ST. LAWRENCE HIGH SCHOOL

A Jesuit Christian Minority Institution

Study Materials 4

Sub: Accountancy **Class: XII**

Chapter: Unit I: Introduction to Partnership

Topic: Goodwill **Date: 19/06/2020**

GOODWILL

Meaning of Goodwill: Goodwill is the value of benefit or advantage that a business has because of the factors that helps in increasing its profitability.

"Goodwill is nothing more than the profitability that the old customers will resort to the old place."

-Lord Eldon

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

-Dicksee

Nature of Goodwill:

(1) Intangible Asset.
(2) Value of Goodwill is dependent on the valuer.
(3) Value is not fixed.
(4) The value may be affected with the change in market condition.
(5) Purchased or Self Generated.
(6) It's existence not separated from business.
(7) It has intangible force.
(8) Leads to earn super profit.

Factors affecting the Value of Goodwill:

(1) Efficient Management.
(2) Favorable Location.
(3) Favorable Contracts.
(4) Longer establishment of business.
(5) Access to supplies.
(6) Quality.
(7) Market situation.
(8) Risks associated with business.
(9) Nature of Business.
(10) Past performance.

Methods of Valuation of Goodwill:

(1) Average Profit Method (Simple Average, Weighted Average)
(2) Super Profit Method
(3) Capitalization of Profit Method
  a. Capitalization of Average Profit Method.
  b. Capitalization of Super Profit Method.

Under any method of valuation it is necessary to determine Normal Business Profit i.e. Rectified amount of Net Profit. So at first Normal Business Profit is calculated as under:

Calculation of Normal Business Profit

	(Rs.)
Net Profit as per problem (before adjustment)	***
Add: (i) Abnormal Losses	***
(ii) Loss on sale of Fixed Assets	***
(iii) Over valuation of Opening Stock and under valuation of Closing Stock	***
(iv) Non recurring expenses	***
(v) Capital Expenditure charged to Revenue	***
Less: (i) Abnormal Gains	***
(ii) Over valuation of Closing Stock and under valuation of Opening Stock	***
(iii) Non recurring income	***
(iv) Partners' Remuneration, if it is not deducted	***
Normal Business Profit	***

Average Profit Method

Step 1: Calculate Normal Business Profit.

Step 2: Find Average Business Profit:

(a) Simple Average Method:

Add normal business profits for all the years and divide the sum by the number of years.

(b) Weighted Average Method:

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

Step 3: Calculate value of Goodwill:

Goodwill = Simple/ Weighted Average Profit X Number of years purchase.

Super Profit Method

Step 1: Calculate Capital Employed:

Under Liabilities Approach:

Capital Employed = Capital + Reserve – Goodwill (if any) – Fictitious Assets

Under Assets Approach:

Capital Employed = All Assets (Except goodwill and fictitious assets) – Outside Liabilities

Step 2: Calculate Average Capital Employed:

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

Step 3: Calculate Actual Average Profit

Step 4: Calculate Normal Profit:

Normal Profit = Average Capital Employed X $\frac{Normal\ Rate\ of\ Return}{100}$

Step 5: Super Profit = Actual Profit – Normal Profit

Step 6: Calculate value of Goodwill:

Goodwill = Super Profit X Number of Years' Purchase

Capitalization Method

Under the Capitalization Method, goodwill can be valued using two methods :

(i) Capitalization of Average Profit.

(ii) Capitalization of Super Profit.

(i) Capitalization of Average Profit:

For calculating goodwill under this method, the steps are:

Step 1: Calculate average normal earned.

Step 2: Calculate capitalized value of the firm.

Capitalized Value = $\frac{Average\ Profit}{Normal\ Rate\ of\ Return}$ x 100

Step 3: Determine the value of Net Assets.

Net Assets = All Assets (other than goodwill and fictitious assets) at their current values minus Outside Liabilities.

Step 4: Goodwill = Capitalized Value (as per step 2) – Net Assets (as per step 3)

(ii) Capitalization of Super Profit:

For calculating goodwill under this method, the steps are:

Step 1: Calculate Capital Employed.

Step 2: Calculate Normal Profit on Capital Employed:

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

Step 3: Calculate Average Profit of past years.

Step 4: Calculate Super Profit:

Super Profit = Average Profit – Normal Profit

Step 5: Goodwill = Super Profit x $\frac{100}{Normal\ Rate\ of\ Return}$