12 Accountancy: Goodwill: Nature and Valuation-Notes VL

Goodwill is good name or the reputation of the business, which is earned by a firm through the hard work and honesty of its owners. If a firm renders good service to the customers, the customers who feel satisfied will come again and again and the firm will be able to earn more profits in future. Thus, goodwill is the value of the reputation of a firm which enables it to earn higher profits in comparison to the normal profits earned by other firms in the same trade.

Features of Goodwill

1. It is an intangible asset: Goodwill cannot be seen or touched. It does not have any physical existence. Thus, it belongs to the category of intangible assets such as patents, trademarks, copy rights, etc.
2. It does not have an existence separate from that of an enterprise: Goodwill of an enterprise entirely depends on the enterprise and the situation of its profits. Thus, normally it has realisable value when business is sold.
3. It is helpful in earning higher profits.
4. It is an attractive force: It is an attractive force as it brings in customers regularly to the place of business.
5. It comes into existence due to various factors: The factors affecting the value of a firm's goodwill may be locational advantages, favourable contracts, brands, trademarks, copyrights, market reputation, etc.
6. It is difficult to place an exact value on goodwill: This is because its value may fluctuate from time to time due to changing circumstances which are internet and external to business. Moreover, the value of goodwill is subjective as it depends on the assessment of the valuer.
7. Its value is liable to constant fluctuations: While goodwill does not depreciate, its value is liable to constant fluctuation, its value is liable to constant fluctuations. It is always present as a silent asset in a business where there are super profits (i.e. More than the normal) but declines in value with the decline in earnings.

Factors Affecting the Value of Goodwill

1. Efficient management: If the business is run by experienced and efficient management, its profits will go on increasing, which results in increase in the value of goodwill.
2. Quality of products: If the firm is supplying good quality of products, then the customer will come again and again for the same and thus will create the goodwill and brand name for the same.
3. Location of business: If the business is located at a convenient or prominent place, it will attract more customers and therefore will have more goodwill.
4. The Longevity of the business: An older business is better known to its customers; therefore, it is likely to have more goodwill. When a business enterprise has built up good reputation over a period of time, the number of customers will be more in comparison to the customers of new entrants. Number of customers is an indicator of profit earning capacity of a business.
5. Monopolistic and other Rights: If a business enjoys monopoly market, it will have assured profits. Similarly, if it holds some special rights such as patents, trademarks, copyrights or concessions, etc, it will have more goodwill.
6. Other factors:
(i) Good industrial relations.
(ii) Favourable Government regulations
(iii) Stable political conditions
(iv) Research and development efforts
(v) Effective advertising to establish brand popularity
(vi) Popularity of product in terms of quality.

Need for Valuing Goodwill: Whenever the mutual rights of the partners change the party which makes a sacrifice must be compensated. This basis of compensation is goodwill so we need to calculate goodwill. Mutual rights of partners change under following circumstances:
1. When profit sharing ratio changes.
2. On admission of a partner.
3. On Retirement or death of a partner.
4. When amalgamation of two firms taken place.
5. When partnership firm is sold.
6. When a partnership firm is converted into a company.

Classification of Goodwill:

I. Purchased Goodwill: Purchased goodwill means goodwill for which a consideration has been paid e.g. when business is purchased the excess of purchase consideration of its net assets i.e. Assets – Liabilities is known as Purchased Goodwill. It is separately recorded in the books because as it is purchased by payment in cash or kind.

Characteristics:
(i) It arises on purchase of a business or brand.
(ii) Consideration is paid for it. So, it is recorded in books.
(iii) Shown in Balance Sheet as on asset.
(iv) It is amortised (depreciated) at the earliest but not later than its estimated useful life.
(v) Value is a subjective judgment & ascertained by agreement of seller & purchaser. It is approximate value and cannot be sold separately in the market or in parts.

II. Self-generated Goodwill: It is also called as inherent goodwill. It is an internally generated goodwill which arises from a number of factors that a running business possesses due to which it is able to earn more profits in the future.

Characteristics:
(i) It is generated internally over the years.
(ii) A true cost cannot be placed on this type of goodwill.
(iii) Value depends on subjective judgment of the value.
(**iv) As per Accounting Standard 26 (Intangible Asset)**, it is not recorded in the books of accounts because consideration in money or money's worth has not be paid for it.

Methods of valuation of goodwill:

It is very difficult to assess the value of goodwill, as it is an intangible asset. In case of sale of a business, its value depends on the mutual agreement between the seller and the purchaser of the business. Usually, there are three methods of valuing goodwill:
A) Average profit method
B) Super profit method
C) Capitalization method
The above methods of Goodwill valuation are explained as followed:

A) Average Profit Method

(i) Simple Average Profit Method: This is a very simple and widely followed method of valuation of goodwill. In this method, goodwill is calculated on the basis of the number of past years. Average of such profits is multiplied by the agreed number of years (such as two or three) to find out the value of goodwill. Formula for calculation of goodwill is as follows:
Goodwill = Average Profits x Number of years' purchase

Number of years' of purchase means for how many years the firm will earn the same amount of profits in future.

Average Profits = Total Profits/Number of years

A buyer always wants to estimate the future profits of a business. Future profits depend upon the average performance of the business in the past. Past profits indicate as to what profits are likely to accrue in the future. Therefore, the past profits are averaged. But before calculating the average profits, the profits earned in the past must be adjusted in the light of future expectations and the following factors should be taken into account while calculating the average profits:

(i) Abnormal income of a year should be deducted out of the net profit of that year.

(ii) Abnormal loss of a year should be added back to the net profit of that year.

(iii) Income from investments should be deducted out of the net profits of that year, because this income is received from outside the business.

(ii) Weighted Average Profit Method: This method is a modified version of average profit method. In this Method each year's profit is assigned a weight. Mostly, the highest weight is attached to profit of most recent year. For example, weights assigned to the years 2011, 2012, 2013 and 2014 may be 1, 2,3 and 4.

Each year profits are multiplied by assigned weights. Products are added & divided by total number of weights. Weighted average is multiplied by agreed Number of years of Purchase.

Weighted Average Profit: = $\frac{\text{Total Product of Profits}}{\text{Total Weights}}$

Goodwill = Weighted Average Profit x No. of years' of purchase.

Weighted average profit method is considered better than the simple average profit method because it assigns more weightage to the profits of the latest year which is more likely to be earned in future. This method is preferred when profits over the past years have been continuously rising or falling.

B) Super profit Method: In this method goodwill is calculated on the basis of surplus (excess) profits earned by a firm in comparison to average profits earned by other firms. If a business has no anticipated excess earnings, it will have no goodwill. Super Profit are the excess of actual profit over normal profits. Normal profits are profits earned by similar business.

If a firm earns higher profit in comparison to normal profit (generally earned by other firms of same industry) then the difference is called Super Profit. Goodwill is calculated on the basis of Super profit due to future expectations of earning capacity of the firm.

Goodwill is calculated by the following formula:

Goodwill = Super Profit x Number of years' of purchase

where, Super Profit = Average profit - Normal profits

and Normal Profit = Investment (Capital Employed) x $\frac{\text{Normal Rate of Return}}{100}$

Capital Employed = Total Capital of all partners + Free Reserves – fictitious Assets (if any),

or

All Assets - (Goodwill, fictitious assets and non-trade Investment) – Outsider's Liabilities

Trade Investments are those investments that are made in another enterprise for the continuance of own business.

Non-Trade Investments are those investments that are made to earn revenue by investing surplus funds and not for the purpose of continuance of own business.

Unless Investments are specified to be Trade Investments, they are taken as Non-Trade Investments.

C) Capitalisation Method: Under this method, goodwill can be calculated in two ways:

(i) Capitalisation of Average Profit Method: Under this method first of all we calculate the average profits and then we assess the capital needed for earning such average profits on the basis of normal rate of return. Such capital is also called capitalised value of average profits.
It is calculated as under.

$$\text{Capitalised value of the firm} = \frac{\text{Average Profits} \times 100}{\text{Normal Rate of Return}}$$

Goodwill is calculated by deducting the actual capital employed in business from the capitalised value of average profits. There will be no goodwill if the actual capital employed in the business exceeds or equals the capitalised value of the average profits.

Net Assets or Capital Employed = Total assets – Outside liabilities
Goodwill = Capitalized value of Average Profits – Capital Employed

(ii) Capitalisation of Super Profit Method: Under this method first of all we calculate the super profits and then we assess the capital needed for earning such super profits on the basis of normal rate of return. Such capital is actually the amount of goodwill. Super profits are calculated in the same manner as calculated in super profits method.

$$\text{Goodwill of the firm} = \frac{\text{Super Profits} \times 100}{\text{Normal rate of return.}}$$

Important Questions

Q1. 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.

Year Ended	(₹)
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 31st March, 2016, an asset was sold at a profit of ₹ 10,000.
2. During the year ended 31st March, 2017, firm had incurred an 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 31st March, 2019.
5. During the year ended 31st March, 2019, a machine got destroyed in accident & ₹ 40,000 was written off as loss in Profit & Loss Account.
Calculate the value of firm's goodwill.

Solution

Calculation of Normal Profit

Year Ended	Profit (₹)	Adjustment (₹)	Normal Profit (₹)
31st March, 2016	90,000	(10000) Profit on sale of Asset	80,000
31st March, 2017	1,60,000	+ 20,000 Abnormal loss	1,80,000
31st March, 2018	1,80,000	(45,000) In note (i) & (ii)	1, 35,000

31st March, 2019	2,20,000	(5000) Depreciation (10,000) Abnormal loss + 40,000 Loss on sale of asset	2,45,000
			6,40,000

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

$= \frac{₹\ 6,40,000}{4}$

Goodwill = Average Profit x No. of years Purchase

= ₹ 1,60,000 × 3 = ₹ 4,80,000

Working Notes:

(i). Repair Expenses that should have been debited to P & L A/c as expense but accounted as capital expenditure ₹ 50,000. Hence, Loss increases by ₹ 50,000.

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

So, adjustment for year ended 31st March, 2018 ₹ (45,000).

(iii) Adjustment of depreciation for year ended 31st March, 2019 (10 % ₹ 50,000) = ₹ (5,000)

Q2. 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-

Year Ended	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 ended 31st March, 2016.

(ii) Expenses of ₹ 50,000 incurred to overhaul a machine on 1st April, 2017 was debited to P&L A/c 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 undervalued by ₹ 20,000.

Calculate the value of goodwill

Solution:

Calculation of Adjusted Profit

Year Ended	Profit (₹)	Adjustment (₹)	Normal Profit (₹)
31st March, 2015	1,80,000	----------	1,80,000
31st March, 2016	1,60,000	(20,000)	1,40,000
31st March, 2017	2,50,000	----------	2,50,000
31st March, 2018	3,00,000	50,000 + (10,000) + 20,000	3,60,000
31st March, 2019	3,50,000	(8,000) + (20,000)	3,22,000

		Total	12,52,000

Calculation of Goodwill:

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

$$= \frac{₹\ (180,\ 000 + 1,40000 + 250,000 + 3,60,000 + 3,22,000)}{5} = ₹\ 2,50,400$$

Value of Goodwill = Average Profit x No. of years' Purchase

Value of Goodwill = ₹ 2,50,400 x 3 = ₹ 7,51,200

Q3. 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 ₹ 8000 for the year. Calculate the value of goodwill on the basis of two years' purchase of super profits.

Solution

Average Adjusted Profit = Average Net Profit - Partner's Remuneration

= ₹ (68,000 – 8,000) = ₹ 60,000

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

$$= ₹\ (3,50,000 \times \frac{12}{100}) = ₹\ 42,000$$

Super Profit = Average Adjusted Profit - Normal Profit

= ₹ (60,000 – 42,000)

= ₹ 18,000

Value of Goodwill = Super Profit x No. of years purchase

= ₹ 18000 x 2 = ₹ 36,000

Q4. Average profit earned by a firm is ₹ 75,000 which includes undervaluation of stock of ₹ 5000 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

Average Adjusted Profit = Average Profit + Undervaluation of Stock

= ₹ 75000 + ₹ 5000 = ₹ 80,000

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

$$= ₹\ (8,00,000 \times \frac{8}{100}) = ₹\ 64,000$$

Super Profit = Adjusted Average Profit - Normal Profit

= ₹ (80,000 – 64,000) = ₹ 16000

Value of Goodwill = ₹ 16000 × 5 = ₹ 80,000

Q5. Bharat and Bhusan are partners in a retail business. Balances in their Capital & Current Accounts as on 31st March, 2019 were as follows:

	Capital Account (₹)	Current Account (₹)
Bharat	4,00,000	4,80,000
Bhusan	1,00,000	20,000 (Dr)

The firm earned an average profit of ₹ 97,000. If the normal rate of return is 8 %, find the value of goodwill.

Solution

Capital Employed = ₹ (400,000 + 4,80, 000 + 10,00,00 - 20,000) = ₹ 9,60,000

Capitalised value of the business = Average Profit x $\frac{100}{\text{Normal Rate of Return}}$

= ₹ 97,000 x $\frac{100}{8}$

= ₹ 12,12,500

Value of Goodwill = ₹ 12,12,500 - ₹ 9,60,000 = ₹ 2,52,500

Q6. 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 year's purchase of Super Profit.

Solution

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

= ₹ 5,00,000 x $\frac{20}{100}$ = ₹ 1,00,000

Capital Employed = Total tangible Assets - Outside liabilities

= ₹ 12,00,000 - ₹ 7,00,000 = ₹ 5,00,000

Average Profit = ₹ 1,50,000 (given)

Super Profit = Average Profit - Normal Profit

= ₹ 1,50, 000 - ₹ 1,00, 000 = ₹ 50, 000

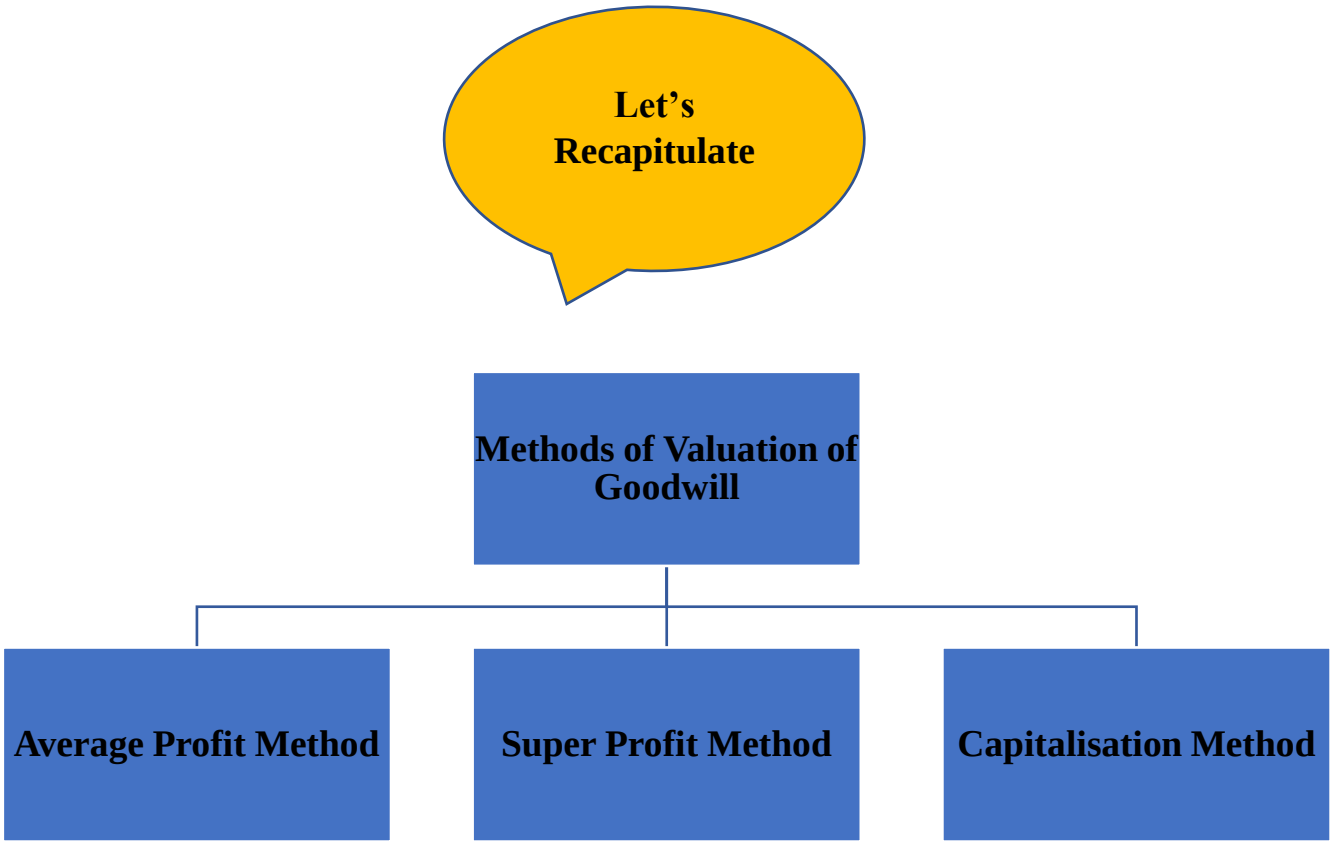
Value of Goodwill = Super Profit x $\frac{100}{\text{Normal Rate of Return}}$

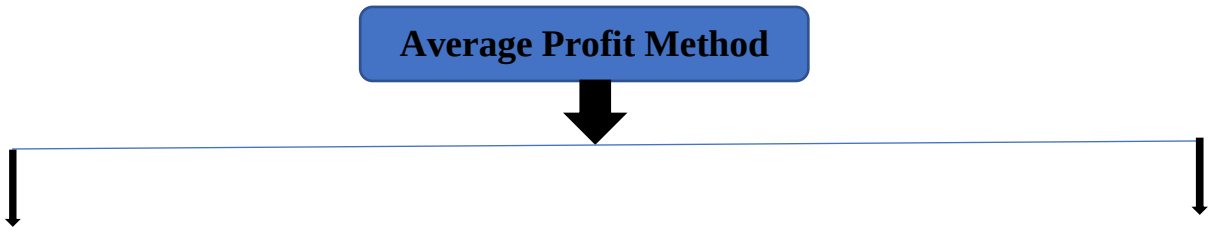
= ₹ (50,000 x $\frac{100}{20}$) = ₹ 2,50,000

Note: Refer to the following links for more explanation:

1) https://youtu.be/u-LLeNWlP6s

2) https://youtu.be/1g FJC8E1E2s



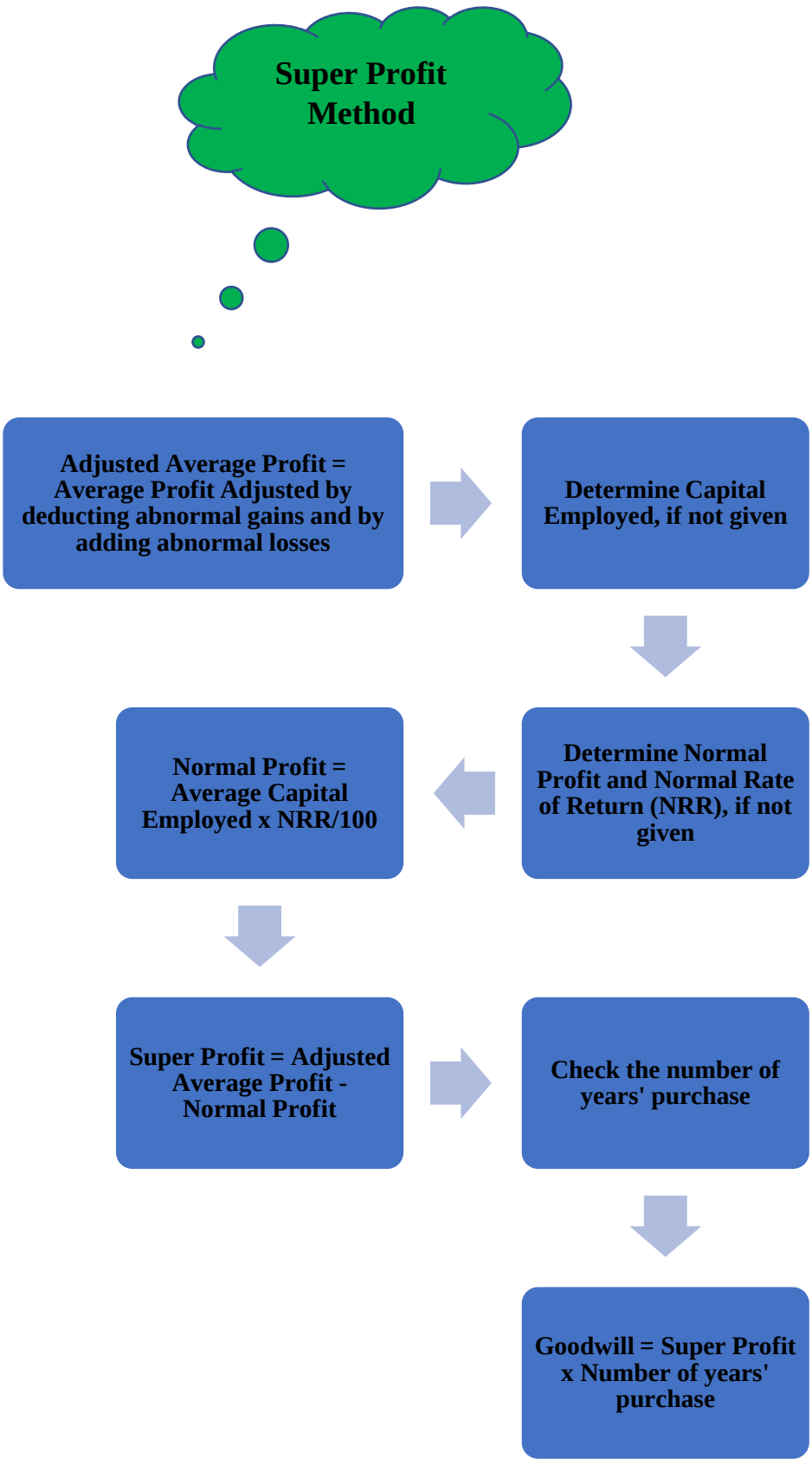


Simple Average Profit Method

1) Determine Normal Profit*
2) Average Profit = Total Normal Profit/ Number of years
3) Check the number of years' purchase
4) Goodwill = Average Profit x Number of years' purchase

Weighted Average Profit Method

1) Determine Normal Profit*
2) Assign weight to each year
3) Determine weighted profit: Normal Profit x Weight assigned
4) Total the weights and total of weighted profit (product)
5) Weighted Average Profit = Total of Weighted Profit (product)/ Total of weights
6) Check the number of years' purchase
7) Goodwill = Weighted Average Profit x Number of years' purchase


Super Profit Method
Adjusted Average Profit = Average Profit Adjusted by deducting abnormal gains and by adding abnormal losses
Determine Capital Employed, if not given
Determine Normal Profit and Normal Rate of Return (NRR), if not given
Normal Profit = Average Capital Employed x NRR/100
Super Profit = Adjusted Average Profit - Normal Profit
Check the number of years' purchase
Goodwill = Super Profit x Number of years' purchase

Capitalisation Method

Capitalisation of Average Normal Profit

- Capitalised Value = Average Normal Profit x 100/ NRR
- Net Assets = All Assets (Other than Goodwill, Non-trade Investments and Fictitious Assets) at their Current Values minus Outsiders' Liabilities
- Goodwill = Capitalised Value - Net Assets

Capitalisation of Super Profit

- Calculate Capital Employed
- Calculate Normal Profit on Capital Employed
- Calculate Average Profit of past years
- Calculate Super Profit, i.e., Actual Average Profit - Normal Profit
- Goodwill = Super Profit x 100/ NRR

***Normal Profit = Adjusted Net Profit by adding abnormal losses and by deducting abnormal gains of past years.**