1. Details of Module and its structure

Module Detail	
Subject Name	Accountancy
Course Name	Accountancy 03 (Class XII, Semester - 1)
Module Name/Title	Reconstitution of Partnership Firm-Admission of a Partner – Part 2
Module Id	leac_10302
Pre-requisites	Basic knowledge of Partnership - Fundamentals
Objectives	After going through this lesson, the learners will be able to understand recording of business transactions in the journal. • Meaning of Goodwill, Necessity for Valuation • Methods of Calculation of Goodwill
Keywords	Goodwill, Necessity and Factors of Goodwill, Classification & Methods of Valuation

2. Development Team

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1. Goodwill- Meaning

- Goodwill is the value of reputation of a firm /Business Earned over a period of time
- By providing quality goods and services
- And the customer feels satisfied, comes back again or recommends to others.
- It helps in earning profits over and above the normal rate of profits.
- The excess profit earned by a firm may be due to its locational advantage, better customer service, unique patent right, personal reputation or similar other reasons.

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Over a period of time, all well-established business develops an advantage of good name, reputation and wide business connections. Now, this helps the business in earning more profits as compared to a newly set up business.

In accounting, this monetary value of such an advantage is known as “Goodwill”.

Thus, goodwill exists only when the firm earns super profits. Any firm that earns normal profits or is incurring losses has no goodwill.

Goodwill requires an adjustment / valuation at the time of reconstitution of a firm. For example, when there is a change in the profit sharing ratio or on Admission of a partner or Retirement or Death of a partner.

2. Necessity for valuation of goodwill in a firm arises in the following cases:

(a) When the profit sharing ratio amongst the partners is changed;

(b) When a new partner is admitted;

(c) When a partner retires or dies; and

(d) When the business is dissolved or sold.

(e) Amalgamation of partnership firms.

3. Factors Affecting the Value of Goodwill

A. Nature of business*:* A firm that produces high value added products or having a stable demand is able to earn more profits and therefore has more goodwill.

B. Location*:* If the business is located at a place having heavy customer traffic, the goodwill tends to be high.

C. Efficiency of management*:* A well-managed organisation enjoys the advantage of cost efficiency which in turn leads to higher profits and so thereby increasing the value of goodwill

D. Market situation*:* A monopoly business or Less competition enables the business to earn high profits which in turn leads to higher value of goodwill.

E. Special advantages*:* The firm that enjoys special advantages like import licences, Raw material availability at low rate and assured supply of electricity, long-term contracts for supply of materials, well-known collaborators, patents, trademarks, etc. leads to higher value of goodwill.

F. Personal Reputation of Business House

If the Owners of the Business are Honest, Sincere, Customer friendly, Hardworking, the business will earn higher profits due to their popularity.

G. Impressive Publicity and Advertisement

Effective and impressive publicity and advertisement by the business helps in creating the demand for its products resulting to an increase in goodwill.

H. Contacts

If the contacts of the firm have been with other reputed firms and business houses or if the firm has received bulk orders from highly reputed firms, its goodwill will increase tremendously.

I. Relations

If a firm has good and harmonious relations with its customers, then it can increase the turnover resulting in increased profits which ultimately increases the goodwill.

4. Classification of Goodwill

(a) Purchased Goodwill and (b) Self-Generated Goodwill

a. Purchased Goodwill

Acquired by making some payment to the seller. For example, when we make excess payment for acquiring net assets. In other words, goodwill is the excess of purchase consideration over net assets.

b. Self-Generated Goodwill

It is based on various attributes of business viz. location, quality products, continuity of the business, after sales service etc.

5. Methods of Valuation of Goodwill

Since goodwill is an intangible asset it is very difficult to accurately calculate its value. Various methods have been advocated for the valuation of goodwill of a partnership firm.
The important methods of valuation of goodwill are as follows:
A. Average Profits Method B. Weighted Average Method
C. Super Profits Method D. Capitalisation Method

A. Average Profits Method

Under this method, the goodwill is valued at agreed number of 'years' purchase of the average profits of the past few years. It is based on the assumption that anew business will not be able to earn any profits during the first few years of its operations. Hence, the person who purchases a running business must pay in the form of goodwill a sum which is equal to the profits he is likely to receive for the first few years.
The goodwill is calculated by multiplying the past average profits by the number of years during which the anticipated profits are expected to accrue.
For example, if the past average profits of a business works out at Rs. 20,000 and it is expected that such profits are likely to continue for another three years, popularly called as (3-year purchase) the value of goodwill will be Rs. 60,000 (Rs. 20,000 × 3),

Example (Simple Average)

The profit for last five years of a firm are as follows – year 2016 Rs. 4,00,000; year 2017 Rs. 3,00,000; year 2018 Rs. 5,00,000; year 2019 Rs. 4,50,000 and year 2020 Rs. 3,50,000. Calculate goodwill of the firm on the basis of 4 years purchase of 5 years' average profits.

Solution

Total Profit = 20,00,000

Average Profit =Total Profit of Last 5 Years/ No. of years= Rs.20,00,000/5= 4,00,000

Goodwill = Average Profits × No. of years purchased= Rs. 4,00,000 × 4 = Rs. 16,00,000

Weighted Average Method

Sometimes, if there exists an increasing or decreasing trend, it is considered to be better to give a higher weight to the profits to the Latest (Current) year than those of the earlier years. Hence, we work out **weighted average** based on specified weights like 1,2, 3, 4 for respective year's profit.

Example (Weighted Average)

The profits of firm for the five years are as follows:

Year	Profit (Rs.)
2015–16	20,000
2016–17	25,000
2017–18	34,000
2018–19	39,000
2019–20	48,000

Calculate the value of goodwill on the basis of three years' purchase of weighted average profits based on weights 1,2,3,4 and 5 respectively.

Solution

Year	Profit	Weight	Product (Rs.)
2015–16	10,000	1	10,000
2016–17	25,000	2	50,000
2017–18	34,000	3	1,02,000
2018–19	39,000	4	1,56,000
2019–20	48,000	5	2,40,000
		15	5,58,000

Weighted Average Profit = Rs.5,58,000/ 15= 37,200

Goodwill = Rs. 37,200 × 3 = Rs. 1,11,600

Normal Maintainable Business Profits

It is very important to note that Goodwill is calculated only for NORMAL MAINTAINABLE BUSINESS PROFITS ONLY.

Average (Normal) maintainable profits can be calculated as under:

Net Profits during the year	xxxx
Add: Abnormal Loss (if the same has already been deducted)	xxxx
Less: Abnormal Gains (if the same has already been included)	xxxx
Less: Normal Expenses (if the same has not yet been considered)	xxxx
Add: Normal Incomes (if the same has not yet been considered)	xxxx
Total Maintainable Profits	xxxx

Example (Weighted Average with Adjustments)

Calculate goodwill of a firm on the basis of three years' purchase of the weighted average profits of the last four years. The profit of the last four years was: 2012Rs. 20,200; 2013 Rs. 24,800; 2014 Rs. 20,000 and 2015 Rs. 30,000. The weights assigned to each year are: 2012 – 1; 2013 – 2; 2014 – 3 and 2015 – 4.

You are supplied the following information:

1. On September 1, 2014 a major plant repair was undertaken for Rs. 6,000, which was charged to revenue. The said sum is to be capitalised for goodwill calculation subject to adjustment of depreciation of 10% p.a. on reducing balance method.

2. The Closing Stock for the year 2013 was overvalued by Rs. 2,400.

3. To cover management cost an annual charge of Rs. 4,800 should be made for purpose of goodwill valuation.

Solution

Calculation of Adjusted Profit 2012, 2013, 2014, 2015

Given Profits 20,200 24,800 20,000 30,000

Less: Management Cost (4,800) (4,800 (4,800) (4,800)

Add: Capital Expenditure 15,400 20,000 15,200 25,200

Charged to Revenue - - 6,000 --

15,400 20,00021,200 25,200

Less: Unprovided Depreciation - - -- (200) (580)

15,400 20,00021,000 24,620

Less: over valuation of Closing Stock- (2,400)- - -----

15,400 17,600 21,000 24,620

Add: over value of opening stock - - -- 2,400 --

Adjusted Profits 15,400 17,600 23,400 24,620

Weight 1 2 3 4

15,400 35,200 70,200 98,480

Total of the Profits = 2,19,280

Weighted Average Profit = Rs.2,19,280/10= 21,928

Goodwill (3 years purchase) = Rs. 21,928 × 3 = Rs. 65,784

Notes to Solution

(i) Depreciation of 2014 = 10% of Rs. 6000 for 4 months

= Rs. 6000 × 10/100 × 4/12 = Rs. 200

(ii) Depreciation of 2015 = 10% of Rs. 6000 – Rs. 200 for one year

= Rs. 5800 × 10/100 + Rs. 580

(iii) Closing Stock of 2014 will become opening stock for the year 2015.

Super Profits Method

Under this method, goodwill is calculated by multiplying the Super Profits (Excess over Normal profits) with the number of years' purchase.

A new firm can earn only normal profits which the other similar companies normally earn in normal circumstances. But when we are thinking of purchasing a business, the Real Intention of the buyer is to earn profits in excess of normal profits, by en-cashing the reputation of that existing business as well as his own connections.

This Excess profit, as compared to the Normal profit, is called Super Profit.

Following steps are to be taken for calculation of goodwill:

Step 1. Compute the Actual / Average profits.

Step 2. Calculate the normal profits on capital employed by multiplying capital employed with normal rate of return

Step 3. Calculate super profits by subtracting normal profits from actual profits /average profits.

Step 4. Now, calculate goodwill by multiplying super profits with number of years' purchase.

So, the formula will be: Goodwill **= Super Profits × No. of Years' Purchase.**

Example A and B earned an average profit of Rs. 50,000. Their capital employed in the firm is Rs. 80,000. It is expected that the average rate of profit is 15% on the capital. Calculate the amount of Goodwill, if goodwill is valued at 2 years' purchase of Super profits.

Solution: Calculation of Goodwill

Average Profits = Rs. 50,000

Normal Profits = Capital Employed × Normal Rate of Return/100

= Rs. 80,000 × 15/ 100= Rs. 12,000

Super Profits = Average Profits – Normal Profits

= Rs. 50,000 – Rs. 12,000 = Rs. 38,000

Goodwill = Super Profit × No. of Years of Purchase

= Rs. 38,000 × 2 = Rs. 76,000

Capitalisation Methods

Goodwill can be calculated either by

(**a**) Capitalisation of Average Profits

(**b**) Capitalisation of Super Profits

(a) Capitalisation of Average Profits

Goodwill is the difference between:

Capitalised value of the firm and Capital employed (net assets) of the firm.

Following steps are to be taken for calculation of goodwill:

Step **1. Calculate the total capitalised value of the firm by following formula.**

Average Future Maintainable Profits / Normal Rate of Return × 100

Step 2. **Calculate capital employed (net assets) of the firm by subtracting the value of outsiders' liability from value of the total assets (excluding goodwill).**

Capital Employed = Total Assets (excluding goodwill) – Outside Liabilities

Step 3. **Calculate goodwill by applying the following formula.**

Goodwill = Capitalised value of the firm – Capital Employed (as above)

Important Observation

No goodwill if Capital employed exceed or equal to capitalised value of the business.

Example (Capitalisation Method). A firm earns a profit of Rs. 32,000 per year. In the same business a 10% return is generally expected. The total assets of the firm are Rs. 3,00,000 and outsiders' liabilities is Rs. 90,000. Find the value of Goodwill.

Solution: First of all calculate Total Capitalised value of the firm

Actual Profit/Rate of Normal Profits = × 100

= Rs. 32,000/ 10 × 100= Rs. 3,20,000

Net Tangible Assets of the firm = Total Tangible Assets – Outsider's Liabilities

= Rs. 3,00,000- Rs. 90,000= Rs. 2,10,000

Goodwill = Total Capitalised Value – Net Assets

= Rs. 3,20,000- Rs. 2,10,000= Rs**. 1,10,000**

Now suppose, we are given GOODWILL, and other information and we have to calculate outsiders' liabilities. Let us take an example

Example A firm earns Rs. 20,000 as its annual profits, the rate of normal profit being 10%. The assets of the firm amounted to Rs. 1,50,000. The value of Goodwill is Rs. 50,000. Find the value of outsiders' Liabilities.

Solution:

(i) Calculation of Outsiders' Liabilities

Total Capitalised value of the firm = Actual Profit/ Rate of Normal Profits× 100

=20,000/10 × 100 = Rs. 2,00,000

Goodwill = Total Capitalised Value – Net Tangible Assets

Rs. 1,50,000 = Rs. 2,00,000 – Net Tangible Assets

Net Tangible Assets = Rs. 50,000

Net Tangible Assets = Total Assets – Outsiders' Liabilities

Rs. 50,000 = Rs. 1,50,000 – Outsiders' Liability **Outsiders' Liabilities = 1,00,000**

(b) Capitalisation of Super Profits Method

Following steps are taken for calculation of goodwill:

Step 1. Calculate Super profits (Actual/Average profits- normal profits)

Step 2. Calculate Goodwill by capitalising the super profits as under:

Super Profits/ Normal Rate of Return × 100

Example (Capitalisation of super profits).

Assets of Rs. 5,00,000 and liabilities of Rs. 2,00,000. Annual profits of Rs. 60,000. The rate of normal profit being 15%. Calculate the amount of Goodwill by capitalisation of super profits method.

Solution:

Average Profits – Rs. 60,000

Normal Profits = (Rs. 5,00,000 – Rs. 2,00,000) × 15/100= Rs. 45,000

Super profits= Average Profits – Normal Profits =Rs. 60,000- 45,000 = Rs. 15,000

Goodwill = Super profit/Normal Rate × 100= Rs. 15,000 × 100 / 15 = Rs. 2,25,000