because of which it is able to earn higher profit.

4. Methods of Valuation of Goodwill

(*i*) Simple Average Profit Method

It is calculated by taking the average profit for a specified number of years and multiplying it with the number of years of purchase.
Goodwill = Average Profit × No. of Years' Purchase

(*ii*) Weighted Average Profit Method

It is calculated by multiplying the profit for each year with the weight assigned to it. The amounts so arrived at are totalled and divided by the total of weights. The weighted average profit is multiplied by the number of years of purchase.
Goodwill = Weighted Average Profit × No. of Years' Purchase

(*iii*) Super Profit Method

Super profit is the profit earned by the business that is in excess of the normal profit. Goodwill is determined by multiplying the super profit by the number of years' purchase.
Goodwill = Super Profit × No. of Years' Purchase

Capitalisation Method

(*iv*) Capitalisation of Average Profit

Under the Capitalisation Method, the capitalised value of the business is determined by capitalising the average profit by the normal rate of return. Out of the value so determined, value of net assets is deducted to determine the value of goodwill.
Goodwill = Capitalised Value of Business – Net Assets of Business.

(*v*) Capitalisation of Super Profit

Under this method, super profit is capitalised at the normal rate of return.

$$\text{Goodwill} = \text{Super Profit} \times \frac{100}{\text{Normal Rate of Return}}$$

SUMMARY OF THE CHAPTER

- **Goodwill:** Goodwill is the benefit and advantage of the good name, reputation and connection of a business. It is the attractive force which brings in customers. It is one factor which distinguishes an old established business from a new business at its first start.

- **Nature and Characteristics of Goodwill:**

  It is a valuable intangible asset (an asset which cannot be seen and touched) like patents, trademarks, copyrights, etc. It is not depreciated like tangible assets but is amortised over its useful life. *Accounting Standard–26 (AS–26), Intangible Assets* prescribes that goodwill should not be recorded in the books of account unless consideration is paid for it. Therefore, self-generated goodwill is not recorded in the books of account but purchased goodwill is recorded. It can be sold, though a sale will be possible only along with the sale of the business itself.

  The characteristics of goodwill are:

  (*i*) It is an intangible asset, *i.e.*, an asset which cannot be seen or touched.

  (*ii*) It does not have an existence separate from that of an enterprise. Thus, it has realisable value when business is sold.

  (*iii*) It helps in earning higher profits.

  (*iv*) It is an attractive force which brings in customers to old place of business.

  (*v*) It comes into existence due to various factors such as locational advantages, favourable contracts, brands, trademarks, patents, market reputation, etc.

  (*vi*) In the context of partnership, it is the value of share of profit sacrificed by the sacrificing partner.

  (*vii*) Value of goodwill is subjective as it depends on the assessment of the valuer.

- **Factors Affecting the Value of Goodwill:** Value of goodwill depends upon the capacity of the business to earn excess profits. Therefore, all such factors which help to increase the profitability of business, will also affect the value of goodwill. These factors are: 1. Efficient Management, 2. Quality of products, 3. Favourable location, 4. Contracts, 5. Control over raw materials, and 6. Other factors like, after sale service, good customer relations, good labour relations, etc.

  In determining normal business profits, interest earned on non-trade investments, is excluded.

- **Need for Valuation of Goodwill for Partnership Firms:** For partnership firms, the need for valuation of goodwill arises in the following circumstances:

  (*i*) When there is a change in the profit-sharing ratio of existing partners.

  (*ii*) When a new partner is admitted.

  (*iii*) When a partner retires or dies.

  (*iv*) When the firm is sold as a going concern.

  (*v*) When two or more firms are amalgamated.

- **Methods of Valuation of Goodwill:** 1. Average Profit Method: Simple Average Profit Method; and Weighted Average Profit Method, 2. Super Profit Method, and 3. Capitalisation Method: Capitalisation of Average Profit Method; and Capitalisation of Super Profit Method.

Solved Questions

Illustration 1.

X and *Y* are partners sharing profits in the ratio of 3 : 2. They agree to admit Z into partnership for 1/5th share. Goodwill of the firm for this purpose is to be valued at three years' purchase of the weighted average profit of the past 4 years.

1. The appropriate weights to be used and profits are:

Year	Weight	Profit (₹)
2014–15	1	15,30,000
2015–16	2	20,30,000
2016–17	3	25,30,000
2017–18	4	30,30,000

2. In 2015–16, a machine having a book value of ₹ 10,000 was sold for ₹ 11,000 but the proceeds were wrongly credited to Profit and Loss Account (No effect has been given to rectify the same). Depreciation is charged on machine @ 10% on Diminishing Balance Method.
3. Interest on non-trade investments is ₹ 10,000 in each year.
4. Closing Inventories were undervalued by ₹ 10,000 in 2015–16, by ₹ 9,100 in 2016–17, by ₹ 8,290 in 2017–18.
5. On 1st October, 2016, a major repair was carried out on plant incurring ₹ 80,000 which amount was charged to revenue. The said sum is agreed to be capitalised for computation of goodwill subject to depreciation @ 10% p.a. on Diminishing Balance Method.
6. It is also agreed that ₹ 20,000 be charged on annual basis as management expenses which have not been charged earlier.

Calculate the value of goodwill.

Solution: CALCULATION OF ADJUSTED PROFITS

Particulars	2014–15	2015–16	2016–17	2017–18
Given Profit	15,30,000	20,30,000	25,30,000	30,30,000
Less: Interest on Non-Trade Investments	10,000	10,000	10,000	10,000
	15,20,000	20,20,000	25,20,000	30,20,000
Less: Sale proceeds of machinery wrongly credited	...	11,000	...	...
	15,20,000	20,09,000	25,20,000	30,20,000
Add: Depreciation on above machinery (Note 1)	...	1,000	900	810
	15,20,000	20,10,000	25,20,900	30,20,810
Add: Under valuation of closing inventories (Note 3)	...	10,000	9,100	8,290
	15,20,000	20,20,000	25,30,000	30,29,100
Less: Under valuation of Opening Inventories (Note 3)	...	...	10,000	9,100
	15,20,000	20,20,000	25,20,000	30,20,000
Add: Repair Expenses debited to Profit and Loss A/c	...	...	80,000	...
	15,20,000	20,20,000	26,00,000	30,20,000
Less: Depreciation (Note 2)	...	...	4,000	7,600
	15,20,000	20,20,000	25,96,000	30,12,400
Less: Management Expenses	20,000	20,000	20,000	20,000
Adjusted Profit	15,00,000	20,00,000	25,76,000	29,92,400

CALCULATION OF WEIGHTED AVERAGE PROFIT

Year	Profits (₹)	Weights	Product (₹)
2014–15	15,00,000	1	15,00,000
2015–16	20,00,000	2	40,00,000
2016–17	25,76,000	3	77,28,000
2017–18	29,92,400	4	1,19,69,600
Total		10	2,51,97,600

$$\text{Weighted Average Profit} = \frac{₹\ 2,51,97,60}{10} = ₹\ 25,19,760$$

Goodwill = Weighted Average Profit × No. of Years' Purchase

= ₹ 25,19,760 × 3 = ₹ 75,59,280.

Notes:

1. Due to wrong entry passed initially, the Machinery Account was overvalued by ₹ 10,000. Depreciation for the said amount of ₹ 10,000 was wrongly charged during the period 2015–2018, which is now added back to Profit and Loss Account.
2. Depreciation for 2016–17 = ₹ 80,000 × 10/100 × 6/12 = ₹ 4,000

   Depreciation for 2017–18 = (₹ 80,000 – ₹ 4,000) × 10/100 = ₹ 7,600.

Illustration 2.

From the following information, calculate the value of goodwill of M/s. Puneet and Gaurav:

(*i*) At three years' purchase of Average Profit.
(*ii*) At three years' purchase of Super Profit.
(*iii*) On the basis of Capitalisation of Super Profit.
(*iv*) On the basis of Capitalisation of Average Profit.

Information:

(*a*) Average capital employed in the business—₹ 25,00,000.

(*b*) Trading profits:

Year	Profit/Loss	₹
2016–17	Profit	7,50,000.
2017–18	Loss	6,25,000.
2018–19	Profit	21,25,000.

(*c*) Rate of interest expected from capital having regard to the risk involved—15%.
(*d*) Remuneration to each partner for his service (to be charged against profit)—₹ 12,500 per month.
(*e*) Assets (excluding goodwill)—₹ 30,00,000; Liabilities—₹ 2,50,000.

Solution:

(*i*) *Goodwill at 3 years' Purchase of Average Profit:*

$$\text{Average Profit} = \frac{₹\ 7,50,000 - ₹\ 6,25,000 + ₹\ 21,25,000}{3} = ₹\ 7,50,000$$

Average Profit for Goodwill = ₹ 7,50,000 – Remuneration of Partners

= ₹ 7,50,000 – (₹ 12,500 × 2 × 12)

= ₹ 7,50,000 – ₹ 3,00,000 = ₹ 4,50,000

Goodwill = Average Profit × No. of Years' Purchase

= ₹ 4,50,000 × 3 = ₹ 13,50,000.

(*ii*) *Value of Goodwill at 3 years' Purchase of Super Profit:*

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

$$= ₹\ 25,00,000 \times \frac{15}{100} = ₹\ 3,75,000$$

$$\text{Super Profit} = \text{Average Profit} - \text{Normal Profit}$$

$$= ₹\ 4,50,000 - ₹\ 3,75,000 = ₹\ 75,000$$

$$\text{Goodwill} = \text{Super Profit} \times \text{No. of years' Purchase}$$

$$= ₹\ 75,000 \times 3 = ₹\ 2,25,000.$$

(*iii*) *Goodwill under Capitalisation of Super Profit:*

$$\text{Goodwill} = \text{Super Profit} \times \frac{100}{\text{Normal Rate of Return}}$$

$$= ₹\ 75,000 \times \frac{100}{15} = ₹\ 5,00,000.$$

(*iv*) *Goodwill under Capitalisation of Average Profit:*

$$\text{Total Capitalised Value of the Firm} = \frac{\text{Average Profit}}{\text{Normal Rate of Return}} \times 100$$

$$= \frac{₹\ 4,50,000}{15} \times 100 = ₹\ 30,00,000$$

$$\text{Net Assets} = \text{Total Assets (excluding Goodwill)} - \text{Outsiders' Liabilities}$$

$$= ₹\ 30,00,000 - ₹\ 2,50,000 = ₹\ 27,50,000$$

$$\text{Goodwill} = \text{Total Capitalised Value of the Firm} - \text{Net Assets}$$

$$= ₹\ 30,00,000 - ₹\ 27,50,000 = ₹\ 2,50,000.$$

Master Question

Illustration 3.

Calculate Goodwill of the firm on the basis of:

(a) Three year's purchase of the Weighted Average Profit of the last four years.

(b) Three year's purchase of Average Profit.

(c) Three years' purchase of Super Profit.

(d) Capitalisation of Super Profit.

(e) Capitalisation of Average Profit.

The weights assigned and profit of each year are:

Year	31st March, 2017	31st March, 2018	31st Mach, 2019	31st March, 2020
Profit (₹)	2,02,000	2,48,000	2,00,000	2,80,000
Weight	1	2	3	4

On scrutiny of the accounts, following matters are revealed:

(i) On 1st December, 2018 major repair was carried out in respect of the Plant incurring ₹ 60,000 which enhanced the capacity of the machine and it was charged to revenue. Depreciation on Machinery is charged @ 10% p.a. on written down value method.

(ii) Closing stock as at 31st March, 2018 was overvalued by ₹ 24,000.

(iii) To cover management cost, an annual charge of ₹ 48,000 should be made for the purpose of goodwill valuation.

(iv) On 1st October, 2017, a machine having book value of ₹ 20,000 was sold for 22,000 but the proceeds were wrongly credited to Profit and Loss Account. No effect has been given to rectify the same. Depreciation is charged on machine @ 10% p.a. on written down value method.

(v) Following is the Balance Sheet as on 31st March, 2020:

Liabilities	₹	Assets	₹
Creditors	50,000	Cash	20,000
Capital	3,00,000	Debtors	80,000
		Plant and Machinery	1,60,000
		Stock	40,000
		Bills Receivable	50,000
	3,50,000		3,50,000

(vi) Normal Rate of Return in similar business is 10%.

Solution: CALCULATION OF ADJUSTED PROFIT

Particulars	31st March, 2017 (₹)	31st March, 2018 (₹)	31st March, 2019 (₹)	31st March, 2020 (₹)
Given Profits	2,02,000	2,48,000	2,00,000	2,80,000
Less: Annual Management Cost	(48,000)	(48,000)	(48,000)	(48,000)
Add: Capital Expenditure on Plant	...	...	60,000	...
	1,54,000	2,00,000	2,12,000	2,32,000
Less: Unprovided Depreciation on Plant	...	...	(2,000)	(5,800)
	1,54,000	2,00,000	2,10,000	2,26,200
Less: Overvaluation of Closing Stock	...	(24,000)	...	...
Add: Overvaluation of Opening Stock	...	...	24,000	...
	1,54,000	1,76,000	2,34,000	2,26,200
Less: Proceeds from Sale of Plant wrongly credited	...	(22,000)	...	...
	1,54,000	1,54,000	2,34,000	2,26,200
Add: Depreciation Wrongly Credited to Profit and Loss	...	1,000	1,900	1,710
Adjusted Profits	1,54,000	1,55,000	2,35,900	2,27,910

CALCULATION OF WEIGHTED AVERAGE PROFIT

Year Ended	Profits (₹)	Weights	Product (₹)
31st March, 2017	1,54,000	1	1,54,000
31st March, 2018	1,55,000	2	3,10,000
31st March, 2019	2,35,900	3	7,07,700
31st March, 2020	2,27,910	4	9,11,640
Total	7,72,810	10	20,83,340

Weighted Average profit = $\frac{₹\,20,83,340}{10}$ = ₹ 2,08,334.

(*a*) Goodwill = Weighted Average Profit × Number of Years' Purchase
= ₹ 2,08,334 × 3 = ₹ 6,25,002.

Working Notes:

1. ₹ 48,000 deducted as annual charge to cover management cost Or we can deduct one year's cost from Average Profit.
2. ₹ 22,000 was wrongly credited to Profit and Loss Account on proceed from sale of machinery. ₹ 1,000 added back on account of depreciation in the year 2017–18, ₹ 1,900 is added back in the year 2018–19 and ₹ 1,710 is added back in the year 2019–20.
3. Closing stock is overvalued by ₹ 24,000 in Financial year 2017–18 which is deducted and added in financial year 2018–19 because opening stock is overvalued because of which profit is reduced.
4. A major repair of plant costing ₹ 60,000 was wrongly charged to revenue. Depreciation is charged @ 10% p.a. on written down value method.

(*b*) Average Profit = $\frac{₹\,7,72,810}{4}$ = ₹ 1,93,203.

Goodwill = Average Profit × Number of Years' Purchase
= ₹ 1,93,203 × 3 = ₹ 5,79,609.

(*c*) Super Profit = Average Profit – Normal Profit

= ₹ 1,93,203 – $\left(3,00,000 \times \frac{10}{100}\right)$ = ₹ 1,63,203.

Goodwill = Super Profit × Number of Years' Purchase
= ₹ 1,63,203 × 3 = ₹ 4,89,609.

(*d*) Goodwill = $\frac{\text{Super Profit}}{\text{Normal Rate of Return}} \times 100$

= $₹\,1,63,203 \times \frac{100}{10}$ = ₹ 16,32,030.

(*e*) Capitlised Value of the Firm = $\frac{\text{Average Profit}}{\text{Normal Rate of Return}} \times 100$

= $\frac{₹\,1,93,203 \times 100}{10}$ = ₹ 19,32,030

Net Assets = ₹ 3,00,000 (Assets – Liabilities)
Goodwill = Capitalised Value of Firm – Net Assets
= ₹ 19,32,030 – 3,00,000 = ₹ 16,32,030.