UNIT 4

GOODWILL IN PARTNERSHIP ACCOUNTS

Contents

Points to recall

The following points are to be recalled before learning goodwill in partnership accounts:

- Meaning and features of partnership firm
- Meaning of intangible assets

Learning objectives

To enable the students to

- Understand the need for valuation of goodwill in partnership firm and factors that determine the value of goodwill
- Understand the different methods of valuation of goodwill

Key terms to know

- Goodwill
- Average profit
- Normal profit
- Super profit

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4.1 Introduction

Student activity 4.1

Ravi has a fruit shop for 10 years in a busy area. The shop is a rented property. He has gained loyal customers for his shop. The business has been consistently performing well and making good profit. Now, Ravi considers moving to a different city to open a big supermarket. He has cleared all his debts to outsiders. His friend, Raja is planning to buy Ravi's business by taking over all the unsold fruits, to continue the business. Ravi is asking for ₹ 1,00,000 to sell his business. But, Raja thinks the cost of inventory that Ravi holds now may be worth only ₹ 5,000. So, he is hesitant to buy the business. What is your advice to Raja. Why do you think that Ravi quotes more than the worth of the asset he holds?

Goodwill is the good name or reputation of the business which brings benefit to the business. It enables the business to earn more profit. It is the present value of a firm's future excess earnings. It is an intangible asset as it has no physical existence. It is shown under fixed assets in the balance sheet.

An old and well established business entity develops a good name and reputation among the public over a period of time, because of various reasons such as good quality of goods and services, location of the business, etc. This enables the business to earn more profit compared to a new business. The monetary value of such advantage is termed as goodwill.

4.2 Nature of goodwill

The nature of goodwill can be described as follows:

(i) Goodwill is an intangible fixed asset. It is intangible because it has no physical existence. It cannot be seen or touched.

(ii) It has a definite value depending on the profitability of the business enterprise.

(iii) It cannot be separated from the business.

(iv) It helps in earning more profit and attracts more customers.

(v) It can be purchased or sold only when the business is purchased or sold in full or in part.

Student activity 4.2

Interview a partner. Discuss with him/her to know the factors that have contributed to the firm's goodwill. Present your findings to the whole class.

4.3 Factors determining the value of goodwill of a partnership firm

Generally, the following factors determine the value of goodwill of a partnership firm:

(i) Profitability of the firm

The profit earning capacity of the firm determines the value of its goodwill. A firm earning higher profits and having potential to generate higher profits in future will have higher value of goodwill.

(ii) Favourable location of the business enterprise

If the firm is located in a prominent place which is easily accessible to the customers, it can attract more customers. Its sales and profit will be higher when compared to a firm which is not located in a prominent place. Hence, it will have high value of goodwill.

(iii) Good quality of goods or services offered

If a firm enjoys good reputation among the customers and general public for the good quality of its products or services, the value of goodwill for the firm will be high.

(iv) Tenure of the business enterprise

A firm which has carried on business for several years will have higher reputation among its customers as it is better known to the customers. Such a firm will have higher earnings and higher value of goodwill when compared to a new firm.

(v) Efficiency of management

A firm having efficient management will earn more profits and the value of its goodwill will be higher compared to a firm with less efficient managerial personnel.

(vi) Degree of competition

In the case of business enterprises having no competition or negligible competition, the value of goodwill will be high.

(vii) Other factors

There are other factors which add to the value of goodwill of a business such as popularity of the proprietor, impressive advertisements and publicity, good relations with customers, etc.

Student activity 4.3

Collect the logos of any five businesses and ask your friend to identify the name of the business.

4.4 Need for valuation of goodwill of partnership firms

In case of partnership firms, whenever there is a change in the mutual rights of partners, the need for valuation of goodwill arises. Following are the circumstances that require valuation of goodwill of partnership firms in order to protect the rights of the partners:

(i) When there is a change in the profit sharing ratio

(ii) When a new partner is admitted into a firm

(iii) When an existing partner retires from the firm or when a partner dies

(iv) When a partnership firm is dissolved

4.5 Classification of goodwill

Goodwill may be classified into acquired goodwill and self-generated goodwill.

(i) Acquired or purchased goodwill

Goodwill acquired by making payment in cash or kind is called acquired or purchased goodwill. When a firm purchases an existing business, the price paid for purchase of such business may exceed the net assets (Assets – Liabilities) of the business acquired. The excess of purchase consideration over the value of net assets acquired is treated as acquired goodwill. The Indian Accounting Standard 10 (AS10) on accounting for fixed assets states that goodwill must be recorded in the books of accounts only when some consideration in money or money's worth has been paid for it. Therefore, acquired goodwill can be recorded in the books of accounts and is shown on the assets side of the balance sheet under fixed assets.

(ii) Self-generated goodwill

It is the goodwill which is self generated by a firm based on features of the business such as favourable location, loyal customers, etc. Such self-generated goodwill cannot be recorded in the books of accounts.

4.6 Methods of valuation of goodwill

Following are the methods generally followed to value goodwill:

4.6.1 Average profit method

Under this method, goodwill is calculated as certain years of purchase of average profits of the past few years. The number of years of purchase is generally determined on the basis of the average period a new business will take in order to bring it to the current state of the existing business. It may also be determined on the basis of the number of years for which the past average profit will be earned in future.

While computing the average profit, in addition to rectification of errors, the following adjustments are to be made:

Adjusted profit = Actual profit

+ Past expenses not required in the future

– Past revenues not likely to be earned in the future

+ Additional income expected in the future

– Additional expenses expected to be paid in the future

The average profit may be either simple average profit or weighted average profit.

(a) Simple average profit method

Under this method, goodwill is calculated by multiplying the average profits by a certain number of years of purchase. Simple average profit is calculated by adding the adjusted profits of certain number of years by dividing the total number of such years.

Goodwill = Average profit × Number of years of purchase

$$\text{Average profit} = \frac{\text{Total profit}}{\text{Number of years}}$$

Illustration 1

The following are the profits of a firm in the last five years:

2014: ₹ 4,000; 2015: ₹ 3,000; 2016: ₹ 5,000; 2017: ₹ 4,500 and 2018: ₹ 3,500

Calculate the value of goodwill at 3 years purchase of average profits of five years.

Solution

Goodwill = Average profit × Number of years of purchase

$$\text{Average profit} = \frac{\text{Total profit}}{\text{Number of years}}$$

$$= \frac{4{,}000 + 3{,}000 + 5{,}000 + 4{,}500 + 3{,}500}{5}$$

$$= \frac{20{,}000}{5} = ₹\ 4{,}000$$

Goodwill = Average profit × Number of years of purchase

= 4,000 × 3 = ₹ 12,000

Illustration 2

The profits and losses of a firm for the last four years were as follows:

2015: ₹ 15,000; 2016: ₹ 17,000; 2017: ₹ 6,000 (Loss); 2018: ₹ 14,000

You are required to calculate the amount of goodwill on the basis of 5 years purchase of average profits of the last 4 years.

Solution

Goodwill = Average profit × Number of years of purchase

$$\text{Average profit} = \frac{\text{Total profit}}{\text{Number of years}}$$

$$\text{Average profit} = \frac{15{,}000 + 17{,}000 - 6{,}000 + 14{,}000}{4}$$

$$= \frac{40{,}000}{4} = ₹\ 10{,}000$$

Goodwill = Average profit × Number of years of purchase

= 10,000 × 5 = ₹ 50,000

Illustration 3

A partnership firm has decided to value its goodwill for the purpose of settling a retiring partner. The profits of that firm for the last four years were as follows:

2015: ₹ 40,000; 2016: ₹ 50,000; 2017: ₹ 48,000 and 2018: ₹ 46,000

The business was looked after by a partner. No remuneration was paid to him. The fair remuneration of the partner valued at comes to ₹ 6,000 per annum.

Find out the value of goodwill, if it is valued on the basis of three years purchase of the average profits of the last four years.

Solution

$$\text{Average profit} = \frac{\text{Total profit}}{\text{Number of years}}$$

$$= \frac{40{,}000 + 50{,}000 + 48{,}000 + 46{,}000}{4}$$

$$= \frac{1{,}84{,}000}{4} = ₹\ 46{,}000$$

Average profit before adjusting fair remuneration of the partner	₹ 46,000
Less: Fair remuneration of partners	6,000
Average profit	40,000

Goodwill = Average profit × Number of years of purchase

= 40,000 × 3 = ₹ 1,20,000

Illustration 4

From the following information relating to Arul enterprises, calculate the value of goodwill on the basis of 2 years purchase of the average profits of 3 years.

(a) Profits for the years ending 31st December 2016, 2017 and 2018 were ₹ 46,000, ₹ 44,000 and ₹ 50,000 respectively.

(b) A non-recurring income of ₹ 5,000 is included in the profits of the year 2016.

(c) The closing stock of the year 2017 was overvalued by ₹ 10,000.

Solution

Calculation of adjusted profit

Particulars	2016 ₹	2017 ₹	2018 ₹
Profit	46,000	44,000	50,000
Less: Non- recurring income	5,000	-	-
	41,000	44,000	50,000
Less: Over valuation of closing stock	-	10,000	-
	41,000	34,000	50,000
Add: Over valuation of opening stock	-	-	10,000
Profit after adjustments	41,000	34,000	60,000

Tutorial note: Over valuation of closing stock in 2017 will result in over valuation of opening stock in 2018

$$\text{Average profit} = \frac{\text{Total profit}}{\text{Number of years}}$$

$$= \frac{41{,}000 + 34{,}000 + 60{,}000}{3}$$

$$= \frac{1{,}35{,}000}{3} = ₹\ 45{,}000$$

Goodwill = Average profit × Number of years of purchase

= 45,000 × 2 = ₹ 90,000

Illustration 5

The following particulars are available in respect of a business carried on by a partnership firm:

(a) Profits earned: 2016: ₹ 30,000; 2017: ₹ 29,000 and 2018: ₹ 32,000.

(b) Profit of 2016 includes a non-recurring income of ₹ 3,000.

(c) Profit of 2017 is reduced by ₹ 2,000 due to stock destroyed by fire.

(d) The stock is not insured. But, it is decided to insure the stock in future. The insurance premium is estimated at ₹ 5,600 per annum.

You are required to calculate the value of goodwill on the basis of 2 years purchase of average profits of the last three years.

Solution

Calculation of adjusted profit

Particulars	2016 ₹	2017 ₹	2018 ₹
Profit	30,000	29,000	32,000
Less: Non- recurring income	3,000	-	-
	27,000	29,000	32,000
Add: Stock destroyed by fire (abnormal loss)	-	2,000	-
Profit after adjustments	27,000	31,000	32,000

$$\text{Average profit} = \frac{\text{Total profit}}{\text{Number of years}}$$

$$\text{Average profit} = \frac{27{,}000 + 31{,}000 + 32{,}000}{3}$$

$$= \frac{90{,}000}{3} = ₹\ 30{,}000$$

Particulars	₹
Average profit before adjusting insurance premium payable in future	30,000
Less: Insurance premium payable in future	5,600
Average profit	24,400

Goodwill = Average profit × Number of years of purchase
= 24,400 × 2
= ₹ 48,800

(b) Weighted average profit method

Under this method, goodwill is calculated by multiplying the weighted average profit by a certain number of years of purchase.

Goodwill = Weighted average profit × Number of years of purchase

In this method, weights are assigned to each year's profit. Weighted profit is ascertained by multiplying the weights assigned with the respective year's profit. The sum of the weighted profits is divided by the sum of weights assigned to determine the weighted average profit.

$$\text{Weighted average profit} = \frac{\text{Total of weighted profits}}{\text{Total of weights}}$$

This method is used when the profits show an increasing or decreasing trend. More weight is generally given to the profits of the recent years.

Illustration 6

For the purpose of admitting a new partner, a firm has decided to value its goodwill at 3 years purchase of the average profit of the last 4 years using weighted average method. Profits of the past 4 years and the respective weights are as follows:

Particulars	2015	2016	2017	2018
Profit (₹)	20,000	22,000	24,000	28,000
Weight	1	2	3	4

Compute the value of goodwill.

Solution

Calculation of weighted average profit

Year	Profits (a) ₹	Weights (b)	Weighted profits (a × b) ₹
2015	20,000	1	20,000
2016	22,000	2	44,000
2017	24,000	3	72,000
2018	28,000	4	1,12,000
Total		10	2,48,000

$$\text{Weighted average profit} = \frac{\text{Total of weighted profits}}{\text{Total of weights}}$$

$$= \frac{2,48,000}{10} = ₹\ 24,800$$

Goodwill = Weighted average profit × Number of years of purchase

= 24,800 × 3 = ₹ 74,400

4.6.2 Super profit methods

Under these methods, super profit is the base for calculation of the value of goodwill. Super profit is the excess of average profit over the normal profit of a business.

Super profit = Average profit – Normal profit

Average profit is calculated by dividing the total of adjusted actual profits of certain number of years by the total number of such years. Normal profit is the profit earned by the similar business firms under normal conditions.

Normal profit = Capital employed × Normal rate of return

Capital employed = Fixed assets + Current assets – Current liabilities

Normal rate of return = It is the rate at which profit is earned by similar business entities in the industry under normal circumstances.

(a) Purchase of super profit method

Under this method, goodwill is calculated by multiplying the super profit by a certain number of years of purchase.

Goodwill = Super profit × Number of years of purchase

Illustration 7

From the following information, calculate the value of goodwill based on 3 years purchase of super profit

(i) Capital employed: ₹ 2,00,000

(ii) Normal rate of return: 15%

(ii) Average profit of the business: ₹ 42,000

Solution

Normal profit = Capital employed × Normal rate of return

= 2,00,000 × 15% = ₹ 30,000

Super profit = Average profit – Normal profit

= 42,000 – 30,000

= ₹ 12,000

Goodwill = Super profit × Number of years of purchase

= 12,000 × 3

= **₹ 36,000**

Illustration 8

Calculate the value of goodwill at 5 years purchase of super profit from the following information:

(a) Capital employed: ₹ 1,20,000

(b) Normal rate of profit: 20%

(c) Net profit for 5 years:

2014: ₹ 30,000; 2015: ₹ 32,000; 2016: ₹ 35,000; 2017: ₹ 37,000 and 2018: ₹ 40,000

(d) Fair remuneration to the partners ₹ 2,800 per annum.

Solution

$$\text{Average profit} = \frac{\text{Total profit}}{\text{Number of years}}$$

$$\text{Average profit} = \frac{30{,}000 + 32{,}000 + 35{,}000 + 37{,}000 + 40{,}000}{5}$$

$$\text{Average profit} = \frac{1{,}74{,}000}{5} = ₹\ 34{,}800$$

Particulars	₹
Average profit before fair remuneration to the partners	34,800
Less: Fair remuneration to the partners	2,800
Average profit	32,000

Normal profit = Capital employed × Normal rate of return

= 1,20,000 × 20%

= ₹ 24,000

Super profit = Average profit – Normal profit

= 32,000 – 24,000

= ₹ 8,000

Goodwill = Super profit × Number of years of purchase

= 8,000 × 5

= ₹ 40,000

(b) Annuity method

Under this method, value of goodwill is calculated by multiplying the super profit with the present value of annuity.

Goodwill = Super profit × Present value annuity factor

Present value annuity factor is the present value of annuity of rupee one at a given time. It can be found out from annuity table or by using formula.

DO YOU KNOW?

Annuity refers to series of uniform cash flows at regular intervals. The table value gives the present value of annuity of rupee one received at the end of every year for a specified number of years.

The following formula is used to compute annuity factor:

$$\text{Annuity factor} = \frac{(1 + i)^n - 1}{i(1 + i)^n}$$

where, i = interest rate

n = estimated number of years

Illustration 9

From the following information, compute the value of goodwill as per annuity method:

(a) Capital employed: ₹ 50,000

(b) Normal rate of return: 10%

(c) Profits of the years 2016, 2017 and 2018 were ₹ 13,000, ₹ 15,000 and ₹ 17,000 respectively.

(d) The present value of annuity of ₹ 1 for 3 years at 10% is ₹ 2.4868.

Solution

$$\text{Average profit} = \frac{\text{Total profit}}{\text{Number of years}}$$

$$= \frac{13{,}000 + 15{,}000 + 17{,}000}{3}$$

$$= \frac{45{,}000}{3}$$

$$= ₹\ 15{,}000$$

Normal profit = Capital employed × Normal rate of return

= 50,000 × 10%

= ₹ 5,000

Super profit = Average profit – Normal profit

= 15,000 – 5,000

= ₹ 10,000

Goodwill = Super profit × Value of annuity

= 10,000 × 2.4868 = ₹ 24,868

(c) Capitalisation of super profit method

Under this method, value of goodwill is calculated by capitalising the super profit at normal rate of return, that is, goodwill is the capitalised value of super profit.

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

Illustration 10

From the following information, compute the value of goodwill by capitalising super profit:

(a) Capital employed is ₹ 4,00,000

(b) Normal rate of return is 10%

(c) Profit for 2016: ₹ 62,000; 2017: ₹ 61,000 and 2018: ₹ 63,000

Solution

$$\text{Average profit} = \frac{\text{Total profit}}{\text{Number of years}}$$

$$= \frac{62{,}000 + 61{,}000 + 63{,}000}{3}$$

$$= \frac{1{,}86{,}000}{3}$$

= ₹ 62,000

Normal profit = Capital employed × Normal rate of return

= 4,00,000 × 10%

= ₹ 40,000

Super profit = Average profit – Normal profit

= 62,000 – 40,000

= ₹ 22,000

$$\text{Goodwill} = \frac{\text{Super profit}}{\text{Normal rate of return}} \text{ x } 100$$

$$= \frac{22{,}000}{10} \text{ x } 100$$

= ₹ 2,20,000

4.6.3 Capitalisation method

Under this method, goodwill is the excess of capitalised value of average profit of the business over the actual capital employed in the business.

Goodwill = Total capitalised value of the business – Actual capital employed

The total capitalised value of the business is calculated by capitalising the average profits on the basis of the normal rate of return.

$$\text{Capitalised value of the business} = \frac{\text{Average profit}}{\text{Normal rate of return}} \text{ x } 100$$

Actual capital employed = Fixed assets (excluding goodwill) + Current assets – Current liabilities

Illustration 11

From the following information, find out the value of goodwill by capitalisation method:

(a) Average profit = ₹ 60,000

(b) Normal rate of return = 10%

(c) Capital employed = ₹ 4,50,000

Solution

$$\text{Total capitalised value of the business} = \frac{\text{Average profit}}{\text{Normal rate of return}} \times 100$$

$$= \frac{60{,}000}{10} \times 100$$

$$= ₹\ 6{,}00{,}000$$

Goodwill = Total capitalised value of the business – Capital employed

= 6,00,000 – 4,50,000

= ₹ 1,50,000

DO YOU KNOW?

Goodwill based on capitalisation of average profit method and capitalisation of super profit method will give the same amount of goodwill.

Points to remember

- ❖ Goodwill is the good name or reputation of the business which brings benefit to the business.
- ❖ It is an intangible fixed asset. Following are the circumstances that require valuation of goodwill of partnership firms in order to protect the rights of the partners:
- ❖ When the profit sharing ratio is changed, when a new partner is admitted into a firm, when an existing partner retires from the firm or when a partner dies and when a partnership firm is dissolved
- ❖ Goodwill may be classified into acquired goodwill and self-generated goodwill.
- ❖ Following are the methods generally followed to value goodwill:

  Average profits methods, super profit methods and capitalisation method

Self-examination questions

I Multiple choice questions

Choose the correct answer

1. Which of the following statements is true?

(a) Goodwill is an intangible asset (b) Goodwill is a current asset

(c) Goodwill is a fictitious asset (d) Goodwill cannot be acquired

2. Super profit is the difference between

(a) Capital employed and average profit (b) Assets and liabilities

(c) Average profit and normal profit (d) Current year's profit and average profit

3. The average rate of return of similar concerns is considered as

(a) Average profit (b) Normal rate of return

(c) Expected rate of return (d) None of these

4. Which of the following is true?

(a) Super profit = Total profit / number of years

(b) Super profit = Weighted profit / number of years

(c) Super profit = Average profit – Normal profit

(d) Super profit = Average profit × Years of purchase

5. Identify the incorrect pair

(a) Goodwill under Average profit method - Average profit × Number of years of purchase

(b) Goodwill under Super profit method - Super profit × Number of years of purchase

(c) Goodwill under Annuity method - Average profit × Present value annuity factor

(d) Goodwill under Weighted average profit method - Weighted average profit × Number of years of purchase

6. When the average profit is ₹ 25,000 and the normal profit is ₹ 15,000, super profit is

(a) ₹ 25,000 (b) ₹ 5,000

(c) ₹ 10,000 (d) ₹ 15,000

7. Book profit of 2017 is ₹ 35,000; non-recurring income included in the profit is ₹ 1,000 and abnormal loss charged in the year 2017 was ₹ 2,000, then the adjusted profit is

(a) ₹ 36,000 (b) ₹ 35,000

(c) ₹ 38,000 (d) ₹ 34,000

8. The total capitalised value of a business is ₹ 1,00,000; assets are ₹ 1,50,000 and liabilities are ₹ 80,000. The value of goodwill as per the capitalisation method will be

(a) ₹ 40,000 (b) ₹ 70,000

(c) ₹ 1,00,000 (d) ₹ 30,000

Answers

1 (a)	**2(c)**	**3(b)**	**4(c)**	**5 (c)**	**6(c)**	**7(a)**	**8(d)**

II Very short answer questions

1. What is goodwill?
2. What is acquired goodwill?
3. What is super profit?
4 What is normal rate of return?
5 State any two circumstances under which goodwill of a partnership firm is valued.

III Short answer questions

1. State any six factors determining goodwill.
2. How is goodwill calculated under the super profits method?
3. How is the value of goodwill calculated under the capitalisation method?
4. Compute average profit from the following information.

   2016: ₹ 8,000; 2017: ₹ 10,000; 2018: ₹ 9,000

   (Answer: Average profit: ₹ 9,000)

5. Calculate the value of goodwill at 2 years purchase of average profit when average profit is ₹ 15,000.

   (Answer: Goodwill: ₹ 30,000)

IV Exercises

Simple average profit method

1. The following are the profits of a firm in the last five years:

2014: ₹ 10,000; 2015: ₹ 11,000; 2016: ₹ 12,000; 2017: ₹ 13,000 and 2018: ₹ 14,000

Calculate the value of goodwill at 2 years purchase of average profit of five years.

(Answer: Average profit: ₹ 12,000; Goodwill: ₹ 24,000)

2. From the following information, calculate the value of goodwill on the basis of 3 years purchase of average profits of last four years.

Year	Result	Amount ₹
2015	Profit	5,000
2016	Profit	8,000
2017	Loss	3,000
2018	Profit	6,000

(Answer: Average profit: ₹ 4,000 ; Goodwill: ₹ 12,000)

3. From the following information relating to a partnership firm, find out the value of its goodwill based on 3 years purchase of average profits of the last 4 years:

(a) Profits of the years 2015, 2016, 2017 and 2018 are ₹ 10,000, ₹ 12,500, ₹ 12,000 and ₹ 11,500 respectively.

(b) The business was looked after by a partner and his fair remuneration amounts to ₹ 1,500 per year. This amount was not considered in the calculation of the above profits.

(Answer: Average profit: ₹ 10,000; Goodwill: ₹ 30,000)

4. From the following information relating to Sridevi enterprises, calculate the value of goodwill on the basis of 4 years purchase of the average profits of 3 years.

(a) Profits for the years ending 31st December 2016, 2017 and 2018 were ₹ 1,75,000, ₹ 1,50,000 and ₹ 2,00,000 respectively.

(b) A non-recurring income of ₹ 45,000 is included in the profits of the year 2016.

(c) The closing stock of the year 2017 was overvalued by ₹ 30,000.

(Answer: Average profit: ₹ 1,60,000; Goodwill: ₹ 6,40,000)

5. The following particulars are available in respect of the business carried on by a partnership firm:

(i) Profits earned: 2016: ₹ 25,000; 2017: ₹ 23,000 and 2018: ₹ 26,000.

(ii) Profit of 2016 includes a non-recurring income of ₹ 2,500.

(iii) Profit of 2017 is reduced by ₹ 3,500 due to stock destroyed by fire.

(iv) The stock was not insured. But, it is decided to insure the stock in future. The insurance premium is estimated to be ₹ 250 per annum.

You are required to calculate the value of goodwill of the firm on the basis of 2 years purchase of average profits of the last three years.

(Answer: Average profit: ₹ 24,750; Goodwill: ₹ 49,500)

Weighted average profit method

6. Find out the value of goodwill at three years purchase of weighted average profit of last four years.

Year	Profit ₹	Weight
2015	10,000	1
2016	12,000	2
2017	16,000	3
2018	18,000	4

(Answer: Weighted average profit: ₹ 15,400; Goodwill: ₹ 46,200)

Purchase of super profit method

7. From the following details, calculate the value of goodwill at 2 years purchase of super profit:

(a) Total assets of a firm are ₹ 5,00,000

(b) The liabilities of the firm are ₹ 2,00,000

(c) Normal rate of return in this class of business is 12.5 %.

(d) Average profit of the firm is ₹ 60,000.

(Answer: Super profit: ₹ 22,500; Goodwill: ₹ 45,000).

8. A partnership firm earned net profits during the last three years as follows:
2016 : ₹ 20,000; 2017 : ₹ 17,000 and 2018 : ₹ 23,000

The capital investment of the firm throughout the above mentioned period has been ₹ 80,000. Having regard to the risk involved, 15% is considered to be a fair return on capital employed in the business. Calculate the value of goodwill on the basis of 2 years purchase of super profit.

(Answer: Super profit: ₹ 8,000; Goodwill: ₹ 16,000)

Annuity method

9. From the following information, calculate the value of goodwill under annuity method:

(i) Average profit	₹ 14,000
(ii) Normal Profit	₹ 4,000
(iii) Normal rate of return	15%
(iv) Years of purchase of goodwill	5

Present value of ₹ 1 for 5 years at 15% per annum as per the annuity table is 3.352

(Answer: Super profit: ₹ 10,000; Goodwill: ₹ 33,520)

Capitalisation of super profit method

10. Find out the value of goodwill by capitalising super profits:

(a) Normal Rate of Return 10%

(b) Profits for the last four years are ₹ 30,000, ₹ 40,000, ₹ 50,000 and ₹ 45,000.

(c) A non-recurring income of ₹ 3,000 is included in the above mentioned profit of ₹ 30,000.

(d) Average capital employed is ₹ 3,00,000.

(Answer: Average profit: ₹ 40,500; Super profit: ₹ 10,500; Goodwill: ₹ 1,05,000)

Capitalisation method

11. From the following information, find out the value of goodwill by capitalisation method:

(i) Average profit ₹ 20,000

(ii) Normal rate of return 10%

(iii) Capital employed ₹ 1,50,000

**(Answer: Total capitalised value: ₹ 2,00,000;
Goodwill: ₹ 50,000)**

CASE STUDY

Priya, Praveen and Pooja started a partnership business of buying and selling of home appliances. They have a partnership agreement. The shop is located in a prime area where there are many potential customers. The employees are trained well and motivated. The partners have good managerial skills. As a result, the customers' needs are met efficiently. The customers are happy with the after sale service too. In a very short period of time the firm gained popularity and strong customer base.

After two years, the partners decide that the business is worth more than its net assets. So, they value goodwill and want to record it in the books.

Discuss the following:

(1) Identify the factors that are affecting the valuation of goodwill in this business.

(2) Name the methods for the valuation of goodwill.

(3) Do you agree with the partners' decision of recording the goodwill in the books? If you do not agree, explain the reasons with reference to the Accounting Standards..

To explore further

A partnership firm wants to expand, but it needs two more people with managerial skills to run the business competently. Also, the business needs more finance to expand. What can be done in such a situation?

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