

Unit 2: TREATMENT OF GOODWILL

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10B

*Whenever you get pains in your life, just think about the full form of pains.
Positive attitude in negative situation.? Follow it, life will change."*

1. Goodwill is the value of reputation of a Firm in respect of profits expected in future over and above the normal rate of profits earned by similar Firms in the same locality.
2. Goodwill is the benefits & advantages of good name, reputation & connections of a business firm. It is that attractive force which brings in customers & enhances the revenues of firm.
3. Extra amount over and above the saleable values of the identifiable assets that could be fetches by selling an existing firm as a going concern.

TYPES OF GOODWILL

A. Purchased Goodwill	B. Self-Generated Goodwill
<ol style="list-style-type: none"> 1. Purchased Goodwill arises when a business is purchased, & the consideration paid therefore is more than the value of assets taken over. 2. Purchased Goodwill = Purchase Consideration Less Net Assets taken over 3. Purchased Goodwill is recorded in books of accounts & is shown in balance sheet. 4. The firm may write off purchased Goodwill over a period of time. 	<ol style="list-style-type: none"> 1. It refers to internally generated goodwill, that arises to the special advantages possessed by the Firm. 2. Internally Generated Goodwill is not recorded in the books of account, since Accounting Standard 26 issued by ICAI specifically provides so.

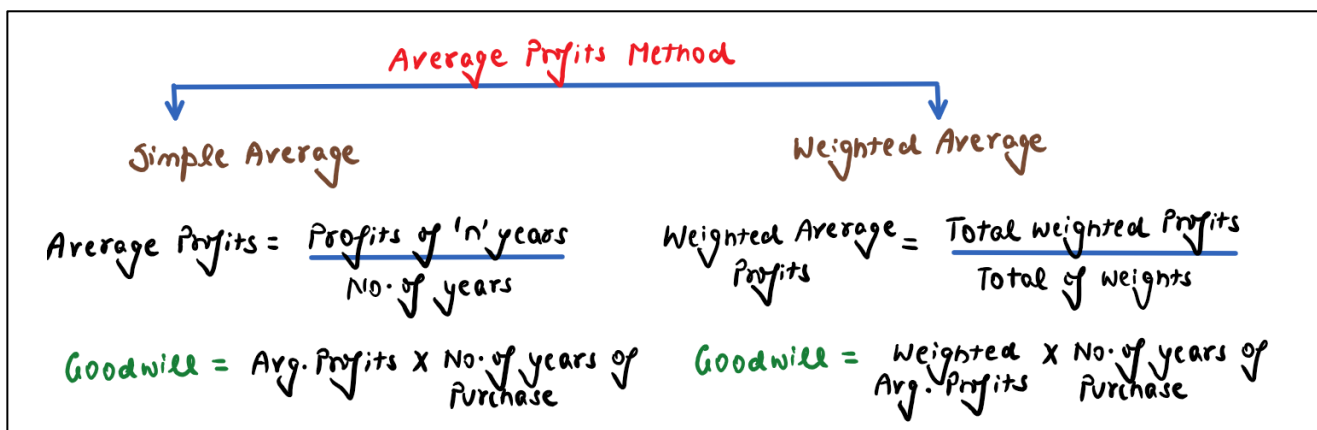
Situations which may involve valuation of Goodwill in case of Firms:

Following are the situations warranting Valuation of Goodwill in case of Partnership Firms-

- ❖ Change in Profit Sharing Ratio amongst the Partners,
- ❖ Admission of a new Partner,
- ❖ Retirement or Death of a Partner

METHODS OF VALUATION OF GOODWILL

METHOD 1: AVERAGE PROFITS METHOD



Computation of Adjusted Profits

Profits	XX
+ Abnormal loss	XX
- Abnormal Gain	(XX)
- Omission of Expense	(XX)
+ Omission of Income	XX
± Rectification of Errors	XX/(XX)
	<u>XX</u>

METHOD 2: SUPER PROFITS METHOD

Super Profits Method

$$\text{Goodwill} = \text{Super Profits (SP)} \times \text{No. of Years of Purchase}$$

$$\text{SP} = \text{Average Profits (AP)} - \text{Normal Profits (NP)}$$

$$\text{NP} = \text{Capital Employed (CE)} \times \text{Rate of Return (rt)}$$

$$\text{CE} = \text{Total Assets} - \text{Outsider Liabilities}$$

(excl. Fictitious assets & Non Trade Investments)

Example:

A firm earned Net Profits during the last three years as follows-

Year	I	II	III
Profit	₹ 24,000	₹ 20,000	₹ 22,000

The capital investment of the Firm is ₹ 60,000. A fair return on the capital having regard to the risk involved is 10%. Compute the value of Goodwill based on three years purchase of the Super Profits for the last three years.

METHOD 3: ANNUITY METHOD

Annuity Method

$$\text{Goodwill} = \text{super profits} \times \text{Annuity Factor (A.F.)}$$

$$A.F. = \sum PVF (r, n)$$

PVF = Present value Factor

r = Rate of Return / Discounted Rate

n = No. of years

Example:

Super Profits = 16,000

What will be the value of Goodwill if future cash flow of next 3 years are discounted at 8% rate?

METHOD 4: CAPITALISATION METHOD

Capitalisation Method

Capitalisation of Average Profits

$$\text{Goodwill} = \text{capitalised value of Business (CVB)} - \text{capital Employed}$$

$$CVB = \frac{\text{Average Profits}}{r}$$

Capitalisation of Super Profits

$$\text{Goodwill} = \frac{\text{super Profits}}{r}$$

Sometimes Question specifies to apply Average Capital Employed

Average Capital Employed = $\frac{\text{Opening Capital Employed} + \text{Closing Capital Employed}}{2}$

TREATMENT OF GOODWILL IN CASE OF CHANGE IN PSR

Accounting Issue involved	Journal Entry
1. Writing off Goodwill existing in books	All Partner's Capital A/c (individually) Dr. (in old ratio) To Goodwill A/c
2. Adjusting Goodwill on change in PSR	Gaining Partner's Capital A/c Dr. (in Gain ratio) To Sacrificing Partners' Capital A/c (in Sacrifice Ratio)

Sacrifice	Gain
Partners whose shares in Profit have deceased as a result of change in PSR, are known as Sacrificing Partners.	Partners whose shares in profits have increased as a result of change in PSR, are known as Gaining Partners
The ratio in which Partners have agreed to reduce their profits in favour of the other Partner(s) is called Sacrifice Ratio or Sacrificing Ratio.	The ratio in which Partners have agreed to gain their profits from the other Partner (s) is called Gain Ratio or Gaining Ratio
Sacrifice Ratio = Old Ratio less New Ratio	Gain Ratio = New Ratio less Old Ratio

Example:

P, Q and R are partners sharing profits and losses in the ratio of 3:2:1. The goodwill of the firm is valued at ₹ 12,000. They have decided to change the profit-sharing ratio to 2:2:1.

Pass Journal Entry for goodwill adjustment.

ASSIGNMENT QUESTIONS

Question 1 _____ Pg no. _____

The past profits of five years of a partnership firm are: ₹ 50,000; ₹ 40,000; ₹ 52,000; ₹ 48,000 and ₹ 56,000 respectively. Calculate the value of goodwill on the basis of 4 years' purchase of the average profits of the last five years.

Question 2 _____ Pg no. _____

A firm of A, B and C has a total capital investment of ₹ 4,50,000. The firm earned net profits during the last four years as: I-₹ 70,000; II-₹ 80,000; III-₹ 1,20,000 and IV- ₹ 1,00,000. The reasonable expected return is 15 per cent having regard to the risk involved. Calculate the value of goodwill based on 3 years' purchase of average super profits of the past four years.

Question 3 _____ Pg no. _____

Calculate the goodwill by annuity method of super profit from the following facts:

- (a) Annual maintainable profit after tax is ₹ 65,000.
- (b) Capital employed is ₹ 4,00,000.
- (c) Normal rate of return is expected at 12% p.a.
- (d) Present value of an annuity of ₹ 1 for five years @ 12% interest is 3.604776.

Question 4 _____ Pg no. _____

The net tangible assets of a firm are worth ₹ 4,10,000 and the average profit of last four years amounts to ₹ 60,000. Find out the value of goodwill under capitalization method if the reasonable return on capital invested is 12%.

Question 5 (ICAI Study Material) _____ Pg no. _____

Lee and Lawson are in equal partnership. They agreed to take Hicks as 1/4th partner. For this it was decided to find out the value of goodwill. M/s Lee & Lawson earned profits during 2020-2023 as follows:

Year	Profit	Year	Profit
2020	1,20,000	2022	1,30,000
2021	1,25,000	2023	1,50,000

On 31.12.2023 capital employed by M/s Lee and Lawson was ₹ 5,00,000. Rate of normal profit is 20%. Find out the value of goodwill following various methods. (Consider 3 years purchase)

Question 6 (RTP Nov 2018) / (Nov 2019) / (Nov 2021) / (Nov 2023) (Similar) _____ Pg no. _____

Vasudevan, Sunderarajan and Agrawal are in partnership sharing profit and losses at the ratio of 2:5:3. The Balance Sheet of the partnership as on 31.12.2021 was as follows:

Balance Sheet of M/s Vasudevan, Sunderarajan & Agrawal

Liabilities	₹	Assets	₹
Capital A/cs		Sundry fixed assets	5,00,000
Vasudevan	85,000	Stock	1,00,000
Sunderarajan	3,15,000	Debtors	50,000
Agrawal	2,25,000	Bank	5,000
Sundry Creditors	30,000		
	6,55,000		6,55,000

The partnership earned profit ₹ 2,00,000 in 2021 & the partners withdrew ₹ 1,50,000 during the year. Normal rate of return 30%. Find out the value of goodwill on the basis of 5 years' purchase of super profit. Calculate super profit using average capital employed

Question 7 *(ICAI Study Material)* Pg no. _____

The following particulars are available in respect of the business carried on by Rathore

1.	Capital Invested	1,50,000
2.	Trading Results:	2020
		Profit 40,000
		2021
		Profit 36,000
		2022
		Loss 6,000
		2023
		Profit 50,000
3.	Market Rate of interest on investment	10%
4.	Rate of risk return on capital invested in business	2%
5.	Remuneration from alternative employment of the proprietor (if not engaged in business).	₹ 6,000 per annum

You are required to compute the value of goodwill on the basis of 5 years' purchase of super profit of the business calculated on the average profits of the last four years.

Question 8 *(ICAI Study Material)* Pg no. _____

A, B and C are in partnership sharing profits and losses in the ratio of 4:3:3. They decided to change the profit sharing ratio to 7:7:6. Goodwill of the firm is valued at ₹ 20,000. Calculate the sacrifice/gain by the partners and make the necessary journal entry.

Question 9 *(ICAI Study Material)* Pg no. _____

A, B, C and D are in partnership sharing profits and losses equally. They mutually agreed to change the profit sharing ratio to 3:3:2:2. Goodwill of the firm is valued at ₹ 20,000. Pass necessary journal entry.

Question 10 *(ICAI Study Material)* Pg no. _____

Wise, Clever and Dull were trading in partnership sharing profits and losses 4:3:3 respectively. The accounts of the firm are made up to 31st December every year.

The partnership provided, inter alia, that:

On the death of a partner the goodwill was to be valued at three years' purchase of average profits of the three years upto the date of the death after deducting interest @ 8 per cent on capital employed and a fair remuneration of each partner. The profits are assumed to be earned evenly throughout the year.

On 30th June, 2023, Wise died and it was agreed on his death to adjust goodwill in the capital accounts without showing any amount of goodwill in the Balance Sheet. It was agreed for the purpose of valuation of goodwill that the fair remuneration for work done by each partner would be ₹ 15,000 per annum and that the capital employed would be ₹ 1,56,000. Clever and Dull were to continue the partnership, sharing profits and losses equally after the death of Wise.

The following were the amounts of profits of earlier years before charging interest on capital employed.

Year	Profit
2020	67,200
2021	75,600
2022	72,000
2023	62,400

Compute the value of goodwill and show the adjustment thereof in the books of the firm.

PRACTICE QUESTIONS

MULTIPLE CHOICE QUESTIONS

- 1) Goodwill brought in by incoming partner in cash for joining in a partnership firm is taken away by the old partners in their.....ratio.
 - (a) Capital.
 - (b) New Profit Sharing.
 - (c) Sacrificing.
- 2) A & B are partners sharing profits and losses in the ratio 5:3. On admission, C brings ₹70,000 cash and ₹48,000 against goodwill. New profit sharing ratio between A, B and C are 7:5:4. Find the sacrificing ratio of A:B.
 - (a) 3:1.
 - (b) 4:7.
 - (c) 5:4.
- 3) Following are the factors affecting goodwill except:
 - (a) Nature of business.
 - (b) Efficiency of management.
 - (c) Location of the customers.
- 4) Weighted average method of calculating goodwill should be followed when:
 - (a) Profits has increasing trend.
 - (b) Profits has decreasing trend.
 - (c) Either 'a' or 'b'.
- 5) In the absence of any provision in the partnership agreement, profits and losses are shared
 - (a) In the ratio of capitals.
 - (b) Equally.
 - (c) In the ratio of loans given by them to the partnership firm
- 6) The profits and losses for the last 4 years are 2018-19 Losses ₹ 10,000; 2019-20 Losses ₹ 2,500; 2020-21 Profits ₹ 98,000 & 2021-22 Profits ₹ 76,000. The average capital employed in the business is ₹ 2,00,000. The rate of interest expected from capital invested is 12%. The remuneration of partners is estimated to be ₹ 1,000 per month not charged in the above losses/ profits. Calculate the value of goodwill on the basis of two years purchase of super profits based on the average of four years.
 - (a) ₹ 9,000.
 - (b) ₹ 8,750.
 - (c) ₹ 8,250.
- 7) A, B and C are partners sharing profits and losses in the ratio 3:2:1. They decide to change their profit sharing ratio to 2:2:1. To give effect to this new profit sharing ratio they decide to value the goodwill at ₹ 30,000. Pass the necessary journal entry if Goodwill not appearing in the old balance sheet and should not appear in the new balance sheet.
 - (a) B's Capital Account Dr. ₹ 2,000
 C's Capital Account Dr. ₹ 1,000
 To A's Capital Account ₹ 3,000
 - (b) Goodwill Account Dr. ₹ 30,000
 To A's Capital Account ₹ 15,000
 To B's Capital Account ₹ 10,000
 To C's Capital Account ₹ 5,000

- (c) A's Capital Account Dr. ₹ 12,000
 B's Capital Account Dr. ₹ 12,000
 C's Capital Account Dr. ₹ 6,000
 To Goodwill Account ₹ 30,000

- 8) Firm has earned exceptionally high profits from a contract which will not be renewed. In such a case the profit from this contract will not be included in
- Profit sharing of the partners.
 - Calculation of the goodwill.
 - Both.

ANSWERS MCQs

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

TRUE / FALSE

State with reasons, whether the following statements are true or false:

- Goodwill is intangible asset therefore it cannot be valued.
- Goodwill is valued whenever there is change in profit sharing ratio among the partners.
- Goodwill is the value of reputation of a firm in respect of profits expected in future over and above the normal rate of profits
- At the time of admission or retirement of a partner, goodwill can be raised in the books of accounts and shown as an asset.
- Only simple average method can be used for valuation of goodwill.
- Super profit means excess of actual average profit over normal profit.
- Normal profit means profit earned by similar companies in the same industry.
- Normal profit depends upon Normal Rate of Return and past profits.
- At the time of admission/retirement of a partner, since goodwill cannot be raised in the books of accounts is recorded through capital accounts of the partners.
- At the time of admission of a partner, goodwill brought in by the new partner is shared equally by old partners.

Solution

- False: Even though Goodwill is intangible asset it can be valued in terms of money.
- True: Goodwill has to be valued every time whenever there is a reconstitution.
- True: Goodwill is the brand image the firm has in the market due to which it enjoys an advantageous position over the other players in the market.
- False: At the time of admission or retirement of a partner, goodwill should not be raised in the books of account of partnership firm because no consideration in money or money worth has been paid for it.
- False: Weighted average profit method, capitalisation method, super profits methods also can be used for valuation of Goodwill.
- True: Super profit means excess profit that can be earned by the firm over and above the normal profit usually earned by similar firms under similar circumstances.
- True: The rate of return is considered as an average for the industry, which is applied to the capital employed in the concerned firm.
- False: Normal profit depends upon Normal rate of return only and not on past profits.
- True: Generally, the goodwill at the time of admission is adjusted through the capital accounts and not shown in the books of the firm.
- False: Goodwill brought in by new partner is shared by old partners in sacrificing ratio and not equally

HOMEWORK QUESTIONS

Question 1 _____ Pg no. _____

Shiv and Mohan are partners in a firm sharing profits and losses equally. On 31st March, 2023, the balances of their capital accounts were ₹ 3,00,000 and ₹ 2,00,000 respectively. The average profits of the firm are ₹ 1,36,000 and the rate of normal profit is 20%. On 1st April, 2023 they agreed to admit Hari as a partner for one fourth share. Hari will bring ₹ 1,00,000 as capital. Compute value of the goodwill of firm on admission of Hari, if it is to be calculated on the basis of:

- a) 5 years purchase of super profit b) Capitalization method
 c) 3 years purchase of average profit.

Question 2 (RTP Nov 2019) / (May 2020) / (Nov 2020) / (May 2022) / (Nov 2022) (Similar) _____ Pg no. _____

J and K are partners in a firm. Their capital are J ₹ 3,00,000 and K ₹ 2,00,000. During the year ended 31st March, 2021 the firm earned a profit of ₹ 1,50,000. Assuming that the normal rate of return is 20%, calculate the value of goodwill on the firm:

- (i) By Capitalization Method; and
 (ii) By Super Profit Method if the goodwill is valued at 2 years' purchase of Super Profit.

Question 3 (RTP May 2023) / (RTP May 2021) / (RTP May 2019) (Similar) _____ Pg no. _____

The profits and losses for the previous years are: 2019 Profit ₹ 15,000, 2020 Loss ₹ 25,500, 2021 Profit ₹ 75,000, 2022 Profit ₹ 1,12,500. The average Capital employed in the business is ₹ 3,00,000. The rate of interest expected from capital invested is 10%. The remuneration from alternative employment of the proprietor is ₹ 9,000 p.a. Calculate the value of goodwill on the basis of 3 years' purchases of Super Profits based on the average of 4 years.

Question 4 (ICAI Study Material) _____ Pg no. _____

A, B & C are equal partners. They wanted to change the profit sharing ratio into 4:3:2. Make the necessary journal entries. Goodwill of the firm is valued at ₹ 90,000.

Question 5 (ICAI Study Material) _____ Pg no. _____

Antoo, Bantoo and Chintoo were in partnership sharing profits and losses 3:4:3 respectively. The accounts of the firm are made up to 31st March every year. The partnership provided, inter alia, that: On the retirement of a partner the goodwill was to be valued at three years' purchase of average profits of the past four years up to the date of the retirement after deducting interest @12%p.a. on capital employed and remuneration of ₹ 2,000 p.m. to each partner. On 1st April 2023, Antoo retired and it was agreed on his retirement to adjust goodwill in the capital accounts without showing any amount of goodwill in the Balance Sheet. It was agreed that the capital employed would be ₹6,50,000. Bantoo and Chintoo were to continue the partnership, sharing profits and losses equally after the retirement of Antoo.

The following were the amounts of profits of earlier years before charging salary to partners and interest on capital employed.

Year	Profit
2019-20	2,60,000
2020-21	2,75,000
2021-22	2,65,000
2022-23	2,80,000

You are required to compute the value of goodwill & show the adjustment there of in the books of firm.

Question 6 *(CA Foundation June 2022) (5 Marks)* Pg no. _____

Mr. X gives the following particulars in respect of business carried on by him:

Particulars	Amount (₹)
Capital Invested in business	9,00,000
Market rate of interest on investment	8%
Rate of risk return on capital invested in business	3%
Remuneration per annum from alternative employment of proprietor if he was not engaged in business	36,000

The business earned profits of ₹ 2,40,000, ₹ 2,16,000 and ₹ 3,00,000 in the years 2018, 2019 and 2021 respectively but made a loss of ₹ 36,000 in the year 2020.

Compute the value of Goodwill on the basis of 6 years' purchase of super profits of the business, calculated on the basis of average profit of last four years.

Question 7 *(CA Foundation Dec 2022) (5 Marks)* Pg no. _____

R and S are partners in a firm with a capital of 14,00,000 and 12,00,000 respectively. During the year ended on 31st March, 2022 firm earned a profit of ₹ 6,50,000. Assuming that the normal rate of return is 20%. Calculate the amount of Goodwill of the firm by using

- Capitalization method
- Super Profit method, if the goodwill is valued at 6 years purchase of super profits.