Ch-02: Goodwill: Nature and Valuation:

Meaning of Goodwill:-It is the reputation that helps the business to earn more profits as compared to a newly setup business. In accounting, the monetary value of such advantage is known as "goodwill".

Factors Affecting the Value of Goodwill:-
The main factors affecting the value of goodwill are as follows:
(a) Nature of business (b) Location
(c) Efficiency of management. (d) Market situation.

Need for Valuation of Goodwill
In a partnership firm, goodwill needs to be valued in the following circumstances:
1. Change in the profit sharing ratio amongst the existing partners; 2. Admission of new partner;
3. Amalgamation of partnership firm. 4. Death of a partner and
5. Dissolution of a firm involving sale of business as a going concern. 6. Retirement of a partner;

Methods of Valuation of Goodwill:-
1.Average Profits Method:-

(a) Simple Average:-
Stepwise procedure to calculate Goodwill under this method:
Step 1: Work out profits or losses given for each of the past year after taking into account abnormalities, if any.
Step 2: Calculate average by dividing the total profit of all the years by the number of years
Step 3: Goodwill= Average Profit x Number of year's purchase.

(b) Weighted Average Profit:-
Under this method, earlier years are less important than the recent yea₹ Thus, each year's profit is multiplied by its respective number (weight) in chronological order. The latest year will be given the highest weight and the earliest year will be given lowest weight. Each profit figure willbe multiplied by its weight and then the total of these products will be calculated. This total will be divided by the total of weights.
Then, **Goodwill = Weighted Average Profit x Number of years' purchase.**

2. Super Profit Method:-
Stepwise procedure to calculate Goodwill under this method:
Calculate the average profit,
Calculate the normal profit on the capital employed on the basis of the normal rate of return,
Formula , *Normal Profit = Capital Employed* x *NRR /100*
Calculate the super profits by deducting normal profit from the average profits,
Formula, SuperProfit = Average Profit - Normal Profit
Then, Goodwill = Super profits x Number of years 'purchase.

3. Capitalisation Method:-
Under this method the goodwill can be calculated in two ways:
(a) by Capitalizing the Average Profits, or (b) by Capitalizing the Super Profits.

(a) Capitalisation of Average Profits: This involves the following steps:
(i) As certain the Average Profits based on the past few years' performance.

(ii) Capitalize the Average Profits on the basis of the Normal Rate of Return to ascertain the capitalised value of Average Profits as follows:
Average Profits x *100/Normal Rate of Return*
As certain the actual capital employed (net assets) by deducting outside liabilities from thetotal assets (excluding goodwill).
Capital Employed/Net Assets = Total Assets (excluding Goodwill) – Outside Liabilities
Compute the Value of Goodwill by deducting Net Assets from the Capitalised Value of Average Profits, i.e.(ii)–(iii).

(b) Capitalisation of Super Profits: It involves the following steps.
(i) Calculate capital employed of the firm, which is equal to total assets minus outside liabilities.
(ii) Calculate normal profit = Capital Employed x Normal Rate of Return/100

Calculate average profit for past years, as specified.
(iv) Super profits = average profits/Actual profit - normal profits
(v) Goodwill = Super Profits x 100/ Normal Rate of Return

Note:- In other words, goodwill is the capitalised value of super profits. The amount of goodwill worked out by this method will be exactly the same as calculated by capitalising the average profits.

Valuation of Goodwill
1. Compute the value of goodwill on the basis of four years' purchase of the average profits based on the last five years? The profits/losses for the last five years were as follows:
2017 – ₹ 25,000; 2018 – ₹ 40,000; 2019 - (₹ 15,000) loss; 2020 –₹ 80,000; 2021 – ₹ 1,00,000
Ans: ₹ 1, 84,000.

2. Capital employed in a business is ₹ 2, 00,000. The normal rate of returnon capital employed is 15%. During the year 2002 the firm earned a profit of ₹ 48, 000. Calculate good will on the basis of 3 years purchaseof super profit?
Ans: ₹ 54, 000.

3. A business has earned average profits of ₹ 1, 00,000 during the last few years. Find out the value of goodwill by capitalisation method, given that the assetsof the business are ₹ 10, 00,000 and its external liabilities are ₹ 1, 80,000. The normal rate of return is 10%?
Ans: ₹ 1, 80,000.

ACCOUNTING TREATMENT OF GOODWILL
GOODWIL TO BE ADJUSTED THROUGH PARTNERS' CAPITAL/CURRENT ACCOUNTS OR BY RAISING ANDWRITING OFF GOODWILL.

CHANGE IN PROFIT-SHARING RATIO AMONG EXISTING PARTNERS:-

Treatment of existing Goodwill appearing in the Balance Sheet:
Journal entry:
Old Partners' Capital/Current A/c………………Dr. (In Old Profit Sharing Ratio)
To Goodwill A/c
(Being the existing goodwill is written off)

Method 1: When goodwill is adjusted through Partners' Capital /Current accounts
Journal Entry:
Gaining Partners Capital/ Current A/c………Dr. (In Gaining Ratio)
To Sacrificing Partners 'Capital /Current A/c (In Sacrificing Ratio)

(Being the compensation of gaining partners to Sacrificing partners)

Method 2: When Goodwill is raised and Written off:-
Goodwill A/c…… …………………….Dr. (Full Revised Value of Goodwill)
To Old Partners' Capital/ Current A/c (In Old Profit Sharing Ratio)
(Being the goodwill raised and credited to Partners Capital accounts in old profit sharing ratio)

All Partners Capital/ Current A/c Dr. (In New Profit Sharing Ratio)
To Goodwill A/c (With value of Goodwill)
(Being the goodwill debited to Partners Capital accounts in New profit sharing ratio)

MULTIPLE CHOICE QUESTION:-

1 Super profit can be calculated:-
(a) Average profit-Normal profit (b) Net profit – Average profit
(c) Capital Employed –Net Profit (d) Net Profit – Capital Employed [a]

2. Which step is not involved in valuing the goodwill according to Super Profit Method:
(a) Ascertain Average profit (b) Multiply Super Profit with Number of years purchased
(c) Ascertain Normal Profit (d) Ascertain Super Profit [a]

3. If Average Profit =₹ 1, 60,000, Actual Capital Employed = ₹5,00,000. If rate of Normal Profit = 20%. What is the amount of Super Profit?
(a) ₹ 60,000 (b) ₹ 1,00,000
(c) ₹ 20,000 (d) ₹ 80,000 [a]

4. If Goodwill is ₹ 1,20,000, Average Profit is ₹ 60,000 Normal. Rate of Return is10% on Capital Employed ₹ 4,80,000. Calculate Capitalized Value of the firm:-
(a) ₹ 6,00,000 (b) ₹ 5,00,000
(c) ₹ 4,00,000 (d) ₹ 7,00,000 [a]

5. Tangible Assets of the firm are ₹ 14,00,000 and Outside liabilities are ₹ 4,00,000, Profit of the firm is ₹ 1,50,000 and Normal Rate of Return is 10% Calculate Capital Employed
(a) ₹ 10,00,000 (b) ₹ 1,00,000
(c) ₹ 50,000 (d) ₹ 20,000 [a]

6. A business has earned Super profit of ₹ 1,00,000during the last few years and Normal rate of returns in 10% Calculate goodwill
(a) ₹10,00,000 (b) ₹ 54,000
(c) ₹ 20,000 (d) ₹ 36,000 [a]

7. Goodwill of the firm on the basis of 2 years' purchase of average profit of the last 3 years is ₹ 25,000. Find average profit.
(a) ₹ 50,000 (b) ₹ 25,000
(c) ₹ 10,000 (d) ₹ 37,500 [d]

8. Calculate the value of goodwill at 3 years' purchase of Super Profit, when: Capital employed ₹ 2,50,000; Average profit ₹ 30,000 and normal rate of return is 10%.
(a) ₹ 3000 (b) ₹ 25,000 (c) ₹ 30,000 (d) ₹1 5,000 [d]

9. What are super profits:-
(a) Actual profit – Normal Profit (b) Normal Profit - Actual profit
(c) Actual profit + Normal Profit (d) None of the above [a]

10. The net assets of the firm including fictitious assets of ₹ 5,000 are ₹ 85,000. The net liabilities of the firm are ₹ 30,000.The normal rate of return is 10% & the average profits of the firm are ₹ 8,000. Calculate the goodwill as per capitalization of super profits
(a) ₹ 20,000 (b) ₹ 30,000
(c) ₹ 25,000 (d) None of the above

11. Which of the following items are added to previous year's profits for finding normal profits for valuation of goodwill?
(a) Loss on sale of fixed assets
(b) Loss due to fire, earthquake etc
(c) Undervaluation of closing stock
(d) All of the above [a]

12. The profits earned by a business over the last 5 years are as follows ₹ 12,000; ₹ 13,000; ₹ 14,000: ₹ 18,000 and ₹ 2,000 (loss). Based on 2 years purchase of the last 5 years profits, value of Goodwill will be :
(a) ₹ 23,600 (b) ₹ 22,000
(c) ₹ 1,10,000 (d) ₹ 1,18,000 [d]

13. Following are the methods of calculating goodwill except:
(a) Super Profit method (b) Average Profit method
(c) Weighted Average Profit method (d) Capital Profit method [d]

TRUE / FALSE :
1. Location of business does not affect the goodwill of business. (F)
2. "Average profit method" takes into consideration the future maintainable profits. (T)
3. Goodwill can be sold in part. (F)
4. Purchased goodwill may arise on acquisition of an existing business concern. (T)
5. Self-Generated goodwill is recorded in the books of accounts as some consideration is paid for it. (F)
6. Goodwill is a fictitious asset. (F)
7. Goodwill is valued during dissolution of a firm. (F)
8. In the event of change in profit sharing ratio, General Reserve existing inthe Balance Sheet is transferred to capital accounts of partners in their new ratio. (F)