

VALUATION OF GOODWILL

Meaning :

The word 'goodwill' means benevolence or well-wishing, i.e., disposition to do good. In trade and commerce, it has special meaning. The Chambers 20th Century Dictionary defines it as "the established custom or popularity of any business or trade – often appearing as one of its assets, with a marketable money value."

In accounting it is regarded as an intangible asset. The Institute of Chartered Accountants of India defines it as 'an intangible asset arising from business connections or trade name or reputation of an enterprise' (Guidance Note on Terms Used in Financial Statements, page 17) Thus goodwill is regarded as an asset which is not tangible i.e., not perceptible to touch. It arises in a firm from business relations, good name, the good impression created upon the customers etc. In this context, some of the definitions forwarded by various authors and experts in accounting are given below.

Definitions:

Dr. Canning defined goodwill as "the present value of a firm's anticipated excess earnings".

G Francis Xavier defined goodwill in the following way – "Goodwill is what goodwill does Once a firm has established a certain reputation, then, its income-generating capacity becomes automatic. This is known as goodwill. This can be achieved over a period of time."

According to **Braden and Allyn** "Goodwill is an intangible asset compounded from a variety of successful business ingredients – competent and energetic management, customer acceptance, a favourable location, a quality and profitable product, efficient production methods, an outstanding reputation, plus the expectation that these ingredients will continue to produce an above – normal rate of return for an indefinite period of time."

According to **Lord Eldon**, "Goodwill is nothing more than the probability that the old customers will resort to the old place."

In the same spirit, **Hatfield** defines goodwill as "the value of business connections, the value of the probability that present customers will continue to buy in spite of the allurements of competing dealers". Another important explanation of goodwill comes from **Lord Lindley**. He says, "It is generally used to denote the benefit arising from connection and reputation and its value is what can be got for the chance of being able to keep that connection

and improve it. Upon the sale of an established business its goodwill has a marketable value..... But it is plain that goodwill has no meaning except in connection with a continuing business....."

From financial accounting point of view **Walton** defines goodwill as "the element of an established business which makes the business as a going concern worth more than its book value, that is, its net worth as shown by the books".

Prof. Disksee has the following views about Goodwill :

"When a man pays for goodwill, he pays for something which places him in a position of being able to earn more money than he would be able to do by his own unaided efforts".

In the words of **C.L. Woelfel** :

"Goodwill is the superior earning power of a business beyond the earning power that would be expected of a firm in a similar business and with a similar amount of other assets. Goodwill includes excess power that can be attributed to such factors as the location of the business, good relations with customers and employees and managerial efficiency".

From the above definitions and explanations, following inferences may be drawn.

(a) *Goodwill is a capacity to retain its customer, to attract more customers and to sale more of its goods or services than what can be sold normally.*

(b) *Goodwill is a capacity to earn super profit which is more than normal profit in the concern industry.*

(c) *Goodwill is an asset which is not visible but which raises the worth of a business firm. Thus with goodwill the worth of the firm will be more than its book value.*

Why is Goodwill considered as an Asset ?

Goodwill is considered as an intangible asset of a firm. Assets are acquired to facilitate the income generating capacity of the business. Goodwill also facilitates earning of income. Several factors contribute to create the goodwill like competent management, favourable location, quality product etc. Some say that since no money is paid for creation of goodwill, so it can not be called an asset. But it is not true. Apparently no money is paid to create goodwill. But a lot of money is spent on those factors which create goodwill. Recruitment and retention of qualified and skilled personnel, setting up of the establishment in a prime location, production of quality goods or providing of quality services, etc. require a considerable amount of expenditure. Customers are the building blocks of goodwill. It takes time for a firm to become well established and earn a name for itself. All these

ultimately create a reputation in the market giving an edge to the firm over its competitors. This is called goodwill which facilitates to attract and retain more customers resulting more sales and more income. Thus like other assets, goodwill also facilitates to earn income, hence it is regarded an asset. Since this asset is not visible, it is called an intangible asset.

Features of Goodwill:

The following are the features of goodwill:

- (1) Goodwill is an abstract term. It has no physical existence.
- (2) Concept of goodwill has relevance only for a going concern business.
- (3) Goodwill has the ability to generate additional income for the business firm like any other asset.
- (4) Goodwill is an intangible asset.
- (5) It is attached with the firm and cannot be isolated from the business. It cannot be realised (sold) separately.
- (6) Goodwill of a firm represents the excess of real net worth of assets over their book value.
- (7) The factors leading to the creation of goodwill are subjective rather than objective. So, goodwill, in a sense is subjective.

Factors/Elements/Ingredients giving rise to Goodwill:

Goodwill is the result of many factors. These are also called elements or ingredients. The factors responsible for emergence of goodwill are as follows.

1. Location of firm
2. Quality of the product or service
3. Quality and skill of management
4. Acceptance of the firm's product or service by the customers
5. After sale service provided by the firm
6. Price of the product or service
7. Behaviour of the sales executive and other sales personnel towards the customer.
8. Work-culture and Team-culture of the employees of the firm.
9. Trademark, Trade name and Brand name.
10. Patent rights
11. Copyrights
12. Licenses
13. Franchises

Types of Goodwill

Goodwill can be classified into the following types:

- A: (a) Purchased Goodwill;
- (b) Non-purchased or Inherent Goodwill;
- B: (a) Positive Goodwill;
- (b) Negative Goodwill;
- C: (a) Dog-goodwill;
- (b) Cat-goodwill; and
- (c) Rat-goodwill.

These are explained below:

- A: (a) **Purchased Goodwill** : Purchased goodwill arises when a firm purchases part of assets or whole business of another firm. If the purchase consideration paid by the purchasing company is more than the value of total net tangible assets received, then the excess price paid is accounted as paid for goodwill. For example, if total purchase consideration paid is ₹ 80,00,000 and the value of net tangible assets acquired is ₹ 65,00,000, then, the excess amount paid ₹ 15,00,000 is for goodwill. This means goodwill purchased for ₹ 15,00,000 and other assets for ₹ 65,00,000.
- (b) **Non-purchased or Inherent Goodwill** : Non-purchased or Inherent Goodwill is the goodwill of the firm created through its own effort and excellence. The good image of the firm created among the public and reflected through self-attracted customer which generates additional revenue to the firm, is the non-purchased or inherent goodwill.
- B: (a) **Positive Goodwill** : If the real worth of the net assets of a firm is more than their book value, then it is said that the firm is having a goodwill. It is called positive goodwill.
- (b) **Negative Goodwill** : In case the real worth of the net assets is less than the book value then it is a case of negative goodwill.
Suppose, the book value of net assets is ₹ 25,00,000 but their realisable value (real worth) is ₹ 30,00,000, then the difference of ₹ 5,00,000 is the value of goodwill. It is positive goodwill. If the realisable value (real worth) is ₹ 18,00,000 then the difference of ₹ 7,00,000 is negative goodwill.
- C: (a) **Dog-Goodwill** : Dog has affinity to a person concerned so the goodwill which is very much personal is called Dog-goodwill. This is the goodwill which is attached to the particular person concerned,

and not to the firm as a whole. This type of goodwill is not so valuable for business firm because it cannot be transferred when the business is sold.

- (b) **Cat-goodwill** : Cat has affinity to the house and not to a person. Goodwill, which is based on the activity of the firm as a whole, is called cat-goodwill. This goodwill is attached with the business firm and not with a person concerned. When the firm is sold, such goodwill is also automatically sold for a price. So, it is transferable. *This type of goodwill is the most valuable among all other types of goodwill.*
- (c) **Rat-goodwill** : Rat-goodwill is not a goodwill in the true sense. Such a goodwill is very temporary in nature created through temporary attraction. Rat-goodwill is reflected temporarily through customers who are here today and will go to another firm tomorrow. So, this type of goodwill has no value for the firm.

Need for valuation of Goodwill :

Need for valuation of goodwill is organisation specific. This means, depending upon the type of business organisations, the need for valuation of goodwill is different. The only common reason or circumstance in which valuation of goodwill is required is when the firm is sold. The various needs for which goodwill is valued are noted below:

1. *In case of a sole proprietorship :*
 - (a) When it is decided to sale a going concern firm then value of the firm is determined to fix the purchase consideration. In the process of valuing the assets, goodwill of the firm is also taken into consideration for valuation.
 - (b) If a sole trading concern is converted into a partnership firm, then also goodwill is valued to determine the value of the firm.
 - (c) In case the firm is converted into a joint stock company, to determine the value of the firms' goodwill.
2. *In case of partnership firm :*
 - (a) When admission of a new partner takes place, it becomes necessary to value the goodwill. This is done to determine the premium for goodwill the new partner has to bring into the firm.
 - (b) If any existing partner retires from the business, or if any partner dies, the goodwill is valued to determine the total amount payable to such partner.
 - (c) When two firms are amalgamated or any firm is sold or converted into a company, then also goodwill of the concerned firm is valued to determine the value of the firm.

3. *In case of a company: In case of a company, need for valuation of goodwill arises in the following situations:*

- (a) **Sale and acquisition of business:** To determine the purchase consideration payable to a company in sale, it is necessary to value the goodwill when one company is sold to another company.
- (b) **Amalgamation of company:** For various reasons, sometimes, two or more companies may be amalgamated to form a new company. In such a case, all the assets of the companies under amalgamation are valued afresh. In such a case, goodwill is also required to be valued alongwith other assets.
- (c) **Valuation of Shares :** When shares of a company are valued under asset-backing method (intrinsic value method), value of goodwill is also determined like the value of other assets.
- (d) **Determination of wealth tax liability:** Quoted price of shares is not available in case shares are not listed in any of the stock-exchanges. In such cases, it is compulsory to value the goodwill in order to calculate the amount of wealth tax liability of the company.
- (e) **Consolidation of accounts by a holding company :** It is the general practice to prepare Consolidated Accounts of the Holding Company and its Subsidiaries. When accounts of a holding company and its subsidiary are consolidated, the cost of acquiring controlling interest or goodwill is ascertained for the purpose of preparation of consolidated balance sheet.
- (f) **Take over of business by the Government or Nationalisation :** Valuation of goodwill is required when a business enterprise is taken over by the Government in order to determine the proper value of the firm.

4. *In case of Government or Public Sector Undertaking:*

When a Government or Public Sector Undertaking or Corporation is sold or partially sold or converted into a joint venture, then also the value of goodwill is determined. This is done to calculate the price of a share of the undertaking to be sold.

The above explanation reveals that the need for valuation of goodwill arises when:

- (a) Capital to the proprietor is restated,
- (b) Assets are revalued,
- (c) Firm is sold,
- (d) Two firms are amalgamated.
- (e) Public sector undertaking is converted into private sector or joint sector company.

Accounting Standard 26 and Valuation of Goodwill:

Accounting Standard 26 (AS 26) issued by the Institute of Chartered Accountants of India on '**Accounting for Intangible Assets**' has prescribed that goodwill for which no money is paid, should not be recorded. The Standard has not stated any procedure for valuation of goodwill. It has simply stated that goodwill should be recorded in the books only when some consideration in money or money's worth has been paid for it. When a business is acquired for a price which is in excess of the value of net asset of the business taken over, the excess should be termed as "**goodwill**".

Methods of Valuation of Goodwill:

There are various methods of valuation of goodwill. These are :

- (a) Arbitrary Method
- (b) Average Profit Method or Year's Purchase of Past Profit Method.
- (c) Weighted Average Profit Method
- (d) Capitalisation of Average Profit Method or Capitalisation of Future Profit Method.
- (e) Capitalisation of Weighted Average Profit Method.
- (f) Super Profit Method or Year's Purchase of Super Profit Method.
- (g) Weighted Average Super Profit method or Year's Purchase of Weighted Average Super Profit Method.
- (h) Sliding Scale Valuation of Super Profit Method.
- (i) Capitalisation of Super Profit Method.
- (j) Capitalisation of Weighted Average Super Profit Method.
- (k) Annuity Method

It can be noticed from the list above that except the Arbitrary Method all other methods are based on Profit. *Profit may be last year's profit or average profit of past few years or super profit or future profit. The average may be simple or weighted average. Where simple average profit is applied, it is mentioned as 'Average Profit Method', and where weighted average profit is applied, it is mentioned as 'Weighted Average Profit Method'.*

Important points to be borne in mind relating to valuation of goodwill:

At this stage, it will be worthwhile to note the following points in the process of valuation of goodwill.

- (a) Only Trading profit is taken into consideration.
- (b) Income from investment outside the business, like, dividend earned on investment in shares of other companies etc. are not included in the profit.
- (c) Fair remuneration to owners in case of sole trading or partnership business is considered while profit is determined.

- (d) Income tax is deducted from profit.
- (e) Abnormal profits and losses (or expenses) are excluded from the profits of the year in which they occur.
- (f) While calculating return from capital employed, income from any asset not used in business (like investments in shares) is excluded from profit and the value of that asset is also excluded from total capital employed.
- (g) While ascertaining the value of Net Tangible Assets, value of intangible assets including goodwill, fictitious assets and all other assets which can not be realised are excluded. Liabilities which are actually payable and liabilities which are contingent in nature, are deducted from the value of realisable assets.

Various methods of valuation of goodwill are explained below along with illustrations:

1. **Arbitrary Method**: In real sense this is not a method. If goodwill is valued by mutual agreement of the two parties – buyer and seller of business, without following any method then this is called arbitrary valuation of goodwill. Such a valuation is not based on adequate objective criteria and is mostly a subjective valuation. The simple advantages are that it avoids complex calculation and is mutually agreed valuation. Generally, this method is applied in case of tiny retail business firms.
2. **Average Profit Method or Year's Purchase of Past Profit Method**. This is the most commonly used method in partnership firms. Under this method the average profit of immediate past few years (generally three to five years) is multiplied by a certain number in the following manner:
 - (a) First, average profit of last three or five years is calculated.
 - (b) Second, the average profit determined as above is multiplied by a certain number of year's purchase, e.g. 2,3,4,5 etc.
 - (c) The result is the value of Goodwill.

Since the average profit is multiplied by a certain number of year's purchase, so, this method is also known as **Year's Purchase of Average Profit Method**. The value of goodwill under this method is = (Total Profits of all concerned past years ÷ Number of years) X Year's purchase

The number of year's purchase, like 2 or 3 or 4 or 5 etc. is not taken arbitrarily. It depends on the number of years for which the goodwill can generate additional income to the firm. If it is justified that goodwill can generate extra income for 4 years, then 4 year's purchase is taken to multiply the average profit.

Illustration 1.

The profits of a firm for the last four years were as follows: 2019 : ₹ 68,000, 2020 : ₹ 92,000, 2021 : ₹ 80,000 and 2022 : ₹ 1,20,000.

Calculate the goodwill of the firm taking 5 year's purchase of the average profits.

Solution:

Average Profit = ₹ $(68,000 + 92,000 + 80,000 + 1,20,000) \div 4 = ₹ 90,000$

Therefore, Value of Goodwill at 5 years' purchase of average profit = Average profit $\times 5 = ₹ 90,000 \times 5 = ₹ 4,50,000$

Illustration 2.

Ascertain the value of goodwill of M/s. X from the following information:

- (i) Profits for the last 6 years after tax were :
2017 : ₹ 20,500; 2018 : ₹ 21,800; 2019 : (-) 5,000
2020 : ₹ 30,800; 2021 : ₹ 25,700; 2022 : 30,200
- (ii) In the year 2019, there was a fire in which goods of ₹ 2,00,000 were destroyed. Insurance company admitted the claim for ₹ 1,80,000.
- (iii) Mr. X, the proprietor has not drawn any salary. The reasonable salary for him is ₹ 600 per month.
- (iv) It is customary to take one year's purchase for valuation of goodwill in the business in which Mr. X is engaged.

Solution :

Working:	(₹)
Goods destroyed by Fire in 2019:	2,00,000
Less : Claim admitted by Insurance Company	<u>1,80,000</u>
	Loss by Fire : <u>20,000</u>

Loss by fire was debited to profit and loss account and the net loss in profit and loss account comes to ₹ 5,000 after considering loss by fire ₹ 20,000. This loss is abnormal loss should not be considered while valuing goodwill.

This means that actually there was a trading profit of ₹ $(20,000 - 5,000) = ₹ 15,000$. This profit of ₹ 15,000 in the year 2019 to be considered for the purpose of valuation of goodwill.

Salaries of ₹ $600 \times 12 \times 6 = ₹ 43,200$ were not drawn by Mr. X. Therefore, it is to be deducted from the total profit before computing average profit.

Calculation of Average Profit of last 6 years :

$$= ₹ [(20,500 + 21,800 + ₹ (15,000 + 30,800 + 25,700 + 30,200)) - ₹ 43,200] ÷ 6$$

$$= ₹ 16,800$$

Calculation of Value of Goodwill at one year purchase :

$$\text{Value of Goodwill} = ₹ 16,800 \times 1$$

$$= ₹ 16,800$$

Illustration 3 .

Mr Swarna Paul proposed to purchase the business of M/s. Anand & Co. Goodwill for this purpose is agreed to be valued at 3 years' purchase of the average profit of the last five years.

Calculate the value of goodwill from the information given below :

(a) Profits for last five years:

Years	Profit (₹)
2018	42,300
2019	45,000
2020	49,000
2021	38,400
2022	52,000

- (b) Mr. Swarna Paul has to leave his present employment where he is drawing ₹ 600 p.m. At the same time, he intends to replace the supervisor of the business who is being paid a salary of ₹ 700 per month.
- (c) The profits of Ananda & Co. for 2020 includes a non-recurring profit of ₹ 5,500; the profits of 2021 has been arrived after deducting an extraordinary loss on account of embezzlement for ₹ 4,300.
- (d) Mr Swarna Paul has decided to insure company properties in future as these were not insured in the past. The insurance premium was estimated at ₹ 750 per annum.

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Solution:**Calculation of Net Average Profit:**

<i>Profits for the last five years</i>	(₹)	(₹)
Years		
2018		42,300
2019		45,000
2020	49,000	
Less: Non-recurring profit	<u>5,500</u>	43,500
2021	38,400	
Add Extraordinary loss	<u>4,300</u>	42,700
2022		<u>52,000</u>
Total profit for five years		2,25,500

Average profit = Total profit ÷ Number of years = ₹ 2,25,500 ÷ 5 = ₹ 45,100

Average profit ₹ 45,100

Less: Expenses or losses likely to occur in future:

Insurance premium	₹ 750	
Loss due to leaving of employment (₹ 600 × 12) =	<u>₹ 7,200</u>	<u>7,950</u>
		37,150

Add: Expenses not to be paid in future

Salary of supervisor (₹ 700 × 12)	<u>8,400</u>
Net expected average profit in future	45,550

Calculation of Value of Goodwill:

Value of goodwill = Net average profit × Number of years' purchase
 = ₹ 45,550 × 3 = ₹ 1,36,650

3. Weighted Average Profit Method :

This is similar to the average profit method. In this method instead of simple average, weighted average is used to determine the average profit. Weights are assigned to each year's profit. The sum total of the products of profits and corresponding weights is divided by the sum total of all weights to find out the weighted average profit. This figure is then multiplied by number of year's purchase to determine the value of goodwill. This method is generally not used by small firms due to the problem of selecting weights.

Illustration 4. The profit of A Ltd. for the last five years and the corresponding weights are as follows:

Year :	2018	2019	2020	2021	2022
Profit (₹) :	90,000	1,10,000	1,40,000	1,50,000	1,60,000
Weight :	1	2	3	4	5

Calculate the value of goodwill on the basis of 3 years' purchase of the weighted average profit.

Solution:

Year	Profit (₹)	Weight	Product
2018	90,000	1	90,000
2019	1,10,000	2	2,20,000
2020	1,40,000	3	4,20,000
2021	1,50,000	4	6,00,000
2022	1,60,000	5	8,00,000
		15	<u>21,30,000</u>

Weighted Average Profit: ₹ 21,30,000 ÷ 15 = ₹ 1,42,000.

Value of Goodwill = 3 years' purchase of weighted average profit:
 ₹ 1,42,000 × 3 = ₹ 4,26,000

4. Capitalisation of Average Profit Method or Capitalisation of Expected Future Profit Method :

This method is based on the earning capacity of assets. For this purpose, only tangible assets are considered. From the value of all tangible assets, value of all liabilities are deducted to find out value of net tangible assets. After this, taking the normal rate of return, the actual profit is capitalised which is compared with the value of net tangible assets. It is found that capitalised value of profit is more than the value of net tangible assets, the difference is called Goodwill.

On the reverse, if the value of net tangible assets is more than the capitalised value of profit, then it is confirmed that the firm is not having any goodwill, implying that the firm is earning at a rate lesser than what is earned by the average firms in the industry.

$$\text{Value of Goodwill} = \left(\frac{\text{Net profit}}{\text{Normal Rate of Return}} \times 100 \right) - \text{Net assets}$$

Note : Sometimes instead of normal rate of return, rate of dividend is given in the question. In such a case, the rate of dividend should be taken as normal rate of return. If rates of dividend for more than one years are given, then average rate of dividend should be taken.

Illustration 5.

A firm's normal return is 15%., of its net assets. The actual profit earned by it is ₹ 60,000. The value of net assets of the firm is ₹ 3,60,000. What is the value of goodwill?

Solution:

The value of goodwill = Capitalised value of profit – Net Tangible Assets

$$\text{Capitalised value of profit} = \frac{\text{Net Profit}}{\text{Normal Rate of Return}} \times 100$$

$$₹ \left(\frac{100}{15} \times 60,000 \right) = ₹ 4,00,000$$

$$\text{Therefore, the value of goodwill} = ₹ (4,00,000 - 3,60,000) = ₹ 40,000$$

Illustration 6.

Smith Limited has the following assets and liabilities : Goodwill : ₹ 2,200, other fixed asset : ₹ 8,800, current assets : ₹ 4,000 and Preliminary Expenses ₹ 200. Its all outstanding liabilities amounted to ₹ 800. It had earned an annual average profit before tax ₹ 3,000 for the last five years. The company is likely to be purchased by Alfred Ltd. in which case, the rent paid by Smith Co. Ltd. ₹ 500 p.a. will not be a charge in future.

Assuming a normal return of 10% and tax rate at 40%., calculate the value of goodwill of Smith Ltd.

Solution :**Value of Net Tangible Assets :**

	(₹)
Other Fixed Assets :	8,800
Current Assets :	<u>4,000</u>
	12,800

Less: Outstanding liabilities	<u>800</u>
Net Tangible Assets :	<u>12,000</u>

Capitalised value of Profit :

Average Profit before Tax :	(₹) 3,000
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Add; Expenses not to be incurred in future :

Rent	<u>500</u>
Adjusted Profit before tax :	<u>3,500</u>

Less: Tax (40% of ₹ 3,500)	<u>1,400</u>
Profit after tax :	2,100

Normal Rate of Return 10%

$$\begin{array}{r}
 \text{When Return (Profit) is 10, Capital is} \quad 100 \\
 \text{" " " 2100, " " } \quad \frac{100 \times 2100}{10} \\
 = \text{ ₹ 21,000}
 \end{array}$$

∴ Capitalised value of Profit at 10% normal rate of return is ₹ 21,000

Value of Goodwill :

Capitalised value of Profit :	₹ 21,000
Less: Value of Net Tangible Assets :	<u>₹ 12,000</u>
Value of Goodwill	<u>₹ 9,000</u>

5. Capitalisation of Weighted Average Profit Method :

This method is similar to the capitalisation method as described above except that instead of simple average, weighted average is taken. Weights to each year's profit are decided on some rational basis. Generally weights are given in the following way :

First Year	: 1
Second Year	: 2
Third Year	: 3 and so on.

Illustration 7 :

M/s. Dependable Ltd. earned the following profits for the last five years : ₹ 32,000; ₹ 39,000; ₹ 44,000; ₹ 49,000 and ₹ 57,000. The normal rate of return in the business in which M/s. Dependable Ltd. deals is 15% of net assets.

Ascertain the value of Goodwill of M/s. Dependable Ltd. if its net assets are ₹ 2,80,000 (assume suitable weights).

Solution :

Since profits are rising, so weights are assumed as 1, 2, 3, 4, and 5 for consecutive five years,

Calculation of weighted Average Profit:

Profits :	32,000	39,000	44,000	49,000	57,000
Weights	1	2	3	4	5
Product :	32,000	78,000	1,32,000	1,96,000	2,85,000

Total Product : ₹ (32,000 + 78,000 + 1,32,000 + 1,96,000 + 2,85,000) = ₹ 7,23,000

Total Weight : (1 + 2 + 3 + 4 + 5) = 15

Weighted Average Profit = ₹ 7,23,000 ÷ 15 = ₹ 48,200

Calculation of value of Goodwill :

Capitalised value of weighted average	(₹)
Profit at 15%.	= $\frac{100}{15} \times ₹ 48,200 = 3,21,333$
Less: Actual value of net assets	<u>2,80,000</u>
Value of Goodwill	<u>41,333</u>

6. Super Profit Method or Years' Purchase of Super Profit Method :

This method is based on the super profit earned by a firm. Super profit is the excess of actual profit over the normal profit of a firm. Normal profit is the average profit earned by all the firms in the industry. If a firm can earn reputation in the market and there is heavy demand for its product or service then it can earn super profit.

In order to arrive at the value of goodwill, this **super profit is multiplied by number of years' purchase** or by the number of years in which the super profit is expected in future.

Under this method, goodwill is calculated in the following way : Value of Goodwill = Super Profit x Number of year's purchase or number of years the super profit is expected.

Illustration 8:

M/s. Reliance Limited is engaged in courier service having a capital investment of ₹ 50,00,000. The normal rate of return in similar business is 20%. The profit earned by M/s. Reliance Limited for the year 2022 is ₹ 15,00,000 and it is expected that the firm will maintain the same at least for next four years.

Calculate the value of Goodwill of M/s. Reliance Limited.

Solution :

Capital investment : ₹ 50,00,000

Normal profit @ 20% : ₹ 10,00,000

(₹ 50,00,000 × $\frac{20}{100}$)

Profit earned during 2022 : ₹ 15,00,000

Super profit earned : ₹ (15,00,000 - 10,00,000) = ₹ 5,00,000

Super profit is maintainable for four years.

$$\begin{aligned} \text{Therefore, Value of Goodwill : } & \text{₹ } 5,00,000 \times 4 \\ & = \text{₹ } 20,00,000 \end{aligned}$$

Illustration 9.

From the following particulars of M/s. Moonlight Ltd., calculate the value of goodwill at 3 years' purchase of the super profit :

- (a) Net Profits ₹ 40,000
- (b) Capital employed ₹ 2,50,000
- (c) Normal rate of return 8 per cent

Solution:

Net Profit		₹ 40,000
Return on Capital employed ($\frac{8}{100} \times \text{₹ } 2,50,000$)		₹ 20,000
Therefore, Super profit (40,000 – 20,000)		₹ 20,000
Hence, Value of Goodwill = Super profit X 3		
	= ₹ 20,000 X 3 =	₹ 60,000

Illustration 10.

The following particulars have been extracted from the Books of Abhik.

	(₹)
(i) Capital Invested	50,000
(ii) Trading results :	
2019 Profit	18,200
2020 Profit	15,000
2021 Loss	2,000
2022 Profit	21,000
(iii) Market rate of interest on investment	8%
(iv) Rate of risk return on Capital in business	2%
(v) Remuneration from alternative employment of the proprietor (if not engaged in business)	6,600 p.a.

Compute the value of goodwill of the business on the basis of three year's purchase of super profits taking average of last four years.

[G.U. B.Com. 2002 (Modified)]

Solution :

Note : If the Rate of Risk Return is given, then the normal rate is the total of Market Rate of Return/Interest and Rate of Risk Return.

(a) Calculation of Average Profit :

$$₹ (18,200 + 15,000 - 2,000 + 21,000) \div 4$$

$$\text{Average Profit} = ₹ 13,050$$

(b) Calculation of Super Profit :

	(₹)
Average Profit	13,050
Less : Proprietor's remuneration	<u>6,600</u>
Adjusted average profit	6,450
Less : Normal Profit on capital employed (8+2)% i.e. 10% on ₹ 50,000	<u>5,000</u>
Super Profit : ₹ (6,450 - 5,000)	<u>1,450</u>

(c) Calculation of Value of Goodwill :

$$\begin{aligned} \text{Goodwill} &= 3 \text{ years' purchase of Super Profit} \\ &= ₹ 1,450 \times 3 \\ &= ₹ 4,350. \end{aligned}$$

Illustration 11.

Compute the value of the goodwill of a firm on the basis of three year's purchase of the average profits of the past four years. The profits of the past four years were as follows :

Year	Profits (₹)
2019	28,000
2020	34,000
2021	32,500
2022	41,000

Following further informations are provided to you for this purpose:

(i) ₹ 6,000 should be provided annually to cover the management cost for the purpose of calculation of goodwill.

(ii) On 1st July, 2021, a major machinery was repaired for ₹ 10,000 but was charged as revenue. It is to be capitalised for the purpose of calculation of goodwill subject to depreciation of 10% p.a. on original cost method.

(iii) Closing stock for the 2020 was overvalued by ₹ 3,000.

Solution:

Calculation of Adjusted Profit:	2019 (₹)	2020 (₹)	2021 (₹)	2022 (₹)
Profit given	28,000	34,000	32,500	41,000
Less: Management Cost	6,000	6,000	6,000	6,000
	22,000	28,000	26,500	35,000
Add: Capital Expenditure which was charged to Revenue	-	-	10,000	-
	22,000	28,000	36,500	35,000
Less: Depreciation on Machinery	-	-	500	1,000
	22,000	28,000	36,000	34,000
Less: Over-valuation of closing stock	-	3,000	-	-
	22,000	25,000	36,000	34,000
Add: Over-valuation of closing stock	-	-	3,000	-
Adjusted Profit	22,000	25,000	39,000	34,000

Total Profits for four years = ₹ (22,000 + 25,000 + 39,000 + 34,000)
= ₹ 1,20,000

Average Profits for four years = ₹ 1,20,000 ÷ 4 = ₹ 30,000

Value of Goodwill at three years Purchase = ₹ 30,000 × 3 = ₹ 90,000

Therefore, the value of Goodwill at three years purchase of the average profits of the last four years = ₹ 90,000.

Notes : Calculation of Depreciation on Machinery:

(i) Depreciation of 2021 for six months = 10% of 10,000 × 6 ÷ 12 = ₹ 500

(ii) Depreciation of 2022 for one year = 10% of 10,000 = ₹ 1,000.

(iii) The closing stock of 2020 is the opening stock of 2020.

As the closing stock of 2020 was overvalued, profit of 220 increased by ₹ 3,000. So, in order to arrive at correct profit, this amount has been deducted. Again, as the opening stock of 2021 was overvalued, profit of that year has been shown reduced. Therefore, the same amount has been added back to the profit of 2021 to get the actual profit.

7. Weighted Average Super Profit or Year's Purchase of Weighted Average Super Profit Method :

This method is similar to the super profit method except that super profit is calculated by taking weights for past profits. The difference between weighted average profit and normal profit is taken as super profit. To get the value of Goodwill, this super profit is multiplied by the year's purchase or by the number of years for which this super profit is expected.

Value of Goodwill = Weighted Average Super Profit x Number of years' Purchase Or Number of years the Super Profit is expected.

Illustration 12.

The normal rate of return in the business in which M/s. Robinson Brothers deals in is 15%. Its profits for the last four years were : ₹ 25,000; ₹ 26,000, ₹ 32,000 and ₹ 35,000. Its total capital employed is ₹ 1,90,000. Assuming suitable weights ascertain the value of goodwill applying 3 years' purchase of super profit.

Solution : Weights are taken as 1, 2, 3 and 4 for consecutive four years.

Profits :	25,000	26,000	32,000	35,000
Weights :	1	2	3	4
Product :	25,000	52,000	96,000	1,40,000

Total Product : (25,000 + 52,000 + 96,000 + 1,40,000) = 3,13,000

Total weights : (1 + 2 + 3 + 4) = 10

Weighted average profit = ₹ 3,13,000 ÷ 10 = ₹ 31,300

Normal rate of return = 15%.

Capital employed = ₹ 1,90,000

∴ Normal Profit = ₹ 1,90,000 × $\frac{15}{100}$ = ₹ 28,500

∴ Super Profit = Weighted Average Profit - Normal Profit
= ₹ (31,300 - 28,500) = ₹ 2,800

∴ **Value of Goodwill** = Super profit x 3 year's purchase
= ₹ 2,800 x 3 = ₹ 8,400

Illustration 13.

The newly formed firm M/s. Y & Company Ltd. has agreed to take over the firm M/s. X Ltd. which has the following assets, equity and liabilities. Share capital ₹ 4,00,000, Debenture ₹ 3,00,000 (at 10% interest), current liabilities ₹ 5,00,000; Fixed assets ₹ 7,00,000 and current assets ₹ 2,00,000 and investment in shares ₹ 3,00,000.

M/s. X Ltd. earned the following profits after charging interest on debentures

2019 :	₹ 50,000
2020 :	₹ 70,000
2021 :	₹ 78,000
2022 :	₹ 94,000

The above profits include dividend received @ 15% on shares. It is agreed that Y & Company Ltd. will pay for goodwill which will be ascertained on the basis of 5 year's purchase of super profit. It is also agreed that super profit will be ascertained on the basis of weighted average profits after interest and before taking credit of dividends from investment. Debentures and investment in share are there for last five years.

The standard rate of return in this type of business is 3% on assets. Ascertain the value of goodwill assuming suitable weights. (Ignore income tax)

Solution : Valuation of Goodwill:

	2019 (₹)	2020 (₹)	2021 (₹)	2022 (₹)
Profit	50,000	70,000	78,000	94,000
Less: Dividend	<u>45,000</u>	<u>45,000</u>	<u>45,000</u>	<u>45,000</u>
Trading Profit :	5,000	25,000	33,000	49,000
Weights	<u>1</u>	<u>2</u>	<u>3</u>	<u>4</u>
Product	5,000	50,000	99,000	1,96,000

Total of the product = ₹(5,000 + 50,000 + 99,000 + 196,000) = ₹ 3,50,000

Weighted Average Profit = ₹ 3,50,000 ÷ 10 (total weights)

= ₹ 35,000

Total assets : ₹ 12,00,000

Less: Investment in shares ₹ 3,00,000

₹ 9,00,000

Normal Profit : 3% of ₹ 9,00,000 = ₹ 27,000

∴ Super Profit : ₹ (35,000 - 27,000) = ₹ 8,000

Value of goodwill: 5 years' purchase of Super Profit

= ₹ 8,000 × 5 = ₹ 40,000

8. Sliding Scale method of Valuation of Super Profit :

Under this method, super profit is not multiplied by a fixed number. In this method, super profit is divided into a few divisions and each is multiplied by a different number of year's purchase in descending order division starting from the first division. This method was first advocated by A. E. Cutfurth in his book "Method of Amalgamation and Valuation of Business."

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Illustration 14. The super profit of ₹ 5,00,000 is divided into 4 divisions and each subsequent scale is diminished by one year's purchase. Calculate the value of goodwill under Sliding Scale method of Valuation of Super Profit.

Solution: The value of goodwill under Sliding Scale method will be calculated as under:

$$₹ 1,25,000 \times 4 = ₹ 5,00,000$$

$$₹ 1,25,000 \times 3 = ₹ 3,75,000$$

$$₹ 1,25,000 \times 2 = ₹ 2,50,000$$

$$₹ 125,000 \times 1 = ₹ 1,25,000$$

$$\text{Value of Goodwill} = ₹ (5,00,000 + 3,75,000 + 2,50,000 + 1,25,000) = ₹ 12,50,000$$

9. Capitalisation of Super Profit method :

Under this method, the capitalised value of super profit is taken as the value of goodwill. Capitalised value is calculated by taking the normal rate of return.

Capitalised value of super profit = Super Profit \times 100 \div Normal Rate of Return.

Value of Goodwill = Capitalised value of super profit

This method is easy to calculate. It is based on the rate of return of the industry. The rationale for this method is that super profit is possible only because of the goodwill, hence, goodwill is the capitalised value of super profit.

Illustration 15. A firm earns ₹ 30,000 as super profit while its normal profitability is 15%. Calculate the value of goodwill.

Super Profit = ₹ 30,000

Normal Rate of Return = 15%.

Solution:

Capitalised value of super profit is :

Super Profit \times 100 \div Normal Rate of Return.

$$= \frac{100}{15} \times ₹ 30,000 = ₹ 2,00,000$$

Since the value of goodwill under this method is equal to Capitalised value of super profit, the value of goodwill = ₹ 2,00,000.

Illustration 16. From the following information ascertain the value of goodwill applying the capitalisation of Super Profit Method.

(i) Normal Rate of Return on Capital employed is 15%.

(ii) Capital employed ₹ 2,70,000

- (ii) Profit for the last five years : ₹ 60,500; ₹ 45,200; ₹ 72,000; ₹ 75,000 and ₹ 80,000.
- (iv) Profits stated above include 7% interest earned annually on an investment of ₹ 1,00,000 in Debentures of a company.
- (v) Proprietor's fair remuneration of ₹ 1,500 per month was not considered while arriving at the above profits.

Solution :

Calculation of Super Profit

Total Profits of last 5 years	(₹)
= ₹ (60,500 + 45,200 + 72,000 + 75,000 + 80,000) =	3,32,700
Less : Interest for 5 years @ 7% of ₹ 1,00,000 i.e. (₹ 7,000x5) = ₹35,000	
Remuneration to Proprietor:	
@ ₹ 1,500 p.m : ₹ 1,500 x 12 x 5	<u>₹90,000</u> <u>1,25,000</u>
Total Net Profit of 5 years :	2,07,700
Average Profit = ₹ 2,07,700 ÷ 5 =	₹ 41,540
Less; Normal Profit on ₹ 2,70,000 at 15%. <u>₹ 40,500</u>	
Super Profit =	₹ 1,040

Calculation of Value of Goodwill :

Value of Goodwill = Capitalised value of super profit

Normal rate of return 15%.

∴ Capitalised value of Super Profit, i.e.

$$\text{Value of Goodwill} = \frac{100}{15} \times ₹ 1,040 = ₹ 6,933.$$

10. Capitalisation of Weighted Average Super Profit Method :

Under this method super profit is calculated after ascertaining the weighted average profit of last few years.

Super Profit = Weighted Average Profit – Normal Profit

Capitalisation of Weighted Average Super Profit = Weighted Average

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

Value of goodwill = Capitalised value of weighted average super profit.

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Illustration 17.

Ascertain the value of goodwill from the following information available from M/s. Lalani International :

Year :	2019	2020	2021	2022
Profit ₹:	75,000	83,000	98,000	1,02,000
Weights	1	2	3	4
Net Assets : ₹ 4,00,000. Normal Rate of Return : 20%.				

Solution:

Weighted Average Profit =

$$₹ \{(75,000 \times 1) + (83,000 \times 2) + (98,000 \times 3) + (1,02,000 \times 4)\} \div (1+2+3+4)$$

$$= ₹ 94,300$$

Normal Profit = Net assets x Normal rate of return
 = ₹ 4,00,000 x 20% = ₹ 80,000

Super Profit = ₹ (94,300 - 80,000) = ₹ 14,300

Valuation of goodwill :

$$\text{Capitalised value of super profit} = \text{Super Profit} \times \frac{100}{\text{Normal Rate of Return}}$$

$$= ₹ 14,300 \times \frac{100}{20} = ₹ 71,500$$

Illustration 18.

From the following information, calculate the value of Goodwill :

- (a) Capital employed ₹ 1,50,000
- (v) Normal Rate of Return 15%.
- (c) Profits before tax for the last four years :
₹ 25,000; ₹ 30,000; ₹ 36,000 and ₹ 49,000
- (d) Tax rate 40%.
- (e) Assume weights to calculate the average profit.

Solution :

Profits (₹)	25,000	30,000	36,000	49,000
(-) Tax (40%) (₹)	10,000	12,000	14,400	19,600
	<u>15,000</u>	<u>18,000</u>	<u>21,600</u>	<u>29,400</u>
Weights	<u>1</u>	<u>2</u>	<u>3</u>	<u>4</u>
Product	15,000	36,000	64,800	1,17,600

Total of Product : 2,33,400

∴ Weighted Average Profit of 4 years

$$= \frac{\text{₹ } 2,33,400}{10}$$

$$= \text{₹ } 23,340$$

Capital employed = ₹ 1,50,000

Normal Rate of Return = 15%.

$$\therefore \text{Normal Profit} = \text{₹ } 150,000 \times \frac{15}{100} = \text{₹ } 22,500$$

$$\therefore \text{Super profit} = \text{₹ } 23,340 - \text{₹ } 22,500 = \text{₹ } 840$$

Valuation of Goodwill =

Capitalised Value of Normal Profit:

$$= \text{₹ } 840 \times \frac{100}{15}$$

$$= \text{₹ } 5,600$$

Illustration 19. The following is the are the assets, equity and liabilities of M/s. XYZ limited for the year ended 31st March, 2023.

Assets	Amount (₹)	Equity and Liabilities	Amount (₹)
Goodwill	30,000	Paid up Capital	
Land and Building	2,50,000	50,000 shares of	
Plant and Machinery	5,40,000	₹ 10 each	5,00,000
Furniture	50,000	Reserve and Surplus	2,00,000
Stock in trade	50,000	Bank Loan	2,50,000
Trade Receivable	1,60,000	Bills Payable	50,000
Cash and Bank	1,70,000	Trade Creditors	2,00,000
		Provision for Income Tax	50,000

Profits earned by the company for last four years before providing for tax are : ₹ 1,40,000; ₹ 1,80,000; ₹ 2,40,000 and ₹ 3,60,000. The rate of dividend paid by the company for the last four years were : 10%, 14%, 16% and 20%. The rate of corporate tax is 40 %.

Calculate the value of goodwill of the company assuming paid up capital was constant for last eight years.

Solution :

Goodwill = Capitalised value of average profit – Net Tangible Assets

Average Profit earned : ₹ (1,40,000+1,80,000+2,40,000+3,60,000) ÷ 4 = ₹ 2,30,000

Profit after Tax = ₹ 2,30,000 – 40% of ₹ 2,30,000 = ₹ 1,38,000

∴ Average maintainable Profit = ₹ 1,38,000

Valuation of Net Tangible Assets :

Total Assets : ₹ 12,50,000

Less : Goodwill : ₹ 30,000

Value of Total Tangible Assets : ₹ 12,20,000

Less : Outside Liabilities ₹ 5,50,000

(Bank Loan + Bills Payable +
Trade Creditors+ Prov. for Income Tax)

Value of Net Tangible Assets : ₹ 6,70,000

Average rate of dividend (Assumed as Normal rate of return)

(10% + 14% + 16% + 20%) ÷ 4 = 15%

Capitalised value of average profit :

$$= \frac{100}{15} \times ₹ 1,38,000$$

$$= ₹ 9,20,000$$

Valuation of Goodwill :

Capitalised value of average profit : ₹ 9,20,000

Less; Net Tangible Assets : ₹ 6,70,000

Therefore, the Value of Goodwill : ₹ 2,50,000

Illustration 20.

Following information as on 31.12.2022, ascertain the value of Goodwill of Sangeeta Ltd. carrying on business in retail trade:

Equity & Liabilities	(₹)	Assets	(₹)
Paid-up Capital 2,500 shares of ₹ 100 each	2,50,000	Goodwill at cost	25,000
Surplus in Profit & Loss	56,650	Land and building at cost	1,10,000
Bank overdraft	58,350	Plant & machinery at cost less depreciation	1,00,000
Sundry creditors	90,500	Stock at cost	1,50,000
Provision for taxation	19,500	Book debts less provision for doubtful debts	90,000

The Company started operation on 1-1-2018 with a paid-up-capital as aforesaid of ₹ 2,50,000. The profits earned before providing for taxation, have been as:

	(₹)
2018	61,000
2019	64,000
2020	71,500
2021	78,000
2022	85,000

You may assume that income tax at the rate of 50% has been payable on these profits.

The average dividend paid by the company for four years is 10% which is taken as reasonable return expected on the capital invested in the business.

[D.U. B. Com.(Maj) 2003]

Solution :

Total Profits for 5 years :

₹ (61,000 + 64,000 + 71,500 + 78,000 + 85,000)	=	₹ 3,59,500
Less : Income Tax 50%		<u>₹ 1,79,750</u>
		₹ 1,79,750
Average Profit = $\frac{₹1,79,750}{5}$	=	₹ 35,950

Capitalised value of average profit at 10% = $\frac{₹ 35,950 \times 100}{10}$ = ₹ 3,59,500

Total Assets	₹ 4,75,000
Less : Goodwill	<u>₹ 25,000</u>
Value of Total Assets excluding Goodwill	₹ 4,50,000

Less : Liabilities :

Bank Overdraft	₹ 58,350	
Sundry Creditors	₹ 90,500	
Provision for Taxation	<u>₹ 19,500</u>	₹ 1,68,350
Net Tangible Assets		<u>₹ 2,81,650</u>

Capitalised value of average Profit

Less : Net Tangible Assets

Value of Goodwill

₹ 3,59,500
<u>₹ 2,81,650</u>
<u>₹ 77,850</u>

Illustration 21. The following are the assets, equity and liabilities of Gauhati Industries Ltd. as on 31st March, 2023.

Assets	Amount (₹)	Equity & Liabilities	Amount (₹)
Goodwill	50,000	Equity Share Capital	15,00,000
Building	4,00,000	Reserve	5,00,000
Furniture	50,000	Debenture	5,00,000
Machinery	5,00,000	Provision for Tax	2,00,000
Patent	40,000	Current Liabilities	8,00,000
Vehicles	2,10,000		
Current Assets	22,50,000		

Assets are revalued as follows :

Goodwill : Nil; Building : ₹ 4,50,000; Furniture : ₹ 28,000; Machinery : ₹ 4,15,000; Patent : Nil; Vehicles : ₹ 1,30,000

Current Assets are valued at 80% of the book value. The company earns an average profit of ₹ 2,00,000 for the last five years. It is considered that a return of 10% on net tangible assets is reasonable in the industry.

Ascertain the value of Goodwill, if any, at two years' purchase of the annual super profit.

Solution : Value of Net Tangible Assets (Realisable) :		(₹)
Land and Building	:	4,50,000
Furniture	:	28,000
Plant and Machinery	:	4,15,000
Vehicles	:	1,30,000
Current Assets	:	<u>18,00,000</u>
Total	:	28,23,000
Less: Outside Liabilities (Debentures + Current liabilities + Prov. for Tax)		<u>15,00,000</u>
Net Tangible Assets		<u>13,23,000</u>
Normal Profit = 10% of Net Tangible Assets		
	$= \frac{10}{100} \times ₹ 13,23,000$	
	$= ₹ 1,32,300$	
Average annual profit		<u>2,00,000</u>
Less : Normal Profit		<u>1,32,300</u>
Super Profit:		<u>67,700</u>

Value of Goodwill at 2 years' Purchase of the Super Profit:

$$= ₹ 67,700 \times 2$$

$$= ₹ 1,35,400.$$

11. Annuity Method : To calculate value of goodwill under this method, annuity table is referred. An annuity is a series of equal periodic payments occurring at equal intervals of time. Super profit is taken as the value of the annuity and is multiplied by the annuity factor at a certain rate of interest for a certain number of years to find out the value of goodwill.

Annuity Method is introduced to replace Super Profit Method.

When a person purchases a business and pays for goodwill, he expects to get back this amount in the form of super profit in instalments spread over a number of years. No consideration is given for the loss of interest that the purchaser would have earned if the amount were invested elsewhere. Annuity method takes into account the interest factor along with the annuity in the form of annual super profit.

Illustration 22. The net tangible assets of a business is ₹ 25,00,000 on which the normal rate of return expected is 15%. The profits earned by it for last four years are ₹ 4,00,000; ₹ 4,20,000; ₹ 4,40,000; and ₹ 4,50,000.

Calculate the value of goodwill when the present value of an annuity of one rupee for four years at 15% interest is 2.855.

Solution:

Average Profits : ₹ (4,00,000 + 4,20,000 + 4,40,000 + 4,50,000) ÷ 4 = ₹ 4,27,500

Normal Profit : 15% of ₹ 25,00,000 = ₹ 3,75,000

Super Profit : ₹ (4,27,500 - 3,75,000) = ₹ 52,500

Value of Goodwill : ₹ 52,500 × 2.855
= ₹ 1,49,887.50

Illustration 23.

Following information is available for M/s. Usha Ltd.

(a) Capital Employed : ₹ 75,00,000

(b) Normal rate of return in the industry : 10%.

(c) Average net profits for the last four years after tax : ₹ 9,00,000

(d) The company is capable of maintaining the super profit for the next four years.

Ascertain the value of goodwill under the following methods :

(i) annuity method; and

(ii) super profit capitalisation method

[Given Annuity of ₹ 1 for four years at 10% interest is 3.17]

Solution:

Average Profit	₹	9,00,000
Less: Normal Return at 10% of capital employed		7,50,000
		1,50,000

(i) Value of Goodwill at an annuity of 3.17 is :

$$₹ 1,50,000 \times 3.17 = ₹ 4,75,500$$

(ii) Value of goodwill under super profit capitalisation method :

Normal rate of return : 10%

Super Profit ₹ 1,50,000

$$\text{Value of Goodwill : } \frac{100}{10} \times ₹ 1,50,000$$

$$= ₹ 15,00,000$$

Illustration 24.

Slow Limited is located in the prime location of the city and Fast Ltd. wants to purchase it as going concern. The total assets of Slow Ltd. amounted to ₹ 78,00,000 including Goodwill ₹ 50,000. Preliminary expenses ₹ 20,000 and Patents ₹ 30,000. Slow Ltd. has total liabilities of ₹ 31,00,000 including Bank Loan ₹ 21,00,000. Bank overdraft ₹ 3,00,000 and Bills Payable ₹ 4,00,000. Of the total trade creditors of ₹ 3,00,000, ₹ 40,000 is not to be paid since the creditor is not traceable. It has earned a steady profit before tax since its formation on 1-4-2018 as follows : ₹ 8,00,000; ₹ 17,00,000; ₹ 18,00,000; ₹ 20,00,000 and ₹ 22,00,000.

It is agreed that the goodwill of Slow Ltd. will be revalued on the basis of two years' purchase of five years' average profit and also on the basis of six years' purchase of super profit, and Fast Ltd. will pay the least of the two for goodwill plus the value of goodwill existed before purchase.

You are required to calculate the amount that Fast Ltd. will pay for goodwill to Slow Ltd. The normal rate of return in the trade is 15% after tax and tax rate is 40%.

Solution :

Valuation of Goodwill under Purchase of Past Profits Method :-

$$\text{Average Profit} = \frac{\text{₹ } (8,00,000 + 17,00,000 + 18,00,000 + 20,00,000 + 22,00,000)}{5}$$

$$= \text{₹ } 17,00,000$$

$$\text{Tax @ 40\%} = \text{₹ } 17,00,000 \times \frac{40}{100} = \text{₹ } 6,80,000$$

$$\text{Average profit after tax} = \text{₹ } (17,00,000 - 6,80,000) = \text{₹ } 10,20,000$$

$$\text{Value of Goodwill at 2 Year's Purchase of average profit}$$

$$= \text{₹ } 10,20,000 \times 2$$

$$= \text{₹ } 20,40,000$$

Valuation of Goodwill under Purchase of Super Profit Method :-

Valuation of Net Tangible Assets:

Value of Total Assets :	₹	78,00,000
Less: value of intangible assets (Goodwill + Preliminary Expenses + Patents)		1,00,000
Total Tangible Assets :		77,00,000
Less: Outside liabilities :	₹ 31,00,000	
Less: Creditors not payable	₹ 40,000	30,60,000
Value of Net Tangible Assets :		46,40,000

Normal Rate of return 15% on net tangible assets:

∴ Normal Profit is 15% of ₹ 46,40,000

$$= \frac{15}{100} \times \text{₹ } 46,40,000$$

$$= \text{₹ } 6,96,000$$

Super Profit = Actual Profit – Normal Profit

$$= \text{₹ } (10,20,000 - 6,96,000) = \text{₹ } 3,24,000$$

∴ **Value of Goodwill = 6 year's purchase of Super Profit**

$$= \text{₹ } 3,24,000 \times 6 = \text{₹ } 19,44,000$$

Amount payable by Fast Ltd. for Goodwill :

(Least of ₹ 20,40,000 and ₹ 19,44,000) + Value of goodwill which existed before purchase = ₹ 19,44,000 + ₹ 50,000

$$= \text{₹ } 19,94,000$$

Illustration 25. The following particulars are available in respect of the business carried on by a trader :

(a) Profits earned	(₹)
2020	50,000
2021	60,000
2022	55,000

(b) Normal rate of profit 10%

(c) Capital employed ₹ 3,00,000

(d) Present value of an annuity of one rupee for five years at 10% is 3.78

(e) The profits included non-recurring profits of ₹ 4,000 p.a. of which it was deemed that even non-recurring profits had a tendency of appearing regularly at the rate of ₹ 1,000 p.a.

You are required to calculate the value of goodwill

(i) as per five years' purchase of super profit

(ii) as per capitalisation of super profit method, and

(iii) as per annuity method.

(B Com. M.U.)

Solution :

1. Calculation of Average Profit : ₹ (50,000 + 60,000 + 55,000)
= ₹ 1,65,000

$$\text{Average Profit } (\text{₹ } 1,65,000 \div 3) = 55,000$$

2. Calculation of Average Expected Profit :

Average Profit	₹	55,000
Less : Non recurring profit		4,000
		51,000

Add : Non-recurring profits having a tendency of recurring profits	1,000
Average expected profit	52,000

3. Calculation of Super Profit :

Average expected profit	₹	52,000
Less : Normal Profit @ 10% on ₹ 3,00,000		30,000
Super Profit		22,000

4. Calculation of Value of Goodwill :

- (i) Goodwill as per five years' purchase of super profit = ₹ 22,000 × 5 = ₹ 1,10,000
 (ii) Goodwill as per capitalisation of super profit method = ₹ 22,000 × 100 ÷ 10 = ₹ 2,20,000
 (iii) Goodwill as per annuity method = ₹ 22,000 × ₹ 3.78 = ₹ 83,160.

Illustration 26.

The net profits of a company after providing for income tax, for the past five years are. ₹ 40,000; ₹ 42,000; ₹ 45,000; ₹ 46,000 and ₹ 47,000. The capital employed in the business is ₹ 4,00,000 on which a reasonable rate of return of 10% is expected.

It is expected that the company will be able to maintain its super profits for the next five years.

Calculate the value of Goodwill of the business :

- (a) On the basis of an annuity of super profit, taking the present value of an annuity of one rupee for five years at 10% interest as ₹ 3.78
 (b) On the basis of capitalising the excess of the annual average distributable profits over the reasonable return on capital employed.

Solution :

Average Profits for Five Years :

$$₹ (40,000 + 42,000 + 45,000 + 46,000 + 47,000) \div 5 = ₹ 44,000$$

$$\text{Less; Reasonable return on Capital Employed (10% on ₹ 4,00,000)} \quad ₹ 40,000$$

$$\text{Super Profit :} \quad ₹ 4,000$$

- (a) Value of goodwill on the basis of an annuity of super profits :

Annuity	Present Value
(Super Profit)	(Goodwill)
1	378
4,000	?

$$? = 4,000 \times 3.78 = ₹ 15,120$$

- (b) Value of goodwill on the basis of capitalisation of super profits :

₹ 4000 capitalised at 10%

$$4,000 \times \frac{100}{10} = ₹ 40,000$$

Illustration 27.

Mr. Baruah desires to invest ₹ 60,000 in the equity shares in a public limited company. He seeks your advice as to the fair value of shares. The following information is made available to you:

Issued and Paid-up Capital :

8% Preference shares of ₹ 100 each	₹ 6,00,000
Equity shares of ₹ 10 each	₹ 3,00,000

Average net profit of the business is ₹ 88,000. Expected normal yield is 10% in case of such equity shares. It is observed that the net assets on revaluation are worth ₹ 50,000 more than the amounts at which they are stated in the books. Goodwill is to be calculated at 5 years' purchase of the super profit, if any. Ignore income-tax.

You are required to compute the value of goodwill for the purpose of determining the fair value of shares.

Solution :

$$\text{Average net profit of the company} = ₹ 88,000$$

$$\text{Preference Dividend : 8% of ₹ 6,00,000} = ₹ 48,000$$

$$\text{Profit of equity shareholders} = ₹ (88,000 - 48,000) = ₹ 40,000$$

$$\text{Normal expectation on equity capital} = 10\%$$

Calculation of Equity capital employed :

Equity share capital	₹ 3,00,000
Add: Appreciation in the value of assets	₹ 50,000
	<u>₹ 3,50,000</u>

$$\text{Normal return on capital} = 10\% \text{ of ₹ 3,50,000} = ₹ 35,000$$

$$\text{Super Profit} = ₹ (40,000 - 35,000) = ₹ 5,000$$

$$\text{Goodwill} = ₹ 5,000 \times 5 = ₹ 25,000.$$

Illustration 28.

The partnership deed of a firm provided, that :

The accounts of the firm should be made up to 31st December every year.

On the death of a partner, the goodwill will have to be valued at three years' purchase of adjusted average profits of three years upto the date of death after deducting interest @ 8% on capital employed and a fair remuneration of partner.

On 30th June, 2022, a partner 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. For the purpose of valuation of goodwill, the fair remuneration for work by partners would be ₹ 45,000 per annum and that the capital employed would be ₹ 1,66,000. The following were the amount of profits of earlier years before charging interest on capital employed.

2019 – ₹ 67,200; 2020 – ₹ 75,600; 2021 – ₹ 72,000; 2022 – (upto 30-6-2022), ₹ 31,200.

You are asked to ascertain the value of goodwill.

Solution :

$$\text{Profit for the year ended 30-6-2022} = ₹ 31,200 + \frac{1}{2} \times ₹ 72,000 = ₹ 67,200$$

$$\text{Profit for the year ended 30-6-2021} = \frac{1}{2} \times ₹ 72,000 + \frac{1}{2} \times ₹ 75,600 = ₹ 73,800$$

$$\text{Profit for the year ended 30-6-2020} = \frac{1}{2} \times ₹ 75,600 + \frac{1}{2} \times ₹ 67,200 = ₹ 71,400$$

$$\text{Average Profit} = \frac{₹ (67,200 + 73,800 + 71,400)}{3} = ₹ 70,800$$

$$\text{Calculation of Adjusted Average Profit} = ₹ 70,800$$

Less: Fair Remuneration	₹ 45,000	
Interest on capital employed =	₹ 13,320	₹ 58,320
Adjusted Average Profit =	₹ 12,480	

Value of Goodwill = No. of Years Purchase x Adjusted Average Profit

Therefore, Value of Goodwill of the Firm = ₹ 12,480 x 3 = ₹ 37,440

Average Capital Employed :

Capital employed means excess of assets over outside liabilities. Average capital employed means average of opening and closing capital employed.

Depending on the availability of information supplied in a given problem, average capital employed may be ascertained in any of the following ways:

- (i) [Opening Capital Employed + Closing Capital Employed] ÷ 2.
- (ii) Opening Capital Employed + 1/2 of Current year's profits after tax.
- (iii) Closing Capital Employed – 1/2 of Current year's profits after tax.

Illustration 29.

Y Ltd. is negotiating to acquire the business of X Ltd. on the basis of the following information :

Balances of Assets and Liabilities as on 31.3.2023 :

	(₹)
Goodwill	50,000
Furniture	60,000
Investments	1,00,000
Stock	4,00,000
Debtors	3,00,000
Bank balance	2,50,000
Cash in hand	20,000
Reserve & Surplus :	2,00,000
Trade Creditors	2,50,000

Profits for the year ended 31.3.2023 amounted to ₹ 4,50,000 after tax 40% and Dividend on Investment ₹ 20,000.

The realisable value of Stock is ₹ 6,50,000 and 5% of Debtors are doubtful. Furniture should be taken at ₹ 40,000. For the purpose of determining the rate of return, profit of the year 2022-23 after necessary adjustments should be taken as expected average profit. Normal Rate of Return is 20% before tax on average capital employed.

You are required to calculate the value of goodwill taking 3 years purchase of Super Profits.

Solution :

Since information about opening capital employed has not been supplied in the question, average capital employed has been ascertained as under:

[Closing capital employed – 1/2 of Average maintainable trading profit after tax]

(a) Calculation of Closing Capital Employed:		(₹)
Furniture :		40,000
Stock :		6,50,000
Debtors :	₹ 3,00,000	2,85,000
Less: 5%	<u>₹ 15,000</u>	2,50,000
Bank balance		20,000
Cash in hand		<u>12,45,000</u>
		<u>2,50,000</u>
Less: Trade Creditors :		<u>9,95,000</u>
Closing Capital Employed		

Note: Closing Capital Employed = Closing Net Tangible Assets

(b) Computation of Average Maintainable Trading Profit :		(₹)
Net Profit before tax ($\frac{100}{60} \times ₹ 4,50,000$) :		7,50,000
Less: Dividend on Investment		<u>20,000</u>
		7,30,000
Less: Tax 40%		<u>2,92,000</u>
Profit after Tax		<u>4,38,000</u>
(c) Calculation of Average Capital Employed :		
Closing Capital Employed :		9,95,000
Less: 1/2 of average profit ($\frac{1}{2} \times ₹ 4,38,000$)		<u>2,19,000</u>
		<u>7,76,000</u>
(d) Calculation of Normal Profit :		
20% on ₹ 7,76,000 :		1,55,200
(e) Calculation of Super Profit :		
Trading Profit after tax :		4,38,000
Less: Normal Profit		<u>1,55,200</u>
		<u>2,82,800</u>

(f) Calculation of Value of Goodwill:

3 years Purchase of Super Profit
 = ₹ 2,82,800 x 3
 = ₹ 8,48,400

Therefore, the Value of Goodwill = ₹ 8,48,000

Illustration 30.

From the following information supplied by the accountant of a company, you are required to compute the value of goodwill on the basis of two years purchase of super profits calculated on the average profit of the last three years:

- (a) Average profits (after tax) for the last three years ₹ 1,65,000, which includes ₹ 15,000 loss on sale of a plot of land
- (b) The company declared a 40% dividend on the shares of ₹ 10 each fully paid.
- (c) The market value of each share is ₹ 40
- (d) The average capital employed is ₹ 10,00,000

Solution :

Super Profit = Actual Profit – Normal Profit

In the given problem, normal rate of return is not given. So, it is calculated on the basis of Dividend Per Share and Market Price.

Hence, Normal Rate of Return = $\frac{\text{Dividend Per share}}{\text{Market Price Per Share}} \times 100$

Dividend Per Share : 40% of ₹ 10 = ₹ 4.00

Normal Rate of Return : $\frac{4}{40} \times 100 = 10\%$

Normal Profit : 10% of ₹ 10,00,000
 = ₹ 1,00,000

(a) Calculation of Actual Average Profit :

₹ (1,65,000 x 3 + 15,000) ÷ 3
 = ₹ 1,70,000

(b) Calculation of Super Profit : ₹ (1,70,000 – 1,00,000)

= ₹ 70,000

Therefore, Value of Goodwill :

2 years' Purchase of Super Profits
 = ₹ 70,000 x 2
 = ₹ 1,40,000

Illustration 31. 1-4-2023, L Ltd. proposed to purchase the business carried on by M/s. X & Co. Ltd. Goodwill for this purpose is agreed to be valued at three years' purchase of the weighted average profit of the past four years. The appropriate weights to be used are:

2019-20	1
2020-21	2
2021-22	3
2022-23	4

The profits of these years are :

2019-20 – ₹ 1,01,000	2021-22 – ₹ 1,24,000;
2020-21 – ₹ 1,00,000	2022-23 – ₹ 1,40,000;

On a scrutiny of the accounts, the following matters are revealed:

(i) On 1st December 2021 a major repair was made in respect of the plant incurring ₹ 30,000 which was charged to revenue. The said sum is agreed to be capitalised for goodwill calculation subject to adjustment of depreciation at 10% p.a. on reducing balance method.

(ii) The Closing Stock for the year 2020-21 was overvalued by ₹ 12,000.

(iii) To cover management cost an annual charge of ₹ 24,000 should be made for the purpose of goodwill valuation.

Compute the value of goodwill of the firm.

[Delhi B. Com.]

Solution :

Valuation of Goodwill

Calculation of Adjusted Profits of Last 4 Years

Details	2019-20 (₹)	2020-21 (₹)	2021-22 (₹)	2022-23 (₹)
(i) Profit (Given)	1,01,000	1,24,000	1,00,000	1,40,000
(ii) Cap. Expenditure (Repairs)	-	-	+ 30,000	-
(iii) Depreciation (Additional)	-	-	- 1,000	- 2,900
(iv) Stock Valuation	-	-12,000	+ 12,000	-
(v) Management Expenses	<u>-24,000</u>	<u>-24,000</u>	<u>-24,000</u>	<u>-24,000</u>
(vi) Adjusted Profits	<u>77,000</u>	<u>88,000</u>	<u>1,17,000</u>	<u>1,13,100</u>

Now Goodwill is valued as under:

Year (1) (₹)	Adjusted Profit (P) (2) (₹)	Weight (W) (3) (₹)	Weighted Profits (PW) (4) [i.e. 2x3] (₹)
2019-20	77,000	1	77,000
2020-21	88,000	2	1,76,000
2021-22	1,17,000	3	3,51,000
2022-23	1,13,100	4	<u>4,52,400</u>
		$\Sigma W = 10$	$\Sigma PW = 10,56,400$

$$\text{Weighted Average Profit (WAP)} = \frac{\Sigma PW}{\Sigma W}$$

$$= \frac{10,56,400}{10} = ₹ 1,05,640$$

∴ The value of Goodwill =

$$(\text{Weighted Average Profits} \times 3 = ₹ 1,05,640 \times 3 = ₹ 3,16,920)$$

EXERCISE

1. State whether the following statements are 'True' or 'False' –

- Goodwill consists of the advantages a business has in connection with its permanent customers only with whom it has to contact.
- Goodwill is an asset which can be disposed of only in the event of the business being sold as a going concern.
- The average profit method takes in account the abnormal profit or loss occurred during the course of business.
- Super profit is the excess of normal profit over the actual profit earned by a business.
- As per AS 26, only purchased goodwill should be recorded in the books of account.

[Ans : (ii) False (iii) True, (iii) False (iv) False (v) True]

2. Fill in the blanks with appropriate word(s)/term :

- Goodwill is an example of _____ asset.
- Goodwill is the capacity to earn _____ profit.
- Goodwill of a firm represents the excess of _____ of assets over their book value.
- _____ goodwill is attached with the person concerned and not with the firm as a whole.
- Of the three types of goodwill Dog-goodwill, Cat-goodwill and Rat-goodwill, _____ goodwill is the most valuable to the firm.
- For valuation of goodwill, only _____ profit is taken into consideration.

[Ans. : (a) Intangible; (b) Super; (c) Real Net worth; (d) Dog; (e) Cat; (f) Trading or Operating;]

Long Answer Type :

- What is goodwill? What are its distinguishing features? Distinguish between 'Purchased' and 'Not Purchased Goodwill'. (D.U. B. Com. 2004)
- List out the contributing factors for the creation of goodwill of a business house. Why goodwill is considered as an asset?
- State the circumstances in which there may be need for valuation of goodwill. (Delhi 2003)
- What is Super Profit? What are the steps to be followed for valuation of goodwill under super profit method?
- Distinguish between capitalisation of super profit method and annuity method for valuing goodwill? Describe the different types of goodwill of a business house. (Delhi 1993)
- Explain and illustrate the Super Profit method of valuation of goodwill? (Delhi 1993)
- Write short notes on different methods of valuation of goodwill. (G.U. '97 '99)
- When the need for evaluating Goodwill arises in case of a company? What points you will keep in mind while estimating Future Maintainable profit of a company? [D.U. B. Com. 2006]
- Explain the following methods of valuation of goodwill :
 - Purchase of Past Profit Method.
 - Capitalisation of Average Profit Method,
 - Super Profit Method
 - Annuity Method.

Practical Problems :

- A Ltd. agreed to purchase business of a sole trader. For that purpose, goodwill is to be valued at 3 years' purchase of the average profits of last 5 years. Profits for these years are :
2018 - ₹ 80,000; 2019 - ₹ 90,000; 2020 - ₹ 72,000;
2021 - ₹ 90,000; 2022 - ₹ 1,00,000

[Ans. : ₹ 2,59,200.]

- Compute the value of the goodwill of a firm on the basis of three year's purchase of the average profits of the past four years. The profits of the past four years were as follows:

Year	Profits (₹)
2019	28,000
2020	34,000
2021	32,000
2022	44,000

Following further informations are provided to you for this purpose:

- ₹ 6,000 should be provided annually to cover the increased management expenses for the purpose of calculation of goodwill.
- On 1st July, 2021, a major machinery was repaired for ₹ 10,000 but was charged as revenue. It is to be capitalised for the purpose of calculation of goodwill subject to depreciation of 10% p.a. on original cost method.
- Closing stock for the 2020 was overvalued by ₹ 3,000.

[Ans. : Value of Goodwill ₹ 92,250]

- The firm of Rahul and Kiran, decided to purchase the business of M/s. A and B on 1-1-2023.
The profits disclosed by M/s. A and B for the last 3 years were as follows:
2020, ₹ 42,000, 2021 ₹ 46,000 and 2022 ₹ 58,000
The profits of 2020 as stated above includes profits on sale of Furniture ₹. 4,000, and those of 2021 have been ascertained after charging an abnormal loss of ₹ 8,000 due to theft.
Calculate the value of firm's goodwill on the basis of 1½ years' purchase of the average profits for the last three years.

[Ans. : ₹ 75,000]

4. The profit of the firm of M/s. A and B Ltd. for the last five years and the corresponding weights are as follows.

Year :	2018-19	2019-20	2020-21	2021-22	2022-23
Profit (₹) :	45,000	55,000	70,000	75,000	80,000
Weight :	1	2	3	4	5

Calculate the value of goodwill on the basis of 3 years' purchase of the weighted average profit.

[Ans : Value of Goodwill ₹ 2,13,000]

5. A Ltd. proposed to purchase the business carried on by M/s. X and Co. 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 are :

Year	Weight	Profit (₹)
2019-20	1	1,01,000
2020-21	2	1,24,000
2021-22	3	1,00,000
2022-23	4	1,40,000

On a scrutiny of the accounts the following matters are revealed:

- On 1st, December, 2021 a major repair was made in respect of the plant incurring ₹ 30,000 which was charged to revenue. The said sum is agreed to be capitalised for goodwill calculation subject to adjustment of depreciation of 10% p.a. on reducing balance method.
- The closing stock for the year 2020-21 was overvalued by ₹ 12,000.
- 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 firm.

[Delhi B.Com.]

[Ans : Value of Goodwill ₹ 3,16,920]

6. On 1st May, 2023, X Ltd. proposed to purchase the business carried on by B and Co. Goodwill for this purpose is agreed to be valued at three years' purchase of the weighted average profits for the past four years.

The appropriate weights and profits for the four years are as under :

Year	Weight	Profit (₹ in Lakhs)
2019-20	1	1,01,000
2020-21	2	1,24,000
2021-22	3	1,00,000
2022-23	4	1,40,000

On a scrutiny of the accounts, the following information is gathered :

- On 1st December 2021, major repairs were carried out on building incurring ₹ 30 Lakhs which were charged to revenue. The above mentioned sum was agreed to be capitalised for goodwill calculating subject to adjustment of depreciation @10% p.a. under written down value method.
 - The closing stock for the year 2021-22 was undervalued by ₹ 10 Lakhs.
 - To cover management cost, an annual charge of ₹ 20 lakhs is to be considered for the purpose of valuation of goodwill.
- Compute the value of the goodwill of the firm.

[C.S. (Inter) Dec. 2001]

[Ans : Value of Goodwill ₹ 3,62,659.62 Lakhs]

7. A firm earned profits of ₹ 8,000, ₹ 10,000, ₹ 12,000 and ₹ 18,000 during 2019, 2020, 2021 and 2022 respectively. The firm has average capital investment of ₹ 50,000. Pure rate of return on investment is 10% p.a. and risk premium expected is 5%.

Calculate the goodwill of the firm based on three years purchase of average super profits of last four years.

[Ans : Value of Goodwill ₹ 13,500.]

8. Excellent Ltd. employs ₹ 8,50,000 as equity capital and actual profits earned amounted ₹ 80,500. The normal rate of return is 8%. You are required to calculate the amount of goodwill on the basis of three years' purchases of super profits.

[Ans : Value of Goodwill ₹ 37,500]

9. M/s. A Ltd. intends to purchase the business of B. It was agreed between them that the goodwill will be valued at 2 years' purchase of the average profits of the last three years. Directors of M/s. A Ltd. have asked you to ascertain the value of goodwill of B's business firm the following information:

Year	Profits (₹)
2020-21	80,000 (Including abnormal gain of ₹ 12,000)
2021-22	1,00,000 (After charging abnormal loss of ₹ 16,000)
2022-23	1,16,000

Till now the business property was not insured, but directors of M/s. A Ltd. argued that the insurance of the business property is a must. B agreed to their point of view. Henceforth, the amount of ₹ 16,000 per annum will have to be incurred for payment of insurance premium.

[Ans : ₹ 1,68,000]

10. KGR runs a chemist shop. His net assets on March 31, 2023, amounted to ₹ 20,00,000. After paying rent of ₹ 15,000 a year to the landlord for premises valued at ₹ 1,00,000, salary of ₹ 20,000 to the chemist, he earns a profit of ₹ 15 lakhs. His landlord, who incidentally is the chemist of the shop, is keen to purchase the shop. 12% is considered to be a reasonable return on capital employed for this type of business.

What can KGR expect as payment for goodwill? Make any reasonable assumption, if necessary. (ICWA, Inter)

[Ans.: Normal Profit ₹ 2,52,000, Expected average Profit ₹ 1,85,000; Hence No Super Profit, no goodwill.]

11. From the following information, calculate the value of goodwill on the basis of three years' purchase of super profit of the business of Ram Kumar:

(i) Total assets of the firm are ₹ 5,50,000 and current liabilities are ₹ 1,75,000.

(ii) Average capital employed in the business is ₹ 3,00,000.

(iii) Rate of interest expected from capital having regard to the risk involved is 20%.

(iv) Net trading profits of the firm of the past three years were ₹ 80,000, ₹ 1,20,000 and ₹ 1,30,000

(v) Fair remuneration to the proprietor for his services is ₹ 10,000 per annum.

[Ans.: Value of Goodwill ₹ 1,20,000]

12. A trader started business on April 1, 2020, with ₹ 25,000 as capital. His profits for the first two years were ₹ 7,200 and ₹ 11,700 but for the year ending March 31, 2023, he incurred a loss of ₹ 1,575. His estimate of the market rate of interest on investment was 10% and of the rate of risk return on his capital was 3%. He estimated his salary from an alternative employment on the basis of ₹ 1,500 per year.

Compute the value of goodwill of the business at 3 years' purchase of super profit of average profits of the past three years.

(B. Com., M.K.U.)

[Ans.: Value of Goodwill ₹ 3,075.]

13. A business has earned an average profit of ₹ 60,000 during the last few years and the normal rate of return in similar type of business is 10%. Ascertain the value of goodwill by capitalisation method assuming that the firm owns total assets worth ₹ 6,50,000 including therein a goodwill of ₹ 50,000 and outside liabilities worth ₹ 1,00,000.

[Ans.: Value of Goodwill ₹ 1,00,000.]

14. A firm earns a profit of ₹ 20,000 with an invested capital amounting to ₹ 1,50,000. Normal rate of earning in the same class of business is 10%. Ascertain the value of goodwill according to capitalisation method.

[Ans.: Value of Goodwill ₹ 50,000.]

15. From the following particulars of M/s. XY & Co. Ltd., calculate the value of goodwill:

(a) Total profit ₹ 75,000

(b) Investment at 10% (outside) ₹ 1,00,000

(c) Rate of Return (Normal) 15%

(d) Rate of risk return on capital 5%

(e) The profit above included a profit of ₹ 10,000 from sale of shares of Hindustan Lever Limited and interest on investment.

(f) Value of Net Tangible Assets : ₹ 2,63,000. Apply

(a) 5 years' purchase of Super Profit Method

(b) Capitalisation of Average Profit Method.

[Ans.: Value of Goodwill (a) ₹ 12,000 (b) ₹ 12,000]

16. Ascertain the value of goodwill of Rollick Ltd. from the following information obtained from the books of the company as at 31st March, 2023:

Equity and Liabilities : Paid up Equity Capital : ₹ 5,000 shares of ₹ 10 each ₹ 50,000, Surplus in the statement of Profit and Loss ₹ 26,650, Bank Overdraft ₹ 28,350, Sundry Creditors ₹ 20,500, Provision for Taxation ₹ 5,500.

Assets: Goodwill ₹ 12,000, Furniture ₹ 18,000, Stock ₹ 52,500, Book Debts ₹ 29,000, Cash ₹ 19,500.

The profits earned before providing for taxation for the last five years, have been as follows :

₹ 11,000; ₹ 15,000; ₹ 22,500; ₹ 32,000; ₹ 29,500

You may assume that income tax at the rate of 40% has been payable on these profits.

Normal rate of return expected on the capital invested in the business is 15%.

[Ans.: Value of Goodwill ₹ 23,350]

17. The following particulars are available in respect of the business carried on by Mr. Bhupen Sarma, of Nagaon.

(a) Capital employed ₹ 1,50,000;

(b) **Trading result :** 2019-20 Profit ₹ 22,000; 2020-21 Profit ₹ 50,000; 2021-22 Profit ₹ 35,000; 2022-23 Loss ₹ 2,000.

(c) Market rate of interest on investment is 8%

- (d) Rate of Risk return on capital invested in business is 5%.
 (e) Remuneration from alternative employment of the proprietor (if not engaged in business) is ₹ 6,000 p.a.

You are required to compute the value of goodwill on the basis 3 years purchase of super profits of the business calculated on the average profits of the last four years.

[Ans : Value of goodwill ₹ 2,250]

18. M/s. Basak and Company supplied the following information

- (a) Fixed assets ₹ 5,10,000 including goodwill ₹ 15,000 and an old vehicle (not in use) realisable value of which is ₹ 5,000.
 (b) Current liabilities ₹ 48,000 including liability for discounted bills of ₹ 5,000 (likely to be dishonoured).
 (c) Long term bank loan ₹ 75,000
 (d) Rate of normal return on net tangible assets is 13 percent.
 (e) Profit of last 5 years after tax : ₹ 35,000, ₹ 62,000 (including ₹ 12,000 Profit on sell of old machine), ₹ 22,000 (including ₹ 30,000 loss on sale of shares), ₹ 64,000 and ₹ 58,000
 (f) The company is carrying on pharmaceutical business and it is customary to calculate goodwill on 5 years purchase of super profit.
 (g) Determine the value of goodwill.

[Ans : Value of Goodwill ₹ 17,200, Capital Employed ₹ 3,72,000]

19. Following balances have been obtained from the books of Nirman Ltd. as on 31.03.2023 :

Equity and Liabilities : 8% 5,000 Convertible Pref. shares of ₹ 10 each ₹ 50,000, 10,000 Equity Shares of ₹ 10 each ₹ 1,00,000, Reserves (including Tax-provision of ₹ 10,000) ₹ 1,00,000, 8% Debentures ₹ 50,000, Trade Creditors ₹ 25,000

Assets: Goodwill ₹ 10,000, Fixed Assets ₹ 2,00,000, Current Assets ₹ 1,00,000.

Preliminary Expenses, ₹ 10,000; Discount on Issue of Debentures ₹ 5,000

Average profit of the company after deducting interest on debentures and taxes is ₹ 31,000. The market value of the machinery included in the fixed assets is ₹ 5,000 more. Expected Rate of Return on Equity is 10%. Evaluate the goodwill of the company at five times of the super profits.

[Ans : Value of Goodwill ₹ 50,000]

20. The following particulars are available in respect of the business carried on by a trader :

(a)	Profits earned	(₹)
	2020-21	50,000
	2021-22	60,000
	2022-23	55,000

- (b) Normal rate of profit 10%
 (c) Capital employed ₹ 3,00,000
 (d) Present value of an annuity of one rupee for five years at 10% ₹ 3.78
 (e) The profits included non-recurring profits on an average basis of ₹ 4,000 p.a. of which it was deemed that even non-recurring profits had a tendency of appearing regularly at the rate of ₹ 1,000 p.a.

You are required to calculate the value of goodwill :

- (i) As per five years' purchase of super profit.
 (ii) As per capitalisation of super profit method; and
 (iii) As per annuity method. (Delhi B.Com.)

[Ans : (i) ₹ 1,10,000 (ii) ₹ 2,20,000 (iii) ₹ 83,160]

21. From the following information calculate the value of goodwill by capitalisation super profit method and capitalisation of average method

- (i) Average capital employed in the business – ₹ 7,00,000.
 (ii) Net trading profit of the firm for the past three year – ₹ 1,47,600; ₹ 1,48,100 and ₹ 1,52,500.
 (iii) Rate of interest 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 and sundry liabilities ₹ 31,329. (Delhi B. Com.)

[Ans : Value of Goodwill (a) ₹ 63,333; (b) ₹ 63,333]

22. From the following information, calculate the value of goodwill by :

- (i) Three years' purchase of super profit; and
 (ii) Capitalisation method.
 (1) Average capital employed ₹ 6,00,000
 (2) Net profits 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) ₹ 7,50,000

[Ans: Value of Goodwill (a) ₹ 87,000; (b) ₹ 45,000]

[Delhi B. Com]

23. From the following information, calculate the value of goodwill of M/s. Das and Barua :

- (i) At three year's purchase of average Profits.
- (ii) At three year's purchase of Super Profits.
- (iii) On the basis of capitalisation of Super Profits.
- (iv) On the basis of capitalisation of Average Profits.

Information:

- (a) Average capital employed in the business ₹ 3,00,000.
- (b) Net Trading results of the firm for the past years: 2020-21 Profit ₹ 80,000; 2021-22 Loss ₹ 50,000; 2022-23 Profit ₹ 2,40,000.
- (c) Rate of interest expected from capital having regard to the risk involved – 18%
- (d) Remuneration to each partner for his service to the firm – ₹ 1,000 per month.
- (e) Assets (excluding goodwill) – ₹ 3,30,000. ; Liabilities – ₹ 22,000.

[Ans : (i) ₹ 1,98,000; (ii) ₹ 36,000; (iii) ₹ 58,667]
