Goodwill Nature And Valuation

I. (Average Profit Method): Akansha, Chetna and Dipanshu are partners in a firm shring profits and losses in the ratio of 3:2:1. They decide to lake jatin into partnership form January 1, 2015 for1/5 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.

Year	(Rs.)
2012	96,000
2013	60,600
2014	62,400
2015	84,400

Calculate the value of goodwill.

Solution

Formula

Average Profit = Total Profits/No. of Years.

Goodwill = Average Profit $\times$ Number of years of purchase

Year	(Rs.)
2012	96,000
2013	60,600
2014	62,400
2015	84,400
Total Profits	**Rs. 3,03,400**

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

Goodwill = $75,850 \times 2$ = Rs. 151,700

2: The profits of a firm for the last five years were:

Year $\rightarrow$	2011	2012	2013	2014	2015
Profits (Rs.)	45,000	50,000	52,000	65,000	85,000

Calculate the value of goodwill on the basis of two years of purchase of weighted average profits, the weights to be used are 2011-1, 2012-2, 2013-3, 2014-4 and 2015-5

Solution:

Year	Profit (Rs.)	Weights	Weights Profit $\times$ Weight
2011	43,000	1	43,000
2012	50,000	2	1,00,000
2013	52,000	3	1,56,000
2014	65,000	4	2,60,000
2015	85,000	5	4,25,400
Total		15	9,84,400

Weighted Average Profit: $= \dfrac{Total\ product\ of\ profits}{Total\ of\ weights} = \dfrac{9,84,000}{15} = 65,600$

Goodwill = Weighted Average Profit $\times$ No. of years of purchase.

Rs. 65600×2 = Rs. 1,31,200

3: (Super Profit Method)

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

Year	2011-13	2013-14	2014-15
Profits (Rs.)	36,000	40,000	44,000

The capital investment of the firm is Rs. 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 super profit for the last three years.

Solution:

Average profit : $\dfrac{36,000 + 40,000 + 44,000}{3} = 40,000$

Normal profit $= \dfrac{Capital\ Employed \times Normal\ Rate\ of\ Return}{100}$

Normal profit $= \dfrac{1,20,000 \times 10}{100} = $ Rs. 12,000

Super profit = Average profit – Normal profit

= Rs. 40,000 – 12,000 = Rs. 28,000

Goodwill = Super profit $\times$ No. of years of purchase.

= Rs. $28,000 \times 3$ = Rs. 84,000

4 (Capitalisation Method):

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

Solution:

Capitalised value of the firm Average Profit $\times \dfrac{100}{Normal\ Rate\ of\ Return}$

= Rs. $\dfrac{1,20,000 \times 10}{100} = $ Rs. 12,00,000

Capital employed = Total assets – liabilities

= Rs. 14,40,000 – 4,80,000 = Rs. 9,60,000

Goodwill = Capitalised value – Capital Employed

= Rs. 12,00,000 – 9,60,000 = Rs. 2,40,000

5. (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 Rs. 10,000, Rs. 15,000 and Rs. 30,000 respectively. Second years profit included profit on sale of Machinery Rs. 10,000. Find the value of goodwill of the firm on C's Admission.

Solution:

(1) Calculation of Average Profit:

Year ended Rs.

1st Year 10,000

2nd Year (Rs. 15,000 – Rs. 10,000) 5,000

3rd Year 30,000

Total Profits Rs. 45,000

$$\text{Average profit} = \frac{Total\ profit}{No.of\ years} = \frac{45000}{3} = \text{Rs. 15,000}$$

Goodwill = Average profit $\times$ No. of years of purchase

$= 15000 \times 2 = $ Rs. 30,000

6 (Super profit method): The average net profits expected of a firm in future are Rs. 68,000 per year and capital invested in the business by the firm is Rs. 3,50,000. The rate of interest expected from capital invested in this class of business in 12%. The remunerating of the partners is estimated to be Rs. 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

(i) Average profit = Rs. 68,000 – Rs. 8,000 = Rs. 60,000

(ii) Normal profit = $\dfrac{Capital\ employed \times Normal\ rate\ of\ return}{100}$

$= $ Rs. $3,50,000 \times \dfrac{12}{100}$ Rs. 42,000

(iii) Super Profit = Average profit – Normal profit

= Rs. 60,000 – Rs. 42,000 = Rs. 18,000

(iv) Value of goodwill = Super profit $\times$ No. of years' of purchase

$= $ Rs. $18,000 \times 2 = $ Rs. 36,000

7. (Super profit method): On April 1st, 2014 an existing firm had assets of Rs. 75,000 including cash of Rs. 5,000. The partners' capital accounts showed a balance of Rs. 60,000 and reserves constituted the rest. If the normal rate of return is 20% and the goodwill of the firm is valued at Rs. 24,000 at 4 years purchase of super profits, find the average profits of the firm.

Solution:

(1) Calculation of Normal Profit

$= \dfrac{Capital\ employed \times Normal\ rate}{100}$

$$= \frac{75,000 \times 20}{100} = \text{Rs. } 15,000$$

(2) Calculation of Super Profit:
Goodwill = Super profit $\times$ No. of years' of purchase
Rs. 24,000 = Super profit $\times$ 4
$$\text{Super profit} = \frac{24,000}{4} = \text{Rs. } 6,000$$
(3) Calculation of Average Profit:
Super Profit = Average profit – Normal profit
Rs. 6,000 = Average Profit – Rs. 15,000
Average Profit Rs. 6,000, Rs. 15,000, Rs. 21,000
(B) Capitalisation of super profit method: Under this method, goodwill is calculated by capitalizing the super profit on the basis of Normal Rate of Return.
$$\text{Goodwill} = Super\ profit \times \frac{100}{Normal\ Rate\ of\ Return}$$

8: M/s Aradhya having the assets of Rs 10,00,000 and Liabilities of Rs 4,20,000. The firm earns the annual profit of Rs. 90,000. The rate of interest expected from the capital having regard to the risk involved is 15%. Calculate the amount of Goodwill by Capitalisation of Super Profit method.
Solution:
Super Profit = Average/Actual Profits – Normal Profits
Actual Profits = Rs. 90,000
$$\text{Normal Profit} = Capital\ Employed \times \frac{Normal\ Rate\ of\ Return}{100}$$
Capital Employed = Total Assets – Outside's Liabilities
= Rs. 10,00,000 –Rs. 4,20,000
= Rs. 5,80,000
$$\text{Normal Profit} = \text{Rs. } 5,80,000 \times \frac{15}{100}$$
= Rs. 87,000
Super Profits = Rs. 90,000 – Rs. 87,000
= Rs. 3,000
$$\text{Goodwill} = Super\ Profits \times \frac{100}{Normal\ Rate\ of\ Return}$$
$$= 3,000 \times \frac{100}{15}$$
Ans : Goodwill = Rs. 20,000