

Q. Goodwill →

→ According to Lord Macnaghten, "goodwill is the benefit and advantage of good name, reputation and connections of business. It is the attractive force which brings in customers. It is one thing which distinguishes an old established firm from a new business at its first start."

• Nature of Goodwill →

→ Goodwill is a fixed asset but not a tangible asset like building, machinery etc. It is an intangible asset but not a fictitious asset.

• Average profit →

→ If the aggregate of profit or loss of several years is divided by the number of years, it is called average profit.

• Super profit →

→ Super profit is the excess profit earned by firm in comparison to normal profit or average profit earned by other similar firms.

• Normal profit →

→ It is the profit which the firm or other similar firms must earn in routine nature.

Valuation of Goodwill And

14.2.19

Valuation of Shares.

1. Valuation of Goodwill

There are several methods for the valuation of goodwill, the most common are:

(i) Average profit method
Or, Simple Average profit method
(औसत मुनाफा विधि)

(ii) Weighted Average method.
(वजनित औसत मुनाफा विधि)

(iii) Super profit method.
(अति मुनाफा विधि)

(iv) Capitalization method
(धन्यकरण विधि)

a. Capitalization of Average profit method.

b. Capitalization of Super profit method.

(v) Annuity Value method.
(वर्षा मूल्य विधि)

(i) Average Profit Method

सर्व वर्षों का औसत मुनाफा

Rule

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

$$\text{Goodwill} = \text{Average profit} \times \text{Number of years purchase.}$$

Example

From the following information, calculate goodwill under average profit method.

Profit for the last four year are given below
Compute goodwill 3 years purchase method.

Years	Profit
2010	12000
2011	9000
2012	-3000
2013	7000

We know that

$$\text{Average profit} = \frac{12000 + 9000 - 3000 + 7000}{4}$$

$$= 6250$$

$$\begin{aligned}\text{So, Goodwill} &= \text{Average profit} \times \text{Number of years purchase} \\ &= 6250 \times 3 \\ &= 18750\end{aligned}$$

(ii) Weighted Average Method.

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Rule

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

$$\text{Goodwill} = \text{Average profit} \times \text{Number of years purchase}$$

(iii) Super profit Method.

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Rule

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

$$\text{Normal profit} = \text{Average Capital Employed} \times \text{Normal rate of return or, Cost of Capital}$$

$$\text{Goodwill} = \text{Super profit} \times \text{Number of years purchase.}$$

(iv) Capitalization Method

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a. Capitalization of Average profit method

$$\text{Goodwill} = \text{Normal Capital Employed} - \text{Actual Capital Employed}$$
$$\text{Normal Capital Employed} = \frac{\text{Average profit} / \text{Normal profit}}{\text{Normal rate of return}} \times 100$$

VALUATION OF GOODWILL

1. The following particulars are available in respect of the business carried on by Bankay Ltd. :

	₹
(a) Profits earned : 2012-13	50,000
2013-14	48,000
2014-15	62,000
(b) Profit for 2013-14 is reduced by ₹ 5,000 due to stock destroyed by fire and profit of 2012-13 included a non-recurring income of ₹ 4,000.	
(c) Profit for 2014-15 includes ₹ 2,000 income from investment.	
(d) The stock is not insured and it is thought prudent to insure the stock in future. The insurance premium is estimated at ₹ 500 p.a.	
(e) Fair remuneration to the proprietor (not taken in the calculation of profits) is ₹ 10,000 p.a.	

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

2. M Ltd. proposed to purchase the business carried on by N Ltd. Goodwill for this purpose is agreed to be valued at three years' purchase of the weighted average profits of the past four years. The appropriate weights to be used and profits for the years are as under :

Year	Weight	Profit ₹
2011-12	1	1,01,000
2012-13	2	1,24,000
2013-14	3	1,00,000
2014-15	4	1,50,000

The books of account were closed every year on 31st March. On a scrutiny of the accounts, the following matters are revealed :

- (i) On 1st December, 2013, major repairs were carried out in respect of the plant, spending ₹ 30,000 which was charged to revenue. The said sum is agreed to be capitalised for goodwill calculation subject to adjustment of depreciation @ 10% p.a. on reducing balance method.
- (ii) The closing stock on 31st March, 2013 was overvalued by ₹ 12,000.
- (iii) To cover management cost, an annual charge of ₹ 24,000 should be made for the purpose of valuation of goodwill.

Compute the value of goodwill of the business.

[ICSI, Inter.]

1. Calculation of actual profit

Particulars	Years		
	2012-13	2013-2014	2014-2015
Profit given	50,000	48,000	62,000
Add: Stock destroyed by fire	—	5,000	—
Less: Non-recurring income	50,000 4,000	53,000 —	62,000 —
Less: Income from investment	46,000 —	53,000 —	62,000 2,000
Less: Insurance premium	46,000 500	53,000 500	60,000 500
Less: Proprietor's remuneration	45,500 10,000	52,500 10,000	59,500 10,000
Actual Profit	35,500	42,500	49,500

$$\text{Average profit} = \frac{35500 + 42500 + 49500}{3} = 42500$$

$$\text{So, Goodwill under average profit method} = \text{Average profit} \times \text{Number of year purchase}$$

$$= 42500 \times 2$$

$$= 85000$$

2. Calculation of Actual profit

Particulars	Years			
	2011-12	2012-13	2013-14	2014-15
Profit given	101,000	124,000	100,000	150,000
Add: Major repairs plant	—	—	30,000	—
Less: Depreciation	101,000	124,000	130,000	150,000
	—	—	1,000	2,900
Less: Closing stock overvalued	101,000	124,000	129,000	147,100
	—	12,000	—	—
Add: Closing stock overvalued	101,000	112,000	129,000	147,100
	—	—	12,000	—
Less: Management Cost	101,000	112,000	147,000	147,100
	24,000	24,000	24,000	24,000
Actual profit	77,000	88,000	117,000	123,100

$$\text{Average profit (Weighted)} = \frac{(77000 \times 1) + (88000 \times 2) + (117000 \times 3) + (123100 \times 4)}{1 + 2 + 3 + 4}$$

$$= \frac{77000 + 176000 + 351000 + 492400}{10}$$

$$= 109640$$

We know that,

$$\text{Goodwill} = \text{Average (Weighted) profit} \times \text{Number of year purchase}$$

$$= 109640 \times 3$$

$$= 328920$$

12. The average net profit (before making any adjustment for valuation of goodwill) of a firm was ₹ 3,02,000 including ₹ 2,000 as income from investment. The cost of investment (as also its present value) was ₹ 40,000. Probable future reduction in expenditure is ₹ 5,000 p.a. Rate of income tax is 50 paise in the rupee. 10% represents a fair commercial return. The average tangible capital employed was ₹ 13,41,600, but upon valuations obtained, the capital employed was found to be ₹ 14,40,000.

Assess the value of the business taking goodwill at 5 years' purchase of super profits.

13. From the following information, calculate the value of goodwill by : (a) three years' purchase of super profits ; and (b) capitalisation method.

(1) Average capital employed ₹ 6,00,000.

(2) Net profit for the last three years : ₹ 1,48,000 ; ₹ 1,50,000 ; ₹ 1,49,000.

(3) Rate of return expected 20%.

(4) Partners' salary ₹ 10,000 p.a.

(5) Net assets (excluding goodwill) ₹ 6,50,000.

14. From the following information, calculate the value of goodwill by : (a) capitalisation of super profits method and (b) capitalisation of average profits method :

(i) Average capital employed in the business ₹ 7,00,000.

(ii) Net trading profit of the firm for the past three years : ₹ 1,47,600 ; ₹ 1,48,100 ; ₹ 1,52,500.

(iii) Rate of return expected from capital having regard to the risk involved 18%.

(iv) Fair remuneration to the partners for their services ₹ 12,000 per annum.

(v) Sundry assets (excluding goodwill of the firm) ₹ 7,54,762 ; Sundry liabilities ₹ 31,328

15. The net profit of a business after providing for taxation, for the past five years are ₹ 40,000, ₹ 43,000, ₹ 46,000, ₹ 52,000 and ₹ 59,000. The capital employed in the business is ₹ 4,00,000. The normal rate of return expected in this type of business is 10%. It is expected that the company will be able to maintain its super profits for the next 5 years.

Calculate the value of goodwill on the basis of :

(a) Five years' purchase of super profits.

(b) Annuity method, taking the present value of an annuity of ₹ 1 for five years at 10% as 3.78.

(c) Capitalisation of super profits.

[ICSI, Inter. (June) '00 - Adapted]

16. The net profits of a company after providing for taxation for the past five years are ₹ 78,000, ₹ 82,000, ₹ 88,000, ₹ 93,000 and ₹ 99,000. The capital employed in the business is ₹ 8,00,000 on which a reasonable rate of return of 10% is expected. It is expected that the company will be able to maintain the super profits for the next five years.

(a) Calculate the value of goodwill of the business on the basis of an annuity of super profits, taking the present value of an annuity of one rupee for five years at 10% interest as ₹ 3.78.

12. Calculation of Actual Average net profit

Average net profit	30200
Less: Income from Investment	200
Add: Probable future reduction in expenditure	300,000
	500
Less: Income tax $(30500 \times \frac{50}{100})$	30500
	15250
Actual Average net profit	15250

Calculation of Actual Capital employed

Capital employed	1440,000
Less: Cost of Investment	40,000
Actual Capital employed	140,000

$$\begin{aligned}\text{Normal profit} &= \text{Capital employed} \times \text{Normal rate of return} \\ &= 140,000 \times 10\% \\ &= 140,000\end{aligned}$$

$$\begin{aligned}\text{Super profit} &= \text{Average profit} - \text{Normal profit} \\ &= 15250 - 140,000 \\ &= 1250\end{aligned}$$

$$\text{Goodwill} = \text{Super profit} \times \text{number of years purchase}$$

$$= 1250 \times 5$$

$$= 6250$$

14.

$$a. \text{ Average profit} = \frac{147600 + 148100 + 152500}{3} = 149400 - 12000 = 137400$$

$$\text{Normal profit} = \text{Average Capital employed} \times \text{Normal rate of return}$$

$$= 700,000 \times \frac{18}{100} = 126000$$

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

$$= 137400 - 126000$$

$$= 11400$$

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

$$= \frac{11400}{18} \times 100$$

$$= 63,333$$

b. Goodwill = Normal Capital Employed - Actual

$$\text{Normal Capital Employed} = \frac{\text{Average profit}}{\text{Normal rate of return} \times 100}$$

$$= \frac{137400}{18} \times 100$$

$$= 763,333$$

$$\text{Actual Capital Employed} = 754762 - 31328$$

$$= 723434$$

$$\text{Goodwill} = \text{Normal Capital Employed} - \text{Actual Capital Employed}$$

$$= 763,333 - 723,434 = 39,899$$

$$a. \text{Average profit} = \frac{40,000 + 43,000 + 46,000 + 52,000 + 59,000}{5}$$

$$\text{Normal profit} = \text{Average Capital employed} \times \text{Normal rate of return}$$

$$= 4,00,000 \times \frac{10}{100}$$

$$= 40,000$$

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

$$= 48,000 - 40,000$$

$$= 8,000$$

$$\text{So, Goodwill} = 8,000 \times 5$$

$$= 40,000$$

$$b. \text{Goodwill} = \text{Super profit} \times \text{Annuity value}$$

$$= 8,000 \times 3.78$$

$$= 30,240$$

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

$$= \frac{8,000}{10} \times 100$$

$$= 80,000$$

16 Average profit = $\frac{78000 + 82000 + 88000 + 93000 + 99000}{5} = 88000$

Normal profit = $\frac{\text{Average Capital Employed} \times \text{Normal rate of return}}{\text{Normal rate of return} \times 100}$

$\frac{800,000 \times 11}{100} = 88,000$

Super profit = Average profit - Normal profit
 $= 88000 - 80000 = 8000$

a. Goodwill = $8000 \times 3.78 = 30240$

b. Goodwill = Normal Capital Employed - Actual Capital Employed.

Normal Capital Employed = $\frac{\text{Average profit}}{\text{Normal rate of return} \times 100}$

$\frac{88000}{10 \times 100} = 880000$

Goodwill = $880000 - 800000 = 80000$