

CHAPTER 3

GOODWILL METHODS OF VALUATION OF GOODWILL

SIMPLE AVERAGE PROFIT METHOD	<p>Under this method, the goodwill is valued at the agreed numbers of years of purchase of the average profits of the past years.</p> <p>STEPS OF CALCULATE GOODWILL</p> <p>1. Calculate Adjusted Profits/Normal Business Profit:</p> <p style="padding-left: 40px;">Profit or Loss of the past year</p> <p>ADD : Abnormal losses</p> <p style="padding-left: 40px;">Loss on Sale of Fixed Assets</p> <p style="padding-left: 40px;">Overvaluation of opening stock</p> <p style="padding-left: 40px;">Undervaluation of closing stock</p> <p style="padding-left: 40px;">Non-recurring Expenses</p> <p style="padding-left: 40px;">Capital Expenditure charged as Revenue Expenditure</p> <p>LESS : Abnormal gains</p> <p style="padding-left: 40px;">Profit on sale of Fixed Assets</p> <p style="padding-left: 40px;">Overvaluation of closing stock</p> <p style="padding-left: 40px;">Undervaluation of opening stock</p> <p style="padding-left: 40px;">Non-recurring incomes</p> <p>Partner's remuneration, if it is not deducted</p> <p>Income from Non-trade Investments</p> <p>Any future Expense</p>
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	ADJUSTED/FUTURE MAINTAINABLE PROFIT
	<p>2. AVERAGE PROFIT = $\frac{\text{TOTAL OF ADJUSTED PROFIT}}{\text{No. of YEARS}}$</p> <p>3. GOODWILL = AVERAGE PROFIT X NO. OF YEAR'S OF PURCHASE</p>
SUPER PROF-IT METHOD	<p>Under this method, the goodwill is valued at the agreed number of year's of purchase of the super profits of the firm</p> <p>STEPS TO CALCULATE GOODWILL</p> <p style="text-align: center;">Opening capital employed + closing capital employed</p> <p>1) Average Capital = $\frac{\text{Opening capital employed + closing capital employed}}{2}$</p> <p>2) Calculate average maintainable profit (as above)</p> <p>3) Normal of profit = Average Capital Employed</p> <p style="text-align: right;">$\times \frac{\text{Normal rate of return}}{100}$</p> <p>4) Super Profit = Average maintainable profits - Normal Profits</p> <p>5) GOODWILL = SUPER PROFIT \times NO. OF YEAR'S OF PURCHASE</p> <p><u>Calculation of capital employed</u></p> <ul style="list-style-type: none"> • Assets side Approach • Capital Employed = All Assets (except goodwill, non-trade investments and fictitious assets) - Outside liabilities • Liabilities side Approach

	<p>Capital Employed = Capital + Reserves - Goodwill (if exists in books)- Fictitious Asset - Non- trade investments</p>
CAPITALISATION OF AVERAGE PROFITS	<p>Under this method, the value of goodwill is calculated by deducting the actual capital employed from the capitalization value of the average profits on the basis of the normal rate of return</p> <p>STEPS TO CALCULATE GOODWILL</p> <ol style="list-style-type: none"> 1. Calculate Average Normal Profit 2. Capitalised value of the Business = $\frac{\text{Average profit} \times 100}{\text{Normal rate of return}}$ 3. Capital Employed = All Assets (except goodwill, non-trade investment and fictitious assets) - Outside liabilities 4. GOODWILL = Capitalised value of the Business - Net Assets
CAPITALISATION OF SUPER PROFITS	<p>Under this method, Goodwill is calculated by capitalizing the super profits</p> <p>STEPS TO CALCULATE GOODWILL</p> <ol style="list-style-type: none"> 1. Capital Employed = All Assets (except goodwill, non-trade investments and fictitious assets) - Outside Liabilities 2. Normal Profit = Capital Employed $\times \frac{\text{Normal rate of return}}{100}$ 3. Capital average maintainable profit (as above) 4. Super Profit = Average maintainable profits - Normal Profits 5. GOODWILL = $\frac{\text{Super Profit}}{\text{Normal rate of return}} \times 100$

Simple Average Profit Method

Illustration 1.

Shweta purchased a business on 1st April 2019. It was agreed to value goodwill at three years purchase of average normal profits of last 4 years. The Profits are as follows.

<u>Year Ended</u>	Profit (₹)
31st March 2016	(₹) 90,000
31st March 2017	(₹)1,60,000
31st March 2018	(₹)1,80,000
31st March 2019	(₹)2,20,000

Following facts are noticed—

1. During the year. ended 31/march/2016, an asset was sold at a profit of ₹ 10,000
2. During the year ended 31/March/2017, firm had incurred a abnormal loss of ₹ 20,000
3. Repairs to car amounting to ₹ 50,000 was wrongly debited to vehicles on 1st May 2017. Depreciation charged on vehicles @ 10 % on straight line Method
4. Firm had abnormal gain of ₹ 10,000 during the year. ended 31 March 2019
5. During the year ended 31 March 2019, a machine got destroyed in accident & ₹ 30,000 was written off as loss in Profit & Loss Account.

Calculate the value of goodwill

Solution

CALCULATION OF NORMAL PROFIT

Yr Ended	PROFIT	ADJUSTMENT (°)	NORMAL PROFIT (°)
31/Mar/2016	90,000	(10000) Profit on sale of Asset	80,000
31/Mar/2017	1,60,000	(20,000) Abnormal loss	1, 80,000
31/Mar/2018	1,80,000	(45,000) In note (i) & (ii)	1, 35,000
31/Mar/2019	2,20,000	(5000) Depreciation (10,000) Abnormal loss 30,000 Loss on sale of asset	245,000
			6, 40,000

$$\text{Average Profit} = \frac{\text{Total Normal Profit}}{\text{No. of years}} = ₹ \frac{640\,000}{4} = ₹ 1,60,000$$

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

$$= 1,60,000 \times 3 = ₹ 4,80,000$$

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i). Repaire Exp. tha should have been debited to P & L A/c as expense but accounted as capital expenditure ₹ (50,000)

Hence, Loss rises by ₹ 50,000

(ii) Depreciation wrongly debited to P & L A/c for the year ended 31/Mar/2018 ₹ (5,000)

Adjustment for year ended 31/march/2018 ₹ (45,000)

(iii) Adjutstment of depreciation for year ended 31/March/2019 (10 % 50,000) = ` (5,000)

Weightened Averarge Profit Mehtod

Illustration 2. Sunil & Anil are partners sharing profit in the ratio 3:2. They admit Deepak into partnership. It was agreed to value goodwill at three years purchase on the basis of average profit of the past five years.

The Profits for these 5 years were-

<u>Year Ended</u>	Profit (₹)
31st March 2015	1,80,000
31st March 2016	1,60,000
31st March 2017	2, 50,000
31st March 2018	3,00,000
31st March 2019	3,50,000

Following additional Information is given

(i) An abnormal gain of ₹ 20,000 was earned in the year eded 31st March 2016

(ii) Expenses of ₹ 50,000 incurred to overhaul a machine on 1st, April 2017 was debited to P&L A/ instead of being debited to Machinery Account. Depreciation is charged on machinery @ 20 % on written Down value Method.

(iii) The closing stock for the year ended 31st March, 2018 was under valued by ₹ 20,000

(iv) To Cover management cost an annual charge of ` 9600 should be made for the purpose of goodwill valuation.

Calculate the value of goodwill

Solution

CALCULATION OF ADJUSTED PROFIT

Particulars	31st March 2015 (₹)	31st March 2016 (₹)	31st March 2017 (₹)	31st March 2018 (₹)	31st March 2019 (₹)
Given Profits Less Abnormal Gain	<u>1,80,000</u>	<u>1,60,000</u> <u>(20,000)</u> 1,40,000	<u>2,50,000</u>	<u>3,00,000</u>	<u>3,50,000</u>
Add Capital Expenditure on Machin- ery	-----	-----	-----	<u>50,000</u>	<u>3,50,000</u>
Less Depre- ciation on Machinery @ 20 % W.D.V	-----	-----	-----	<u>(10,000)</u>	<u>(8,000)</u>
	1,80,000	1,40,000	2,50,000	3,40,000	3,42,000

Particulars	31 March 2015 (₹)	31 March 2016 (₹)	31 March 2017 (₹)	31 March 2018 (₹)	31 March 2019 (₹)
Add Undervaluation of closing stock	1,80,000	1,40,000	2,50,000	3,40,000	3,42,000
	-	-	-	20,000	-
Less undervaluation of opening stock	1,80,000	1,40,000	2,50,000	3,60,000	3,42,000
					(20,000)
	1,80,000	1,40,000	2,50,000	3,60,000	3,22,000

Calculation of Goodwill

$$\text{Average Profit} = \frac{\text{Total Normal Profit}}{\text{No. of years}}$$

$$= \frac{1,80,000 + 1,40,000 + 2,50,000 + 3,60,000 + 3,22,000}{5}$$

$$= \frac{12,52,000}{5} \quad \text{₹. 2,50,400/-}$$

$$\text{Value of Goodwill} = \text{Average Profit} \times \text{No. of years Purchase}$$

$$= ₹ 250,400 \times 3$$

$$= ₹ 7,51,200$$

Super Profit Method

Illustration (3) 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. Calculate the value of goodwill on the basis of two years purchase of super profits.

Solution

$$\begin{aligned} \text{Average Profit} &= \text{Average net Profit} - \text{Partner's Remuneration} \\ \text{(Adjusted)} & \end{aligned}$$

$$₹ 68000 - ₹ 8000$$

$$= ₹ 60,000$$

$$\begin{aligned} \text{Normal Profit} &= \frac{\text{Capital Employed} \times \text{Normal Rate of Return}}{100} \end{aligned}$$

$$₹ 3,50,000 * \frac{₹ 12}{100}$$

$$= ₹ 42,000$$

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

$$₹ 60,000 - ₹ 42,000 = ₹ 18,000$$

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

$$= ₹ 18,000 \times 2 = ₹ 36,000$$

Illustration 4. Average profit earned by a firm is ₹ 75,000 which includes undervaluation of stock of ₹ 5,000 on average basis. The capital invested in the business is ₹ 8,00,000 & the normal rate of return is 8 %. Calculate goodwill of the firm on the basis of 5 times the Super Profit.

Solution

$$\text{Adj. Average Profit} = \text{Average Profit} + \text{Undervaluation of stock}$$

$$₹ 75000 + ₹ 5000$$

$$= ₹ 80,000$$

$$\text{Normal Profit} = \frac{\text{Capital Employed} \times \text{Normal Rate of Return}}{100}$$

$$₹ 800,000 \times \frac{8}{100}$$

$$= 64,000$$

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

$$= ₹ 80,000 \times 2 - ₹ 64,000$$

$$= ₹ 16000$$

$$\text{Goodwill} = ₹ 16000 \times 5 = ₹ 80,000$$

Capitalisation of Average Profit Method

Illustration 5.

Bharat and Bhusan are partners in a retail business. Balances in Capital & Current Accounts as on 31st March 2019 were

	Capital Account	Current Account
Bharat	₹ 400 000	₹ 1000 000
Bhusan	₹ 480 000	₹ 20, 000 (Dr)

The firm earned an average profit of ₹ 97000. If the normal rate of return is 8%, find the value of goodwill

Solution

$$\begin{aligned}\text{Capital Employed} &= ₹ 400,000 + ₹ 4,80,000 + ₹ 10,00,000 - ₹ 20,000 \\ &= ₹ 9,60,000\end{aligned}$$

$$\begin{aligned}\text{Capitalised value of the Business} &= \frac{\text{Average Profit}}{\text{Normal Rate of Return}} \times 100 \\ ₹ 97,000 \times \frac{100}{8} &= ₹ 12,12,500\end{aligned}$$

$$\begin{aligned}\text{Goodwill} &= ₹ 12,12,500 - ₹ 9,60,000 \\ &= ₹ 2,52,500\end{aligned}$$

Capitalisation of Super Profit Method

Illustration 6. Average Profit of the firm is ₹ 1,50,000. Total tangible assets in the firm are ₹ 12,00,000 & outside liabilities are ₹ 7,00,000. In the same type of business, the normal rate of return is 20%. Calculate the value of goodwill of the firm by Capitalisation of Super Profit method if the goodwill is valued at 2 years. Purchase of Super Profit.

Solution

$$\begin{aligned}\text{Normal Profit} &= \text{Capital Employed} \times \frac{\text{Normal Rate of Return}}{100} \\ &= ₹ 5,00,000 \times \frac{20}{100} \\ &= ₹ 1,00,000 \\ \text{Capital Employed} &= \text{Total tangible Assets} - \text{Outside liabilities} \\ &= ₹ 12,00,000 - ₹ 7,00,000 \\ &= ₹ 5,00,000\end{aligned}$$

$$\text{Average Profit} = ₹ 1, 50,000 \text{ (given)}$$

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

$$= ₹ 1, 50, 000 - ₹ 1,00, 000$$

$$= ₹ 50,000$$

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

$$= ₹ \frac{50, 000}{20} \times 100$$

$$= ₹ \underline{2, 50, 000}$$

Practice Exercise

Ques.1. On 1st April 2018, a firm had assets of ₹ 3,00,000 including Cash of ₹ 5,000. The Partner's Capital A/c showed a balance of ₹ 2, 00, 000 & the Reserve Constituted the rest. If the normal rate of return of is 10 % & the goodwill of the firm is valued at ₹ 200,000 at four years purchase of Super Profit. Find the average Profit of the firm.

[Hint:- Average Profit = Super Profit + Normal Profit]

Ques.2. Balance Sheet of M/s Laxmi Stores as at 31/3/2019 was as follows.

Liabilities	₹	Assets	₹
Capital A/cs		Land & Building	400,000
A 1,50,000		Computers	70,000
B 1,50,000		Furniture	30,000
C 1,50,000	4,50,000	Investments	1,00,000
Reserves	2,50,000	Stock	2,00,000
		Sundry Debtors	1,50,000
Sundry Creditors	3,00,000	Bill Receivable	50,000
Outstanding Ex- penses	10,000	Cash in Hand	50,000
	90,000	Advertisement	50,000
bank Overdraft		Suspense	
	11,00,000		11,00,000

Average Profit was ₹ 125000. Calculate goodwill at 3 year's purchase of Super Profit given NRR = 15 % if ---

- Investment is treated as Trade Investment
- Investment is taken as Non- Trade Investment

[Hint;- Non Trade Investment are deducted to calculate Capital Employed]

Ques.3. Calculate value of goodwill of the firm -

- At 3 years purchase of Average Profit
- At 3 year's purchase of Super Profit
- On the basis of Capitalisation of Super Profit
- On the basis of Capitalisation of Average Profit

Following Information is given -

(i) Average capital Employed is ₹ 6,00,000

(ii) Net Profit/(Loss) of the firm for the last 3 years ender are

31st March 2019	₹ 2,00,000
31st March 2018	₹ 1, 80, 000
31st March 2017	₹ 1,60,000

iii) Normal Rate of return in similar business is 10 %

(iv) Remuneration of ₹ 1,00,000 to partners is to be taken as charge against profit

(v) Assets of the firm (excluding goodwill) fictitious assets and Non-trade investments) is ₹ 7,00,000 whereas Partner's Capital is ₹ 6,00,000 & outside liabilities ₹ 1,00,000.

Ques.4. The Capital Employed in a firm is ₹ 10,00,000 & the market rate of interest is 15 %. Annual Salary of the partners is ₹ 80,000. the profit of the last 3 years were ₹ 3,00,000. ₹ 4,00,000 & ₹ 5,00,000 respectively. Calculate value of goodwill on the basis of 2 years purchase of average super profit of last 3 years.

Ques.5. Average profit earned be a firm is ₹ 2,50,00 which includes overvaluation of stock of ₹ 10,000 on an average basis. Capital invested in the business is ₹ 14,00,000 & the normal rate of return is 15 %. Calculate goodwill of the firm on the basis of 4 times the Super Profit.

Ques.6. On April 1, 2018, a firm has assets of ₹ 1,00,000 excluding stock of ₹ 20,000 . The current liabilities were ₹ 10,000 and the balance constituted partner's capital Accounts. If the normal rate of return is 8 %, the Goodwill of the firm is valued at ₹ 60,000 at four years purchase of super profit, find the actual profits of the firm.

Sol. Total Assets = ₹ 1,20,000

Capital Employed = Total Assets - Current Liabilities

$$= 1, 20,000- 10,000$$

$$= ₹ 1,10,000$$

Normal Profits = 8 % of 1, 10,000

= ₹ 8,800

Goodwill = Super Profits X No. of Years Purchase

Super Profits = Actual Average Profits - Normal Profits

Given Goodwill = ₹ 60, 000

60,000 = 4 (Average Actual Profits - Normal Profits)

15000 = Average Actual Profits - 8,000

Average Actual Profits = 15, 000 + 8,800 = ₹ 23, 800