Chart No. I - Goodwill

Meaning of Goodwill

- ✓ Goodwill is the value of reputation of a business in respect of the profits expected in future which enables it to earn more than other firms in the industry
- ✓ Reputation created through its successful operations and customers' satisfaction.
- ✓ In other words, goodwill is the present value of a firm's anticipated super normal earnings.
- ✓ The term super normal earnings means the earnings over and above the normal rate of return earned by representative firms in the same industry.

Factors affecting Goodwill

Goodwill is an intangible asset. The following are some of the factors that generally contribute to the value of goodwill of a firm:

- Quality of goods sold by the firm
- Location of the business unit
- Reputation of the owners of the firm
- Monopolistic nature of the business
- Risk involved in the business
- Efficiency of management
- Possibility of competition
- Government attitude
- Possession of special contracts for availability of materials
- Trends of profits, etc.

Features of Goodwill

- ✓ It is an intangible asset
- ✓ it helps in earning higher profits
- ✓ It brings customers regularly to the place of business
- ✓ It comes into existence due to various factors such as location advantages, brands, market reputation etc.
- ✓ Valuation of goodwill is subjective as it depends on the assessment of the valuer

Accounting of Goodwill

AS- 26 "intangible assets"-

Only purchased goodwill is recorded in the books, therefore self generated goodwill is not recognised in the books because its value is a subjective and is not evidenced by payment.

Notes

Types of Goodwill

- **Purchased Goodwill**
- **Self generated Goodwill**

1. Purchased Goodwill

means goodwill for which the firm has paid consideration, in cash or kind.

Purchased goodwill = Consideration paid - Net Assets
= Consideration paid - (Total Assets - liabilities)

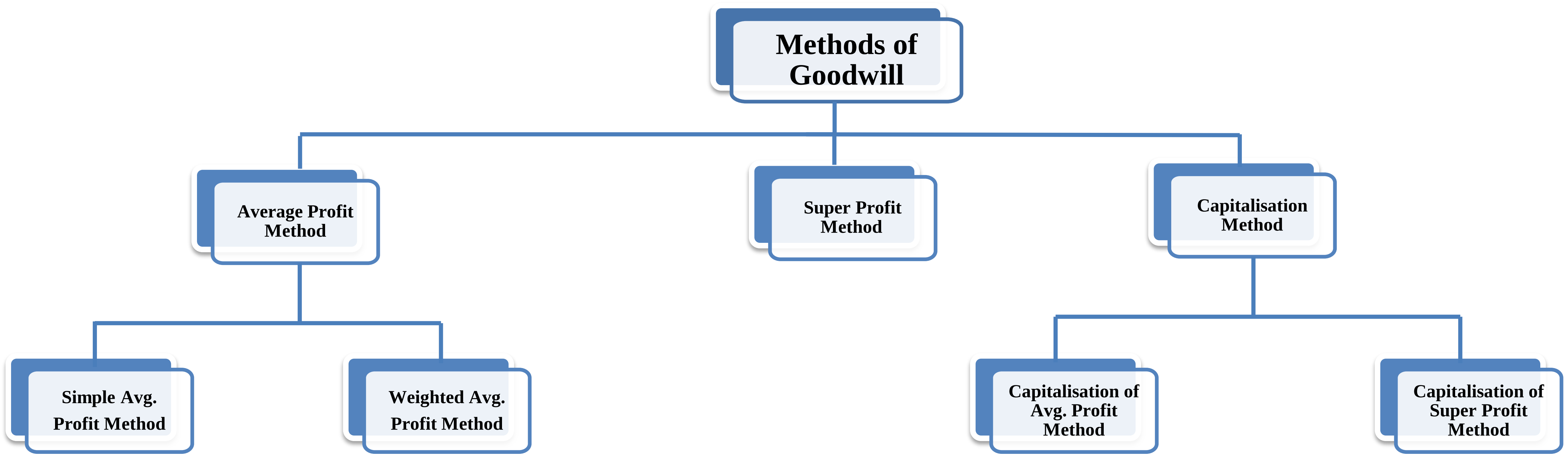
For ex. ABC Ltd. purchased the business of BC Ltd. for Rs. 10,00,000, assets of BC Ltd. valued at 12,00,000 and liabilities taken over were of 4,00,000.

Therefor purchased goodwill = 10,00,000-(12,00,000-4,00,000)
= 2,00,000

2. Self generated Goodwill

means goodwill which is not purchased for money but is earned by the efforts of the partners (or management)

Chart No. II - Goodwill



1. (a) Simple Average Profit

Value of goodwill = Average Profit x Number of year of purchase

$$\text{Average Profit} = \frac{\text{Total profits}}{\text{Number of Year}}$$

Year (1)	Profit (2)
1	****
2	****
3	****
4	****
5	****

Note

Number of year of purchase means

- ✓ the number of years for which the firm is likely to earn same amount of profit after change of ownership
- ✓ because of the efforts put in the past

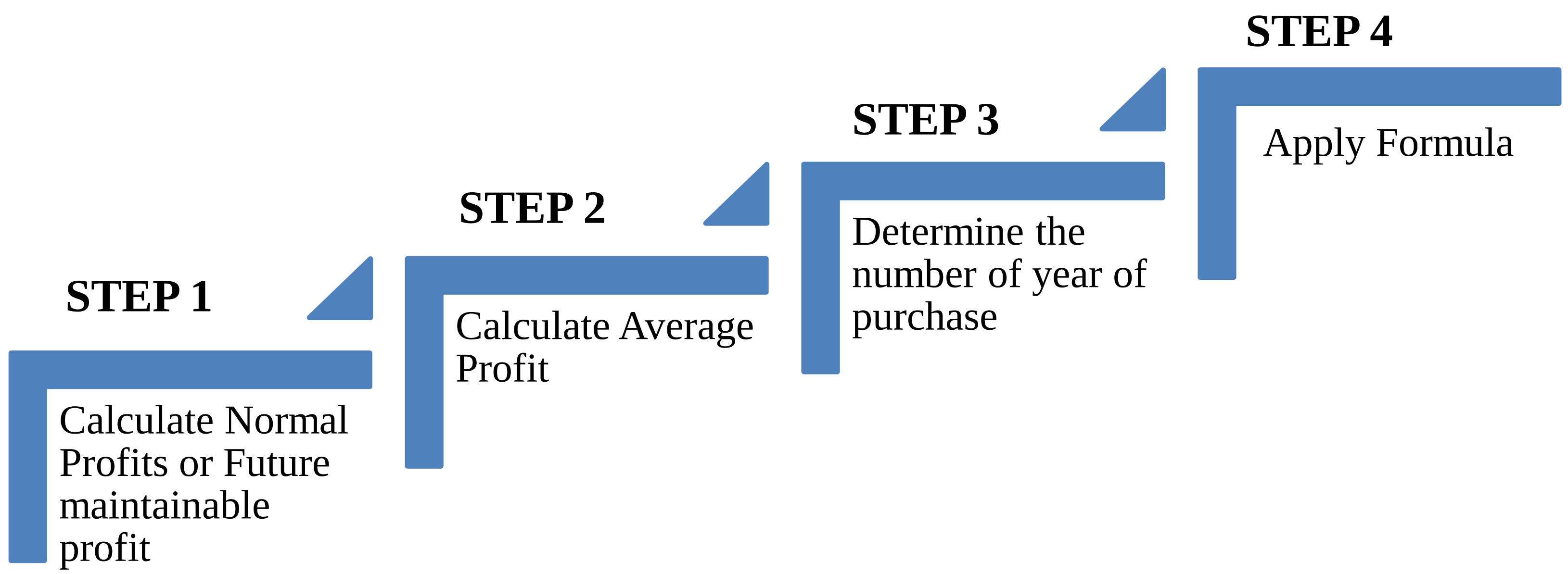


Chart No. III - Goodwill

Calculation of Normal Profit or Future Maintainable Profit for goodwill

Profit/ Loss

Adjustment

1. **Abnormal Losses (losses by fire, theft)**
2. **Loss on sale of fixed assets (not a normal business activity)**
3. **Overvaluation of opening stock or undervaluation of closing stock (as it would have decrease the profit)**
4. **Non recurring expenses (since not expected in future)**
5. **Capital Expenditure recorded as revenue expenditure**

1. **Abnormal Gain (profit on sale of assets)**
2. **Overvaluation of closing stock or undervaluation of opening stock (as it would have increase the profit)**
3. **Non recurring incomes (since not expected in future)**
4. **Income from non trade investment (as it is not a normal business activity**
5. **Partners remuneration, if it is not paid (to be paid in future for their services)**
6. **Any future expenses, like insurance premium**

1. (b) Weighted Average Profit Method

Value of goodwill = Weighted Average Profit x Number of year of purchase

$$\text{Weighted Average Profit} = \frac{\text{Total Product}}{\text{Total weights}}$$

Year (1)	Profit (2)	Weight (3)	Product (2 * 3)
1	****	1	****
2	****	2	****
3	****	3	****
4	****	4	****
5	****	5	****
	Total	***	***

Notes

Chart No. IV - Goodwill

2. Super Profit Method

Value of goodwill = Super profit x Number of year of purchase

Super profit = Actual Profit - Normal Profit

Normal profit = Capital employed x normal rate of return

Normal rate of return (NRR)
When similar type of business earns profit at a certain percentage of the capital employed, it is called normal return

Note
unless investments are specified to be trade investments, they are taken as Non- Trade Investment

Capital Employed or Net Assets

Liabilities side Approach

Capital Employed = Capital + Reserves- Non Trade Investment - Goodwill - Fictitious Assets

Assets Side Approach

Capital Employed = All Assets – Outside Liabilities (assets excludes Non Trade Investment - Goodwill - Fictitious Assets)

Note

- ✓ Trade Investment - investment that are made in another enterprise for the furtherance of own business [ex- BYJUS invested in Aakash Institute]
- ✓ Non Trade Investment - investment made to earn income by investing surplus fund and not for the purpose of furtherance of own business [ex- investment in Bank, shares , bonds, Debentures etc.]

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3. (a) Capitalisation of Average Profit Method

Goodwill = Capitalised Value of Profits - Capital Employed

$$\text{Capitalised Value of Profit} = \text{Average Profit} \times \frac{100}{\text{Normal Rate of Profit}}$$

Note
Sometime average capital employed is taken instead of capital employed for calculating the value of goodwill

Average Capital Employed =

$$\frac{\text{Opening capital employed (as on 1/4)} + \text{Closing capital employed (as on 31/3)}}{2}$$

3. (b) Capitalisation of Super Profit Method

$$\text{Goodwill1} = \text{Super Profit} \times \frac{100}{\text{Normal Rate of Return}}$$

Super Profit = Average Profit - Normal Profit

Normal profit = Capital employed x normal rate of return